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## *From Fiduciary to Facilitator: Employers and Defined Contribution Plans*

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Although it represents a striking success in some ways, the private pension system suffers from at least two major flaws: it is too complicated, and it covers too few workers. A vigorous debate on whether the best approach to fixing these problems is to expand or contract the role of the government in the pension system is exemplified by the papers in this volume by Groom and Shoven and by Halperin and Munnell.

We take a different—and complementary—approach to pension reform. Specifically, we focus on proposals that would alter the role of the *employer* in the provision of pensions. In the current pension system, employers are expected or required to perform many roles, from the simplest facilitation of saving—through payroll deductions and wiring the funds to an account, for example—to extremely complicated regulatory tests involving funding rules, contribution limits, nondiscrimination standards, and the maintenance of fiduciary standards. There appears to be no logical reason why employers should be saddled with so many responsibilities, especially when it comes to defined contribution plans, since similar products offered by the financial services industry are free of such rules. In addition, the burdens placed on employers, particularly fiduciary standards, are inconsistent across types of plans.

Our approach would be to encourage firms to do more by requiring them to do less. In particular, we would maintain and emphasize the role of the employer in facilitating saving behavior by workers. This role includes providing

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payroll deductions and simplified enrollment; making or matching contributions; and serving as an intermediary between employees and the financial services industry. But we would also move the defined contribution system more toward a system of individual accounts held, managed, and administered by the financial services industry. Under this approach, tax law would continue to encourage employers to offer plans and make contributions, while the financial services industry would provide those other services (such as providing investment alternatives and education, along with tax reporting and participant record-keeping and communication) that represent its comparative advantage. Overall, this approach would provide the pension system with an allocation of functions and responsibilities more appropriate for defined contribution plans than that now found in the Employee Retirement Income Security Act (ERISA) of 1974. Along the way, we believe that the simplification could be done in a way that would only increase the incentives to save, partly by reducing administrative costs and risks to employers.

### **Employers' Responsibilities before ERISA**

Pension regulations were modest in scope before ERISA.<sup>1</sup> The central requirement was that pension plans had to satisfy legal rules to qualify for special tax treatment. Most of the rules governing contributions aimed to ensure that some of the tax benefits flowed to rank-and-file employees. Other provisions described when and how distributions of benefits would be taxed. Few rules described how contributions were to be invested because state—not federal—law then set the standards for plan investments. Assets had to be held in trust apart from the plan sponsor's other assets and for the "exclusive benefit of employees and their beneficiaries" until all liabilities were satisfied, but there were no explicit standards for the investment of assets, and the regulations gave trustees wide discretion. The rules were more explicit on how trust assets should *not* be invested, creating special rules for employer securities and prohibitions on conflicts of interest or self-dealing.

Penalties were largely tax-related and imposed on the plan. When violations occurred, the plan was immediately disqualified, the trust lost its tax-exempt status, and participants were taxed on their vested benefits. It seems extraordinary today, but participants had no effective legal means to protect their assets from harmful actions by plan officials or to obtain redress from those responsible for injuring the plan, even though they alone bore the consequences of plan disqualification.<sup>2</sup>

1. Employers responsibilities were set out in Internal Revenue Code §§ 401(a)(1) – (7) and supporting regulations in effect before ERISA.

2. Before enactment of ERISA, participants had no private right of action to contest a plan disqualification and even today have only such rights as are available through ERISA. Internal Revenue

## Employers' Responsibilities under ERISA

The passage of ERISA in 1974 was inspired in part by the bankruptcy of the Studebaker Company in 1963 whose pension plan also failed. The purpose of ERISA was to secure the pension promise by adding new protections for participants and by ensuring that plans had assets sufficient to pay promised benefits. In aiming to meet these goals, ERISA fundamentally altered the organization and administration of pension plans and created a comprehensive legal and regulatory structure.

New provisions considerably strengthened tax rules for coverage, participation, funding, and benefit accrual. Participants have legal rights to information about the plan, and plan officials who do not provide such information face civil and criminal penalties.

Of particular interest for this paper, ERISA imposed stringent fiduciary standards on plan investments and fiduciary duties on those who performed them. In the usual contractual relationship, each party makes a series of promises to the other and is liable for the monetary value of a promise it breaches. In a fiduciary relationship, however, one party assumes responsibility for the affairs of others and must act on their behalf and in their best interest. Fiduciaries must conduct themselves with the utmost good faith and fidelity and are personally liable if they breach their duties. Liability is measured by how much it would cost to make the beneficiaries "whole," that is, to place them in the position they would otherwise have been if no breach had occurred. A fiduciary breach often results in much greater financial liability than a contractual breach.

The standards incorporated into ERISA require fiduciaries to act prudently as investors from both a procedural and substantive point of view.<sup>3</sup> Fiduciaries are judged not so much on the outcome of a particular investment decision but on whether they initially used appropriate methods to evaluate its merits.<sup>4</sup> ERISA also imposes an "exclusive benefit" standard, requiring plan fiduciaries to

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Code § 7476 permits a plan participant, in certain cases, to ask the Tax Court to intervene when the continuing qualification of a plan has become the subject of an actual controversy with the Internal Revenue Service. As might be expected, few participants avail themselves of this right.

3. ERISA § 404(a)(1)(B) requires a fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters would use in the conduct of a enterprise of a like character and with like aims."

4. The regulations under ERISA § 404(a) require a fiduciary to determine that a particular investment decision, as part of the portfolio, is "reasonably designed . . . to further the purposes of the plan by taking into consideration the risk of loss and the opportunity for gain associated with the investment" choice. A fiduciary, in making an investment decision, must consider the following factors: the composition of the portfolio with regard to diversification; the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and the projected return of the portfolio relative to the funding objectives of the plan. See DOL Regulation § 2550.404a-1(b)(2).

consider only the interests of participants when making investment decisions. As one court has expressed it, this standard requires fiduciaries to act with “an eye single” to the interests of participants when dealing with plan assets.<sup>5</sup> Fiduciaries must also diversify plan investments to minimize the risk of large losses and avoid specified prohibited transactions that involve conflicts of interest and self-dealing.

In the normal case, the plan trustee is the primary investment fiduciary because ERISA assigns plan trustees the “exclusive authority and discretion to manage and control the assets of the plan.” There are three permissible exceptions. First, a named fiduciary can retain investment authority, in which case the trustees are merely conduit or “directed” trustees with no fiduciary responsibility.<sup>6</sup> Second, a named fiduciary can appoint an investment manager, in which case the trustee is no longer a fiduciary with respect to those assets. The named fiduciary, however, retains responsibility for all such appointments and must monitor the performance of the investment manager carefully. Third, there is a special exception for self-directed plans—commonly known as 404(c) plans after the authorizing section of the legal code—where participants choose their own investments. The exception states that “if a participant . . . exercises control over the assets in his account (as determined under regulations of the Secretary)—(A) such participant . . . shall not be deemed to be a fiduciary by reason of such exercise, and (B) no person who is otherwise a fiduciary shall be liable . . . for any loss, or by reason of any breach, which results from such participant’s . . . exercise of control.”

In a 404(c) plan, then, plan participants, not plan fiduciaries, are responsible for the outcome of their own investment decisions. Even in a 404(c) plan, though, a named fiduciary is ultimately responsible for the menu of investment choices available to participants. Fiduciaries are answerable to plan participants, the Department of Labor, and the courts for plan investment performance and face personal liability and financial penalties for misconduct. Being an ERISA fiduciary, particularly of plan assets, is very serious business. In most cases, fiduciary responsibility comes to rest ultimately on the company sponsoring the plan.

### The Role of the 404(c) Regulations

The new fiduciary duties imposed by ERISA did not result in significant litigation by disgruntled parties, for any of several reasons. Defined contribution plans were then mostly supplemental plans and represented a small share of the

5. *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).

6. Trustees, however, may only follow directions that are “proper,” made in accordance with the terms of the plan, and not contrary to ERISA. So trustees must perform at least some minimal form of review on the merits of the directions they receive if they wish to avoid the fiduciary label.

pension universe. The relatively few plans that were self-directed offered small numbers of investment options and permitted investment changes infrequently—some only annually. Many employers hired investment advisors to create unique investment pools for their plans that did not routinely provide information about their assets or value. So employees had little information about their investments and could not track investment performance easily.

In addition, while ERISA gave participants the right to sue, it included some features almost guaranteeing that litigation would be a last resort, if it were resorted to at all. For example, the typical ERISA claim—a claim for individual benefits involving only a small amount of money—is not attractive. A participant can win at most the benefit to which he or she is entitled.<sup>7</sup> ERISA does not permit punitive damages or damages for pain and suffering and effectively preempts state laws that do.<sup>8</sup> Attorneys' fees are rarely awarded, so a participant either pays for litigation out of pocket or through any recovery. As a result, few plan participants exercised their newly granted rights to challenge how their plans were managed.

Since then the landscape for self-directed plans has changed considerably. Defined contribution plans have expanded rapidly. Participants are more knowledgeable about their benefits. Employees have assumed a higher share of the responsibility for funding their own pensions through 401(k) and 401(k)-type plans. And increasingly participants have assumed responsibility for the investment performance of their plan accounts. The last fact is attributable largely to the issuance of final regulations for 404(c) plans in 1992.

As noted above, a 404(c) plan that permits participants to exercise investment control over their accounts relieves fiduciaries of some of their usual investment responsibilities. A fiduciary sued for a breach of duty can use this section of ERISA to argue that participants are alone responsible for any bad investment outcomes in their accounts. Before 1992 the status of self-directed plans as 404(c) plans was unclear. Once the regulations were issued, however, fiduciaries of self-directed plans could finally take some concrete steps to obtain 404(c) protection.

The regulations themselves seem straightforward. They contain three broad requirements.<sup>9</sup> Each plan seeking 404(c) status must provide

—*A broad range of investment alternatives.* A 404(c) plan must have at least three different investment alternatives that permit diversification of accounts to minimize the risk of large losses and afford participants a reasonable opportunity to materially affect the potential return and degree of risk in their portfolios.

7. ERISA § 502(a)(1).

8. ERISA § 514(a) provides that the provisions of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan," except those state laws that regulate insurance, banking or securities.

9. These regulations can be found at DOL Regulation § 2550.404(c)-1.

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—*Appropriate frequency of investment instructions.* Participants must be able to change their investment choices frequently enough to be appropriate for the volatility of each investment alternative and no less than once every three months.

—*Sufficient investment information.* A 404(c) plan must provide participants with sufficient information to make informed investment decisions, an explanation that plan fiduciaries are not responsible for participants' investment losses in a 404(c) plan, information about the objectives and risk/return characteristics of each alternative, procedures for choosing and changing investment choices, and descriptions of transaction fees or expenses charged to participants' accounts.

If a plan complies perfectly with the 404(c) regulations, then plan fiduciaries have effectively relieved themselves of liability for participants' investment choices and their outcomes. But plan fiduciaries remain subject to the general ERISA fiduciary requirements of prudent behavior and the exclusive benefit rule. In addition, the Department of Labor has warned that in a 404(c) plan "the plan fiduciary has a fiduciary obligation to prudently select . . . [the investment] vehicles as well as a residual fiduciary obligation to periodically evaluate the performance of such vehicles to determine, based on that evaluation whether the vehicles should continue to be available as participant investment options."<sup>10</sup>

Few investment professionals will assume liability associated with selecting a 404(c) plan's investment options. Those that do charge a premium. Even with investment professionals, a plan fiduciary—generally the plan sponsor—retains a duty to monitor their performance. So, inevitably, it is the plan sponsor—usually the employer—who bears ultimate responsibility for the investment options in a 404(c) plan, no matter who selects them.

The 404(c) regulations are significant not so much because they changed the law—they did not—but for the effect they had on plan design. The regulations are sensible, practical, and consistent with ERISA's fiduciary scheme. But their issuance sparked a rush by plan sponsors to add self-directed investment options to their defined contribution plans. By 1997 almost one-half of all profit-sharing plans and almost one-third of all money purchase plans—the most common defined contribution plans among corporate employers—described themselves as participant-directed plans.<sup>11</sup> Moreover, 404(c) plans account for 65 percent of the assets of profit-sharing plans and almost 70 percent of all active participants.

10. See the Preamble to DOL Regulation § 2550.404(c)-1.

11. These numbers are based on calculations of data provided by Judy Diamond Associates, Washington. These data include the Form 5500 filings of about 800,000 pension benefit plans for the 1997 plan year. These data do not include data from governmental plans and have minimal information on plans offered by nonprofit organizations. But the fiduciary rules of ERISA usually do not apply to these plans in any event. The figures provided were based upon a subset of profit-sharing and money purchase plans that had not terminated during the 1997 plan year. The term "active participants" means those participants who are currently employed or are terminated but still entitled to service credit under the plan if they are rehired.

Among money purchase plans, the comparable figures are about 40 percent and 30 percent, respectively.

Plan sponsors transferred investment control to plan participants largely in the expectation that the transfer would reduce their fiduciary exposure. Even though there was no obvious threat of large-scale litigation over plan investments, plan sponsors felt they had nothing to lose—and perhaps a lot to gain—by conforming their plans to the 404(c) regulations. They also found that, prompted by the popularity of 401(k) and 401(k)-type plans, participants expressed more interest in the performance of their accounts and more willingness to accept investment control. Participants in these plans typically feel strongly that their contributions are their funds, and they should be permitted to decide how they should be invested.

The mutual fund industry—for whom the 404(c) regulations were almost tailor-made—was also influential in persuading employers to shift responsibility for investment choice to employees. The industry already had the product—a vast array of investment funds—necessary to satisfy the broad range of alternatives requirement of the 404(c) regulations. It already had the technology—daily transfers, voice (and now Internet) initiated transactions—necessary to satisfy the frequency of investment instructions requirement. And it already had the disclosure material—prospectuses prepared under Securities and Exchange Commission (SEC) requirements—necessary to satisfy the sufficient investment information requirement. It also had a bundled product of investment options, record-keeping services, and prototype plans to offer just as employers were beginning to lessen their administrative burden through outsourcing. Most important, it held a very important trump card over its competitors: banks offering common and collective trust funds, and insurance companies offering separate accounts as investment options. The mutual fund industry alone had been granted a total exemption from the fiduciary liability provisions of ERISA when it was enacted.<sup>12</sup> Although mutual funds are subject to fiduciary standards under the securities laws, the same standards apply whether an investor is a private individual or a plan participant. The industry could therefore heavily promote the 404(c) regulations to expand its defined contribution business without assuming additional fiduciary liabilities. It took several years for banks and insurance companies to convert their traditional investment products into the technical legal form of a mutual fund and become competitive on this front.

The mutual fund industry utilized the 404(c) regulations as a marketing tool to employers, and they responded. Since the regulations were issued, the mutual

12. Mutual funds are technically known as investment companies registered under Investment Company Act of 1940. They are regulated by the Securities and Exchange Commission and their exemption from ERISA's fiduciary responsibility rules was apparently based on the theory that there was no need for duplicate federal regulation through the Department of Labor. See ERISA §§ 3(21)(B) and 401(b)(1) and the plan assets regulations under DOL Regulation § 2510.3-101.

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fund industry has rapidly increased its market share and the amount of assets under management. In 1992, for example, mutual funds held an 18 percent share in the defined contribution plan market with about \$184 billion in assets; by 2002, the comparable figures were a 45 percent share and \$1 trillion in assets. In 1992 they held a 15 percent share of the 401(k) asset market with about \$82 billion in assets; by 2002 that market had grown to \$1.5 trillion in assets, and the share held by mutual funds had tripled to 45 percent or about \$686 billion in assets.<sup>13</sup>

The irony is that as employers turned to the 404(c) regulations as insurance against litigation over plan investment performance—litigation that was not even on the horizon—they may have inadvertently created what they sought to avoid. The 404(c) regulations provide both the substance and the means for fiduciary litigation on a large scale. Class-action lawyers have recently discovered 404(c) plans as a source of potentially lucrative litigation, and 404(c) plans have all the ingredients they need: large numbers of similarly situated plaintiffs, identical causes of action, huge amounts of potential damages, and possible generous awards of attorneys' fees.

Even before the recent stock market crash, class-action lawyers sued several large employers for fiduciary violations related to the investment options offered in their plans, alleging that the options had been improperly chosen or supervised and seeking to have the accounts of thousands of plan participants made whole.<sup>14</sup> Cases arising from the stock market crash and the promotion of employee investment in company stock by companies such as Enron are now working their way through the judicial system. The ultimate legal disposition of these cases is still uncertain, and it is not clear how the law will develop. But they will provide a good test of the value of a 404(c) defense to fiduciary violations for employers. At the very least, 404(c) plans will likely result in the creation of something that ERISA has always lacked: a plaintiffs' bar. Courts will scrutinize the conduct of 404(c) plan fiduciaries where they are most vulnerable: the performance of the available investment alternatives; the size of the investments fees charged; the adequacy of the investment information provided; and the failure of fiduciaries to put the interest of plan participants first when selecting plan investments. The most predictable consequence of the 404(c) regulations is litigation. Sooner or later some plaintiffs will win a big case and some

13. Investment Company Institute (2000, 2003). The data include both non-ERISA and ERISA plans.

14. First Union Bank, for example, recently agreed to pay \$28 million to settle two well-publicized cases involving its fiduciary duties to select and monitor investment options in its 401(k) plans. Although these cases do not make new law, the settlement will certainly bring these types of issues to the attention of both employers and class-action lawyers (who will receive \$8 million from the settlement). A good discussion of the implications of the First Union cases can be found in Reish, Ashton, and Faucher (2001).

employer will pay large damages. When that happens, employers will recognize that a 404(c) plan is not a liability-free form of plan sponsorship. Their financial exposure may be so great they will rethink their alternatives but find very few. The trend to self-directed plans seems irreversible. Making investment decisions for participants will not be practicable and would just give plan sponsors more, not less, fiduciary exposure. Many will question whether they really want and can afford to be the involuntary insurer of their employees' investment choices. And many plan sponsors—particularly small employers—will probably decide they do not.

### Rethinking the Role of the Employer

This prospect alone is sufficient to motivate a reexamination of the role of the employer in providing pension plans, as opposed to merely contributing to or collecting employee deposits to retirement plans. Several additional factors also suggest that the role of employers in today's pension system is based on outdated and unproductive notions. In this section, we outline five factors that seem central to designing a better pension system.

*1. Employers play very significant and special roles in today's defined contribution plans.* For a variety of reasons, employers seem to be crucial to "saving" by employees. Many of the routine services they provide encourage saving by making it easy and convenient: payroll deductions, simplified enrollment, periodic reports, and investment education. There is much evidence that employees contribute much more when employers are involved than when similar tax incentives are offered merely at the individual level, as with Individual Retirement Accounts (IRAs). Employers may also add their own financial incentives to save through matching contributions. They also serve as an important intermediary between their employees and the financial services industry and thus simplify the investment process for their employees. These roles are important and often critical determinants of employee saving, but in performing them employers act more as a facilitator than a fiduciary.

*2. ERISA's fiduciary scheme suits defined benefit—but not defined contribution—plans.* Under a defined benefit plan, employers promise today to pay benefits many years in the future. If the plan has insufficient assets as the promised benefits mature, the obligation to make good any shortfall lies with the employer and ultimately, after ERISA, with the government-run insurance program.<sup>15</sup> It was logical to require the defined benefit plan sponsor to be the ultimate fiduciary under ERISA in order to compel it to keep the plan solvent and to keep its other promises. To protect taxpayer resources, it was also rational to

15. See ERISA §§ 4001 – 4402, which govern the Pension Benefit Guaranty Corporation and its program of plan termination insurance.

impose personal liability on plan officials and investment professionals and hold them accountable for mismanagement of these large pools of assets. The fiduciary structure created by ERISA has served defined benefit plan participants well.

But defined contribution plans are fundamentally different. The employer promises only to make a contribution from time to time. There is still a risk that employees will reach retirement and find no pension but not because the employer has defaulted on a promise to contribute. The employer fulfills that contractual promise, or both tax code and ERISA enforcement systems soon compel it to do so. The pension risk in defined contribution plans is that not enough dollars will be saved or the dollars saved will be poorly invested. In today's defined contribution world, that risk has largely been transferred from the employer to the employee anyway.

3. *Defined contribution plans today are like other financial services industry products. But employers remain responsible under ERISA.* Many employers today do not operate or manage their own defined contribution plans. The typical 404(c) plan is actually a bundle of services provided by an investment provider or through a strategic alliance of consulting firms and mutual fund families. The employer's unique contribution is to decide whether to make a contribution in a given year and to deduct employees' contributions from wages. The employer's primary role—and it is an extraordinarily important one—is to collect contributions (with employer contributions, most economists would still consider them to be close to a mandated contribution from employees because employees generally pay for their cost by reduced wages) out of total compensation, and then to serve as the conduit of contributions (its own and participants) to the investment provider. In addition to investment services, the provider in turn performs most other plan functions: accounting, record-keeping, discrimination testing, compliance, tax reporting, and disclosure. It also provides a “check-the-box” prototype plan. Participants communicate directly with the provider when they wish to choose or change their investment options.

Today, the employer remains liable even though third parties actually perform almost all plan functions. Standard legal documents usually provide that plan officials “direct” the activities of service providers, so they are not ERISA fiduciaries, who assume liability only for “gross” negligence. Many plan sponsors routinely sign such documents without knowing not only that they have not reduced their own fiduciary liability, but that they have also assumed liability for the actions of third parties over whom they have no control. As a result, while the employer's operational significance has decreased in today's defined contribution plan, its ERISA responsibilities have actually grown.

4. *The private pension system has no consistent rule about fiduciary liability for employers in self-directed plans.* If the true purpose for imposing fiduciary liability is to protect participants, it would seem logical to apply these standards to employers in a more consistent fashion. Simplified Employee Plans (SEPs), an

IRA-based defined contribution plan, are employer-sponsored and funded and are subject to ERISA, but participants' accounts are actually their own IRAs, and the participants bear investment responsibility for their own accounts. ERISA completely exempts from fiduciary liability governmental employers who sponsor similar types of self-directed plans. Employees of charitable and educational institutions contribute to tax-sheltered annuities that are also exempt from ERISA's fiduciary liability rules under the theory that the annuities are really not employer-sponsored or funded. But by that standard, some 401(k) plans are not truly employer-funded either because they only permit contributions by employees; nonetheless, employers are subject to ERISA fiduciary standards. Largely for historical reasons, for-profit employers consequently bear the greatest burden of fiduciary liability.

*5. Self-directed plans are evolving toward offering multiple funds and fund families in place of a fixed investment menu.* Few 404(c) plans today restrict themselves to the minimum three investment options required by the regulations. The financial services industry continues to create new funds and products, and employers continue to expand their plan menus. In 2001, 69.8 percent of plans offered ten or more fund options, compared with 61.5 percent of companies in 2000 and 51.2 percent in 1999.<sup>16</sup> Moreover, some plan sponsors are moving to a completely open-ended option. This format allows participants to buy and sell virtually any asset—any mutual fund or individual security—available through a stockbroker. The technology to service such accounts already exists, and the financial services industry is promoting them heavily. The advantage of an open-ended structure is that it represents one possible end run around the 404(c) fiduciary dilemma. It easily satisfies the basic requirements for the 404(c) regulations and provides enhanced protection for employers. In addition, it holds class action lawyers at bay. Because every participant has a unique portfolio and free choice of investments, claims for fiduciary breaches should be fewer in number, individual in nature, and smaller in size.

### A Model of Pension Reform

Based on the analysis above, we propose to simplify pension law to fit the defined contribution plan of today and tomorrow. This would involve the following key features.

—*Create separate individual accounts out of today's employer plan.* Like an IRA and most 403(b) tax-deferred annuities, defined contribution plans could be disaggregated into individual accounts—the equivalent of each participant's

16. These figures come from a synopsis of the 45th Annual Survey of Profit-Sharing and 401(k) Plans conducted by Profit Sharing/401k Council of America ([www.pzca.org/data/45th.html](http://www.pzca.org/data/45th.html)) [August 2003]).

individual account in today's employer plan—to receive all contributions and hold all investment options in which those contributions are invested. This approach would relieve employers from liability for the day-to-day responsibility for their employees' retirement assets, assets that are effectively held and managed by third-party administrators and investment professionals.

Dodging for the moment the different tax rules on contributions and withdrawals for different types of defined contribution plans, these accounts could be established by individuals, independent of their employment status, at participating financial institutions. Of course, employers might also serve as an intermediary and arrange for financial institutions to offer such plans to their employees, much like the arrangement today in most of the 403(b) world. Employers might also choose a single financial institution for an initial deposit of their own and their employees' contributions with employees having the right, as is true today under a SEP, to transfer those contributions to their provider of choice. Any number of different arrangements—to suit both employers who wish to assist their employees in their investment choices and those who do not—would be feasible. Of course, one result would be an increased ability for individuals to combine together multiple accounts, as opposed to the situation today, where an individual might have IRA accounts in one place, profit-sharing and money purchase accounts in another, and a 403(b) account in yet another place. Thus, for instance, employers could also facilitate employee deposits to what are now individual IRAs. (Note that this requires simplification and unification especially of penalty and withdrawal rules, an issue we do not address further here.)

—*Have regulated financial institutions hold the accounts.* The legal significance of this requirement is that the accounts—rather than an umbrella employer plan—are the legal owner of each employee's retirement savings. This would relieve the employer from fiduciary responsibility for employees' retirement savings. Today's voluminous plan document would be replaced by a simple document spelling out the legal relationship between the employee and the financial provider holding those funds, as is true of an IRA today. To ensure that such accounts were held by responsible entities, it would be preferable to permit only regulated financial institutions to offer them.<sup>17</sup> Tax law would set guidelines for eligible financial institutions, again as is true with IRAs today.

Today's trust document would also disappear as the accounts would be custodial in nature, as is true today for most IRAs, and governed by contract law without an overlay of trust and fiduciary law. Breaches by custodians could be subject to contractual remedies that might include punitive damages, not available

17. Almost anyone, including private individuals, can serve as a plan trustee, unless barred by ERISA § 411 from acting in any capacity on behalf of a plan. But, under Internal Revenue Code § 408(a)(2), IRAs may only be held by a bank or by any other entity or individual that has received specific approval from the Treasury Department to act in such a capacity.

today. This arrangement, of course, would apply only to defined contribution plans. ERISA in its current form would continue to apply to defined benefit plans. The treatment of hybrid plans would depend on which type of plan—defined contribution or defined benefit—they most closely resembled. Cash balance plans, for example, could easily be accommodated within the proposed new account structure as employers could contribute contributions and interest credits directly to them.

—*Use tax law to promote employer participation and to structure the accounts.* In this model the employer's primary function is merely to serve as a conduit of contributions to its employees' accounts. It deducts employee contributions from their pay, adds its own contributions, if any, and wires those funds directly to the appropriate provider for transfer to each employee's plan. In many ways, this would be no more complicated than the direct deposit of payroll checks or the direct transfer of 401(k) contributions to the investment provider that most employers now do routinely.

But the employer would continue to play its unique and very valuable role as a contributor to its employees' accounts. How much it contributes and to whom would be governed by tax law, and many of today's rules could continue to apply. Tax law would still attempt to encourage employer participation by providing special tax benefits for contributions while discouraging contributions that disproportionately favor highly compensated employees. So employer contributions would still be subject to rules on participation, coverage, and nondiscrimination. There would still be per-employee limits on the annual contributions any account could receive and any employer could make. And, this scheme could easily accommodate any movement toward a mandated employer contribution, which is what many Social Security reform plans contemplate when they envision individual accounts. Today's automatic 401(k) contribution certainly looks and acts a lot like a mandatory employee contribution. Perhaps someday there might be a parallel provision for employees or employers, either as part of the nondiscrimination rules or in place of them, or as part of a Social Security reform plan. (Such Social Security accounts might be integrated with other defined contribution arrangements, but that is the subject for a future paper.)

Tax law would continue to have rules for how much employees could contribute to their plans every year. After all, it is Congress' job to decide how tax benefits should be allocated. It would also determine when employees could or must take distributions, just as it does today. For example, these accounts could offer loans and hardship distributions much like an employer plan does today. Tax law would also include rules that the account would have to satisfy to remain tax-qualified and impose penalties for violations of those rules, much like it does today for pension plans and IRAs.

—*Use labor and tax law to protect employees' rights to contributions.* Employees

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would continue to look to labor law as well as tax law to protect their rights to an employer contribution. Any promised contribution would become a legal part of each employee's contract of employment and be enforceable by employees and the Department of Labor. An employer who failed to make a promised contribution would be subject to contractual damages and equitable relief as well as enforcement penalties imposed by the Department of Labor.

—*Encourage employers to promote saving and serve as intermediaries for their employees.* In this model it is not so much that employers' roles would diminish as that they would be concentrated on what they do best: bargain on behalf of the employee (especially in larger firms) for better service providers, create viable pension and insurance options (especially in larger firms), and provide direct deposit, payroll deduction, and tax services for employer and employee contributions to pensions. Many still will engage in low-cost paternalistic efforts to encourage their employees to save enough so they can retire when their skills decline. And, whether or not there are 404(c) regulations to compel them, they may wish to perform some sort of oversight function over where and how their employees save.

—*Use securities laws to regulate the investment industry and create new products for retirement saving.* The federal securities laws are the primary regulators of the financial services industry as well as of its investment products, investment providers, and investment advisers. Eliminating the fiduciary role of employers in defined contribution plans does not mean that these accounts would be completely deregulated. Instead, their investment function would be supervised and protected by the primary regulator of the financial markets—the SEC. The SEC already oversees most investment markets and the securities they offer as well as the behavior of investment professionals who provide custodial, management, and advisory services.

It is important to recognize, however, that the federal securities laws today do not provide retirement plan investors special treatment or protections. Whether they should do so is certainly open to argument. It is unlikely that the industry would agree to assume additional fiduciary responsibility toward retirement plan investors. But the industry has shown itself to be adept at creating special products and services for niche investors in the past. Perhaps that ingenuity could be turned to the service of retirement plan investors. Many feel that 404(c) plans impose too much investment risk on participants who are unprepared or incapable of assuming investment control over their accounts. The investment industry might well take the lead on designing new investment products to minimize risk or simplify investing for participants. It might be possible, for example, to create a special family of government-approved "retirement" mutual funds with appropriate diversification strategies and low fee structures. This would provide retirement plan investors with simple, low cost, and suitable investment alternatives as default options. Other products that protect

retirement plan investors against some of the risks inherent in the markets and educate them about investing are certainly feasible and desirable.

## Conclusion

Our proposal recognizes that each participant's account in today's defined contribution plan is really a separate plan with a unique contribution pattern and investment portfolio. The proposal strips away the superstructure of the increasingly obsolete employer plan. What is left is a personal defined contribution account for individuals. Eventually many employees could even create a centralized account for all their retirement funds. Employees would largely control how their own funds are invested and where they are held, so portability and rollovers would be vastly simplified. Employers would be free to focus on the function we want most to encourage: making contributions for or on behalf of employees. Employers need only send contributions to their employees' individual accounts with no other plan management responsibilities, liabilities, or costs.

But employers would still play the critical role of being facilitators for their employees' retirement savings. Many would choose to retain oversight and act as an intermediary in a variety of ways from encouraging saving to providing investment education and retirement planning services. Moreover, many would wish to designate a preferred provider for their employees or to review the quality and limit the number of providers they make available to employees. The financial services industry would likely respond by creating new types of investments and innovating new services, products, and providers. These accounts, for example, could be run as easily by a TIAA-CREF or a Federal Thrift Board as by a brokerage house or mutual fund family that offers access to almost any mutual fund or individual security. And employers would play an important role in helping their employees make a successful transition through those new products and services to appropriate providers.

This model is not particularly revolutionary. In fact, it is prerevolutionary. It looks a lot like the classic TIAA-CREF account that has been available for years. The model thus borrows features and systems available elsewhere and applies them to ERISA plans. Its primary contribution is to recognize that the regulatory structure in ERISA was created for defined benefit plans, never fit defined contribution plans well, and has become increasingly outdated. In particular, the full burden of liability placed on the employer is no longer justifiable, given the dominant role played by the financial services industries.

Rethinking the role of the employers in defined contribution plans is just one of many reforms needed in the pension system today. But changing pension law to fit today's defined contribution world—and today's employer—is crucial. Facilitating expanded involvement of employers in pensions is just one way of increasing the probability that employees reach retirement with adequate wealth.

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