United States General Accounting Office

GAO

Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

September 2002

PRIVATE PENSIONS

Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification

GAO Accountability * Integrity * Reliability

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Abbreviations

DOL	Department of Labor
EIN	Employer Identification Number
ERISA	Employee Retirement Income Security Act
ESOP	employee stock ownership plans
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation
PWBA	Pension and Welfare Benefits Administration
SAR	summary annual report
SEC	Securities and Exchange Commission
SMM	summary of material modifications
SPD	summary plan description

United States General Accounting Office
Washington, DC 20548

September 6, 2002

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

The financial collapse of the Enron Corporation and other large firms and the effects on workers and retirees has raised questions about retirement funds being invested in employer securities and the laws governing such investments. Pensions are an important source of income for many retirees, and the federal government has encouraged employers to sponsor and maintain pension and savings plans for their employees. Over 70 million U.S. workers participate in pension and savings plans, and such plans in 1998 represented about $4 trillion in retirement savings. The continued growth in these plans and their vulnerabilities has caused Congress to focus on issues related to participants investing in employer securities through employer-sponsored retirement plans.

Enron's plan participants held a substantial percentage of their retirement assets in employer securities. Because of the financial losses suffered by Enron plan participants and the potential for losses to be incurred by participants in retirement and savings plans that are highly concentrated in employer securities, you asked us to: (1) determine the number, types, and dollar amounts of private pension plans that invest in employer securities; (2) describe why investing in employer securities through employer-sponsored plans can pose risks to plan participants; and (3) describe the regulatory provisions for disclosures to participants owning employer securities through their employer-sponsored plans. You also asked us to discuss the Securities and Exchange Commission's (SEC) administrative determination not to explore the application of the Securities Act of 1933 and the Securities Exchange Act of 1934 to retirement plans. This information is presented in appendix III.

To determine the number and types of private pension plans invested in employer securities, we analyzed plan financial information filed annually (Form 5500s) with the Department of Labor's Pension and Welfare Benefits Administration (PWBA). We analyzed data for the Fortune 1,000 companies for plan year 1998, which was the most recent year for which complete plan-specific data were available for our review. To calculate the percentage of pension plan assets held as employer securities, we first subtracted certain assets that cannot be specifically identified as employer securities from total plan assets to arrive at “known assets.” To describe the risks of investing in employer securities through employer-sponsored plans, we focused on six companies whose private pension plans according to industry data were heavily invested in employer securities. We used these companies as examples to illustrate the risks that employees face when their employer-sponsored plans have high concentrations of employer securities or real property. For four of the companies we used publicly available information. We obtained information directly from the other two companies, but we agreed not to disclose their names. In addition, as part of our review of regulatory provisions, we interviewed officials from the Department of Labor (DOL), SEC, and industry associations about the laws governing employer securities purchases by retirement plans and the investment information that employers provide to plan participants.

We conducted our work between February and August 2002 in accordance with generally accepted government auditing standards. (See app. I for more details about our scope and methodology.)

Results in Brief

Our analysis of the 1998 plan data for the Fortune 1,000 firms showed that about 550 of those companies held employer securities in their defined benefit plans or defined contribution plans, covering about 13 million participants.[1] Our review is not representative of the entire employer-sponsored plan universe, but Fortune 1,000 plans covered about 40 percent of the total participants in company plans in 1998. Employer securities held by these plans totaled $213 billion, or 21 percent of total known assets. However, when all assets are included, including those that cannot be specifically identified as employer securities, employer securities represented 12 percent of total plan assets. DOL’s analysis showed that for defined contribution plans in 1998, employer securities represented about 16 percent of total plan assets and less than 1 percent for defined benefit plans.[2] Manufacturers held 45 percent of the employer

[1]Defined benefit plans promise to provide generally a level of monthly retirement income that is based on salary, years of service, and age at retirement. The benefits from defined contribution plans are based on the contributions to and investment returns on individual accounts.

[2]DOL’s analysis included all plans with 100 or more participants.

stock holdings of the Fortune 1,000 firms. However, such holdings only represented about 10 percent of the total plan assets held by that sector. For plans that reported holding employer securities, employee stock ownership plans (ESOPs), including ESOPs combined with other defined contribution plans, held the highest concentrations of employer securities,[3] with these securities making up 58 percent of the total plan assets of ESOPs. 401(k) type plans held 26 percent of their total assets in employer securities.[4] Defined benefit plans had less than 5 percent of their plan assets in employer securities. The highest dollar value of employer stock holdings were held in companies whose plans combined components of 401(k) type plans with ESOPs. The amount of employer securities in private pension plans is likely higher than we reported. Some companies did not report holding employer securities directly in their plans, but reported holding plan assets in separate accounts, such as master trust agreements, that may include employer securities.[5]

Investment in employer securities through employer-sponsored retirement plans can present significant risks for employees. If the employees' retirement savings is largely in employer securities in these plans, employees risk losing not only their jobs should the company go out of business, but also a significant portion of their savings. Employees at such companies as Enron and Southland experienced such consequences as both companies declared bankruptcy. Even if employers do not declare bankruptcy, employees are still subject to the dual risk of loss of job and loss of retirement savings because corporate losses and stock price declines can result in companies significantly reducing their operations, such as in the case of Lucent. However, despite the risks, not every company whose retirement plans have high concentrations of employer securities results in employees incurring significant losses. Much depends on the corporate decisions made by the company's leadership, which will determine whether or not the company stays in business. Two companies whose plans we reviewed had high concentrations of employer securities

[3]ESOPs are defined contribution plans that require plan sponsors to invest plan assets principally in shares of the sponsor's stock.

[4]These are limited to defined contribution plans with a 401(k) type feature that are combined with profit-sharing/thrift savings plans.

[5]An employer-sponsored plan that pools its assets in a master trust with those of other plans for investment purposes reports only one asset amount on the Form 5500. This amount represents the plan's interest in the master trust but provides no information about the master trust's investments, such as employer stock.

holdings, and, other than the volatility of the companies' stock price, the employees have not suffered substantial losses due to company failure or downsizing. Finally, some companies help employees mitigate their losses by balancing plans where risks of loss are borne by employees with plans where the employer bears such risks. Other plans limit restrictions they place on diversification of employer contributions. For example, employees at one company held employer securities through the companies' profit-sharing plan that was combined with the company's 401(k) plan, and the company placed few restrictions on the ability of employees to diversify employer contributions.

Under the Employee Retirement Income Security Act (ERISA) and the Securities Acts, DOL and SEC are responsible for ensuring that certain disclosures are made to plan participants regarding their investments.[6] Although employees in plans where they control their investments (participant-directed accounts) receive disclosures under ERISA regarding their investments, such regulations do not require companies to disclose the importance of diversification or warn employees about the potential risks of owning employer securities. SEC requires companies with defined contribution plans that offer employees an opportunity to invest in employer stock to register and disclose to SEC specific information about those plans. In addition, in most cases the underlying securities of those plans must be registered with SEC. However, SEC does not routinely review these company plan filings because pension plans generally fall under other federal regulation. (See app. III for SEC's determination of how securities law applies to pension plans.) Industry representatives that we spoke with said that some companies provide plan participants with investment education, including information about the risks involved in owning employer stock. However, the investment information the companies provide is done on a voluntarily basis and varies by company. These industry officials also said that employers are concerned about the potential liability associated with making individualized investment advice available to plan participants. DOL recently issued guidance about investment advice to make it easier for plans to use independent investment advisors to provide advice to participants in retirement plans.

[6]ERISA is a federal law that sets minimum standards for pension plans sponsored by private employers.

This report includes a Matter for Congressional Consideration to require employers to provide an investment education notice containing basic information on risk management and the importance of diversification.[7]

We provided a draft of this report to the Department of Labor, the Department of Treasury, and the Securities and Exchange Commission. All three agencies provided us with technical comments and we incorporated each agency's comments as appropriate. DOL also provided written comments that are reprinted in appendix IV. DOL agreed with our conclusion that additional investment education is necessary, but stated that the Secretary of Labor does not currently have the legal authority under ERISA to require DOL to issue an investment education notice. Consequently, we changed our recommendation to a Matter for Congressional Consideration to amend ERISA so that it requires plan sponsors to provide an education notice.

Background

The U.S. private pension system is voluntary; employers decide whether to establish a retirement plan and determine the design, terms, and features of the plan or plans they choose to sponsor. The federal government encourages employers to sponsor and maintain private pension plans for their employees and provides tax incentives offered under the Internal Revenue Code to those who do. Although there is a wide range of specific plan designs that are permissible under current law, private sector pension plans are classified either as defined benefit or defined contribution plans. Defined benefit plans promise to provide, generally, a level of monthly retirement income that is based on salary, years of service, and age at retirement. The benefits from defined contribution plans are based on the contributions to and investment returns on individual accounts. Most private sector pension plans are defined contribution plans and this has been true for a number of years. Since the late 1980s, the number of defined benefit plans has decreased, and most new pension plans have been defined contribution plans. Many employers, particularly those with more than 1,000 employees, sponsor both defined benefit and defined contribution plans. More workers are covered by defined contribution plans than defined benefit plans, and the assets held by defined contribution plans now exceeds those held by defined benefit plans.

[7]For information on other issues we raised with Congress, see U.S. General Accounting Office, *Private Pensions: Key Issues to Consider Following the Enron Collapse*, GAO-02-480T (Washington, D.C.: Feb. 27, 2002).

According to DOL, employers sponsored over 673,000 defined contribution plans as of 1998 compared with about 56,400 defined benefit plans. Defined contribution plans had about 58 million participants while defined benefit plans had about 42 million participants.

Defined contribution plans are central to the debate about employee stock ownership through employer-sponsored plans. Defined contribution plans include thrift savings plans, profit-sharing plans, and ESOPs. The most dominant and fastest growing defined contribution plans are 401(k) type plans, which are plans that allow employees to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of the Internal Revenue Code. Most 401(k) plans are participant-directed, meaning that participants make investment decisions about their own retirement plan contributions within a set of investment choices selected by the plan sponsor. Employees are usually able to choose from a menu of diversified fund options when investing their own contributions. Over the last 20 years, employers have gradually expanded the investment choices of participants such that most plans are offering over 10 investment choices for participants, including investing in employer stock. Employees generally have less flexibility over the investments of the employer contributions to these plans, which frequently take the form of company stock.

Many employers combine defined contribution plans with a 401(k) feature and ESOPs or profit-sharing/thrift savings plans with a 401(k) feature.[8] High concentrations of employer securities are likely to be found when ESOPs and 401(k) type plans are linked or when 401(k) plans and profit-sharing plans are linked. This is especially true when plans are combined with ESOPs, which by definition seek to provide for employee ownership. Moreover, under current law, ESOPs may require participants not to divest their employer stock holdings until they reach the age of 55 or 10 years of service, essentially restricting participant's rights to diversify employer stock holdings.

ERISA has a rule that places a 10 percent limitation on acquiring and holding employer securities and employer real property for defined benefit

[8] A profit-sharing plan is a type of defined contribution plan that provides for contributions to employees based on employer profits. Profit-sharing plans provide for employer contributions to participants based on a definite formula that is generally based on employee compensation. A thrift savings plan is a defined contribution plan to which employees make contributions, usually as a percentage of salary.

plans. The 10 percent limitation states that a plan may not acquire any qualified employer securities or real property if immediately after the acquisition the aggregate fair market value of such assets exceeds 10 percent of the fair market value of the plan's total assets. Employer securities and real property that appreciate in value after acquisition to 10 percent or more of total plan assets do not have to be sold. Defined contribution plans other than 401(k) type plans that are not ESOPs are generally exempt from the 10 percent limitation.

Under ERISA, the Internal Revenue Service (IRS) and DOL's PWBA are primarily responsible for enforcing laws related to private pension plans. PWBA enforces ERISA's reporting and disclosure provisions and fiduciary standards, which concern how plans should operate in the best interest of participants. The IRS enforces requirements concerning how employees become eligible to participate in benefit plans and earn rights to benefits. The IRS also enforces funding requirements designed to ensure that plans subject to such requirements have sufficient assets to pay promised benefits.

In addition to the types of plans employers provide, some employer-sponsored plans have complex designs, such as floor-offset arrangements. Such arrangements consist of separate, but associated defined benefit and defined contribution plans. The benefits accrued under one plan offset the benefit payable from the other. In 1987, Congress limited the use of such plans significantly invested in employer securities. However, plans in existence when the provision was enacted were grandfathered.

Because plan participants are investing in employer securities, securities law investor protection and disclosure requirements are also important. Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 in response to fraud in the securities markets and because of a perceived lack of public information in the stock markets. The 1940 Investment Company Act, combined with the 1933 act, is the basis for SEC regulation of investment companies. Companies meeting this description must register under the Investment Company Act of 1940 and offer their shares under the Securities Act of 1933. These laws seek to ensure vigorous market competition by mandating full and fair disclosure and prohibiting fraud. Under these acts, a primary mission of the SEC is to protect investors and maintain the integrity of the securities market through extensive disclosure, enforcement, and education, but the securities laws also presume individual responsibility for investment decisions.

More Than Half of the Fortune 1,000 Companies Hold Employer Securities in Their Defined Contribution and Defined Benefit Plans

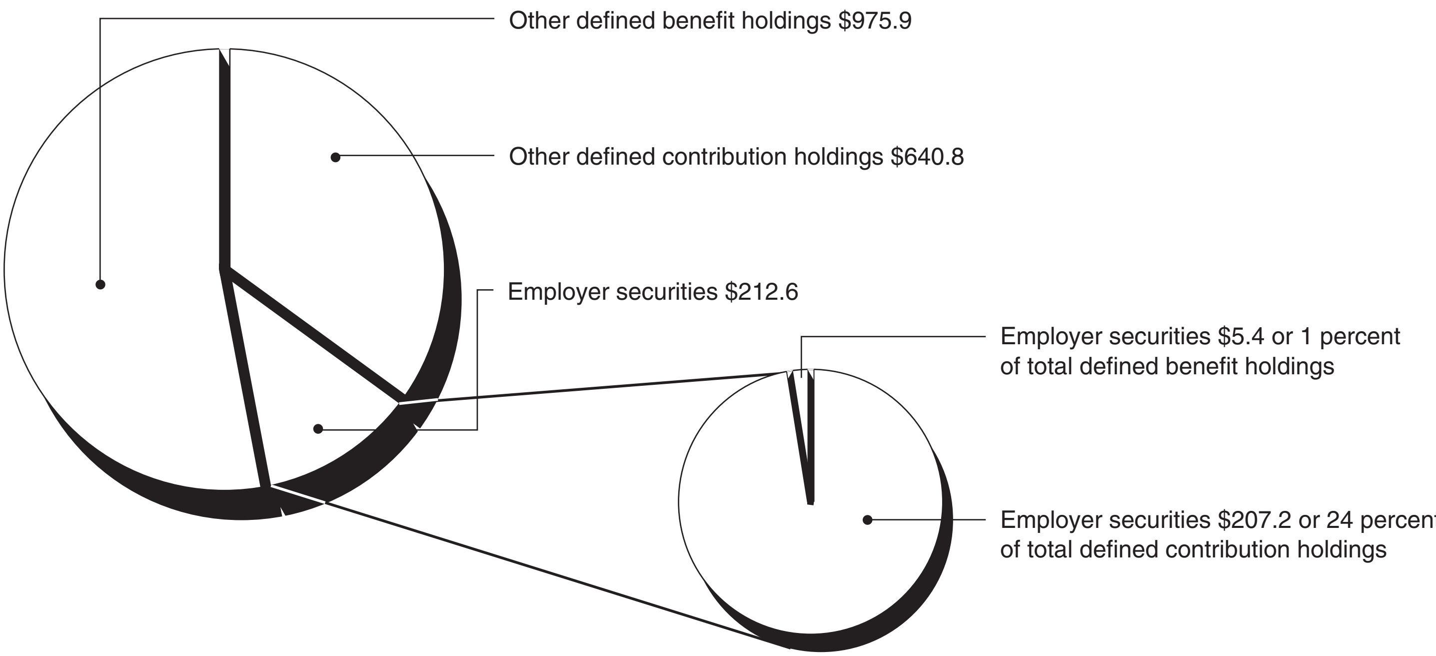
About 550 of the Fortune 1,000 firms in 1998 held employer securities in their defined contribution or defined benefit plans. Such holdings totaled over $213 billion and represented 21 percent of the known assets. However, when all assets are included, including those that cannot be specifically identified as employer securities, employer securities represented 12 percent of total assets. DOL's analysis showed that for defined contribution plans in 1998, employer securities represented about 16 percent of total plan assets and less than 1 percent for defined benefit plans. Our analysis found that the employer securities holdings were concentrated in different industries, with the bulk of the holdings held by manufacturers, which included technology and computer companies. For plans that reported holding employer securities, most of the employer securities were concentrated in ESOPs, including ESOPs combined with other defined contribution plans. A significant portion of employer securities were also held in the companies' 401(k) type plans. The largest dollar amounts of employer securities holdings were in companies whose retirement plans combined their 401(k) type plan with ESOPs. Because some companies reported holding their plan assets in master trust agreements, the amount of employer securities holdings in these firms' employer plans are likely to be higher than we can determine based on 1998 Form 5500 data.

Fortune 1,000 Employer Plans Report Over $213 Billion of Their Assets in Employer Securities

About $213 billion in plan assets held in the employer-sponsored plans of the Fortune 1,000 were held in employer securities. Almost all of the $213 billion of assets in employer securities were held in the Fortune 1,000's defined contribution plans. As shown in figure 1, less than 1 percent of defined benefit plan holdings were in employer securities and 24 percent of defined contribution holdings were in employer securities.[9]

[9]The Fortune 1,000 defined contribution plans had about $848 billion in plan holdings and defined benefit plans had about $981 billion in holdings.

Figure 1: Employer Securities Held by Defined Benefit and Defined Contribution Plans (billions)



Source: GAO analysis of 1998 Form 5500 data.

The Fortune 1,000 sponsored roughly 3,500 defined contribution or defined benefit plans. Fifty-six percent, or about 2,000 of those plans, were defined contribution plans and 44 percent, or more than 1,500 plans, were defined benefit plans. More than 37 million employees were covered by these plans, which was nearly 40 percent of the total participants in all company plans in 1998.[10] Twenty million employees participated in one or more defined contribution plans sponsored by the Fortune 1,000, and over 17 million employees were covered by defined benefit plans.

[10]Total participant numbers include double counting.

Manufacturers Held the Highest Amounts of Plan Assets in Employer Securities, but Such Holdings Were Less Than 10 Percent of the Industry's Assets

Manufacturers had the highest amount of plan assets in employer securities of the Fortune 1,000.[11] These companies included computer chip companies and technology firms, as well as traditional manufacturing companies, such as tool production and hardware firms. The sector held about $976 billion plan assets in 1998. As shown in table 1, manufacturing companies held about 45 percent of the employer securities holdings of the Fortune 1,000 and covered about 41 percent of plan participants of the Fortune 1,000.

Table 1: Pension Plan Assets for Fortune 1,000 Companies by Industry

(Dollars in billions)

Industry	Employer securities owned	Percent of all employer securities	Total assets	Concentration of employer securities (percent)	Plan participants	Percent of all plan participants
Manufacturing	$94.7	44.54	$975.9	9.7	15,117,571	40.84
Finance, insurance and real estate	28.9	13.61	152.8	18.9	3,270,537	8.84
Communication and information	21.0	9.91	202.9	10.4	2,785,218	7.52
Retail trade	19.9	9.36	61.5	32.3	4,508,681	12.18
Utilities	14.2	6.69	115.2	12.3	1,239,577	3.35
Services	13.7	6.45	106.0	12.9	4,362,308	11.79
Industry not reported	9.0	4.25	102.5	8.8	2,668,234	7.21
Transportation	6.5	3.08	75.4	8.7	2,018,620	5.45
Wholesale trade	2.3	1.08	14.3	16.1	547,821	1.48
Mining	1.4	0.69	15.7	9.4	254,506	0.69
Construction	0.706	0.33	5.4	13.1	159,462	0.43
Agriculture	0.27	0.01	1.4	1.9	81,322	0.22
Total	**$212.6**	**100.00**	**$1,829.3**	**11.6**	**37,013,857**	**100.00**

Source: GAO's analysis of 1998 Form 5500 data. Numbers may not add to total due to rounding.

Although manufacturers held the highest amount of employer securities of the 12 sectors, such holdings represented less than 10 percent of the sector's total assets. More than 90 percent of the manufacturing sector's assets were held in assets other than employer securities, which provided for some diversification for the industry. The retail sector, which includes car, food, and clothing sales companies, had the highest concentration of industry assets in employer securities, with about 32 percent of the

[11]We based our industry classifications on those used by DOL in the Private Pension Bulletin: Abstract of 1998 Form 5500 Annual Reports, Number 11, Winter 2001-02.

industries' plans assets in employer securities. Companies in the industries of mining, construction, and agriculture had the lowest amounts of employer securities and also covered the fewest number of plan participants.

ESOPs Held the Highest Percentages of Plan Assets in Employer Securities Although 401(k) Type Plans Had Higher Dollar Amounts, and Plans That Combined Features Held the Most Employer Securities

Not surprisingly, ESOPs had the highest percentages of plan assets in employer securities of plans that reported holding such assets. ESOPs, including ESOPs combined with other defined contribution plans, held over three-fifths of their known assets in employer securities, while 401(k) type plans held a little over a quarter of their known assets in employer securities. Given the requirements that plans must meet to be designated as an ESOP, it is not surprising that ESOPs and ESOPs with other plan features hold the highest percentages of employer securities holdings. For example, ESOPs must be primarily invested in qualifying employer securities in order for the plan to receive the legal designation of an ESOP. In addition, in order to ensure that a company's employees continue to hold that minimum threshold of company stock, many ESOPs restrict employees' ability to sell their company stock.

About 220 firms in the Fortune 1,000 sponsored plans that were ESOPs or ESOPs combined with other defined contribution plans. Those plans held a total of $143 billion in employer securities. Fifty-eight percent of ESOP total plan assets were in employer securities. However, certain types of ESOPs reported higher concentrations than others. For example, stand-alone ESOPs—ESOPs that are not combined with other defined contribution plans—had over 98 percent of plan assets in employer securities. Eighty-four companies sponsored such ESOPs, covering a little over 1 million participants.

About 475 companies had defined contribution plans with a 401(k) type feature and such plans had the highest total dollar amount of employer securities totaling $172 billion in employer securities. Given that twice as many companies sponsored a 401(k) type plan as those offering an ESOP, the high dollar amounts in the 401(k) plans are not unusual. 401(k) type plans also held significant percentages of plan assets in employer securities, although not as high as ESOPs. For example, about 324 companies reported sponsoring 401(k) plans that were combined with profit-sharing/thrift savings plans, which was by far the most prevalent type of 401(k) plan offered by the Fortune 1,000 and covered more than half of the participants participating in 401(k) plans. Twenty-six percent of those plans' assets were held in employer securities, totaling about $44 billion.

The type of defined contribution plan that had the greatest amount of employer securities were plans that combined a 401(k) type plan with an ESOP. About 96 companies sponsored such plans, covering about 2.5 million employees. These plans held about $93 billion of employer securities and about 44 percent of all employer securities, which was the highest amount of employer securities holdings in any of the plan types sponsored by the Fortune 1,000.

Recent industry data suggest that companies are increasingly sponsoring plans that combine features of defined contribution plans. For example, plans that combine ESOPs with a 401(k) type plan are becoming more prevalent among large, publicly traded companies. Because these plans hold the most employer securities, many more workers are likely to have a significant amount of their retirement savings invested in the securities of their employers. Retirement savings, therefore, may increasingly become more dependent on employer stock ownership.

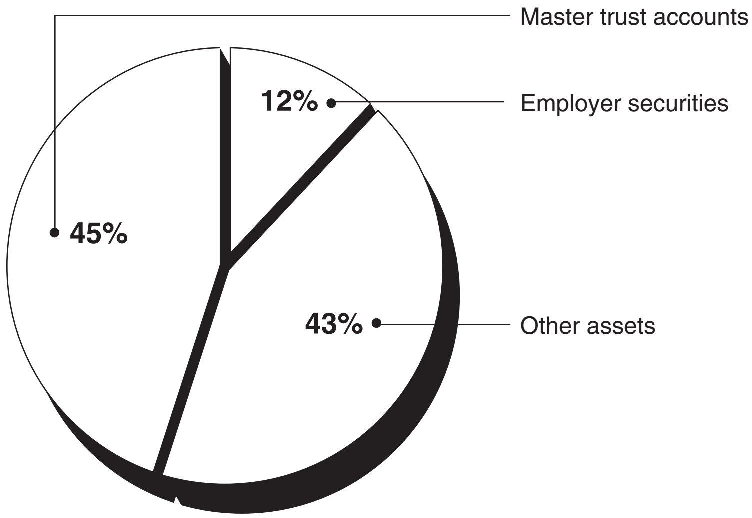
Defined benefit plans have smaller percentages of employer securities than ESOPs or 401(k) type plans. Seventy-five companies of the Fortune 1,000 sponsored defined benefit plans holding employer securities. Such plans covered 2.3 million participants and held about $120 billion of plan assets. Employer securities accounted for about 5 percent, or over $5 billion, of the known assets of these defined benefit plans.

Finally, little information is reported on complex plan designs such as floor-offset arrangements. The 1998 Form 5500 did not require employers to identify plans with floor-offset arrangements. Furthermore, agency and industry officials said there is little information on the number of employer-sponsored plans that have such features.

Amount of Employer Securities Could Likely Be Higher

Because we cannot isolate employer securities held in “master trust agreements,” our figures on employer securities holdings are likely to be understated. A master trust agreement is a trust in which assets of more than one plan sponsored by a single employer or by a group of employers are held under common control. As shown in figure 2, master trust assets held the highest percentage of pension plan assets.

Figure 2: Holdings of Fortune 1,000 Companies' Pension Plans



Note: Total Plan Assets: $1.8 trillion.

Source: GAO's analysis of 1998 Form 5500 data.

The amount of employer securities plans held within master trust agreements cannot be determined from the 1998 Form 5500. For reporting purposes, assets of a master trust are considered to be held in one or more investment accounts that may consist of a pool of assets or a single asset. In addition, only the account total of the master trust account is required to be reported on the Form 5500. For example, 29 percent of the ESOPs sponsored by the Fortune 1,000 reported not holding employer securities. However, because ESOPs are required by law to hold employer securities, if such holdings are not reported under the ESOP account they are likely to be in the master trust agreement accounts. Consequently, our reported dollar amounts of employer securities are likely to understate the amount of plan assets held in employer securities. However, DOL officials said that few Fortune 1,000 companies are likely to hold a significant percentage of employer securities in master trust agreements.

Recognizing the difficulty of identifying plan assets held in master trusts, DOL revised the Form 5500 for the 1999 plan filing year. Beginning with the 1999 filing year, master trusts will file a form 5500 report along with schedules itemizing the types of assets they hold. According to DOL officials, this will help ensure adequate reporting on the plan assets held in master trust investment accounts.

In addition to employer securities holdings in master trust agreements, we also found basic filing errors in the data. While examples we found may understate or overstate our concentrations, we were not able to determine the extent to which such filings errors occurred. For example, we found filing errors such as the misreporting of employer securities as corporate debt instruments or stock (other than employer's own common stock). In one case, we identified an ESOP that was reported to hold no securities. A DOL official reviewed this plan and, by examining an accountant's report that accompanied the Form 5500, discovered that the plan actually held employer securities and had made a mistake in filling out the Form 5500—a mistake that, according to DOL officials, occurs frequently. Furthermore, data reported on the Form 5500 combines all employer securities into a single line item. Employer securities held by pension plans may include employer stock, a marketable obligation such as a bond or note, or an interest in a publicly traded partnership. Thus, the line item for employer securities does not accurately reflect the amount of pension plan assets solely in employer stock.

Investing in Employer Securities Can Present Significant Risks for Employees' Retirement Savings

Investment in employer securities through employer-sponsored retirement plans can present significant risks for employees. If the employees' retirement savings is largely in employer securities or other employer assets, employees risk losing not only their jobs should the company go out of business, but also a significant portion of their savings. However, despite the risks, not every company whose employer plan has high concentrations of employer stock will result in employees incurring significant losses. Much depends on the decisions made by the company's leadership and other factors such as market forces, which determine whether the company stays in business. Some companies help employees mitigate their risks by balancing plans where risks of loss are borne by employees with plans where employers bear such risk. In addition, some companies help employees limit their exposure to the risk of loss by allowing employees, if they so choose, to diversify their holdings.

High Concentrations of Employer Stock Holdings Can Expose Employees to the Risk of Losing Their Jobs and Their Retirement Savings

Concentrating their retirement savings in employer securities means that employees are not only concentrating their assets in a single security, but are investing in a security that is highly correlated to their work effort and earnings. Unlike investors, who have ownership in a company but do not work for the company, employees with high concentrations of holdings of employer securities in their retirement plans are subjecting two sources of income, their retirement income and their employment income, to similar risks. Such holdings directly expose the employee to the losses of the company they work for much more so than if they worked in another company. In addition, holding significant proportions of employer securities is directly at odds with modern financial theory, which says that diversifying a portfolio offers the benefits of reducing risks at very limited cost.

Companies prefer to provide company contributions in employer stock for a number of reasons. Contributions in employer stock puts more company shares in the hands of employees who some officials believe are less likely to sell their shares if the company's profits are less than expected or in the event of a threatened takeover. Companies also point out that contributing employer stock promotes a sense of employee ownership, linking the interest of employees with the company and other shareholders. In addition, employer stock contributions provide several tax benefits for companies.

When employees choose to allocate a large portion of their total assets to their employer's securities, they are assuming significant risk in order to achieve a particular expected rate of return. Studies have shown that employees feel a great deal of loyalty to their company. Because they work at the company and interact with the company's managers, they believe they know the company and feel more comfortable investing in it. In addition, some employees enjoy being an owner-employee and some believe their employer's stock will outperform the overall market over some particular time horizon. As a result, some employees consider investments in employer stock through their employer-sponsored plans a safe investment. However, employees who have significant portions of their retirement savings invested in employer stock may be exposing themselves to greater financial risks than necessary. Generally, financial theory indicates that, through diversification, an investor can achieve a similar expected rate of return with less risk than a portfolio concentrated in employer securities.

The financial collapse of Enron and other companies, such as Color Tile and Southland, has highlighted how vulnerable participants are when they tie their retirement savings to their place of employment. For example,

- Enron employees lost their jobs and a significant amount of their retirement savings as the company became insolvent. The decline in Enron's stock price and its subsequent failure substantially reduced the value of many of its employees' retirement accounts. Enron's stock price went from a high of $80 per share in January 2001, to less than $1 per share in January 2002. About 62 percent of the assets held in the company's 401(k) consisted of shares of Enron stock. These concentrations are the result both of employee investment choice and employer matching contributions with employer stock. In all, about 20,000 employees lost money because their 401(k) accounts were heavily invested in Enron stock.

- Color Tile employees lost their jobs and their retirement savings when Color Tile filed for bankruptcy in January 1996. More than 83 percent of its $34 million in 401(k) plan assets were invested in Color Tile real property. During the bankruptcy, participant withdrawals or asset transfers in the 401(k) plan were prohibited until the property was appraised and sold.

- Southland Corporation employees incurred losses in their retirement savings. Southland's pension plans included a 401(k) and profit-sharing plans. Fifty-eight percent of the assets in Southland's 401(k) plan was used to buy 1,100 7-Eleven stores which were then leased back to the company. When Southland filed for Chapter 11 protection in October 1990, the 401(k) plan reduced its holdings in 7-Eleven stores to 46 percent of the assets in Southland's 401(k) plan. Unlike Enron and Color Tile, the Southland Corporation emerged from bankruptcy fairly quickly, with relatively small job loss to its employees.

See appendix II for additional details on of each company.

Even if Companies Do Not Declare Bankruptcy, Employees Are Still Subject to Certain Risks

Even without bankruptcy, employees are still subject to the dual risk of loss of job and retirement savings because corporate losses and stock price declines can result in companies significantly reducing their operations. For example, between December 31, 1999, and July 2001, Lucent Technologies' stock price fell from $82 to $6 per share and employees' account balances fell because about 30 percent of the company's 401(k) plan assets were in employer securities. For nonmanagement employees, about one-third of Lucent's workforce, the employer 401(k) match was in the form of an ESOP contribution made in employer stock. Employer contributions to Lucent's management 401(k) plan were made in the form of employer stock. In addition, more than 29,000 workers were laid off as a result of the company's financial troubles, although the company remains in business.

There are various reasons for companies experiencing financial difficulties. Although recent company failures have been attributed to company mismanagement, companies can also experience difficulties because of such problems as business cycles, market downturns, and declines in a sector of the economy. Depending on the circumstances of the company, the employer's stock price can experience a precipitous drop or it can decline gradually. In either case, substantial holdings of employer securities in employer-sponsored plans will be affected because of the company's financial problems.

Some Companies Mitigate Risks of High Concentrations of Employer Securities

Not every company whose employees have high concentrations of employer securities holdings will experience substantial losses in their plan assets. Much depends on the corporate decisions made by the company, which determine whether the company stays in business and the extent to which the company is forced, if necessary, to reduce operations. In addition, much depends on the extent that employer's stock is affected by general market cycles or market volatility.

Proponents of employer stock investments through employer plans point to numerous companies that have high concentrations of employer securities in their employer-sponsored plans and whose participants have not suffered as a result of such holdings. They state that high concentrations of employer securities are typically in large companies and that such companies have demonstrated long-term financial success. They also state that company performance improves when employees understand the relationship between their behavior and the accompanying rewards that accrue to them when they own employer stock.

Two companies whose plans we reviewed had high concentrations of employer stock holdings and their employees had not suffered substantial losses in their retirement savings because of company failure or downsizing. Each company offered defined contribution plans in the form of profit-sharing, ESOPs, and 401(k) plans. The 401(k) plans at both companies allowed participants to contribute a portion of their salaries on a pre-tax basis, and the companies offered a variety of investment fund choices to give plan participants the flexibility and option of investing their 401(k) accounts. Overall, more than 57 percent of account balances at one company and up to 92 percent of the employees' account balances at the other company are invested in employer stock. At one of the companies, 83 percent of the employees' contributions to the 401(k) plan are invested in employer stock, and roughly 92 percent of the company's contribution to employee accounts is invested in employer stock.

Although each company's stock price has experienced declines in the recent overall downturn in the stock market, such declines have not caused their employees to lose significant portions of their retirement savings. Company officials said that their company would continue to give their employees every opportunity to invest in employer stock. In addition, company officials said that despite the recent downturn in the market, plan participants have not significantly diversified out of the employer stock.

Some companies help employees mitigate their exposure to risk by balancing the types plans where risks of loss are borne by employees with plans where employers bear such risk. When companies provide defined benefit plans, employees are likely to receive some level of retirement income even if they have incurred losses in their defined contribution plans. With a defined benefit plan, the employer, as plan sponsor, is responsible for funding the promised benefits, investing and managing the plan assets, and bearing the investment risk. If the defined benefit plans terminate with insufficient assets to pay promised benefits, the Pension Benefit Guaranty Corporation (PBGC) provides plan termination insurance to pay participant's pension benefits up to a certain limit.[12] For example, according to PBGC, Enron sponsored at least five defined benefit plans insured by PBGC. The largest of these plans covered about 20,000 participants. If one or more of Enron's defined benefit plans is unable to pay promised benefits and is taken over by PBGC, vested participants and retirees will receive their promised benefits up to the limit guaranteed under ERISA.[13]

In addition, some companies help employees mitigate their exposure to the risk of loss by allowing employees, if they so choose, to diversify their holdings. Two companies whose plans we reviewed had few restrictions on their employees' ability to diversify their holdings of employer securities. For example, one company allowed vested participants at any age to diversify out of employer stock in the company-contributed portion of their account. The other company allowed 100 percent diversification of employee 401(k) contributions, the company match, and the profit sharing contributions at all times. Several other companies have publicly

[12]PBGC was created to insure the pension benefits of participants—in certain defined benefit plans—whose plans terminate without sufficient assets to pay all benefits owed. If a defined benefit plan terminates without sufficient funds to pay all benefits that participants are entitled to, PBGC takes over the plan and its assets and is responsible for paying benefits up to limits set by law to participants who are entitled to receive them.

[13]In accordance with ERISA, PBGC benefit payments are subject to a maximum benefit guarantee. For plans terminating in 2002, the maximum insured amount payable is $42,954 per year for a worker who retires at age 65.

announced easing restrictions on when employees can diversify employer contributions in their accounts. For example, one company announced in February 2002 that 401(k) plan participants could sell any of their individual account assets, including their employer match in employer securities, without restriction. Other companies have also lifted their restriction that required employees to hold their employer securities from company contributions until age 50.

Current Laws Provide for Disclosures to Plan Participants, but Information about Investment Diversification and Risk Is Not Required

ERISA and the Securities Act of 1933 require DOL and SEC to ensure that appropriate disclosures are made to plan participants and investors regarding their investments. Under ERISA, companies with participant-directed individual account plans are to provide plan participants with certain information and disclosures beyond the general ERISA reporting requirements. The Securities Act of 1933 requires companies with defined contribution plans that offer employer stock to employees to register and disclose to SEC specific information about those plans. Under the current disclosure requirements of DOL, there is no requirement that companies disclose to plan participants the risks involved in investing in employer stock or the benefits of diversification. Industry representatives we spoke with said that companies provide employees with investment education and plan information and in some cases go beyond the minimum requirements. However, because there is no requirement to educate employees about the investment risks or the benefits of diversification, investment education can vary by company. Few employers make more specific individualized or tailored investment advice available to their plan participants, in part because of concerns about fiduciary liability.[14] DOL has recently issued guidance about investment advice, which should help clarify when companies can use independent investment advisors to provide advice to participants in retirement plans.

ERISA Establishes Disclosure Requirements for Plan Participants

ERISA requires DOL to ensure that appropriate disclosures are made to plan participants regarding their ERISA-covered pension plans. While companies automatically make certain information available to plan participants, there is other information that participants must request in writing. Certain plans, which are designed to meet specific ERISA provisions, must provide plan participants with disclosures beyond what is

[14]Under ERISA, providing investment advice results in fiduciary responsibility for those providing the advice.

generally required by ERISA. Compliance with this regulation is optional, but provides employers with a defense to fiduciary liability claims related to investment choices made by employees in their participant-directed accounts.

Disclosures on Pension Plans Required under ERISA

ERISA requires companies to automatically disclose to plan participants certain information pertaining to their pension plans. These disclosures are the summary plan description (SPD), summary of material modifications (SMM), and the summary annual report (SAR). The SPD tells participants what the plan provides and how it operates. Specifically, the SPD provides information on when an employee can begin to participate in the plan, how service and benefits are calculated, when benefits become vested, when and in what form benefits are paid, and how to file a claim for benefits. ERISA states that the SPD must be written in a manner “calculated to be understood by the average plan participant” and must be “sufficiently comprehensive to apprise the plan’s participants and beneficiaries of their rights and obligations under the plan.” In other words, the disclosed information should be understandable and all-inclusive so participants can have useful information that will aid them in effectively understanding their pension plans. New employees must receive a copy of the most recent SPD within 90 days after becoming covered by the plan.

In addition to the summary plan description, plan participants are entitled to receive a summary of material modifications. The summary of material modifications discloses any material changes or modifications in the information required to be disclosed in the SPD. Plan administrators must furnish participants with an SMM within 210 days after the close of the plan year in which the modification was made.

Participants must also receive a summary annual report from their plan’s administrator each year. The summary annual report summarizes the plan’s financial status based on information that the plan administrator provides to DOL on its annual Form 5500. Generally, the SAR must be provided to participants no later than 9 months after the close of the plan year.

Plan participants may also request additional information about their plans. If plan participants wish to learn more about their plan’s assets, they have the right to ask their plan administrator for a copy of the plan’s full annual report. In addition, a participant can request a copy of his or her individual benefit statement, which describes a participant’s total accrued and vested benefits. Plan participants can also request the documents and instructions under which the plan is established or operated. This includes the plan document, the collective bargaining agreement (if applicable), trust agreement, and other documents related to the plans.

Regulation under Section 404(c) of ERISA Establishes Additional Disclosure Requirements

Under the 404(c) regulation, participants receive certain disclosures pertaining to the plan and its investment options.[15] The regulation is a benefit to plan participants because it allows them to receive additional disclosure beyond what is generally required under ERISA. The purpose of these informational requirements is to "ensure that participants and beneficiaries have sufficient information to make informed investment decisions."[16] The regulation also benefits employers who comply with its requirements, because it exempts them from fiduciary liability related to the investment choices made by their employees in their participant-directed accounts.

The regulation specifically requires that the plan administrator automatically provide the plan participant with (1) an explanation that the plan is a 404(c) plan and that the fiduciary will be relieved of liability; (2) a description of investment alternatives; (3) the identification of any designated investment managers; (4) an explanation of circumstances under which the participant may give investment instructions or limitations; (5) a description of transaction fees and expenses; and (6) the name, address, and telephone number of the fiduciary to contact for further information regarding these disclosures. In addition, for a plan with employer stock, plan administrators are to provide all voting information and the procedures for ensuring the confidentiality of participant investment transactions, as well as a prospectus immediately before or after the initial investment.

Plan participants can also request certain plan information. This includes (1) a description of the annual operating expenses of the plan's investment alternatives, including any investment management fees; (2) copies of any prospectuses, financial statements and reports, and other information furnished to the plan relating to investment alternatives; (3) the list of assets comprising the portfolio of each investment option that holds plan assets; (4) information about the value of shares or units in investment

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[15]29 C.F.R. 2550.404c-1. ERISA 404(c) generally relieves employers of liability for fiduciary error when the employer permits participants to exercise control over their accounts.

[16]Final Regulations Regarding Participant Directed Individual Account Plans, 57 Federal Register 46,906, 46,909-10 (Oct. 13,1992) (codified at 29 C.F.R. 2550.404c-1).

alternatives available along with information concerning past and current investment performance of each alternative; and (5) information pertaining to the value of shares or units in investment alternatives held in the participant's account.

Compliance with Section 404(c) Regulations of ERISA Is Optional

Employers choose whether to provide disclosures under the regulation. Those who comply with the regulation are afforded certain protections from their fiduciary liability.

- First, compliance exempts plan fiduciaries from responsibility for investment decisions of employees when employees exercise control over their investments. However, the regulation establishes conditions employers must meet in order to be exempted from fiduciary liability related to investment choices made by participants. Employers must provide employees with the opportunity to choose from a broad range of investment options; allow employees to transfer the assets in their accounts into and out of the various plan investment options with a frequency that is reasonable in light of the market volatility of those investment options; and the plan's investment options must permit employees to diversify their investments. If the plan meets the requirements of the regulation and a participant fails to diversify his or her account and invests all the account assets in his or her employer's stock, the employer will be able to assert that the company is not responsible for any financial losses incurred by the participant because the company has complied with the regulation.

- Second, participants that manage the investments of their accounts are not considered to be fiduciaries. The employer is also not subject to potential fiduciary liability for the participant's investment decisions.

Plan sponsors are not relieved of all fiduciary responsibilities by complying with the regulation. For example, they remain responsible for the prudent selection of investment alternatives and monitoring plan investments on an ongoing basis.

Under the Securities Act Certain Pension Plans Are Required to Register with SEC

Because defined contribution plans require that employees assume the investment risk, securities law protections applicable to investors are relevant to plan participants. Employees in participant-directed plans might be given the choice of investing in securities, including employer securities, as well as a variety of mutual funds. The securities laws require disclosure of information about investment objectives, performance, investment managers, fees, and expenses of mutual funds and information about the business objectives, financial status, and management of companies that are issuing securities. However, distribution of these disclosure materials to plan participants making investments may depend on employer compliance with requirements of ERISA's 404(c) regulations. In addition, interests in certain pension or profit-sharing plans are securities subject to the registration and antifraud requirements of the Securities Act of 1933 (1933 act), which we discuss in further detail in appendix III. Pension or profit-sharing plans that have the investment characteristics of securities are required to register under the 1933 act. Interests of employees in plans are securities where the employees voluntarily participate in the plan and their individual contributions can be used to purchase employer stock. This generally includes 401(k) salary reduction plans and savings plans where participant contributions are used to purchase employer securities. If employer securities are offered and sold to employees pursuant to a pension plan, those securities must be registered also.

SEC Makes Registration Documents Available to the Public, but Does Not Routinely Review Them

The 1933 act requires registration of securities being offered for sale to the public. The registration statement, which SEC makes publicly available, must disclose the basic business and financial information for the issuer with respect to the securities offering. SEC requires companies that offer securities to their employees under any employee benefit plan to register those securities on Form S-8. SEC generally makes the companies' Form S-8 publicly available, but does not routinely review these forms. The SPD may be used to satisfy the prospectus delivery requirement applicable to Form S-8.[17] However, the SPD is not filed with the SEC as part of the Form S-8. Although ERISA requires SPDs to be provided to participants, DOL no longer requires the SPD to be filed with the Department.

SEC generally limits its review of corporate filings to ensure that the initial registration of the security and other reporting comply with its disclosure requirements. As part of its interpretive responsibility, SEC has no requirement in law or regulation to verify the accuracy or completeness of the information companies provide. SEC's review of corporate filings may involve a full review, a full financial review, or monitoring of certain filings

[17] Rule 428 under 17 C.F.R. Section 230.428 specifies what companies must deliver to plan participants to satisfy the prospectus delivery requirement of Form S-8.

for specific disclosure requirements.[18] In our work at SEC, we found that its ability to fulfill its mission has become increasingly strained, due in part to imbalances between SEC's workload and staff resources.[19] Like other aspects of SEC's workload, the number of corporate filings has grown at an unprecedented rate. SEC's 2001 goal was to complete a full financial review of an issuer's annual report required by the Exchange Act in 1 of every 3 years—a review goal of about 30 to 35 percent of these annual reports per year. However, SEC only completed full or full financial reviews of 16 percent of the annual reports filed or about half of its annual goal in 2001. In this post-Enron environment, SEC plans to reconsider how it will select filings for review and plans to revise its approach for allocating staff resources to conduct those reviews.

The SEC does not routinely review companies' Forms S-8 for completeness or accuracy and has not routinely reviewed these filings for the last 20 years, according to SEC staff.[20] SEC staff said that while they track the total number of Form S-8 filings each fiscal year. They do not separately track the number of filings for different types of plans, such as 401(k) plans or stock option plans. SEC staff can, however, take action against an issuer if it discovers that a Form S-8 does not comply with applicable law. For example, SEC has taken enforcement actions against companies that have abused the S-8 short form registration. In the late 1990's, some companies had used Form S-8 filings inappropriately for raising capital and not for compensatory offerings for employee plans.

Recently, SEC has placed increased emphasis on clear, concise and understandable language in prospectuses. SEC requires that in drafting disclosure documents, registrants should aim to write clearly and to provide for more effective communication. SEC implemented the plain English requirement for certain parts of the 1933 act prospectus. For

[18]A full review involves an in-depth examination of the accounting, financial, and legal aspects of an issuer's filing. A full financial review involves an in-depth accounting analysis of an issuer's financial statements and management's discussion and business plan disclosure.

[19]See U.S. General Accounting Office, *Human Capital: Major Human Capital Challenges at SEC and Key Trade Agencies*, GAO-02-662T (Washington, D.C.: Apr. 23, 2002).

[20]According to SEC's Interpretive Release No. 6188, SEC made revisions to the Form S-8 and revised its procedures for making it effective. The Commission believed that the public interest would be better served by prompt effectiveness of such filings without the delay necessitated by the low review priority given to them. SEC substantially revised Form S-8 in 1990.

example, with respect to mutual funds, SEC's rules require that the prospectus should contain information appropriate for an average or typical investor who may not be sophisticated in legal or financial matters.

Investment Education Is Not Required, but Is Sometimes Provided in Addition to Disclosures

ERISA was enacted in 1974 within the context of defined benefit pension plans where employers make plan investment decisions; consequently, ERISA does not require plan sponsors to make investment education or advice available to plan participants. Moreover, according to DOL officials, employers that sponsor pension plans are not required to provide educational materials on retirement saving and investing. Hence, employers are not required to provide information about the risks involved in investing in employer securities and the importance of diversification to a prudent investment strategy. Additionally, under ERISA, providing investment advice results in fiduciary responsibility for those providing the advice, while providing investment education does not.

Industry officials that we spoke with said that many companies provide employees with investment education and plan information. Plan participants are given a number of investment education materials, such as newsletters, quarterly reports on participant accumulations, and annual reports with benefit projections. Companies also provide information to employees about their investment plan options. Employees are also provided information explaining the value of diversification. Furthermore, according to these officials, diversification is a theme that they emphasize in their investment education programs.

Investment education varies by company in part because ERISA has no requirements about informing participants about investment risks or diversification. Industry officials that we spoke with told us that many companies voluntarily provide some investment education to plan participants and that they do so because education is needed to improve employees' abilities to manage their retirement savings. However, because there is no standard format for investment education, companies provide employees with information that they believe is important to managing their retirement savings accounts and this information varies by employers.

DOL does not monitor the type of investment education provided to plan participants and little is known about the accuracy and usefulness of the investment education programs and materials provided to employees. SEC provides broad investor education, only to the extent that it affects all investors, but it does not specifically target pension plan investors.[21]

Industry officials also said that providing investment education to employees does not necessarily mean that companies are providing information on the risks of holding employer securities. These officials said that telling plan participants that an investment may be risky or that an employee's holdings are risky could be interpreted as providing investment advice. Consequently, companies provide general information about the benefits of diversification, but little information about the risk of holding certain investments, such as employer stock.

Some studies also indicate that the type and amount of investment education varies by company. For example, one study by a benefits consulting firm found that 24 percent of their respondents reported that their companies offered investment information on an as-needed basis, and 11 percent reported that their companies offered no information at all. The remaining respondents said their companies offered detailed information, either on an ongoing basis (33 percent), or at plan enrollment and annually thereafter (32 percent).

Industry officials told us that many companies do not offer investment advice mainly because of fiduciary concerns about the liability for such advice if it results in losses to the participant, even if the investment advisor is competent and there is no conflict of interest. Companies also have fiduciary concerns about the ability to select and monitor a competent investment advisor under ERISA's prudence standard.[22] Additionally, ERISA currently prohibits fiduciary investment advisors from engaging in transactions with clients' plans where they have a conflict of interest, for example, when the advisors are providing other services such as plan administration. As a result, these investment advisors cannot

[21]Within SEC, its Office of Investor Education is responsible for disseminating information to educate the investing public about the advantages and risks associated with investing. In this capacity, SEC seeks to protect investors by first providing them with pertinent information to assist in making investment decisions appropriate for their circumstances. SEC provides web-based links to other federal, state, and related investor education web sites that contain materials or information useful to investors.

[22]ERISA's prudence standard requires a fiduciary to act as a prudent person experienced in such matters would in similar circumstances.

provide specific investment advice to plan participants about their firm's investment products without approval from DOL.

Industry officials we spoke with said that more companies are providing plan participants informational sessions with investment advisors to help employees better understand their investments and the risk of not diversifying. They also said that changes are needed under ERISA to better shield employers from fiduciary liability for investment advisors recommendations to individual participants. In 1996, DOL issued guidance to employers and investment advisers on how to provide educational investment information and analysis to participants without triggering fiduciary liability.[23] This guidance identifies and describes certain categories of investment information, and education employers may provide to plan participants. These categories are (1) information about the plan, (2) general financial information, (3) information based on "asset allocation models," and (4) "interactive investment materials." According to DOL, these investment education categories merely represent examples of investment information and materials that if furnished to participants would not constitute the rendering of investment advice.

DOL has recently issued guidance about investment advice, which should help clarify when companies can use independent investment advisors to provide advice to participants in retirement plans. In 2001, DOL issued Advisory Opinion 2001-09A. This Advisory Opinion was a response to an application for exemption filed on behalf of SunAmerica Retirement Markets, Inc. (SunAmerica) with DOL, which sought exemption from the prohibited transactions restrictions.[24] DOL determined that SunAmerica's proposed method of issuing investment advice directly to plan participants would not violate the prohibited transaction provisions of ERISA. DOL's ruling allows financial institutions to provide investment advice directly to retirement plan participants when the advice is based on the computer programs and methodology of a third party, independent advisor; therefore eliminating conflicts of interest. DOL officials said that they hope the Advisory Opinion ruling helps plans to sponsor the type of nonconflicted investment advice they are allowed to provide plan participants.

[23]Interpretive Bulletin 96-1.

[24]The Advisory Opinion prohibited fiduciary investment advisors from engaging in transactions with clients' plans where they have a conflict of interest.

Conclusion

The Enron collapse serves to illustrate what can happen under certain conditions when participants' retirement savings are heavily invested in their employer's securities. When the employer's securities constitutes the majority of employees' individual account balances and is the primary type of contribution the employer provides, employees are exposed to the possibility of losing more than their job if the company goes out of business or into serious financial decline—they are also exposed to the possibility of losing a major portion of their retirement savings. We presented other concerns about what can happen to employees' retirement savings under certain conditions to the Congress in our testimony in February 2002.[25] In addition to the issues of diversification and education, we suggested that further restrictions on floor-offset arrangements may be warranted.

As our analysis shows, it is not unusual to find concentrations of employer securities in the plans of large firms such as the Fortune 1,000 that cover a significant portion of employees. To the extent these defined contribution plans become the primary component of employees' retirement savings; these plans are most subject to risk of loss, and employees and policy makers should be concerned about the risks employees face by holding large portions of their retirement savings in employer securities. This is especially important as fewer companies are offering defined benefit plans that could provide some level of guaranteed retirement savings to employees even if they incur substantial losses in their defined contribution plans.

Current ERISA disclosure requirements provide only minimum guidelines that companies must follow on the type of information they provide to plan participants. In addition, there is little government oversight of the information companies provide to plan participants. Consequently, the type and amount of information plan participants are receiving about their investments is not known. Improving the amount of disclosure provided to plan participants could help ensure that plan participants are at least getting some minimum level of information about investing, especially with regard to employer securities. In addition, providing plan participants with disclosures on the risks of holding employer securities and the benefits of diversification in mitigating employees' losses may help

[25]See U.S. General Accounting Office, *Private Pensions: Key Issues to Consider Following the Enron Collapse*, GAO-02-480T (Washington,D.C.: Feb. 27, 2002).

employees make more informed decisions regarding the amount of employer securities they hold in their retirement plans.

Matter for Congressional Consideration

To address the lack of investment education and information provided to participants, the Congress should consider amending ERISA so that it specifically requires plan sponsors to provide participants in defined contribution plans with an investment education notice that includes information on the risks of certain investments such as employer securities and the benefits of diversification.

Agency Comments

We provided a draft of this report to the Department of Labor, the Department of the Treasury, and to the Securities and Exchange Commission for review and comment. We received written comments from the Department of Labor that are reprinted in appendix IV. DOL, SEC, and the Department of Treasury also provided technical comments on the draft. We incorporated each agency's comments as appropriate.

Included in the draft for DOL's review was a recommendation to the Secretary of Labor to direct the Assistant Secretary, Pension and Welfare Benefits Administration, to require plan sponsors to provide participants in defined contribution plans with an investment education notice. DOL agreed with our conclusion that additional investment education is necessary, but stated that the Secretary of Labor does not currently have the legal authority under ERISA to require an investment education notice. Consequently, we changed our recommendation to a matter for consideration for the Congress to amend ERISA so that it requires plan sponsors to provide an education notice.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. We are sending copies of this report to the Secretary of Labor; the Secretary of the Treasury; and the Chairman, Securities and Exchange Commission. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact Barbara Bovbjerg at (202) 512-7215, Richard Hillman at (202) 512-8678, George Scott at (202) 512-5932, or Debra Johnson at (202) 512-9603. Other major contributors include, Joseph Applebaum, Tamara Cross, Rachel DeMarcus, Jason Holsclaw, Raun Lazier, Carolyn Litsinger, Gene Kuehneman, Alexandra Martin-Arseneau, Corinna Nicolaou, Vernette Shaw, Roger Thomas, and Stephanie Wasson.

Sincerely yours,

Barbara D. Bovbjerg
Director, Education, Workforce
and Income Security Issues

Richard J. Hillman
Director, Financial Markets
and Community Investments

Appendix I: Scope and Methodology

Review of Form 5500 Data

To determine the number and types of private pension plans invested in employer securities, we analyzed plan financial information filed annually (Form 5500s) with the Internal Revenue Service and Pension and Welfare Benefits Administration(PWBA). The annual Form 5500 report is required to be submitted annually by the administrator or sponsor for any employee benefit plan subject to Employee Retirement Income Security Act (ERISA) as well as for certain employers maintaining a fringe benefit plan. It contains various schedules with information on the financial condition and operation of the plan. PWBA provided us with a copy of the complete 1998 electronic Form 5500 database and a preliminary 1999 electronic database for Form 5500s for our analysis. The 1998 database contained information from over 215,000 Form 5500 reports. We did not independently verify the accuracy of the Form 5500 databases. In addition, the data we analyzed were accurate only to the extent that employers exercised appropriate care in completing their annual Form 5500 reports.

We decided to focus our analysis on the largest 1,000 corporations. In order to determine the Fortune 1,000 companies for our review, we used the “Fortune Magazines” listing of the largest corporations in the United States, which determines the largest corporations by looking at corporations’ revenue during the preceding year.[1] After determining the 1,000 largest corporations, we analyzed data for the Fortune 1,000 companies (the corporations and their subsidiaries) for plan year 1998, which was the most recent year for which complete plan-specific Form 5500 data were available for our review.

In order to review the Fortune 1,000’s Form 5500s, we matched the Fortune 1,000 companies to their pension plans on the basis of their Employer Identification Numbers (EINs). An EIN, known as a federal tax identification number, is a nine digit number that the IRS assigns to

[1]All companies on the list must publish financial data and must report part or all of their figures to a government agency. Private companies and cooperatives that produce a 10-K are, therefore, included; subsidiaries of foreign companies incorporated in the United States are excluded. Revenues are as reported, including revenues from discontinued operations when they are published on a consolidated basis (except when the divested company’s revenues equal 50 percent or more of the surviving company’s revenues on an annual basis). The revenues for commercial banks and savings institutions are interest and noninterest revenues. Such figures for insurance companies include premium and annuity income, investment income, and capital gains or losses, but exclude deposits. Revenues figures for all companies include consolidated subsidiaries and exclude excise taxes.

organizations.[2] We used several methods to identify the EINs associated with the Fortune 1,000. We started with a list of EINs for over 500 companies that was provided to us by the Pension Benefit Guaranty Corporation (PBGC). To identify the EINs for the remaining companies we searched public filings, including 10-K statements filed with the SEC, using the search tools available through nexis.com. Where we could not find a company's EIN and for companies whose EIN was not associated with a Form 5500, we conducted a text search of the electronic Form 5500 data to find plans sponsored by these companies. Additionally, we used 10-K filings for the Fortune 1,000 companies to identify major subsidiaries that might have their own pension plans. We conducted further text searches of the electronic Form 5500 data to identify pension plans for these subsidiaries. Our analysis includes information for subsidiaries to the extent we were able to identify them during our review. We eliminated from our analysis any Form 5500 returns that did not report end-of-year assets and also eliminated plans that did not report end of year participants. This resulted in a database containing the information of 3,480 Form 5500 returns filed by 996 of the Fortune 1,000 companies or their subsidiaries. Our totals for the number of plan participants include double counting of participants because some individuals may participate in more than one pension plan sponsored by the same employer.

Because master trust holdings accounted for 45 percent of the assets held by the Fortune 1,000 employer-sponsored plans, we tried to identify employer securities held outside of master trusts. To calculate the percentage of pension plan assets held as employer securities, we first subtracted master trust assets from total plan assets to arrive at "known assets." We then calculated the percentage of known assets comprised of employer securities to determine the percentage concentration of plan assets in employer securities. Plans holding assets in master trust accounts reported only the total asset value of these holdings and did not itemize or otherwise identify any the individual investments held by a master trust for 1998 Form 5500 filings. As such, we were unable to determine what fraction of that 45 percent consisted of employer securities. However, we analyzed preliminary 1999 Form 5500 data for master trust accounts and found that some of the assets reported by these master trust accounts were holdings of employer securities.

[2]The IRS uses the number to identify taxpayers who are required to file various business tax returns as well as the Form 5500. EINs are used by employers, sole proprietors, corporations, partnerships, nonprofit associations, trusts, estates of decedents, government agencies, certain individuals, and other business entities.

Implications of Investing in Employer Securities

To address the implications of investing in employer securities, we identified companies whose pension plans were heavily invested in company's securities. We specifically looked for companies where employees have experienced substantial retirement losses similar to Enron and ones where the employees have benefited. Given the sensitivity and nature of our review, it was difficult to find companies that would speak with us and share their plans' investment experiences, whether good or bad. However, we were able to find officials in two companies that were willing to discuss their pension plan and experiences.

To identify and describe the implications of companies where employees have experienced significant losses due to bankruptcy or declines in the market valuations of the company's stock, we obtained information about the company's history and pension plans through U.S. news, trade industry reports, business journals, and company Web sites. We researched fraud cases on the world wide web; reviewed legal briefs and opinions outlining the details of lawsuits filed against the companies; and reviewed bankruptcy filings and proceedings to describe the history of events that lead the company to seek bankruptcy protection.

To identify and describe situations where employees have not experienced significant losses, we interviewed two companies whose private pension plans are heavily invested in company securities. We developed a set of structured interview questions to obtain information about the companies, specifically background information and information about the company's pension plans. We also reviewed and analyzed the company's summary plan descriptions and prospectus to determine how the plans were administered and to identify requirements and restrictions of each plan.

Regulatory Provisions for Disclosures

To report on the regulatory provisions for disclosures to participants owning employer stock through their employer-sponsored plans, we reviewed relevant laws and regulations and spoke with agency and industry officials. In order to understand the regulatory provisions for securities, we reviewed the Securities Act of 1933 and the Securities Act of 1934. Similarly, we reviewed ERISA and 404(c) regulations to under disclosure requirements for pension plans. We also reviewed past reports on private pension plans, ERISA, Employee Stock Ownership Plans (ESOPs), and issues regarding investment education and advice. We also spoke with Department of Labor (DOL) pension and legal experts and officials from the Securities and Exchange Commission's Market Regulation Division, Investor Education Division, Corporate Finance Division, and the Enforcement Division.

In order to determine the types of disclosures companies were providing to plan participants, we spoke with officials from the American Benefits Council, 401(k) Profit Sharing Council of America, the ESOP Association, the ERISA Industry Committee, the American Society of Pension Actuaries, the Investment Company Institute, and retirement plan administrators and financial service providers.

To determine whether the SEC should reconsider its administrative determination not to explore application of the Securities Act and the Securities Exchange Act to defined contribution plans, we first researched what SEC's determination had been and second determined whether SEC planned to reconsider its determination. We researched the relevant legal history and SEC's position papers. We reviewed relevant securities laws, SEC regulations, and public SEC statements, as well as pertinent legal matters. We interviewed and discussed SEC's position on the application of the Securities Act and the Securities Exchange Act to defined contribution plans with SEC's legal counsel and appropriate SEC staff.

Appendix II: Bankruptcy and Legal Proceedings of Companies Whose Employees Participated in Employer-Sponsored Plans

Enron

Enron was engaged in the business of providing natural gas, electricity, and communications to wholesale and retail customers. Only months before its bankruptcy filing, the company was regarded as one of the most innovative, fastest growing, and best managed businesses in the United States. However, Enron's problems did not arise in its core energy operations, but in other ventures, particularly "dot com" investments in Internet and communications businesses and in certain foreign subsidiaries. Rather than recognize these problems, the company assigned business losses to unconsolidated partnerships and other vehicles, which reportedly inflated its income.[1] On December 2, 2001, the Enron Corporation filed for Chapter 11 bankruptcy protection.

The decline in Enron's stock price and its subsequent failure substantially reduced the value of many of its employees' retirement accounts. Under Enron's 401(k) type plan, participants were allowed to contribute from 1 to 15 percent of their eligible base pay in any combination of pre-tax salary deferrals or after-tax contributions subject to certain limitations. Participants were immediately fully vested in their voluntary contributions.[2] Enron generally matched 50 percent of all participants' pre-tax contributions up to a maximum of 6 percent of all employee's base pay, with matching contributions invested solely in the Enron Corporation Stock Fund. Participants were allowed to reallocate their company matching contributions among other investment options when they reached the age of 50.

On April 8, 2002, a class action suit was filed on behalf of the plan participants representing 24,000 current and former Enron employees who participated in Enron's plans. The lawsuit alleges that the Enron Corporation Savings Plan Administrative Committee and other persons responsible for safeguarding the assets of the employee's plans are liable for breaching their fiduciary duties under ERISA. In addition, the Department of Labor (DOL) has opened an investigation to determine whether there were any ERISA violations in the operation of the company's employee benefit plans. DOL also reached an agreement with Enron to appoint an independent fiduciary to assume control of the

[1]In late 2001, Enron revealed it would incur losses of at least $1 billion and would restate its financial results for 1997, 1998, 1999, 2000, and for the first quarters of 2001, to correct errors that inflated Enron's net income by $586 million.

[2]Employees hired after July 1999 are fully vested in their company contributions after 1 year of service.

company's retirement plans. SEC had not taken any enforcement actions as of August 1, 2002.[3]

Color Tile

Color Tile's financial problems began as a result of a 1993 business transaction that left the company undercapitalized, without the ability to service its debts and operate in a competitive fashion. In 1995, the company defaulted on a $10.4 million interest payment, forcing the company to seek relief under Chapter 11 of the bankruptcy code. In 1996, after 44 years in the floor-covering business and failing at several attempts to remain competitive in a changing flooring market, Color Tile sought Chapter 11 protection. One day after filing for bankruptcy protection, the company closed 234 of its 621 company-owned stores nationwide. After several attempts to save the company, Color Tile closed the remaining of its stores a year later affecting some 3,900 employees. Company executives blamed its financial troubles on slow flooring sales and competition from other centers.

In 1996, a former Color Tile employee sued Color Tile, alleging mishandling of the plan assets, including investing the plan assets in Color Tile property. The employee won, and the settlement required the plan trustee and fiduciary carrier to pay about $4 million to Color Tile's $34 million 401(k) plan. In 1993, DOL investigated Color Tile and found no violations. SEC did not open an investigation of Color Tile.

Southland

The company began to experience financial difficulties as a result of a failed 1987 leveraged buyout. The value of the company's stock declined, and the company found itself under $4.9 billion of debt, which it had incurred as the result of the 1987 leveraged buyout. In addition, the company lost $1.3 billion and then suddenly ran out of money to pay the interest on the debt, forcing the company to sell 58 of its convenience stores to a Japanese retailer. Southland's pension plans included a 401(k)

[3]SEC has taken few enforcement actions to date against companies concerning their pension plans. SEC staff advised that the SEC had not taken actions to safeguard or recover assets of retirement plans triggered by situations where—in the last 10 years—employees have suffered substantial losses because plans that held employer stock had declined in value or had limited employees' ability to diversify investments or sell company stock. According to SEC staff, these matters do not deal with disclosure or registration issues that are under SEC's authority. Instead, these matters are more related to the merits of the plans and how they operate under ERISA, thus, falling under DOL's regulatory authority.

plan and a profit-sharing plan. Fifty-eight percent of the assets in Southland's 401(k) plan was used to buy 1,100 7-Eleven stores and then leased back to the company. After its bankruptcy, Southland reduced its holdings in 7-Eleven stores to 46 percent of Southland's 401(k) plan assets.

In 1991, Southland's Japanese partners acquired 70 percent of Southland's common stock for $430 million. The cash infusion allowed the company to emerge from bankruptcy with its debt load reduced by 85 percent. Southland emerged from bankruptcy protection on March 5, 1991.

Lucent

Lucent Technology, which spun off from AT&T in 1996, at one time held a dominant position in the telecommunications equipment market. During the first quarter of fiscal year 2000, the company's revenues began faltering as a result of the company's inability to develop and deliver new products as the market required. In addition, Lucent developed problems with AT&T, its largest and most important customer. As a result, Lucent shares began falling in January 2000, when the company said its fourth-quarter profits would fall short. In subsequent quarters, the company kept cutting forecast and the shares kept plunging. Between December 31, 1999, and July 2001, Lucent shares declined from $70 to $6. In fiscal year 2001, Lucent posted a $16 billion loss and anticipated a large-scale layoff.

Employer contributions to Lucent's management 401(k) plan were made in the form of employer stock. For nonmanagement employees, about one-third of the Lucent's workforce, the employer 401(k) match was in the form of an ESOP contribution made in employer stock. It is not clear to what extent participants were able to diversify their employer contributions. With some 30 percent of the company's 401(k) plan invested in company stock, employee account balances declined when Lucent's stock price fell.

The collapse of Lucent's stock sparked a class-action lawsuit by Lucent employees whose 401(k) accounts suffered losses. The suit alleges that Lucent breached its fiduciary duty for allegedly failing to inform employees that investing in Lucent stock was imprudent. The lawsuit also alleges that Lucent executives knew the company's business was deteriorating, but continued to encourage participants and beneficiaries to make and maintain substantial investments in company stock. The case is currently pending the in the courts. SEC had not taken any enforcement actions as of August 1, 2002.

Appendix III: SEC's Application of the Securities Laws to Retirement Plans

The federal securities laws regulate the securities markets, the companies issuing securities, and market participants. The securities laws can relate to employee benefit plans in several ways. The interests of employees in the plan itself can be securities, or the plan may invest in instruments that are securities, such as stocks, bonds or interests in mutual funds. Finally, the plan may have investments in collective investment vehicles such as interests in pooled investment funds, bank common and collective trust funds, or insurance company pooled separate accounts.

In most cases, participation interests in pension and profit-sharing plans[1] are not required to register under the Securities Act of 1933 (1933 act). Registration is not required unless participation in the plan is voluntary and employee contributions can be used to purchase employer securities. Thus where a plan includes a 401(k) arrangement and employees can choose to invest in employer securities through voluntary salary reductions or deferrals, participation interests will be securities. Pension and profit-sharing plans that are required to register are permitted by SEC to use an abbreviated registration form and may use various documents, including a Summary Plan Description[2] as the prospectus deliverable to employees.

The company securities offered to employees through such a voluntary and contributory employee benefit plan must be registered under the 1933 act, unless an exemption is available. These offerings qualify for an abbreviated registration statement. Interests of plans in collective investment vehicles are also securities, but may be exempt from registration.

[1]"Pension" and "profit sharing" plans are generally qualified under §401(a) of the Internal Revenue Code, and receive favorable tax treatment. Qualified plans must satisfy coverage, participation, vesting, and benefit accrual standards that are intended to ensure that plans are established for the exclusive benefit of employees and prevent discrimination in favor of highly compensated individuals. A pension plan is established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. 26 C.F.R. §1.401-1(b)(1)(i). A profit-sharing plan is a plan established by an employer to provide for participation in profits by employees pursuant to a definite formula for allocating the contributions and distributing accumulated funds. 26 C.F.R. §1.401-1(b)(1)(ii). A profit-sharing plan is a defined contribution plan because the employer's contribution is set at a percentage of profits.

[2]29 U.S.C. §1021(a) requires the administrator of an ERISA plan to furnish each plan participant a summary plan description.

Registration Requirements Under the Securities Act and the Exchange Act

The 1933 act requires the registration with the Securities and Exchange Commission (SEC) of all offers and sales of securities, unless an exemption from registration is available. The registration regime is based on the premise that investors are protected if all relevant features of the securities being offered are fully and fairly disclosed. Full disclosure is believed to provide investors with sufficient opportunity to evaluate the merits of an investment. A registration statement that meets the 1933 act's disclosure requirements must be filed, unless one of the exemptions under section 3 or 4 of the 1933 act is available. The 1933 act also prohibits the use of fraud or misrepresentation in the offer or sale of a security, whether or not registration is required.

Section 2(a)(1) of the 1933 act contains a broad definition of security, which includes any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest, or participation interest in an investment contract.[3]

The Securities Exchange Act of 1934 (Exchange Act) also imposes registration and reporting requirements upon issuers of certain securities. These requirements keep shareholders and markets informed about the issuer. Section 12(a) of the Exchange Act requires that all securities traded on a national exchange be registered with the SEC.[4] The Exchange Act also requires an issuer to register if it has a class of equity securities held by more than 500 shareholders of record and more than $10 million in total assets.[5] An issuer with a class of registered securities must file periodic reports, including quarterly and annual reports.

[3] 17 U.S.C. § 77b(a)(1).

[4] 15 U.S.C. § 78*l*(a).

[5] 15 U.S.C. §78*l*(g)(1); 17 C.F.R. §240.12g-1.

The U.S. Supreme Court Has Determined That an Employee's Interest in an Involuntary, Noncontributory Retirement Plan Is Not a Security

With respect to the definition of security, the Supreme Court in *SEC v. W.J. Howey Co*. determined that "an investment contract for the purposes of the 1933 act means a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of a promoter or a third party."[6]

In *International Brotherhood of Teamsters v. Daniel*,[7] the Supreme Court found that an interest in a compulsory (all employees automatically participate), noncontributory (the employer makes all the contributions) defined benefit employee pension plan is not a security under the 1933 act's definition. In determining that the interest in the plan did not meet the commonly understood definition of an investment contract, the Court focused on the factors set out in the *Howey* test. First, the Court found that an employee who participates in a noncontributory, compulsory pension plan makes no payment into the pension plan, and the employer's payments into the plan do not relate to the individual benefit received by employees. Therefore, the investment portion of the *Howey* test is not satisfied in the case of a defined benefit plan. In addition, the Court found that because a major part of the retirement benefits were to be derived from the employer's contributions, rather than from the efforts of the plan's managers in investing the income, the plan did not have sufficient profit aspects to fall within the test for an investment contract in *Howey*.

The Court also pointed out that the fact that ERISA comprehensively governs the use and terms of employee pension plans severely undercuts all arguments for extending the securities laws to noncontributory, compulsory pension plans. The Court explained that ERISA regulates the substantive terms of pension plans, setting standards for plan funding and limits on the eligibility requirements an employee must meet as well requirements for disclosure of specified information in a specified manner.

[6]328 U.S. 293, 298-99 (1946).

[7]439 U.S. 551(1979).

SEC's Position That Interests in Voluntary Contributory Plans Are Securities and Must Be Registered if Employee Funds Can Be Used to Purchase Employer Stock Is Reiterated in Interpretive Releases

In 1941, the SEC first stated its view that employee interests in pension and profit sharing plans generally are securities, but did not require registration of interests in the plans unless the plan provided for purchase of the employer's stock.[8] In SEC's view, the burden of preparing a registration statement in connection with a pension plan could result in many employers not sponsoring pension plans. However, a registration requirement is justified if employer stock can be purchased, because the employer has a direct financial interest in the solicitation of employees' contributions. This conclusion was based on the view that where employer stock is among the investment options, "it is not unfair to make the employer assume the same burdens which corporations typically assume when they go to the public for financing." According to the Supreme Court's opinion in the *Daniel* case, after 1941, SEC made no further efforts to register plan securities other than voluntary, contributory plans where the employees' contributions were invested in the employer's securities.

Subsequent to the *Daniel* decision, the SEC issued two major interpretive releases,[9] the first of which set forth views on when a participation interest in a pension plan is an investment contract and thus a security. Release No. 6188, dated February 1, 1980, reiterated the SEC's view that, while employee interests in pension plans generally are securities, employee interests should be registered only when the plan is both voluntary and contributory and may invest in stock of the employer an amount greater than that paid into the plan by the employer. The release defines a "voluntary" plan as one in which employees may elect whether or not to participate, and a "contributory" plan as one in which employees make direct payments, usually in the form of cash or payroll deductions.

This administrative practice is based on the SEC's opinion that (1) registration serves no purpose where a plan is involuntary, since in that situation the participant is not permitted to make an investment decision, and (2) the costs of registration are a significant burden to an employer and should be imposed only where the employer has a direct financial interest in soliciting voluntary employee contributions.

[8]Opinion of Assistant General Counsel, CCH Fed. Sec. L. Rep. [1941-1944 Transfer Binder], para. 75,195.

[9]An interpretive release sets forth the views of the SEC or its staff on questions of current concern, without stating them in the form of legal requirements. They are general public statements of policy.

The 1980 release found that voluntary, contributory plans where an employee is permitted to invest in employer securities met the four parts of the *Howey* test defining an investment contract. First, the payment of cash or its equivalent by an employee satisfies the "investment" requirement. Second, the "common enterprise" requirement is met where the interests of employees in the plan are "separable" and possess "substantially the characteristics of a security." In both defined contribution and defined benefit plans, there is a separate account maintained for each participant to the extent of each person's contribution to the plan. Third, the "expectation of profits" requirement is met when the employee voluntarily contributes his or her own funds to the plan and can expect that the funds will generate profits through the efforts of the plan managers. In the *Daniel* case, the Court suggested that unless a defined benefit plan has a substantial dependence on earnings, as well as vesting requirements that are not excessively difficult to satisfy, there might be no expectation of profits. The 1980 release stated, however, that a voluntary, contributory defined benefit plan could meet the expectation of profits test because it may depend on earnings to pay promised benefits and because the vesting requirements under ERISA are much less strict than the requirement that was present in the *Daniel* case. Finally, the 1980 release stated that the "from the efforts of others" test was easily satisfied because the earnings generated by a plan would result from the efforts of the plan managers.

SEC's analysis concluded that the interests of employees in voluntary, contributory pension plans are securities within the meaning of the 1933 act. The staff also concluded that the interests are offered and sold to employees within the meaning of the 1933 act. Consequently, the interests are subject to registration requirements unless one of the exemptions from registration applies. Antifraud laws apply to all sales of securities.

Most Types of Pension Plans Are Exempt from Registration under Section 3(a)(2) of the 1933 Act

Section 3 of the 1933 act exempts various types of securities from the registration requirements, generally based on the nature of the issuer and the terms of the security. The statutory exemptions apply to the 1933 act's registration requirements, but do not apply to prevent potential liability under the antifraud provisions.

Section 3(a)(2) of the 1933 act exempts collective funding vehicles maintained by banks and insurance companies for employee benefit plans and the interests of employees in qualified plans, unless any employee funds can be used to purchase employer securities.[10] In addition, if the plan does not restrict the plan's overall investment in employer securities so that it cannot exceed the employer's contribution, the exemption is not available, and the interests offered by the plan must be registered.[11] Under the SEC's analysis, registration will generally be required in connection with any plan that permits contributions from participants and permits all or any portion of these contributions to be applied to the purchase of employer stock. The SEC's view that the 3(a)(2) exemption extends to pension plans is based on its reading of the legislative history of the provisions and its view that the section should be given a broad interpretation so as to exempt most plans.

On January 15, 1981, the SEC issued Release No. 33-6281, an interpretive release providing further guidance on the application of the 1933 act to employee benefit plans. In the 1981 release, the staff expanded on the definition of a voluntary, contributory plan, explaining that the determination of whether a plan is voluntary and contributory depends solely on whether participating employees can decide at some point whether or not to contribute their own funds to the plan. The release also discussed the amendments to the section 3(a)(2) exemptions made by the Small Business Investment Incentive Act of 1980. The 1980 amendments broadened the scope of the exemption by including certain insurance contracts and governmental plans within its coverage. In addition, the amendments make clear that any security arising out of a contract with an insurance company will be exempt under section 3(a)(2) in connection with a plan specified in the section.

In the 1981 release, the staff also discussed cash or deferred arrangements qualifying under section 401(k) of the Internal Revenue Code. Arrangements considered in the 1981 release allowed employees to elect to receive immediate payment of the employer's plan contribution or to defer receipt and have it invested in a plan where it will accumulate for

[10]In the *Daniel* decision, the Supreme Court read the 3(a)(2) exemption to refer only to the plan's interest in the investment vehicle. SEC's view that the exemption also applies to interests of participants in the plans themselves is based on its reading of the exemption's legislative history and the practical consideration that many plans would have no exemption without a broad interpretation.

[11]Comdial Corporation, SEC No-Action Letter, available May 28, 1984. A "no action letter" is an SEC staff response to private requests for an indication that certain contemplated transactions will not trigger SEC enforcement action.

later repayment. The staff determined that these arrangements are not contributory on the part of employees because they did not involve out-of-pocket investments by employees of their own funds in employer stock. Instead, the plans are funded by employer contribution.

However, subsequent to the 1981 release, the Treasury Department issued rules[12] under section 401(k) that allowed plans to provide for pre-tax employee contributions through salary reduction. In a salary reduction plan, the employee elects to reduce his compensation and have the amount contributed to a plan. This type of salary reduction is considered to be an out-of-pocket contribution into the plan. Because such a plan is voluntary and contributory, plan interests would be securities. Registration of 401(k) plan interests in a salary reduction plan would be required if employee contributions are permitted to be invested in employer stock.[13]

Other Exemptions from Securities Act Registration

Other Securities Act exemptions may apply to offers and sales of employer securities. In 1988, SEC adopted Rule 701 to exempt from 1933 act registration employee plans of employers that are not subject to the Exchange Act's periodic reporting requirements. Rule 701 is available to a number of types of employee benefit plans.[14] During a 12-month period, an offering may be exempt for an amount up to the greatest of $1 million, 15 percent of the total assets of the issuer, or 15 percent of the outstanding amount of the class of securities being offered and sold in reliance on section 701. Securities acquired under a Rule 701 offering are treated as restricted securities and may not be resold unless the 1933 act's registration requirements are complied with or unless another exemption applies.

[12]Certain Cash or Deferred Arrangements Under Employee Plans, 46 F.R. 55544, (Nov.10, 1981). A 401(k) feature can be appended to a qualified plan. The Treasury regulations refer to 401(k) features as "qualified cash or deferred arrangements." The cash or deferred arrangement can be in the form of a salary reduction agreement between an employee and the employer under which a contribution will be made only if the employee elects to reduce his compensation or to forgo an increase in his compensation. 26 C.F.R. 1.401 (k)-1(a)(3)(i).

[13]Diasonics, Inc., SEC No-Action Letter, available December 29, 1982.

[14]17 C.F.R. §230.701. The Rule 701 exemption applies to purchase plans, option plans, bonus plans, stock appreciation rights, profit sharing, thrift, incentive, or similar plans.

Private and limited offerings also are exempt whether or not the company is subject to Exchange Act reporting. Under Section 3(b) of the 1933 act[15] SEC may adopt regulations exempting issuers in the amount of $5 million or less. Under section 3(a)(11), "intrastate" offerings are exempt from registration where all aspects of the offering are within the confines of one state and are purely local in nature.[16]

Section 4(2)[17] exempts transactions by an issuer not involving any public offering. This exemption applies to offerings to sophisticated institutional and individual investors who do not need the protections of federal registration. In *SEC v. Ralston Purina Co.*,[18] the Supreme Court determined that an offering to employees was not necessarily exempt as not involving a public offering. Ralston Purina made its stock available to all employees regardless of their connection with the company or knowledge of the business. Citing the design of the 1933 act to protect investors by promoting full disclosure of information necessary to informed investment decisions, the Court found that the employees were a class of persons that needed the protection offered by registration because they were not able to fend for themselves in connection with the transaction.

Registration Requirements That Apply to ESOPs

An ESOP is a defined contribution plan that invests primarily in employer securities and usually distributes the securities upon the employee's retirement. Under SEC's analysis, an employee's interest in a voluntary, contributory ESOP is a security. In *Uselton v. Commercial Lovelace Motor Freight*[19] the Tenth Circuit held that an interest in a contributory and voluntary employee stock ownership plan was a security and that ERISA did not provide sufficient protection to displace the application of the federal securities laws. However, an interest in a mandatory stock

[15] 15 U.S.C. §77c(b).

[16] 15 U.S.C. §77c(a)(11).

[17] 15 U.S.C. §77d(2).

[18] 346 U.S. 119 (1953). In more recent cases, the ability to fend for oneself has been interpreted to mean that the persons to whom the securities are offered must be "sufficiently sophisticated to demand and understand the information that is available to them." Thomas Lee Hazen, 1 *Treatise on the Law of Securities Regulation* 406 (4th ed. 2002).

[19] 940 F. 2d 564 (10th Cir. 1991).

ownership plan completely funded by the employer was held not to be a security in *Matassarin v. Lynch.*[20]

A 1992 Study Recommends Disclosure to Plan Participants Who Make Their Own Investments in Pension Plans

In May 1992, the SEC's Division of Investment Management issued a study entitled, "*Protecting Investors: A Half Century of Investment Company Regulation.*" The study proposed that all pooled investment vehicles for participant-directed defined contribution plans be required to deliver prospectuses for the underlying investment vehicles to plan participants. The study reviewed the legislative history of the 1970 amendments to Section 3(a)(2) of the 1933 act and found that the basis for the exemption was concerns expressed by both the banking and insurance industries that the lack of a clear exemption under the securities laws for pooled investment vehicles might expose banks and insurance companies to civil liabilities. Congress exempted these pooled investment vehicles, in part, because they were subject to oversight by bank and insurance regulators. The interests issued by the pooled investment vehicles in question were still subject to the anti-fraud provisions of the 1933 act, notwithstanding the amendments. In addition, Congress assumed that the person making investment decisions for a plan (the sponsoring employer or a professional investment manager) was a sophisticated investor able to fend for itself with the application of only the 1933 act's antifraud provisions. The study highlighted, however, that since the passage of the 1970 amendments, the character of employee benefit plans has shifted from defined benefit plans, in which the plan sponsor bears the investment risk, to participant-directed defined contribution plans, in which the plan participant bears the investment risk.

Finding that the information received by plan participants was far less than the information received by investors who invest directly in securities issued by investment companies and other issuers, the Division of Investment Management expressed its view that disclosure to these plan participants should be improved. It recommended that the SEC send to Congress legislation that would: (i) remove the current exemption from registration in Section 3(a)(2) for interests in pooled investment vehicles consisting of assets of participant-directed defined contribution plans; and (ii) require delivery of the prospectuses and other disclosure documents of the pooled investment vehicles (other than mutual funds) to all plan participants.

[20] 174 F. 3d 549 (5th Cir. 1999).

Subsequent to the issuance of the study, the DOL issued voluntary rules under Section 404(c) of ERISA that provide plan fiduciaries with a safe harbor from liability under certain conditions when plan participants exercise control over the assets in their individual accounts. One of the rule's specific guidelines allowing fiduciaries of participant-directed plans potentially to avoid fiduciary liability is that plan participants who invest in securities that are subject to the 1933 act receive at or about the time of a participant's initial investment in the securities a copy of the issuer's most recent prospectus.[21] In general, the guidelines obligate the plan sponsor to provide or make available to plan participants sufficient information so that they may make informed investment decisions. While the disclosures required by the 404(c) rules generally make more information available to plan participants by encouraging plan sponsors to provide or make available more information about the underlying investment options offered by the plan, the view of the Division of Investment Management is that plan participants have a continuing need for information in order to evaluate their investments, and decide whether to maintain or reallocate those investments. Accordingly, the approach of the Division of Investment Management would go farther by requiring delivery to plan participants of a current mutual fund prospectus on a continuing basis as well as delivery of annual and semi-annual shareholder reports by mutual funds and other underlying investment vehicles.[22]

Interests in Employee Benefit Plans That Are Securities May Be Registered Using Form S-8

If Securities Act registration of employee's interests in an employee benefit plan is required, then Form S-8 is generally the appropriate form for use. Form S-8 is also used for registering employer securities issued in connection with employee benefit plans. Form S-8 is available only if the employer is subject to the Exchange Act reporting requirements. Form S-8 utilizes an abbreviated disclosure format that reflects the SEC's distinction between offerings made to employees primarily for compensatory and incentive purposes and offerings made by registrants for capital-raising purposes. The SEC has exercised its rule-making authority to reduce the

[21]Final Regulations Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans) 29 C.F.R. §2550.404c-1.

[22]Mutual funds must send semiannual reports to their shareholders. These reports are required to include information concerning the investments' aggregate value, a listing of amounts and values of securities owned; an itemized income statement; a statement of the remuneration paid to all directors and members of an advisory board. In addition, SEC applies certain requirements to the mutual fund prospectus, including a requirement that mutual funds provide shareholders with after-tax performance information.

costs and burdens incident to registration of employee benefit plan securities.

The SEC substantially revised Form S-8 in 1990.[23] The revisions included making the registration statements effective automatically upon filing.[24] A prospectus is customarily part of a registration statement, and contains the basic business and financial information about the issuer with respect to a particular securities offering. Investors use the prospectus to appraise the merits of the offering and make educated investment decisions. However, Form S-8 is the only registration form that does not require the registrant to prepare and file with the SEC a separate document to satisfy the prospectus delivery requirements under the federal securities laws. Instead, Form S-8 requires only that certain specified current plan information be delivered to employees in a timely fashion. No particular legal format is specified. The information could be provided in one or more documents prepared in the ordinary course of employee communications. Registrants can deliver materials required to be prepared for plan participants by ERISA and could deliver the Summary Plan Description as a basic disclosure document.[25] The issuer must also supply participants with a written statement that certain documents are incorporated by reference into the prospectus, and advise the participant of their availability on request. These documents include the Exchange Act filings containing issuer information and financial statements.

At the same time, the SEC also permitted 1933 act registration of an indeterminate amount of plan interests; simplified the calculation of filing fees; and amended Form 11-K, the Exchange Act annual report for employee benefit plans, to require only plan financial statements.

[23]See Release No. 33-6867 (July 13, 1990).

[24]A registration statement is generally effective twenty days after the later of the filing of the initial registration statement or the most recent amendment to the registration statement.

[25]Release No. 33-6281, pt. IV (C) outlines staff interpretive positions regarding the incorporation by reference in a Form S-8 prospectus of plan information contained in an ERISA summary plan description.

Registration and Reporting Requirements Under the Securities Exchange Act

Section 12(g) of the Exchange Act[26] requires that registration statements be filed by issuers that have both a class of equity securities having more than 500 shareholders of record and more than $10 million in total assets. Companies must register their stock and satisfy all reporting requirements of the Exchange Act if these criteria are met. For purposes of determining the number of record holders of a class of securities, an employee benefit plan holding employer securities is counted as only one record holder.[27] If the employer's securities must be registered under the Exchange Act, the employer will incur periodic reporting obligations, including annual and quarterly reports, as well as filings reporting certain specified material changes in the issuer's condition or operations.

If the interests of the plan participants are considered securities, the plan may be subject to registration under the Exchange Act. However, interests in qualified plans are exempt from registration under the Exchange Act because Rule 12h-1 exempts from registration all interests in employee stock bonus, stock purchase, pension, profit sharing, retirement, incentive, or similar plans that are not transferable by the employee.

Employee plans that are owners of securities that are registered under the Exchange Act may be subject to different Exchange Act reporting requirements. A plan that becomes the beneficial owner of more than 5 percent of a class of equity securities registered under the Exchange Act must file a report with the SEC on Schedule 13G.[28] When a plan acquires stock for the benefit of officers and directors of an employer, the officers and directors are required to follow the Section 16 reporting requirements. Transactions of these company insiders may be subject to the short swing profit recovery rules if the insider switches into or out of an employer stock fund or takes a cash distribution from the fund in a "discretionary

[26]15 U.S.C. §78*l*(g).

[27]Rule 12g5-1(a)(2). Of course, the number of beneficial owners (plan participants) will be far more numerous.

[28]The reporting requirement is intended to notify SEC of a potential change in control, however, because employee plans are not the beneficial owners of securities, they may qualify for an abbreviated reporting requirement. Rule 13d-1(b)(1)(ii)(F) permits employee benefit plans subject to the provisions of ERISA to file the short-form 13G if the securities are acquired in the ordinary course of business and not with the purpose or effect of changing the control of the issuer. Beneficial ownership is defined as the power to vote and/or exercise investment power over the security. 17 C.F.R. §240.13d-3. Defined contribution plans generally pass through voting rights.

transaction" if the transaction occurs less than 6 months after any previous "opposite way" transaction.[29]

Anti-fraud Rules Applicable to Employee Benefit Plans

Section 10(b) of the Exchange Act[30] prohibits the use of any manipulative or deceptive practices in connection with the purchase or sale of a security. Rule 10b-5[31] makes it unlawful for any person to make a material misstatement or omission in connection with the purchase or sale of a security. Section 10(b) and Rule 10b-5 will apply to material misrepresentations and omissions made to plan participants in connection with plan transactions that involve securities. Violations of Rule 10b-5 can be asserted by plan participants if the plan is making material misstatements or omissions in the materials the plan provides to participants in connection with a sale of company stock to plan participants. Rule 10b-5 can also apply to the purchase or sale of a security on the basis of material nonpublic information about that security in breach of a duty of trust or confidence.[32] This could apply where an officer or director buys or sells shares through a plan and was aware of material non-public information when the transaction took place.

Section 17(a) of the 1933 act[33] prohibits fraud, material misstatements and omissions of fact in connection with the sale of securities. Section 17(a) applies whether the sale is registered or exempted from the 1933 act registration. Neither section 17(a) nor Exchange Act Rule 10b-5 imposes an affirmative duty to disclose, but can impose liability for omissions that make statements materially misleading.

[29]Section 16(b) of the Exchange Act requires insiders to disgorge to the company any profit realized from a short swing transaction. A discretionary transaction is generally at the volition of the participant.

[30]15 U.S.C. §78j(b).

[31]17 C.F.R. §240.10b-5.

[32]Rule 10b5-1 defines "on the basis of" to mean the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale. However, Rule 10b5-1(c) establishes conditions whereby a person's purchase or sale is not "on the basis of" material non-public information if another person is instructed to make the purchase or sale for the instructing person's account and at the time of the original instruction the instructor was not aware of the material nonpublic information. This could include a situation where a person enrolls in a plan and agrees to have a payroll deduction invested in employer securities.

[33]15 U.S.C. §77q(a).

Conclusion

Historically, SEC has taken the position that interests in employee benefit plans can be securities for purposes of the 1933 act requirements to register offers and sales of securities. However, SEC has taken the view that offers and sales of plan interests are not subject to registration unless the plan allows employee funds to be used to purchase employer stock. In 1979, the U.S. Supreme Court decided that interests in plans where employees had no choice concerning participation and where employees did not make contributions to the plan were not securities and did not have to be registered. In the wake of the Supreme Court's decision, SEC issued two releases indicating that only voluntary, contributory plans where employee funds could be invested in employer stock would be required to file registration statements.

SEC's position is based, in part, on its interpretation of the registration exemptions contained in section 3(a)(2) of the 1933 act. In SEC's view, in light of the *Daniel* opinion, the 3(a)(2) exemption applies to all qualified employee plans, except those that allow the use of employee funds to purchase employer stock. While SEC's 1980 release indicated that it did not favor a broader registration requirement, this release was issued when the prevalent plan was a defined benefit plan. SEC has not reconsidered its position as expressed in this 1980 release and believes it is bound by the Supreme Court's decision in *Daniel*.

Appendix IV: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

AUG 23 2002

Ms. Barbara D. Bovbjerg
Director, Education, Workforce,
and Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Bovbjerg:

We have reviewed the General Accounting Office's (GAO) draft report entitled "Private Pensions: Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification" (GAO-02-943). This letter provides some general comments and our response to the draft report's recommendation to the Secretary of Labor.

We agree with GAO's conclusion that additional investment education is necessary. The Department recognizes that in an environment where workers are becoming increasingly responsible for their own retirement security through the direction of investments in defined contribution plans (such as 401(k)-type plans), access to investment education and advice is of critical importance. The President proposed such a change to strengthen the retirement security of workers and their families, as part of his pension reform package that was passed by the House of Representatives with bipartisan support in H.R. 3762. While there are a number of bills currently under consideration by the Congress to address these issues, H.R. 3762 would, among other things, require individual account plans to furnish quarterly benefit statements that would not only inform participants and beneficiaries of the value of the investments allocated to their individual accounts, but also explain the importance of a well-balanced and diversified investment portfolio, as well as the risks of investing a significant portion of one's investment portfolio in one entity, such as employer securities. H.R. 3762 also would increase worker access to affordable, quality investment advice by clarifying the limited liability of employers when selecting investment advice providers and creating, through a statutory exemption from the prohibited transaction provisions, a level-playing field among investment advice providers.

The draft report recommends that "the Secretary of Labor should direct the Assistant Secretary, Pension and Welfare Benefits Administration, to require plan sponsors to provide participants in defined contribution plans with an investment education notice that includes information on the risks of certain investments such as employer securities and the benefits of diversification." However, the Secretary does not currently have the legal authority under ERISA to require all sponsors of defined contribution plans to provide either investment education or investment advice. Therefore, we suggest the GAO consider revising its recommendation to conclude that Congress should take appropriate action to address this matter.

Finally, the report presents a number of statistics illustrating the investment of ERISA pension plan assets in employer securities. The Department would like to highlight certain contextual issues that merit consideration when interpreting these statistics. Most of the statistics presented in the report pertain to plans sponsored by Fortune 1000 companies. These large companies are likely on average to invest a larger proportion of 401(k) assets in employer securities than are smaller companies. They are also more likely to sponsor additional plans, including defined benefit plans, which are not heavily invested in employer securities. An individual participant's risk from investments in employer securities is best understood in the context of his or her combined retirement assets, including both defined benefit and contribution pensions, as well as other retirement savings.

The Department of Labor appreciates having had the opportunity to comment on this draft report.

Sincerely,

Ann L. Combs

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