ENRON AND BEYOND: ENHANCING WORKER RETIREMENT SECURITY

HEARING

BEFORE THE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

OF THE

COMMITTEE ON EDUCATION AND THE WORKFORCE

HOUSE OF REPRESENTATIVES

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ENRON AND BEYOND:

ENHANCING WORKER RETIREMENT SECURITY

Wednesday, February 13, 2002

Subcommittee on Employer-Employee Relations

Committee on Education and the Workforce

Washington, D.C.

The Subcommittee met, pursuant to notice, at 2:00 p.m., in Room 2175, Rayburn House Office Building, Hon. Sam Johnson, Chairman of the Subcommittee, presiding.

Present: Representatives Johnson, Boehner, Fletcher, Ballenger, Tiberi, Payne, Andrews, Tierney, Miller and Holt.

Staff Present: David Connolly, Jr., Professional Staff Member; Dave Thomas, Legislative Assistant; Jo-Marie St. Martin, General Counsel; Victoria Lipnic, Workforce Policy Counsel; Kevin Smith, Senior Communications Counselor; Molly McLaughlin Salmi, Professional Staff Member; Alison Dembeck, Executive Assistant; and, Deborah L. Samantar, Committee Clerk/Intern Coordinator.

Mark Zuckerman, Minority General Counsel; Michele Varnhagen, Minority Labor Counsel/Coordinator Camille Donald, Minority Counsel, Employer-Employee Relations; Cheryl Johnson, Minority Counsel; Peter Rutledge, Minority Senior Legislative Associate/Labor; Dan Rawlins, Minority Staff Assistant/Labor; and, Ann Owens, Minority Clerk.

Chairman Johnson. A quorum being present, the Subcommittee on Employer-Employee Relations will come to order.

The Subcommittee is meeting today to hear testimony on enhancing worker retirement security, and I am really eager to proceed with our witnesses' testimony. So opening statements are going to be limited to the Ranking Member and myself. Therefore, if other Members have statements, they will be included in the record. Without objection, so ordered.

OPENING STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Welcome to Capitol Hill, where we're all Enron all the time, without a doubt.

If you've heard about someone losing his or her life savings with the collapse of Enron, raise your hand. Anybody in the audience? Pretty good crowd isn't it? Like you, I hear stories about people who have literally lost everything. It is just devastating. It is the ultimate opposite of the American dream, but we've got to rely on the American spirit of creativity and enterprise and learn lessons from the collapse of Enron and apply them.

I believe that Congress should help, not hinder, investing for retirement. As we look over what happened, we also need to look at the past to defend benefit pension plans. Make no mistake. Congress so loved the defined benefit pension system and made it so safe, with so many layers of protection, that Congress loved this benefit to death, and these plans are so safe and so secure that hardly anyone uses them anymore, as you know.

I think that we do not want to repeat that demise of the defined benefit system and ruin the defined contribution system. These retirement plans are voluntary. Employers don't have to offer them. Much less, they don't have to contribute to them. So we need to move cautiously. If we make successful plans like 401(k)s so difficult to offer and so difficult to match, then these investment plans could also become extinct. Now, that's a mistake that we don't want to make, and I hope this Committee won't do that.

Keeping that in mind, we need to look for ways that empower Americans and give them the tools they need to save for a safe and secure retirement. In the wake of Enron, it is just plain wrong not to give employees access to high quality investment advice. I hope the Senate learns from the Enron collapse that knowledge is power and employees want it now. I would urge the Senate to pass the Pension Security Act now.

We also need to understand the contributions that ESOPs make and the difference between publicly held and privately held ESOPs. Thousands of rank and file workers have accumulated substantial wealth through employee stock ownership plans, company matches in corporate stocks and other programs. As we consider the President's proposal on pension reform, which Chairman

Boehner and I will probably introduce tomorrow, and other legislative proposals, we must be mindful of our responsibility not to threaten the retirement savings of a number of American workers.

We should keep in mind the implications of any legislation to our overall economy. Our goal should be to encourage, not discourage retirement savings. I hope this Committee and the Congress keep that in mind as we move ahead, to ensure that both American employees and employers enjoy a secure retirement.

We appreciate all of you being here today.

OPENING WRITTEN STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE – SEE APPENDIX A

Chairman Johnson. Mr. Andrews, do you have a statement?

OPENING STATEMENT OF RANKING MEMBER ROBERT E. ANDREWS, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

I do, Mr. Chairman. We appreciate you calling this hearing so we can collectively learn more about this problem and how we can address it, and I thank the witnesses for their attendance here this afternoon.

Last week, the Full Committee heard from a 59-year-old citizen named Tom Padgett, who was a former employee of Enron. He had worked for nearly 30 years in his industry, and if I recall, more than 10 years for the company and its predecessor, in a power plant doing very hard, demanding work. His hope was to retire either this year or next year and buy a ranch and do some good things for his family and his community. At its height, his retirement fund, the 401(k) account with Enron, exceeded $600,000 in value. When he sat in one of those chairs last week, his account was worth less than $10,000.

We owe Mr. Padgett and millions of other workers around this country two obligations. The first is to find out what happened specifically to him and what we can do about it. I am skeptical we can do much, since most of that money has now evaporated, but I think there is a shared commitment from both Republicans and Democrats here that Mr. Padgett and his co-workers be given every benefit of the doubt. We commend the Secretary of Labor, Elaine Chao, for her decision a few days ago to appoint an oversight administrator at the Federal level for what is left of the Enron plans. We think that was a step in the right direction, and we commend her for that.

The second responsibility we have is to do whatever we can to make sure that something like this never happens again. When I heard Mr. Padgett testify, I was reminded of the movie Titanic, which I'm sure most people here have seen. When it was obvious the boat was sinking, the very wealthiest people, who were in the first-class area of the ship, got the lifeboats and got off the ship and many of them, were rescued. But the working class people were locked below deck and couldn't get out as the ship sunk. What happened in the Enron situation sounds an awful lot like that, and we want to make sure it doesn't happen to anyone ever again.

There are five questions that I am particularly interested in as we hear from the witnesses. I don't know what the answers to these five questions are, but I sure do want to learn what some skilled observers think the answers might be.

The first question is what kind of remedy should people have when all goes wrong? When there is a breach of the fiduciary duty by those who are supposed to be looking after the assets of someone in a pension plan, when that duty is breached, what kind of remedy should be at the disposal of the people who are victimized by that?

The second question is when should the assets that someone holds vest? When should be the maximum amount of time that an employer can require before vesting takes place? What kind of consequences does that have for an employee and his or her compensation?

The third question is what can we do collectively to provide better investment advice for people who so sorely need it? I really believe that this Committee was ahead of the curve. We had some disagreements over what to do, but we were ahead of the curve on that all last year. We were debating the question of how to get people better investment advice. The Enron debacle is a monument to what happens when you don't have competent, let alone any, investment advice whatsoever.

The fourth question that I think we need to ask is the representation on the management boards, the governing boards of these funds, sufficiently diverse and broad? Should employees, as a matter of law, be represented on such boards? What would have happened in the Enron situation if there had been non-management employees on the board of that pension fund? Would different decisions have been made earlier on? Would different information have been shared with the employees?

Finally, what do we do about this whole question of diversification? I had a conversation the other day with a friend of mine, who is one of the wealthiest people in America, and as a matter of course, he has diversified his personal holdings and any that he has responsibility for. He would never have put all of his eggs in one proverbial basket, the way so many Enron employees did with their 401(k) plans. What could and should we do about that? Is it a proper matter of public policy for us to mandate diversification? Should we suggest it? What is the right answer to that kind of question?

There are many other questions, but those are the five that I think are most salient to this discussion, and I commend the chairman for giving us the chance to hear from four real experts in

the field here this afternoon.

Chairman Johnson. Thank you, Mr. Andrews.

I would like to introduce our panel of witnesses, and then I'm going to deviate a little bit from the norm. I will tell you about that in a moment.

Our first witness is Dr. Jack VanDerhei, a Professor at Fox School of Business and Management, Temple University, Philadelphia, Pennsylvania. He is testifying on behalf of the Employee Benefit Research Institute. The second witness is Dr. Douglas Kruse, a Professor at the School of Management and Labor, Rutgers University, Somerset, New Jersey. The third witness is Mr. Norman Stein, a Professor at the University of Alabama, School of Law, Tuscaloosa, Alabama. Thank you for being here. We would have been at a loss without a lawyer. And our final witness is Ms. Rebecca Miller, Partner with the firm of McGladrey & Pullen, in Rochester, Minnesota.

Before I begin, I would like to remind the Members that we will ask questions of the witnesses. I am going to ask Ms. Miller to testify first because Mr. Ballenger has another commitment and I would like to have him question her, because he has an ESOP company. Then we will continue with the other three witnesses and the rest of us can ask questions, if that is satisfactory.

In addition, we will implement Committee Rule 2, which imposes a five-minute limit on all questions and five minutes for the witnesses to testify. The little light comes on down there. It is green for the first four minutes, and then it turns yellow, and then red. So if you would adhere to that, we would appreciate it very much.

Ms. Miller, will you give your testimony now, please?

STATEMENT OF REBECCA MILLER, CPA, PARTNER, McGLADREY & PULLEN, LLP, ROCHESTER, MN

Chairman Johnson and Committee Members, thank you for the opportunity to speak with you today.

My name is Becky Miller, and I am the Employee Benefits Services Policy Director with R.S.M. McGladrey, Inc., a business-consulting firm that has been involved with employee stock ownership plans since the early 1970s. I have been invited here to present background information on ESOPs and to help differentiate ESOPs of public companies with those of private companies.

Statistical evidence from many sources has recorded that employee ownership has served to strengthen companies, improve productivity, drive innovation, and enthuse workers throughout a wide range of industries and locations. It has given millions of rank and file employees personal wealth that would never have been attained without it. It has produced that ideal “win-win”

situation. Employees thrive, companies prosper, and our economy and society are enhanced. The great story of employee ownership through ESOPs, however, remains largely misunderstood.

There are only about 11,000 ESOP companies in this country. Those companies' plans cover about eight and a half million employees. A 1998 study of more than 100 ESOP companies in the State of Washington found that employees at those companies had an average retirement plan balance of over $30,000, while employees at comparable non-ESOP companies had balances of about a third of that. This added retirement benefit was not in exchange for wages. In fact, the medium hourly wage of those employees was five to 12 percent higher than the comparable companies. The study made clear that companies were providing the ESOP as an additional benefit and not a substitute for others. This conclusion has been confirmed in other recent studies that are included in my written testimony.

Accumulating wealth is certainly an important goal, but it's not all there is to employment. When companies recognize their employees as critical and grant them ownership, they create status and community among those workers. Employee stock ownership plans are a marriage between employee benefit objectives and corporate finance. Sounds like something other than a marriage made in heaven, but in fact, over the last decades, it has worked out very well for many companies. That happiness, however, has been threatened by recent events.

As a blend of corporate finance and employee benefits in their simplest form, ESOPs provide simply a benefit through stock, not cash. In more complicated form, stock is sold, debt is incurred by the plan, and shares are allocated over time for the benefit of the employees as that debt is repaid.

Common employee benefit objectives that we see are intended to motivate and retain employees, to share the company's success with those employees, to align the employee's goals with those of management, to replace a high cash cost employee benefit with another benefit, and, my personal favorite, to add the long view to the employee's perspective on their job. Just like in the investment community, a long-term planning horizon is critical, the same attitude is critical among our employees. The finance objectives that may include cash flow management, creating a market for shares, the most common use in closely held companies, expanding the equity base, protecting from a takeover attempt, and many others.

The ESOP is regulated like any other qualified retirement plan, subject to the same standards of eligibility, vesting, non-discrimination, reporting and disclosure of fiduciary conduct, et cetera, but it has two notable differences. It is authorized to invest up to 100 percent of plan assets in qualifying employer securities. It can borrow funds from a related party to finance these acquisitions. It is these two differences that make the ESOP a combination of both an employee benefit plan and a finance tool.

All of the prior discussion applies equally to public and private companies. Some of the uses may vary, but the same opportunities for ownership transfer exist. There are, however, two fundamental differences in the operation of ESOPs in public companies and private companies: cash flow and value.

From the perspective of cash, when eligible for a distribution, ESOP participants have the right to demand a distribution in stock. If the stock is not actively traded, the participant, by law, is provided with access to cash. The cash to fund these distributions may come from company contributions, dividends, or direct purchases of the stock. This is a uniquely private company matter. Public companies can distribute stock and allow the participants to take it from there.

A reliable cash flow is critical to the continuing success of any business venture. Unexpected claims against this cash flow can create disruptions in business activities to the detriment of all shareholders. Thus, the current ESOP rules, which grant a diversification privilege under a scheduled table, distribution form, and distribution timing under known terms, make cash management much more beneficial and predictable for private companies.

From a value perspective, ESOPs, by law, must value stock not less frequently than annually. For most private companies, this is through a qualified independent appraisal, taking into account all economic factors, not just audited financial statements. It means that the well-advised ESOP company will reflect a value based upon economic realities.

It is tough to describe this in a short time period. I tried to hit the high points, and all I can say is that the continued success of private companies will be significantly jeopardized by any legislation that disrupts this predictable cash flow for participants.

Thank you.

WRITTEN STATEMENT OF REBECCA MILLER, CPA, PARTNER, McGLADREY & PULLEN, LLP, ROCHESTER, MN – SEE APPENDIX B

Chairman Johnson. Thank you, Ms. Miller. I appreciate your testimony.

Mr. Ballenger, you are recognized for five minutes.

Mr. Ballenger. Thank you, Mr. Chairman. I apologize to you, but the President of Uruguay is going to call me in about 20 minutes.

The first thing to say, Ms. Miller, is that McGladrey & Pullen did our books for many years and we haven't had any shenanigans. Everything has been on the up-and-up, and I commend you for working for a good outfit.

Ms. Miller. Thank you.

Mr. Ballenger. Just for the education of those here, the reason for the ESOP in my particular case was the fact that my mother was 80 years old. I had a brother who landed in France on D-Day and was in and out of hospitals on a regular basis, and they had stock in the company. It was obvious, common sense said that they needed AT&T or some bank stock rather than a plastic packaging company stock. So we used the ESOP to buy them out. At the same time that we bought them out,

we spread the stock among the employees.

I think the one thing that the panelists should recognize is that the employees didn't put anything in there except hard work. Because the truth of the matter is we decided at the end of every year how much money to put in the ESOP. As an example, because I am here and don't work there anymore, but still participate in the ESOP because I own some stock, I only get money. I don't get stock anymore, because it's not that way.

I was trying to figure off the top of my head, the company was founded in 1957 and so far we've had probably 25 or 30 employees that have retired. I would say the average retirement probably was anywhere from $30,000 a year to $60,000 a year.

But I would like to say that each year it is valued. We hire a professional to come in and value the stock. We have a management board, the president of the company, the comptroller, and one chief supervisor, and that's the way we operate and we decide at the end of every year how much money we have to put in it. We did have good years, we did have bad years, and it's variable.

I think people don't realize that when you have a defined benefit program, which we had to start with, and the Federal Government comes along with ERISA, it scares us to death. We figure that Uncle Sam is going to be in our pocket before long, so why don't we just get into something else. So we went to a defined contribution plan, an ESOP, with the freedom to choose how much to put in it.

My time is running out. The one thing that I think needs to be answered, because I know that there is a problem, could you give us an idea of what a KSOP is?

Chairman Johnson. We intend to keep the hearing going through the voting periods. Go ahead.

Ms. Miller. Everybody loves acronyms. A **K**SOP is a combination of an employee stock ownership with a 401(**k**) plan.

Basically, it functions like the typical structure of a 401(k) plan, where participants have the right to direct investments into different categories. One of those categories would be a company stock fund. That company stock fund is typically structured as if it's a separate ESOP blended into the 401(k) plan. By characterizing it as an ESOP within the 410(k) plan, the plan sponsor has access to all of the tax incentives that are available through an ESOP, which are broader than what would be available if it was a profit-sharing type 401(k) that happened to have a company stock fund.

Mr. Ballenger. Is that, generally speaking, a publicly owned company?

Ms. Miller. In my experience, most of them are publicly owned companies. It is a very popular feature in publicly traded companies. But it is not exclusive to public companies. We do see a fair number of private companies that also have such arrangements.

Mr. Ballenger. We have the 401(k) and the ESOP, but we completely separate them. So that's not a KSOP, then, is it?

Ms. Miller. No.

Mr. Ballenger. I just wondered what kind of rules I have been breaking.

Thank you, Mr. Chairman. I'm going to run out on you, if you don't mind.

Chairman Johnson. Thank you, Mr. Ballenger.

Dr. VanDerhei, you may begin your testimony, sir.

STATEMENT OF JACK L. VANDERHEI, Ph.D., CEBS, PROFESSOR, DEPARTMENT OF RISK, INSURANCE, AND HEALTHCARE MANAGEMENT, THE FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, TESTIFYING ON BEHALF OF EMPLOYEE BENEFIT RESEARCH INSTITUTE

Chairman Johnson, Members of the Subcommittee, I am Jack VanDerhei, a faculty member at the Fox School of Business and Management, Temple University. I am also the Research Director of the Employee Benefit Research Institute Fellows Program.

My testimony today will focus on the role of company and 401(k) plans; drawing on the research I have conducted since 1995. During that period of time, I have written several articles on 401(k) plans, many of them authored with Sarah Holden, from the Investment Company Institute. I wish to emphasize, however, that the views expressed in this statement are mine alone and should not be attributed to my co-authors, Temple University, the Employee Benefit Research Institute, or their officers, trustees, sponsors, or other staff.

In an attempt to put together the most complete picture possible for this testimony, I have utilized three different sources:

First, I am using administrative data from the EBRI/ICI 401(k) database that were used to assess the relative frequency of 401(k) plans offering company stock and the percentage of company stock held in participant portfolios. The EBRI/ICI database contains individual information on more than 11 million participants from more than 35,000 401(k) plans and is by far the largest 401(k) database in the nation.

Second, I have used enhancements to the EBRI retirement income projection model to program and simulate the financial impact of potentially eliminating company stock from 401(k) plans.

Third, a survey of more than 3,000 employee benefit professionals was used to collect data and other items of interest for which no other information was available.

As you know, the 401(k) universe is growing very rapidly. By 1997, the most recent year for which published government data is currently available, there were 265,000 401(k) type plans, with 34 million active participants, holding $1.26 trillion dollars in assets. By year-end 2000, it was estimated that approximately 42 million American workers held 401(k) plan accounts, with a total of $1.8 trillion in assets.

Most 401(k) plans do not include company stock as an investment option or mandate. For the 1996 version of the EBRI/ICI database, only 2.9 percent of the plans included company stock. However, the plans that do have company stock are generally quite large and represented 42 percent of the participants.

In terms of account balances, plans with company stock accounted for 59 percent of the universe. The fact that plans with company stock had higher average account balances was no doubt partially due to the bull market preceding this time period, but may also be a function of the plan's generous parameters and the average tenure of employees. The overall percentage of 401(k) account balances in company stock has remained constant, in the 18 to 19 percent range, from 1996 to 2000, inclusive.

It should be noted, however, that a sizeable percentage of 401(k) participants are in small plans and do not generally include company stock in the investment menu. The average allocation in company stock varies from less than one percent for plans with fewer than 500 participants to slightly more than 25 percent for plans with more than 5,000 participants. When our analysis is limited to only those plans that include company stock, the average allocation to company stock is approximately 30 percent.

Several proposals have called for an absolute upper limit on the percentage of company stock that an employee will be allowed to hold in his or her 401(k) account. Analysis of the year 2000 EBRI/ICI data showed that a total of 48 percent of the 401(k) participants under age 40 in these plans have more than 20 percent of their account balances invested in company stock. The percentages decrease over time and goes down to 41 percent for participants in their 60s.

Some employers require that employer contributions be invested in company stock rather than as directed by the participant. Participants in these plans tend to invest a higher percentage of their self-directed balances in company stock than participants in plans without employer directed contribution. Company stock represents 33 percent of the participant directed account balances in plans with employer directed contributions, compared to only 22 percent of account balances in plans offering company stock as investment option, but not requiring that employer contributions be invested in company stock.

For purposes of today's testimony, I also simulated the overall gain or loss from prospective retention of company stock in 401(k) plans as opposed to company stock being entirely eliminated immediately. What we are trying to determine is, who wins and who loses under the current situation compared with new limits being imposed on company stock. This analysis was

performed for birth cohorts between 1936 and 1970, and the results indicate the estimated gain of retaining company stock is either 4.0 percent of 7.8 percent of 401(k) balances, depending on the assumptions being used.

Males would be expected to gain more than females from retention of company stock, regardless of salary level, while participants in the lower salary levels would stand to gain more than their higher paid counterparts for both genders. There would be a widespread distribution of winners and losers from retaining company stock. For example, at least 25 percent of the sample is expected to gain 5.1 percent or more, if they are allowed to have company stock going forward, while at least 25 percent of the sample is expected to lose 10.8 percent or more if the company stock continues to be permitted.

Thank you very much for the opportunity to testify today, and I look forward to your questions.

WRITTEN STATEMENT OF JACK L. VANDERHEI, Ph.D., CEBS, PROFESSOR, DEPARTMENT OF RISK, INSURANCE, AND HEALTHCARE MANAGEMENT, THE FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, TESTIFYING ON BEHALF OF EMPLOYEE BENEFIT RESEARCH INSTITUTE – SEE APPENDIX C

Chairman Johnson. Thank you, sir. We appreciate your testimony.

Dr. Kruse, you may begin your testimony now.

STATEMENT OF DOUGLAS KRUSE, Ph.D., PROFESSOR, SCHOOL OF MANAGEMENT AND LABOR RELATIONS, RUTGERS UNIVERSITY, SOMERSET, NJ

Thank you. I am pleased to be here. As an economist, I've spent a lot of the last 20 years doing research on employee ownership, adding a lot of gray hairs to this head. Apart from the intellectual issues, there are also practical and policy questions about what role employee ownership should play in firms and the economy.

My original interest was in how employee ownership can sometimes be used to create win-win situations for firms and workers, enhancing company performance, along with employee pay, job security and quality of work life. Obviously, that doesn't always happen. I have spent much of the past 20 years trying to understand how employee ownership actually works in the real word, and the risks, as well as the benefits it can provide the workers and firms.

In my testimony, I want to do two things: provide some new evidence on the extent of employee ownership in the U.S. economy and provide the major conclusions from over 70 studies

on employee ownership that have been done in the past 25 years by myself and others.

First, I will discuss the extent of employee ownership. Using the most recent data set from the Department of Labor, I have created tables on all large defined contribution pension plans. Some of my findings show that there are between 17 and 20 million U.S. employees participating in large ESOPs, 401(k)'s or other plans that hold employer stock. Employer stock in these plans totals $330 billion, or 20 percent of the total assets of DC plans.

Average employer stock per participant ranges from $10,000 to $27,000 across the different types of plans. Most participants, interestingly, in ESOPs and other employer stock plans are in companies that also maintain diversified pension plans. In fact, other research shows that the ESOP companies are four times more likely than non-ESOP companies to have defined benefit pension plans, which clearly mitigates the financial risk for the employees.

So what does the research show?

I will just summarize the bottom line results from the 70-plus studies. First, studies are generally split between favorable and neutral findings on the effects of employee ownership, on employee attitudes, and firm performance. There are extremely few negative findings. With regard to employee attitudes, studies, in particular, tend to find higher organizational commitment under employee ownership. With regard to firm performance, our analysis of ESOP studies found ESOP adoption is linked to an increase in average productivity levels.

The studies have also indicated that employer ownership firms have greater employment stability and higher survival rates, indicating greater job security for workers. However, employee ownership does not automatically improve attitudes or performance whenever it's implemented. Obviously, some employee ownership companies do fail.

An important question in this regard is whether employee-owners sacrifice pay or benefits for ownership. Several studies indicate they do not. The pay and benefits of employee owners are as high as that of other employees. So employee ownership tends to come on top of rather than in place of other compensation.

What does this imply for public policy? My objective reading of the evidence is that most basically, employee ownership generally appears to provide benefits both to firms and workers. Employee ownership companies can, of course, fail and put the jobs and assets of workers at risk. Because of this, it is clear that plans with heavy investments in any one asset should not be the basis for sound retirement planning, although they may supplement other funds. Employees who own substantial amounts of employer stock are constantly reminded of this, perhaps in boldly lettered words on every plan statement they receive.

To further ensure good planning, like all owners, employees who own company stock should have good access to information on the state of the company. I'm not an expert on fiduciary rules. I make no specific recommendation here. But I think there should be careful thought given to ensuring and possibly expanding mechanisms to enhance employee information. This might even include, in some circumstances, employee representatives or monitors at board of trustee

meetings. In addition to providing better information, this can also instill more of a sense of ownership, which is a key ingredient of enhancing workplace performance of employee ownership.

Finally, should employee ownership be scaled back in order to lessen financial risk for workers? After long, hard thought on this, my conclusion is no. Scaling back could destroy many of the potential benefits of employee ownership for firms and workers. Employee ownership tends to come on top of other paying benefits, as I have noted.

Employees clearly need good information and advice, but given that, they should not be restricted from accepting company stock from employers or investing their own assets in company stock. It is analogous to the situation facing owner-operators of farms or small businesses. These are often risky assets, but we obviously allow people to invest both their livelihoods and assets in farms and small businesses.

We simply need to make sure it's a well-informed choice. So my ultimate conclusion is that given the potential economic and social benefits of employee ownership, published policy should seek to ensure employee owners have standard prerequisites of ownership, such as good information, to enhance workplace and financial decision-making, but should not substantially restrict employees' ability to own company stock.

Thank you.

WRITTEN STATEMENT OF DOUGLAS KRUSE, Ph.D., PROFESSOR, SCHOOL OF MANAGEMENT AND LABOR RELATIONS, RUTGERS UNIVERSITY, SOMERSET, NJ
SEE APPENDIX D

Chairman Johnson. Mr. Stein.

STATEMENT OF NORMAN STEIN, DOUGLAS ARANT PROFESSOR OF LAW, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, AL

Mr. Chairman, Members of the Committee, I am Norman Stein, a Professor of Law at the University of Alabama. I thank you for the opportunity to share my views today on the Enron failure's catastrophic consequences to the retirement security of its workers and what lessons that failure has taught about the regulation of the private pension system in this country.

In my testimony, I will reflect on just three issues: first, the general problem of excessive employer stock in defined contribution plans; second, the difficulty of catching Enron type problems before they happen; and, third, the failure of the judicial system to adequately remedy such problems after they happen.

The Enron retirement program implies numerous problems for the private pension system today, but the glamour issue, at least in the mire of the media, has been the concern with the large concentration of employer stock in many 401(k) accounts. When Enron failed, employees lost not only their job security, but their retirement security, as well. The key arguments against permitting employee retirement investment accounts to hold more than small amounts of employer stock are simple enough.

In the field of finance and investment, one of the marvelous discoveries of the 20th Century was the value of a well diversified investment portfolio, which helps protect investors from a possibility of large loss and, at the same time, allows them to enjoy some of the premium return on relatively risky investments. In financial planning for retirement, where excessive risk-taking should be verboten, the value of diversification is a simple fact, not a debatable principle.

Indeed, professional guidelines generally prohibit the professional investment managers of these plans from investing more than a small percentage of a plan's assets in a single asset. Too much investment in a single security is bad, but too much investment in employer stock is worse. Why? The cliché, of course, is that an employee's investment capital and human capital should not be tied together.

There is also some behavioral evidence now, and Enron is a startling example, that suggests employees are inclined to overvalue the financial future of their employer in relationship to the market as a whole, and thus are likely to over-invest in their employer stock. For every company that outperforms the market, there is another that underperforms it, and as in Enron's case, some firms will do both over time.

In my written testimony, I talk about some of the arguments in favor of leaving the law more or less the way it is and I am going to skip over that in the oral testimony.

There has been much debate on what type of restrictions to impose on employee stock, of employer stock ownership. My own view has not changed since I last testified on this subject in 1997, when we had similar failures, although not on such a large scale. Retirement plans should hold no employer stock, other than as a small part of a portfolio index to broad market criteria, but it is probably much too late in the day for this to be a realistic possibility politically. But it is not too late for some additional limits on employer stock and retirement plans.

It is not my purpose here to summarize the different ideas on how to shape such limits, but I do want to mention two variations on other ideas that have not yet been thrown into the mix. First, giving employees a diversification option for employer stock is not enough. We have learned from behavioral economists that inertia is a powerful force in human behavior and that many employees are not likely to take affirmative action to diversify because of inertia.

Richard Thaler, at the University of Chicago, and Shlomo Bernatzi, of UCLA, have done trailblazing work in 401(k) plans and negative matches. In order to count employee inertia and other behavioral forces, they have designed a 401(k) plan model, the SMART plan, in which employees agree that they will up their contribution levels in 401(k) plans in the future, when they get pay raises. No further action is necessary. This same principle can be applied to

diversification. Plans to which employees make matching contributions should be required to diversify those contributions within a certain time period, unless the employee affirmatively elects to keep the investment in employer stock.

Second, some concerns have been raised about the administrative difficulties of complying with some overall limit, for example, 20 percent, on the amount of employer stock in a defined contribution plan. Such a limit would require constant monitoring of accounts during the year to make sure the limit was not exceeded; at least that is the argument. To counter such concerns, we might adopt a start of the year snapshot, in which an employee cannot allocate new contributions to employer stock, if, at the start of the year, his or her account exceeds certain thresholds.

I want to turn now to the question on catching problems before they become disasters. Enron revealed something that many lawyers know. Many people who run employee benefit plans do not understand what their fiduciary roles require or, alternatively, believe that violating their fiduciary obligations will impose on them more than minor costs. If this is a problem at a company such as Enron, I can assure you that it is a problem at many firms, many small firms, as well.

Let me give you one example from a pension clinic we run at the University of Alabama. We recently dealt with an employer, a small employer who claimed that its bank trustee was the plan administrator, when, in fact, every single document named it as the administrator. The personnel manager, who ran virtually all aspects of this plan, who as a very decent person, at a settlement conference, indicated that she did not know what a fiduciary was, did not know what rules governed fiduciary behavior, and did not, of course, realize that she herself was a fiduciary.

The Department of Labor lacks the resources to ensure compliance with ERISA's many commands, either through investigation and enforcement efforts or through education. I think even though we're in a time of national crisis, the Department of Labor probably requires additional resources.

I guess I'm not going to get to talk about remedies.

WRITTEN STATEMENT OF NORMAN STEIN, DOUGLAS ARANT PROFESSOR OF LAW, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, AL – SEE APPENDIX E

Chairman Johnson. We'll be happy, Mr. Stein, to give you an opportunity during our questions and answers to expound upon your last point. But in fairness to the other witnesses, we try to keep to the five-minute rule. I realize that as a professor, being limited to five minutes is a challenge.

Mr. Stein. My students would like me to be limited to five minutes.

Chairman Johnson. It would be like asking my colleagues in the other body to adhere to the five-minute rule. They wouldn't know what you were talking about.

Let me begin the questioning with a statement and a question to the panel. I think all of us agree that as we proceed in looking for corrections to our pension laws, that we must proceed carefully, because in our business, the law of unintended consequences always seems to jump up and bite us, and then we're back fixing the corrections. Does anyone disagree that we, the United States Congress, should move carefully and deliberately to avoid the law of unintended consequences? Everyone agrees? We're off to a good start.

Let's talk for a moment about stock in company 401(k) plans and other types of diversified plans. Why don't we start with Dr. VanDerhei. Why do you think it would be unwise or do you think it would be unwise to impose an arbitrary cap on the amount of company stock in a 401(k) plan?

Dr. VanDerhei. It really depends on what objective you are trying to serve.

If you take a look at the simulation results I ran for this particular testimony, the one thing that we do find, even though company stock obviously does increase the volatility of the expected returns for an individual, is that there is a large percentage of individuals, especially in their 20s and 30s, that are investing in a very, very risk averse nature.

Perhaps it is not the ideal equity to have somebody invest in, but the fact that the current system without the caps provides more equity exposure for people that are young enough to absorb the volatility over time, has a tendency to increase their overall retirement income by anywhere from 48 percent, depending on the assumptions. So you have to keep in mind that it may indeed have the unintended consequence of having people with less aggressive portfolios and, therefore, lower expected rates of return and lower retirement income in the end.

Chairman Johnson. Dr. Kruse.

Dr. Kruse. No, I'm not in favor of such caps. I consider myself very pro-employee and want to ensure that there are employee protections. However, employees tend not to give up anything, as I indicated, in exchange for employer stock and if companies want to give employer stock to employees without employees sacrificing anything, I don't have a real problem with that.

The employees should have good information and good advice, as I said, to ensure that they can make wise decisions, and they should not treat employer stock-heavy plans as a basis for retirement planning. But given that, I don't see a reason to restrict companies from giving employer stock to employees.

Chairman Johnson. Ms. Miller, why don't we go to you next.

Ms. Miller. I was waiting to hear what Norm was going to say.

I appreciate the perspectives of the other two speakers. I think that creating caps fails to recognize the fact that each employee, as an individual, has a different kind of risk-reward portfolio that includes their assets outside of the plan. They need the ability to make the decisions with

complete flexibility, recognizing whatever other issues that they are confronted with.

But I do believe that they should have access to more information, frankly. I'm the mother of teenagers and so I also think it wouldn't hurt to send people a warning that says the choice that you have made is in conflict with normal diversification standards. It may be perfectly okay, but just think about it.

Chairman Johnson. Mr. Stein.

Mr. Stein. I favor the ultimate limit. Alabama just narrowly averted the death penalty, and I compare the death penalty, I think, to plans holding employer stock. Dr. VanDerhei's argument that employer stock does push people into equities, I think, is almost certainly correct. But we would be much better off with a system.

Twenty-five years ago, individual employees did not manage defined contribution plans. In my written testimony, I talk about this at some length. The original practice, even in defined contribution plans, was that employers had incentives to hire capable investment managers and the investment managers managed the portfolio of the entire plan. If they did that employees would have adequate exposure to equity investments, because we know the investment managers know that is where the plan's investments should be.

I think in terms of education, the argument for education seems to be this. We know that for most people who are in these plans, over concentration in employer stock is a very stupid thing to do. We can very inexpensively and effectively adopt a rule that ensures that all people essentially have access to this wisdom or we could try and educate 75 or a hundred million Americans about the value of diversification.

I deal with people who are participants in pension plans every day through my pension clinic. I can tell you with absolute confidence that there is no way you can educate some of the people who come to our clinic about the value of diversification. It is just a different world.

Chairman Johnson. As the author of a defined contribution plan for my own company back in 1978, we continue to have good investment advisors, and it has worked well for all the employees.

But I just have to ask, how do you argue against companies where employees for 50 years, their families, their fathers, their grandparents all worked for the same company and they bought company stock through a stock purchase plan or a 401(k) plan, who have done very well for themselves? How do you argue that the Federal Government should step in and say to these employees no, you're not going to do it the way you want to do it, you're going to do it the way we want you to do it?

Mr. Stein. First, let me say I am not against employee ownership of stock. What I am against is that ownership being accomplished through tax incentives that basically encourage employers to set up these plans in employer stock.

My stepdad was in an ESOP, in a family-owned corporation, and Enron is not the only example of an ESOP or employer stock plan going bad. When he was 61 years old, his company, which had done fabulously well up till then, went bankrupt, and he was left with no retirement. I think within the retirement system, the goal should be to avoid disaster, not to accommodate people's desire to take risk. They should do that with their private investments.

But the government is a substantial partner in these retirement plans. We know that we have substantial tax expenditures invested in these plans. I think what the government should want out of these plans is to ensure against disasters like Enron, rather than allow some people to beat the market.

Chairman Johnson. My time has expired. The Chair recognizes Mr. Andrews.

Mr. Andrews. Thank you, Mr. Chairman. I apologize to the witnesses for running out for the vote during their oral testimony. I have read the statements, however, and I appreciate it.

I want to ask about remedies to each of the four panelists. Let's assume we have a situation where we have clearly established a breach of fiduciary duty by the fiduciaries in the plan. Starting with Dr. VanDerhei, what do you think the remedies ought to be for a plan participant whose assets have been dissipated or eliminated because of breach of fiduciary duty?

Dr. VanDerhei. I think you started on the wrong end of the panel. I am not a lawyer. It is my impression that there are currently provisions available through the legal system for court cases to solve that. Were you referring to something legislative?

Mr. Andrews. Let me ask the question this way. If someone lost her pension plan assets and was unable to make her mortgage payments as a result of that, had her house foreclosed on, should she be able to get her house back or get the economic value of her house back as a consequence of the breach of fiduciary duty? What do you think?

Dr. VanDerhei. Again, I'm not quite sure how to answer that. I would assume that would certainly be part of the class action suit that is allowable under current ERISA 404(a). I'm just not exactly sure what you're driving at. I'm sorry.

Mr. Andrews. My understanding of the law is to the contrary. That kind of recovery would not be permissible under the present law. You are essentially limited to getting your pension money back and that's it.

Dr. Kruse, what would your answer be?

Dr. Kruse. I'd have to say, like Jack, I'm not an expert on fiduciary rules. If someone breaks the rules, they should be sued. It certainly sounds reasonable to me that they be able to sue for damages in addition to the pension money. But, again, I'm not an expert on that. I'm just offering an opinion based on what you just mentioned.

Mr. Andrews. Mr. Stein, what do you think?

Mr. Stein. Actually, I'm glad you asked that, since that was the point at which my red light came on in my testimony.

ERISA is a very interesting statute. It's sort of a paradox. On the one hand, it says it imposes the highest standards on people administering the plans, and I think it does. But on the remedial side, it basically says if you violate those standards, it is likely very little consequence is going to happen to you and that your employees are not going to be made whole.

In the Enron situation, I think a lot of this is very much up in the air now. One reading of the case law is that the fiduciaries of the ESOP, and certainly the people who were not formally involved in the ESOP but encouraged people to hold onto the stock, who knew the stock was tanking, probably cannot be sued for money damages under ERISA.

That is, right now. The Supreme Court, in the Great West case decided just last month, made clear that equitable relief, which is all that is available against non-fiduciaries and may be all that's available against fiduciaries in the Enron situation for misrepresentations that they made, do not include money damages. So in some sense, these rules are going to do nothing for the Enron employees.

Mr. Andrews. Your statement is bad policy, but correct law.

Mr. Stein. Yes. I think that's right. The question you raise, I think, is another problem that is broader than just the Enron situation, the “make whole” remedy.

When participants who spend years sometimes without benefits they are lawfully entitled to finally win a case, and the court says you are right, the plan was wrong, the people running the plan were wrong, all they get are their benefits. What is even worse in both fiduciary and benefit cases, despite Congress putting into the statute a provision that I think it thought in 1974 would assure attorneys' fees, most courts today do not automatically give attorneys' fees to prevailing plaintiffs.

Mr. Andrews. Ms. Miller, I want to give you a chance to answer the question, also. What is your view?

Ms. Miller. On this issue, I am, first of all, not a lawyer. I am an accountant by training and a consultant. So my perspective is more a matter of 25 years of working with ESOP companies.

I would actually concur with Norm's assessment. The situation is extremely complicated and burdensome. When a participant discovers they are harmed because of limitations within ERISA, it is difficult for them to find someone to take a case, and it is difficult for legal counsel to bring a case and it is difficult for anyone to recover any real value.

Mr. Andrews. So given that difficulty, do you think that the full range of money and equity remedies ought to be available, financial and equitable remedies?

Ms. Miller. I'm really worried about the full range of remedies. There have been too many remedies that seem to me to be larger than the damages. But I guess from my perspective, I would see that the solution as access to getting their benefits back needs to be simpler and faster, and then they shouldn't have so many other losses.

Mr. Andrews. Thank you.

Chairman Johnson. Can I ask you, Mr. Stein, if you sue under a failed plan aren't all remedies available in court?

Mr. Stein. No. There are actually two tracks that can be pursued under ERISA when something bad happens.

One track is where the plan basically is suing for all the participants. For example, if you had an investment advisor who made very bad investment choices or stole money from the plan or used plan assets to advance his own business, then the plan would or a participant essentially would be able to compel or the equivalent of compelling the plan to sue the breaching fiduciary. Money damages then could flow to the plan.

If, you were suing for individual harm, that is, harm to you rather than the plan, you would sue the fiduciary.

Chairman Johnson. Would they sue the fiduciary or the company?

Mr. Stein. They would sue the fiduciary. Often, the company will be the fiduciary.

If, on the other hand, you are suing for example, because somebody made a misrepresentation to you or somebody did something bad to you personally, which I think may be the Enron situation, or if you are suing somebody who helped a fiduciary breach a trust but isn't himself a fiduciary, you cannot get money damages according to the Supreme Court.

Chairman Johnson. What is the remedy?

Mr. Stein. The remedy is equitable relief and there are cases now. There is a case and I can't remember which circuit it was, but right after the Supreme Court made clear that equitable remedies means equitable remedies, there was a plan that gave terrible advice to a participant and they suffered a very large tax burden that could have been avoided had they gotten accurate advice. The case said this is clearly a fiduciary violation, but, unfortunately, there is no remedy to help the participant.

I think that may very well turn out to be the case with some of the Enron participants' claims against people who lied to them about what the future of Enron stock really was.

Chairman Johnson. There is no timeline on when a fiduciary has to act, is there?

Mr. Stein. I think the timeline is dictated by the general fiduciary standards of prudence. A fiduciary is required to act when it would be prudent to act. That may sound logical, but I think that is probably the requirement. You can't delay acting simply because you feel like delaying. If it is prudent to do something now, you have to do it now.

Chairman Johnson. But in the Enron case, the fiduciary knew there was a problem.

Mr. Stein. Yes.

Chairman Johnson. And didn't do anything.

Mr. Stein. Yes.

Chairman Johnson. Because they were investigating it. Now, how does that play into a normal situation?

Mr. Stein. Again, I think there were numerous types of fiduciary breaches in Enron. The lawyers of the Enron employees will be trying to argue that the breaches affected the plan as a whole, and, thus, there should be money damages.

What the defendant's lawyers will argue, and I think have a reasonable chance of success with respect to some of the claims, is that these people did something very bad, but they harmed individual participants in the plan rather than the plan itself.

Chairman Johnson. Is that because they had some freedom of choice?

Mr. Stein. Yes. So those claims may be very problematic. Under ERISA, there may be securities claims, but the state law securities claims would be preempted.

Chairman Johnson. Thank you very much. I appreciate that.

Mr. Fletcher, you are recognized for five minutes.

Mr. Fletcher. Thank you, Mr. Chairman. I appreciate your testimony. Sorry I missed some of it because of votes. Let me ask Mr. Stein about the redress that individuals have.

In the Enron case, I understand ERISA has certain redresses regarding the plan and what they can do to the fiduciaries. What about the executives of a company? What kind of civil liability is there for recipients if information is withheld about the financial status of the company, and what kind of lawsuits would be available against them in that regard?

Mr. Stein. I think this is being thought about very hard by the lawyers of the Enron employees now. As I said, to the extent the executives were fiduciaries, they do have liability under ERISA.

Mr. Fletcher. Help me with this. Are they fiduciaries under ERISA law? I don't know.

Mr. Stein. ERISA's definition of a fiduciary is actually a functional definition. Essentially, it looks at whether you have control over significant aspects of plan operations or plan assets.

Mr. Fletcher. So regarding a suit, they would first have to be designated as a fiduciary.

Mr. Stein. It's more complicated. If they are not fiduciaries, they can still be sued, but then you are limited only to equitable relief. Equitable relief in this case is not going to help them because it essentially means no money damages. To the extent you could sue executives under ERISA who are not fiduciaries, you're not going to get any money from them.

Mr. Fletcher. I think certainly there are some serious concerns about that and the responsibility the executives have to fully disclose the financial condition of the company.

Mr. Stein. It is also possible that the executives made themselves fiduciaries by giving employees advice about what to do with their 401(k) plans. So that is an issue that the courts are going to have to sort out.

So even though they weren't fiduciaries before, just telling employees who you know are invested in Enron stock and the 401(k) plan that the future is rosy for Enron might have made them fiduciaries.

Mr. Fletcher. I think it is very important for a fiduciary, first off, to be defined, so we know who can be held accountable and responsible. But even still, the executives of the company have a certain inherent fiduciary responsibility for disclosure, reporting and making sure that the general stockholders, not only the people that were employed by Enron, had a clear understanding of the financial situation.

Certainly if we make changes we need to make sure that there is stronger accountability. Let me ask you what you think would happen if companies out there were totally subject to unlimited liability for fiduciaries and executives, regarding how an ESOP or a 401(k) operates? What effect would that have on the company's ability to offer such plans?

Mr. Stein. The calculus or the basic formula has always been this. We want to protect participants as much as we can without really stifling plan formation. That is, we don't want to have a world that protects participants when there won't be any participants.

I think Congress initially tried to strike a balance. What I say in my written testimony, and I think this is true, is the courts have tried to strike that balance on a case by case basis, and I think in the process of doing that they're looking at an individual case and naked words on the page of a statute.

I think that the balance has shifted so much away from protection of plan participants that I really think the time has come for Congress to say we need to go back to the original balance that we thought we were putting in place in 1974. Now I think the things I see that can't be remedied under the statute and the rules that have developed in the courts to help employees, make it difficult for employees to bring lawsuits, everything from statute of limitations. There are cases now in

several of the circuits that suggest as soon as you learn of a breach, you have to bring an action.

In the real world, if you're an employee and you have worked for six or seven years and your employer tells you something about the plan and you're not sure that it's the last word, you may think maybe when I retire, they'll change their minds. If you don't bring an action right then, you may lose your cause of action, but you're not going to bring an action if you want to keep your job. That is just one example. Attorneys' fees.

Mr. Fletcher. I'd like to hear from some of the others, but my time is up, Mr. Chairman. Maybe they can answer later.

Chairman Johnson. Let me add, if anybody wants to put questions in the record for answering later, we can allow that, also.

The Chair recognizes the gentleman from New Jersey, Mr. Payne, for five minutes.

Mr. Payne. Thank you very much.

The advent of defined contribution plans is relatively new over the last 20 to 25 years or so. The old defined pension plans where the company and employees invested were guaranteed for the future. I listened to most of you who feel that when the big changeover to ESOPs, 401(k)'s, and now the KSOP occurred, it seemed a laissez faire policy; a government that governs least is best, water seeks its own level, and people shouldn't be constrained. It's your right to elect. However, when we see what happened in the Enron situation, it appears to me that government, and the taxpayers are participating by virtue of people being able to defer taxes, therefore, paying fewer taxes that go into a 401(k). So therefore, all the taxpayers are really indirectly subsidizing those plans.

I'll just ask you individually. What do you feel government should legislate, if anything, in order to protect the employee? Do you think it should be a percentage, a cap, or just a laissez faire policy? It's their money; let them do what they want to do.

Ms. Miller. I'll start.

Mr. Payne. Like my old class, I'd ask a question and nobody would want to start. Go ahead.

Ms. Miller. First of all, I want to clarify that defined contribution plans are really not a new phenomenon. The first plan recognized as a tax-exempt retirement plan was the Sears & Roebuck stock bonus plan under the Excess Profits Tax Act back in the 1920s. These are longstanding arrangements, but were less common until the 401(k) plan arrived and blossomed, as one of the other speakers mentioned.

In terms of protecting employees, I think we've already beat on this horse, regarding access to remedies needing to be reconsidered with speed, efficiency and at a comfort level at which the employee knows they have someplace to go rather than just being lost.

I think the other thing that needs to be looked at is the reporting and disclosure rules under ERISA. You know, these were drafted in the 1970s, before we had the Internet and ready access to a lot of financial information. I think maybe it's time to rethink some of those rules in terms of timing and format. The Department of Labor has done some work on electronic communications and offering some comfort levels there.

Finally, I think the legislation that the Congress has been struggling with about advice and that transition, and how employers can provide advice without providing influence and flip-flopping from being the good guy advisor and educator into the bad guy fiduciary who is manipulating and influencing people. That is a tough situation particularly for closely held companies to deal with. I think some sort of legislation in that regard that creates some safe harbors, some known standards of conduct, would be very helpful.

Mr. Stein. As Becky said, defined contribution plans are not new animals. There are three things, though, that I think are new about them. One is that they became the most popular type of new retirement plan. The second thing is that due to the 401(k) plan, a lot of people who would have been covered by traditional plans are no longer covered, because they have to make the initial decision to participate, and that, I think, has been a real problem. And third, which in some ways I think is the greatest problem, is that we've seen in the last 20 to 25 years an abdication of the investment responsibility to the employees that we talked about earlier.

I don't think education is really the answer. It is for a lot of employees, but a lot of employees just are not educable, frankly. I have a cartoon in my testimony, which I think really summarizes some of the problems and asks whether we really want to be a nation where everybody has to be an investor. And the cartoon, for those of you who don't have a copy of the testimony, has a blue-collar worker, up at night, with his wife asleep beside him. The caption is: "Eugene, who delivers bananas for a large produce company, couldn't sleep at night. He understood why the Europeans, seeking unified financial stability, had gone to the Euro, but he also knew that if it disrupted any of the fragile global economies, he could take quite a big hit on his 401(k)." I think this shift to individual employees has not been without cost. We've lost leisure hours, we've lost work hours, and I think it has created a degree of anxiety, which doesn't have to be there.

Chairman Johnson. Thank you, sir.

Mr. Payne. Thank you, Mr. Chairman.

I just wanted to clarify that I did not mean that they were brand new. It's just that it's only been over the last 10 to 20 years that everyone talks about 401(k) s. They really don't know what they are, but everyone is talking about them. And that's what I meant. Thank you.

Chairman Johnson. Thank you. The Chair recognizes the gentleman from California, Mr. Miller.

Mr. Miller. Thank you, Mr. Chairman.

Mr. Stein, let me ask you a question. You indicate in your testimony that we have a tax subsidized employment system that encourages employers to contribute stock as opposed to cash.

Eventually, I guess, theoretically, this can encourage where you end up without the diversification, which all of us talk about on the floor every day. We tell all of these people about the brilliance of long-term investing, diversifying, buying mutual funds, buying a family of funds, buying a fund of funds, and make sure you've got all the numbers on the board covered here. But what has happened here is that that tax incentive has worked in just the opposite direction. Is that your testimony?

Mr. Stein. That is part of my testimony. Actually, you have read my testimony because it wasn't something I really talked about orally today. But, yes, there is much in the tax code that encourages employers to encourage their employees to invest in employer stock.

Mr. Miller. I just don't want to misrepresent you, if that's basically it. Let me ask you the second question.

You get to a point for a whole host of reasons and I'm not even suggesting that they are bad or evil or wrong. You see Proctor & Gamble in the chart for example, 94 percent is held in Proctor & Gamble stock; Home Depot, 74 percent; Enron, somewhere in between or below; and Coca-Cola. At what point is it conceivably contrary to a fiduciary relationship to continue to lead your employees to believe that this is a prudent investment or preservation of funds? Is there no time in the economic cycle when you might say, people get out of these consumer stocks, get the hell out of here now, folks, get back into tech or go over here with auto, whatever it is. But you sit there saying, well, Proctor & Gamble. They've had some rough rides.

Mr. Stein. I think there are two answers. Your question really has to be thought about in two different situations.

One is the ESOP situation. Those are plans designed to invest in employer stock. Courts have really struggled when the stock is tanking and the insiders know the stock is tanking and what do they do if they don't diversify, because here is a plan that is supposed to invest in employer stock.

Mr. Miller. Let me ask you this question then. We had this woman in here from Enron, vice president, directly reporting to Mr. Lay. I assume in some other corporation, if somebody who directly reports to the chairman of the board is on the pension plan at what point do they walk in and exercise their fiduciary relationship? When do they say, you know what, we have 90 percent of our stock invested in XYZ Corporation, I think we ought to divest ourselves of some of this stock? What is the message that Wall Street receives on that exercise of fiduciary relationship?

Mr. Stein. I think she did a real favor, by the way, for the plaintiffs' attorneys in her testimony.

It's all so confusing. There are so many different messages. I don't know what messages people derive. In the 401(k) plan something that I think is very unfortunate, and one reason why we allow employees to make these investment choices, is we immunize, by and large, fiduciaries from responsibility for bad investment decisions.

Mr. Miller. I understand that. I understand that. But, we have the case here of Ms. Olsen, who has access to all of this information, acts on that information based on her own stock, but doesn't think there is a fiduciary relationship that runs there. But at what point, in terms of her career at Enron, does she believe she can go in and say I think we ought to sell 50 percent of the Enron stock?

Mr. Stein. Or tell the employees that you better start thinking about diversifying.

Mr. Miller. Or tell the employees. They, in fact, held the stock for the employees in a plan, right? It's not put into individualized accounts. The employees don't have dominion over that stock.

Mr. Stein. I can tell you what I would do if I were a Federal judge and making the rules. If you are asking me to predict what I think Federal judges will do, I'm out at sea.

Mr. Miller. If people are going to argue, I don't know where I am on the caps yet. I'm almost coming to the conclusion that they are necessary. But if you are going to argue that you don't have caps, you better dramatically change and strengthen this so-called fiduciary relationship.

Mr. Stein. If you don't have caps and you dramatically change the fiduciary relationship or the consequences of breaching the relationship, I guarantee you won't need caps. If the people are going to be responsible for employees' bad decisions, they won't need caps.

Mr. Miller. Wouldn't the marketplace make the fiduciary relationship mean something so that people would understand what they are taking on with respect to their employees?

Mr. Stein. My view always is if we know something is stupid and we could stop bad things from happening before they happen, that is preferable to trying to sort out messes. So for that reason, I would favor caps rather than simply strengthening fiduciary relations. I would do both.

Chairman Johnson. The gentleman's time has expired. Thank you for your questions.

The Chair recognizes Mr. Tiberi for five minutes.

Mr. Tiberi. Mr. Chairman, I am going to yield my five minutes to the Chairman of the Committee, Mr. Boehner.

Mr. Boehner. Let me thank my colleague for yielding.

Dr. VanDerhei, can you outline what you believe the fiduciary responsibility of a fiduciary is in a 401(k) plan?

Dr. VanDerhei. Certainly, within the best interest of the participants overall.

Mr. Boehner. That would be the administration of the plan, setting up of the plan, and multiple options for investment.

Dr. VanDerhei. Multiple options for investment certainly could be one route. Not all defined contribution plans certainly had participant direction. In fact, that was something relatively recent, when 401(k)'s were first introduced and employee deferrals became a bigger part of the picture. It was a situation of, and this actually goes back to some of the previous questions, what might be a likely response to additional liability on the part of the employers.

Certainly one response might be that it's just not worth the risk anymore. Instead of allowing employees self-direction, for example, young employees have aggressive portfolios or older employees have conservative portfolios, just have one balanced fund portfolio that applies to all individuals.

Mr. Boehner. But in a 401(k) plan, the fiduciary has no responsibility over how much diversification or how little diversification there is in any individual account; is that correct?

Dr. VanDerhei. I think with respect to what we're referring to today, that is more or less true, in general. There are some diversification requirements that are very important. For example, when you offer something referred to as a gig portfolio, in some cases, there have been lawsuits that have come up that perhaps the portfolio of life insurance company general assets that are included in that gig portfolio have not been sufficiently diversified.

Mr. Boehner. Let me ask each of the members of the panel based on what you know about the Enron situation, do you believe that there is a clear indication of a lapse of fiduciary responsibility with regard to Enron?

We'll start with you, Dr. Kruse.

Dr. Kruse. I actually only know what I read in the paper about Enron, and I don't feel qualified to comment on the lapse.

Mr. Boehner. All right. Mr. Stein?

Mr. Stein. I certainly think there are fiduciary violations when you have people telling employees don't sell the Enron stock in your plan, because the future of Enron is bright, when they were selling their own stock.

Mr. Boehner. In that case, what you are referring to are company executives who may, in fact, not be fiduciaries.

Mr. Stein. Yes. Was there any requirement to diversify? I don't think, under current law, if you structured your plan to comply with Department of Labor Regulations, diversification is the responsibility of the employees.

Mr. Boehner. Ms. Miller?

Ms. Miller. I would say the same thing, from reading the newspaper reports and I looked at their SEC filings on the plan to get some details too. But the way the plan was designed and apparently

the way it was administered, there is no clear ERISA fiduciary violation by those named fiduciaries under ERISA. There may have been. It just hasn't come out in the press.

Mr. Boehner. Dr. VanDerhei, anything to add?

Dr. VanDerhei. I would agree with that.

Mr. Boehner. As I look at our hearings last week and as I read the countless articles based on what we know today, I don't see clear fiduciary irresponsibility at this point. Now, in the case of an executive who may have talked in a very positive way about the future of Enron stock, they could have put themselves into a fiduciary role, although they may not be a named fiduciary. But in light of the testimony last week, I don't see the violation.

Now, Mr. Miller and I had a conversation at one point about what Ms. Olsen's responsibility was based on information that was given to her, but she didn't really confirm those as inappropriate, in terms of what was happening to the company, in those 401(k) accounts. It is the participant who makes that decision.

Mr. Stein. There is one area in which she may have breached, other than just making misrepresentations. I don't think you can simply say, well, I know this information personally and, therefore, I don't know it in my fiduciary capacity.

If you know information, you know it in all your capacities, including your fiduciary capacity. It may be that there was an affirmative obligation, when she knew the stock was really in danger, to affirmatively notify the participants, and that is going to be one of the claims that I think is new to this case.

Mr. Boehner. But at what point? This started dropping in February and it dropped all the way through December. So she could see it, just like any other employee.

Mr. Stein. I think she has some knowledge that not all employees had, from what I understood.

Ms. Miller. I think, also, that we might want to clarify that to the extent that there were assets in the match account over which the participants did not have control, there are risks associated with those assets and there might have been a fiduciary breach.

Mr. Boehner. Thank you, Mr. Chairman.

Chairman Johnson. Thank you. The Chair recognizes the gentleman from Massachusetts, Mr. Tierney.

Mr. Tierney. Thank you, Mr. Chairman.

This is such a broad area. I know that we used to think of people retiring and having protections and we always talked about there being a real firm foundation. You had your savings. You had your pension plan, which, at that time, seemed to be a defined benefit pension plan, and

you had your Social Security. Social Security always secures a guaranteed amount, with a cost of living increase built into it, and wasn't a great risk. Savings, unfortunately, was never enough. The whole idea of having public policies that tried to encourage employers to have pension plans was what we thought would really firm up that end of it.

So we had mostly defined benefit plans. We gave them favorable tax treatment. We had them protect the plans with a fiduciary responsibility as to how they invested it. We limited the amount that they could invest in the subject company to 10 percent, and then we insured it. Now, over time, we moved away from that to the defined contribution plan, and there isn't any set amount when you retire. You're totally at risk for the ups and downs of the market during any time. No fiduciary responsibility. It all falls on the employee's shoulders.

We have a big debate around here as to why we should give people the right to advice if it's going to be conflicted advice, an unlimited amount to invest in employer company stock, but it's not insured. It seems to me that we have walked away from what originally had been our plan of a public policy to keep people out of poverty when they retired and just let this thing slide back down to where we're exposed.

So my questions to you are, am I right and does that seem to be the trajectory of things, and, secondly, ought there be some way that we can firm this up again? Is there some way that the 401(k) participants or the defined contribution participants could have a reasonable insurance plan if things went bad?

Begin at whichever end of the spectrum you want. Ms. Miller?

Dr. VanDerhei. I have just one quick clarification.

Certainly, in the past, defined benefit plans were definitely more predominant than they are today. But I think there is an allusion that, at least in the private sector, there was much more of a guarantee for a particular type of adequate retirement income. Many of these are what are known as final averaged plans, which will take a look at what you have earned in the last few years prior to the time you leave employment. If somebody has several jobs during the course of their career, which most employees do, oftentimes what is going to be earning the vast majority of the total retirement wealth will be what they have in their final job.

So, yes, for a career employee, somebody who spent 35-40 years with the same employer, the final averaged defined benefit plans did an excellent job of giving this type of guarantee, probably very adequate retirement income you're referring to. But many of the studies that have been done by the academics have looked at exactly this question. Let's look at people's job tenure patterns, let's look at when they changed jobs, let's look at what they would be better off in defined contributions or defined benefit plans. Andrew Samrik and some other individuals have looked exactly at this and found that overall, the defined contribution plans tend to do better given these job change scenarios than defined benefits.

Mr. Tierney. Given Enron, given Lucent, given Polaroid, given all those companies, I think those findings are probably going to change a little.

Dr. VanDerhei. You can always pick a few anecdotes, I'm sure, that are going to end up in a situation where those things happen. I'm not saying every defined contribution participant does better than defined benefit participants, but I'm speaking to the previous comment.

Mr. Tierney. I guess it has the potential to do better and the potential to do a lot worse, because you're considerably more at risk. Was there ever any attempt to look at the ability of having defined benefit plans, whereas you change jobs, have it portable and take it with you?

Dr. VanDerhei. It's not so much portability as the economics of what the benefit accruals look like at various stages. It is an inherent fundamental design feature of a defined benefit plan under final averaged plans that if you change jobs a lot, you will end up with a much lower benefit than somebody with the same salary progression who has stayed with that same employer for the entire time.

Mr. Boehner. Mr. Chairman? Will the gentleman yield?

Mr. Tierney. Sure.

Mr. Boehner. There is an alternative to a defined benefit plan that does allow you to take most of it with you, and that would be a cash balance plan.

Mr. Tierney. We'll get to that later on.

Mr. Boehner. I know how popular they are, in your mind.

Mr. Tierney. Maybe we'll let somebody else have a crack at this, too.

Dr. Kruse. I would like to address your question. As I said in my testimony, to the extent that assets are concentrated in one stock, I don't think that should be the basis for retirement planning. Quite frankly, while my view may not be popular with some companies, my view is that ESOPs and employer stock heavy plans should not be seen as retirement plans. They should be seen as potentially lucrative employee benefits. Employees should be made aware of that. However, if my employer wants to give me lots of stock that may turn out to be worth a lot, that's great.

Mr. Tierney. So as public policy, you think we ought to put a firewall between what is retirement and what is this other simple benefit?

Dr. Kruse. I think ESOPs were originally put into ERISA mainly because Senator Russell Long, the champion of ESOPs, was head of the Senate Finance Committee at the time ERISA was being passed, and that's where he managed to stick ESOPs. Quite honestly, I wish ESOPs were treated separately as a potentially lucrative employee benefit, as I said, but not as a retirement plan by the employees.

Mr. Tierney. Thank you.

Mr. Stein. I think there have actually been two really important shifts in the last 20 years in retirement plans.

One of the shifts is a move away from retirement security to asset accumulation, and I think that is one of the things we see with defined contribution plans. The other thing I think we have seen is that ERISA had amazing success right around 1980.

If you look at the period beginning a little before ERISA, well-managed plans were viewed as employee property and you saw employers routinely indexing benefits for retirees after they retired to help them catch up with inflation. Somehow that idea vanished in the wave of conversions from defined benefit plans and the rush into 401(k) plans. Now we see employers regarding plans as profit centers for the employer, or employer property, and that is the emphasis, rather than it being employee money.

Mr. Tierney. Would you expand on that a little bit?

Mr. Stein. Well, in defined benefit plans, I think you can see that except for a few plans that are negotiated between organized labor and companies, there is no more inflation of benefits. There is no more indexing of benefits. I think the notion of setting up individual accounts with employer stock, to some extent, is really too broad a statement. But for some small plans, I think it is often a way to create a market, as Becky said, for the stock and keep control of the company in a few people's hands, and that to me is not really employee ownership.

So I think those are two trends that don't bode well if what we're interested in is retirement security. I'm not opposed to asset accumulation. I'm trying to do as much of it myself as I can. But I'm not sure if that is what the retirement funds do. I agree entirely that stock ownership would be fine if it wasn't a retirement vehicle or wasn't seen as a retirement vehicle and didn't have all the tax incentives. There is a Christmas tree decorated with tax incentives for that particular kind of plan and if the market thinks that these plans are good, it doesn't need all these tax incentives from the government to help them come into place.

Also, this isn't really in response to your question, but I want to point out that what Becky said earlier is absolutely right. In the Enron plan, some of the employees were locked into stock. They couldn't diversify. And with respect to that stock, I think it almost clearly was a fiduciary violation just to leave that large amount of money, the stock that the employees couldn't move or sell, in Enron stock. So there is a difference between the stocks the employees had control over and the stock that they didn't.

Chairman Johnson. For the record, it was 11 to 13 percent of the stock that they had no control over, a very small amount.

The Chair recognizes the gentleman from New Jersey, Mr. Holt.

Mr. Holt. Thank you, Mr. Chairman, for letting me join you today. As you know, in the last Congress, I was on this Subcommittee, but the choices of more senior Members meant that I couldn't formally be a Member. I remain very interested in what you are doing and I thank you for letting me join you today.

Mr. Stein, you said in your testimony that stock ownership aligns the interests of firms and workers. Dr. VanDerhei, I believe you talked about the building of company allegiance and attitudes toward the company that goes along with stock ownership. Perhaps the answer coming up to my question would be different if you see this as a retirement plan as opposed to an asset accumulation plan. But what I wanted to find out is whether company allegiance and this alignment of interests between workers and firms is very different if employees have 40 percent of their assets in direct stock of the company as opposed to 90 percent of their assets in the stock of that company.

Let me start with Dr. VanDerhei, then Mr. Stein, then anyone else who wants to comment.

Dr. VanDerhei. If I could defer to Dr. Kruse, because that is right up his line of research. That is nothing that I have investigated.

Mr. Holt. I'm sorry if I confused your testimony. I beg your pardon. Dr. Kruse from New Jersey. Thank you.

Dr. Kruse. A very interesting question. There have, as I say, been many studies done on employee ownership and firm performance. There have not been studies specifically on how percent as you were describing, whether it be 40 percent or 90 percent of employees' stake, relates to employee ownership. There clearly is the finding that the higher the percent of a company owned by employees, the better the outcome overall.

Mr. Holt. Outcome in what sense?

Dr. Kruse. The higher the percent of the company that is owned, the better the outcome in terms of productivity and organizational commitment. But in terms of the individual employee stake there hasn't been good research there. I suspect it has to be at least 5 or 10 percent of pay before you see a positive productivity effect.

Mr. Holt. We have a triangle. We are balancing here with company interests, public interests, and employee interests.

I will take answers in order.

Mr. Stein. I would defer to Becky.

Ms. Miller. I would agree, and my evidence is anecdotal. I have worked with several ESOP companies and I can tell you that Norm alluded to what we refer to as the hidden ESOP, the company that has a concentration of company stock, but never walks the walk or talks the talk about actually being a participatory management employee owned company. Those companies are

different. I mean, that doesn't belong at this table when we're talking about employee ownership.

When we are talking about really having an effect on productivity and value and survivability of the company, it is two things. One, as Dr. Kruse mentioned, it is the percentage of ownership that the employees have in the company, so their sense as a group is that they matter and that they can influence decision-making.

More importantly is the whole attitude within the company of do the employees matter, are they involved, do they get information, are they listened to, do they have active exchange programs with management, and are they able to influence the areas of the business that is important to them. Those are the companies who see the real effects of productivity increases.

Mr. Stein. I want to say three things, two of which, I think, are in direct answer to your question.

I'm a little bit skeptical whether employee stock ownership plans really always align the interests of employees with the interests of other shareholders. When John Langbein testified, about two weeks ago before the Government Operations Committee in the Senate, he alluded to a study that showed that at about 20 percent you get maximum effect. Beyond that, there is very quickly a point of diminishing return.

The second thing that I want to mention briefly, which I think is in response to your question, is there is also research showing that any type of involvement of employees in decision-making on the production floor and otherwise increases productivity. It could very well be that ESOPs are just an example of employee involvement increasing productivity. That is, it may not be the ESOP. It may be the participation of the employees in the decision-making process of the business, and not all ESOPs give employees that sense of participation, although many do. So what you may have is simply good employers, a lot of good employers adopting ESOPs as one way of involving employees, but it's not the only way.

The third thing I want to mention, and I talked about this extensively in 1997, when I testified before the Advisory Council at the Department of Labor on employer stock and retirement plans, is there is a potential for terrific conflict of interest, which I think we saw with Enron. Enron, at some point had a very strong interest in people not selling the stock. I mean, to the extent the executives were trying to protect themselves, they were selling stock, but they didn't want their employees or other investors to dump the stock because it was going to trigger all these debt obligations if the stock fell below a certain level. They have all this inside information and they should be sharing it with the employees, but if they share it with the employees, they're going to be hurting themselves.

I have an ESOP case now that I am consulting on, where the management just made some very stupid acquisitions and the stock began tanking. At some point, what the employees feel is that the business judgment that the executives of this company made affected their retirement security, and they are angry and they want to bring a lawsuit that basically says if you have an ESOP that owns 100 percent of the company, everything you do has fiduciary implications. And that is pretty scary from a lot of different perspectives, especially from the employer's perspective.

Mr. Holt. Thank you, Mr. Chairman.

Chairman Johnson. Thank you. Let me ask a question here.

Pension plans are audited annually and they were in Enron's case. The Enron witness indicated that filing those audited plans was good enough to meet the rules of ERISA. They file a Form 5500 with the Labor Department. Do you think that the Department of Labor should be following up on those audits? Shouldn't they have noticed something, as well, or do you think they're just filing them and not looking at them either?

Ms. Miller. I'll take that one, since I have to look at 5500s all the time.

You have to realize that the Department of Labor's duty with respect to the 5500s is a huge task. There are hundreds of thousands of retirement plans and welfare plans that file annual reports every year. It is only just recently with the evolution of what is referred to as the EFAS system that these reports have been on a computerized database that is what we want to call time contiguous, so they can compare 1999 to 2000 and start plotting a trend. Up until this point in time, they have been confronted with simply a monumental task.

Yes, they do access this information and trigger audits off of unusual effects that they see in the filings, but it's just a big task and it's not a big group of folks over there.

Chairman Johnson. Do you think the law should be changed to force them to look at those closer or is it an impossible thing to do?

Ms. Miller. Speaking for myself, there are a few changes that could be made.

Within the body of ERISA, there is a concept called the limited scope audit that says if assets are held by a financial institution, insurance company, et cetera, when the audit is conducted, the audit really only audits the assets as they come into the plan and the assets as they leave the plan. There is no requirement to audit any activity within the plan regarding the existence of the assets and the appropriateness of earnings allocations, et cetera.

That is an ERISA provision that actually did not apply in Enron's case, because Enron had to file an SEC report on their filing. So they had to have what we call a full scope audit, but the existence of the limited scope audit means that the accountants who are viewed by a lot of people as being one of the enforcement arms for ERISA just never look at a lot of investment activity.

Chairman Johnson. So you are saying it's a company responsibility, really a fiduciary responsibility, not the Labor Department.

Ms. Miller. Right. The way the law is structured right now, it would be really difficult to shift that obligation to anybody else.

Chairman Johnson. Thank you. Listen, we've got Mr. Tiberi, Mr. Fletcher and Mr. Miller, who all want to ask another question. I would like to try to wind this up quickly before we go vote.

Mr. Fletcher, can you ask a quick question?

Mr. Fletcher. Let me just say a couple of things.

One, somebody mentioned tax subsidies that go to the employers. Let me say the tax subsidies that we set up in the pension plans eventually go to the employees and the workers who benefit from those things. That is clearly obvious if you look at who benefits. Certainly, there is some encouragement for the employers. Secondly, would everyone here that has a defined contribution plan, a 401(k), or an ESOP plan raise your hands? Audience and everybody, please. Even the media. That's good.

Dr. VanDerhei, how much individual wealth has accumulated in this country because of these plans, any idea?

Dr. VanDerhei. Well, if you look at the current asset holdings, there is not a direct answer to your question. It was about $1.8 trillion at the end of 2000. But if you project it forward, which is certainly what is going to be the primary retirement vehicle for the baby boom generation and those following, it becomes more and more of a predominant source vis-à-vis defined benefit plans.

The one thing I think individuals have to consider, though, is a thing that will make even 401(k)'s and defined contributions pale in comparison and that is what is happening with the IRA market. When employees change from job to job, they have a tendency to roll over not to the new employer, not leave it with the older employer, but to roll it over to an IRA. All the projections we have done thus far show that in the very near future, the IRA assets will be much bigger than either the defined contribution or the defined benefit plan as far as retirement wealth is concerned.

Mr. Fletcher. Thank you.

Given the fact that this Committee passed out an almost unanimous education bill that was based on the concept of no child left behind, which means every child can learn, it is just unconscionable to me, Mr. Stein, to think that a lot of employees are not educable. I wonder if you might be able to point out those in this room that are not able to understand their investments.

Mr. Stein. I don't think there are any in this room, although I have to say some of the behavioral constraints on people maximizing value for themselves apply to me.

Mr. Fletcher. I think the point you made was that you feel like there are certain people who are not capable of understanding if they had advice on investments. I think this shows a marked difference in the approach we take to how we're going to deal with individuals' retirement security and what freedoms we give to build personal wealth.

Mr. Stein. I can give you an example. I would like to take you to Alabama and introduce you to some of my clients, some of whom are illiterate. They are not yet the beneficiaries of what I hope

will be the major successes of the education bill that this Committee brought to Congress and ultimately got enacted. Thirty years from now, we may live in a different world.

Mr. Miller. Mr. Chairman?

Chairman Johnson. Yes.

Mr. Miller. Mr. Stein, if I may.

It seems to me that one of the conflicts you have is with employer-donated stock that has restrictions on it, whether it's a vesting restriction on the stock or whether it's a 55-year or KSOP. If you sold that stock, you lost six months of further contributions under their plan. There are penalties. There are restrictions. Someone said it's only 10 or 12 percent. For Enron, that's $120 million in assets that the fiduciary sat there with. I bet those employees would like to have them now.

If this is, in fact, going to be a real 401(k) plan, don't we have to get rid of these restrictions? The day you deposit it in my account, I mean, this is like a bad social security plan. We keep telling people it's in the trust fund and then we keep stealing from the trust fund. The day it is put into my account, shouldn't I have complete dominion over that?

Mr. Stein. I think so. One has to look at this. Enron would tell employees, today we put stock in your account that's valued at $75, that's a match for the $75 you put in.

If I went into the market and Enron stock was selling for $75 and they told me, here's a sure stock, but you can't sell it for 20 years, I would not have paid $75 for it.

Mr. Miller. That would be a tradeoff.

Mr. Stein. And the stock Enron was putting in this plan wasn't worth its market value to those employees, because they lacked the most basic feature of ownership.

Mr. Miller. So the employee really ought to have the freedom immediately, if you want people to stay with the company. Michael Eisner has hundreds of millions of dollars in stock options and they give him new ones to make him a more faithful employee. The guy at Global Crossing was given stock options at ten dollars below the market share.

There's a loyalty factor you want to have. What, so you can drive it down? Can't you give more after five years and more after ten years, or a different match?

Chairman Johnson. I'm going to stop you right here, Mr. Stein. You agreed with him and he has made his point. I want to defer to Mr. Tiberi for one question.

Mr. Tiberi. Dr. VanDerhei, just a quick question.

In a meeting, in response to a comment that Ms. Wade made with respect to the Federal Government getting involved in preventing a further Enron or further Global Crossing or further Lucent, a former employee of a company, who had a high school degree, made this comment. "In doing that, let's make sure the Federal Government doesn't prevent employees from becoming wealthy at companies like AEP, Wendy's, The Limited, or Cardinal Health." Those are companies in my district that have generous stock options and retirement plans for employees.

My question to you is, we hear the anecdotes about Enron, obviously, and Global Crossing and Lucent, but in my district, those are just a few headquarters that have made employees prosperous. Are there any studies to show how employee wealth is accumulated through stock options and retirement plans, as currently configured?

Dr. VanDerhei. Certainly. If I can just quickly refer back to the comments I made at the beginning. As I mentioned, talking just about the 401(k) universe now, only 2.9 percent of the 401(k) plans have company stock, but they tend to be the large ones. So they constitute 42 percent of the 401(k) participants.

If company stock had not, during that period of time, resulted in more advantageous average balances, you would have expected, from a plan asset standpoint, only 42 percent of the 401(k) assets to be associated with those plans, when in fact 59 percent of the assets were held by those plans. So I could do the quick math for you later, but by far, the average account balances tend to be larger for those plans that do include company stock.

Now, it shouldn't be a big surprise, because when you measured it, it was at the end of a rather extensive bull market, and basically one of the better things you could have done for people was to force them in the equity market one way or another. Now, the offset is increased volatility, but certainly, on average, when we did this study in 1996, being in a 401(k) plan with company stock, you ended up with a much larger 401(k) balance.

Chairman Johnson. Thank you very much.

Without objection, I am going to allow Mr. Andrews to enter into the record an addendum to Mr. Stein's testimony. Ms. Miller, I know you had a comment you wanted to make. I appreciate that, but we are out of time and we need to go vote.

I just want to thank all of you for your valuable time and testimony and thank the Members for their participation. If there is no further business, the Subcommittee stands adjourned.

Whereupon, at 3:50 p.m., the Subcommittee was adjourned.

APPENDIX A - OPENING WRITTEN STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Opening Statement of Chairman Sam Johnson
Employer-Employee Relations Subcommittee

February 13, 2002

"Welcome to Capitol Hill today where we are all Enron, all the time.

"Please raise your hand high if you have read a story about someone losing his or her life's savings with the collapse of Enron?

"Like you, I hear about the stories where people have literally lost everything. It's just devastating.

"It's the ultimate opposite of the American dream.

"But we must rely on the American spirit of creativity and enterprise and learn valuable lessons from the collapse of Enron - and apply them.

"Congress should help, not hinder, investing for retirement.

"But as we examine what happened over the last several months, we must also look a bit farther into the past - to defined benefit pension plans.

"Make no mistake, Congress so loved the defined benefit pension system…And made it so safe…With so many layers of protections…That Congress literally loved this type of benefit plan to death.

"And these plans are so safe and so secure that hardly anyone offers them anymore.

"I do not want to repeat the demise of the defined benefit system and ruin the defined contribution system that has provided retirement security for millions of Americans.

"These retirement plans are voluntary. Employers don't have to offer them, much less contribute to them.

"We must move cautiously.

"If we make successful plans like 401(k)s so difficult to offer and so difficult to match, then these investment plans may become extinct.

"Now that's a mistake we would make at the expense of every American who hopes to retire someday.

"Keeping that in mind, I hope we can look to ways that empower Americans to save for their retirement and give them the tools they need to make it to their golden years - safe and secure.

"In the wake of Enron, it is just plain wrong not to give employees access to high quality investment advice - like their executive level counterparts.

"I hope that the Senate learns from the Enron collapse that knowledge is power and employees want it now. I urge the Senate to pass Investment Advice now.

"Today I hope our witnesses will educate the Subcommittee on the role retirement plans like 401(k)s play in ensuring retirement security for workers as well as providing a sense of worker ownership and pride in corporate America.

"We also need to understand the contributions that Employee Stock Ownership Programs, or ESOPs, make and the difference between publicly held and privately held ESOPs.

"Thousands of rank and file workers have accumulated substantial wealth through Employee Stock Ownership Programs, company matches in corporate stock and other programs. As we consider the President's proposal on pension reform, which Chairman Boehner and I are introducing today, and other legislative proposals, we must be mindful of our responsibility not to threaten the retirement savings of a large number of American workers.

"We should also keep in mind the implications of any legislation to our over all economy.

"Our ultimate goal should be to encourage, not discourage, retirement savings. I hope that this Committee and this Congress keeps that in mind as we move ahead to ensure American employees and employers may enjoy a secure retirement."

APPENDIX B - WRITTEN STATEMENT OF REBECCA MILLER, CPA, PARTNER, McGLADREY & PULLEN, LLP, ROCHESTER, MN

Testimony for the Subcommittee on Employer-Employee Relations "Enron and Beyond: Enhancing Worker Retirement Security"

February 13, 2002

By Rebecca Miller
Managing Director for Employee Benefits Practice Policy
RSM McGladrey, Inc.

Brief U.S. History Of Employee Stock Ownership Plans[1]

Stock bonus plans have been part of the benefit plan environment since the earliest part of this century. ESOPs can be distinguished from plain stock bonus plans by their authority to borrow funds to acquire company stock. Thus, ESOPs are frequently used to assist a business in the transition of ownership to the employees, to finance an acquisition or expansion, to create capital, etc. ESOPs represent the forging of financial or capital structure goals with employee benefit or motivation goals.

Officially, ESOPs were recognized as a tool to combine corporate finance and employee benefits with the passage of ERISA in 1974.[2] This is done by allowing the ESOP to purchase stock through financing obtained with the assistance of related parties. The plan sponsor then repays those funds over time, getting a tax deduction for both interest and **principal.** As payments are made, shares are released from collateral and allocated to the accounts of plan participants. Such allocation must pass the general non-discrimination, eligibility, participation and vesting standards applicable to all tax-qualified retirement plans.

Always remembering that the company stock must also be a prudent investment.

The success of this tool can be illustrated by its growth in popularity. The following table was assembled by the National Center for Employee Ownership.

Year	Plans[3]	People
1975	1,600	248K
1980	4,000	3.1M
1990	8,080	5.0M
1993	9,225	7.5M
1994	9,670	7.9M
1995[4]	10,170	8.3M

[1] ESOPs include many, many technical requirements for the privileges outlined in this section. For purposes of this presentation, only the general terms are included. Reference should be made to the attachments and the applicable Code or ERISA provisions for the detailed requirements.
[2] See ERISA Sections 407(d)(6) and Rev. Rul. 79-122.
[3] Includes statutory ESOPs as well as plans that are not true ESOPs but are primarily invested in employer securities AND made distributions in employer securities.
[4] Based on most current U.S. Department of Labor data.

1996[5]	10,670	8.7M
1997[3]	11,100	8.5M
1998[3]	11,400	8.5M
1999[3]	11,400	8.5M
2000[3]	11,400	8.5M
2001[3]	11,400	8.5M

ESOP assets are estimated to have grown from about $60 billion in 1989 to over $400 billion in 2001.[6]

Much of this success can be attributed to a steady pattern of increasing income tax incentives. In today's ESOP community, not all ESOPs incur debt. But most of the significant income tax incentives require a true or statutory ESOP, not simply a stock bonus or profit sharing plan.

Current Tax Incentives for Employee Ownership

In today's tax environment, the ESOP is the most tax-advantaged means for sharing ownership with employees.

All ESOP sponsors, whether public or private, get the advantage of combining financing with an employee benefit. A company forms an ESOP. The ESOP borrows funds to purchase stock (new stock or currently outstanding stock). Over time, the ESOPs debt is retired with tax-deductible contributions. Thus one, tax-deductible dollar serves two masters – financial and employee benefit. Where the plan sponsor is a C corporation, the normal deduction limit of 25 percent of pay can be calculated without including the portion of the contribution that is used to pay the interest.

For private companies, the following additional tax-benefits are available:

- For a C corporation, if immediately following the sale, an ESOP owns at least 30 percent of the qualifying employer securities of the plan sponsor, then the selling shareholder(s) need not pay any current capital gain tax on the transaction, as long as the proceeds are reinvested in other qualifying domestic corporation securities.[7]
- A C corporation that pays dividends can receive a deduction for dividends[8] that are paid on the ESOP's shares as long as the dividends are:
  - Applied to the outstanding ESOP debt.
  - Distributed in cash to participants
  - Allocated to participants under a cash or deferred election where the participant gets to choose to take a cash distribution or retain the dividends in the plan, reinvested in company stock.

[5] Based on National Center for Employee Ownership estimates using IRS letters of determination.
[6] Source – National Center for Employee Ownership (NCEO).
[7] IRC Section 1042
[8] IRC Section 404(k) and related legislative history.

- For an S corporation, there is no income tax due with respect to the portion of the sponsor's profits that is attributable to ESOP ownership.[9]

All of these tax incentives are subject to multiple restrictions to balance lost tax revenues with the economic goal of broadened stock (employee) ownership.

Besides these current tax incentives, over the last 30 years ESOPs have also enjoyed the following tax incentives (which have expired or been repealed):

- Income Tax credit for securities contributed to a plan in correlation with job expansion or investment expansion. (TRASOP or PAYSOP credits.)
- Expanded individual allocation limits
- Estate Tax Exclusion
- Tax sheltered interest income for institutional ESOP lenders.

Operational Distinctions of a *True* ESOP

Besides defining the concept of an ESOP, ERISA also created a less well-known concept - the "EIAP"[10] or eligible individual account plan. This is a defined contribution plan, generally profit sharing or stock bonus, which is exempt from the general diversification standard. All ESOPs are EIAPs, but not vice versa. EIAPs are substantially less restricted than ESOPs in their employee ownership attributes.

To be a true ESOP, a plan must include the following features:

- Allocation of contributions cannot be tested for discrimination by taking into account Social Security Benefits. [11]

- For a public company, all voting rights must be passed through to plan participants. For a private company, voting pass through is limited to major issues. [12] (The concept of a *public company* for this standard is one with a class of securities subject to registration under section 12 of the Securities Exchange Act of 1934.) Non-ESOP stock bonus plans may also require the pass through of voting rights.

- The participant must, generally, have the right to demand a distribution in stock. This right can be restricted for certain non-public companies such as S corporations or ones that restrict ownership to active employees or an ESOP.[13]

- If non-traded stock is distributed, the plan sponsor must make a market for that stock. This grants the participant the right to demand cash within 60 days of receiving an installment distribution or to receive a fully secured note payable over a period not to

[9] IRC Section 512(e).
[10] ERISA Section 407(d)(3).
[11] IRC Regulation Section 54.4975-11(a)(7).
[12] IRC Section 409(e)
[13] IRC Section 409(g)

exceed 5 years upon receipt of a lump-sum distribution.[14] The note is to bear a *reasonable* rate of interest. (Some stock bonus plans, that are not true ESOPs, are also subject to this rule.)

- The securities held by the plan are limited to any common stock of the employer that is *readily tradable on an established securities market.* Where no such marketable stock exists, a qualifying security is that stock having a combination of the greatest voting rights and greatest dividend rights. A preferred stock that is convertible into the appropriate common stock is also permissible.[15] There are numerous special rules applicable to the nature of a qualifying security.

  This is, perhaps, the most fundamental difference between ESOPs and EIAPs. EIAPs are permitted to hold non-voting stock, non-convertible preferred stock, debt instruments in certain very limited fact patterns, etc.

- If a security is not actively traded, it is also subject to an independent annual appraisal requirement.[16]

- True ESOPs and certain stock bonus plans face more stringent distribution rules than other defined contribution retirement plans. These rules impose a requirement for distributions to commence earlier than required of other defined contribution plans. However, in today's marketplace of daily valuation, participant directed profit sharing and 401(k) plans, many ESOPs actually commence distributions later than other defined contribution retirement plans.

  Defined contribution retirement plans are permitted to defer all distributions until an employee or former employee attains normal retirement age. (Generally age 65 or earlier.) ESOPs, in contrast, are required to commence distributions within 1 year of the death, disability or retirement of a plan participant and in the sixth year following some other termination of employment.

  Further, other retirement plans are permitted to make distribution installments over a period not to exceed the life expectancy of the former participant or the joint life expectancy of the participant and his or her designated beneficiary. In contrast, ESOP distributions are to be made over a period of 5 years, unless the participant requests a longer distribution period. This 5-year distribution period may be extended by up to another 5 years for very large distributions. (Currently balances of as much as $800,000 must be distributed in not more than 5 installments.)[17]

- Finally, though such plans are permitted to hold 100 percent of plan assets in employer securities, Congress decided in 1986 that participants should have the right to diversify their accounts as they neared retirement age. For persons who have

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[14] IRC Section 409(h)
[15] IRC Section 409(l). For this purpose, an *established securities market* is generally considered to be a NASDAQ level market or superior.
[16] IRC Section 401(a)(28)
[17] IRC Section 409(o)

attained age 55 and completed 10 years of participation in the plan, an ESOP must offer that participant the right to take a cash distribution of the current value of 25 percent of their shares or to convert the value of those shares into at least 3 economically diverse investment alternatives. This 25 percent diversification privilege applies for 5 years. In the sixth year, diversification can be increased to 50 percent. (Note that this is 25 percent or 50 percent of the shares that the participant has accumulated. It is not 25 percent of each year's balance. For example, assume a participant had accumulated 1,000 shares and elected to diversify 20 percent or 200. In the following year they received another 20 shares, their additional diversification privilege would only be 55 shares. This would be 25 percent of 1,020 total shares, less the 200 shares already diversified.)[18]

This provision applies to the ESOPs of public and private companies.

Common ESOP Applications

As noted earlier, the remarkable thing that the ESOP created was a vehicle that could combine corporate finance objectives with employee benefit consequences. However, this combination of features is not obvious in all ESOP applications. In some situations, the financing attribute is simply that the benefit is provided through stock, not current cash.

1. *Alignment of Interests*: Frequently, the primary reason for forming an ESOP is to create a tax-advantaged vehicle to focuses the attention and personal self-interest of employees on the success of the company. This application is seen in both public and private companies. It is frequently cited as being easier to achieve in smaller, private companies. However, substantial public companies such as Procter & Gamble put great emphasis on this application.

2. *Long View*: Many human resource consultants complain that too much attention is paid to very short-term results. With the ESOP focusing on share value, rather than current profits combined with a payment of the reward well into the future; an ESOP can add a longer view to the decision making process. This application is seen in both public and private companies.

3. *Replace Other Employee Benefits:* Since other employee benefits require cash, employers occasionally will replace other benefits, supplement other benefits or avoid increasing the level of other benefits by adding an ESOP or increasing the funding of an existing ESOP. Many discussions on this subject took place in the early 1990's when companies were evaluating their post retirement medical care programs in light of the publication of SFAS No. 106 – *Employers' Accounting for Postretirement Benefits Other than Pensions.* This is more commonly a public company application, but it is also seen in private companies.

4. *Create a Marketplace/Liquidity for Existing Shareholders:* Private companies are frequently faced with few options for transitioning ownership. Tax rules make it

[18] IRC Section 401(a)(28)(B).

disadvantageous for a shareholder to reduce their ownership interest over time. [19] Yet, lenders frequently want to see a gradual shift in management or control. A properly constructed ESOP creates tax advantages for both the shareholder and the plan sponsor, thus facilitating this transaction of ownership.

For smaller public companies this application is seen to keep the marketplace active.

5. *Share Ownership:* Particularly common in private companies, ESOPs are used to create means of sharing ownership with employees on an equitable basis with little income tax complications for the employees.

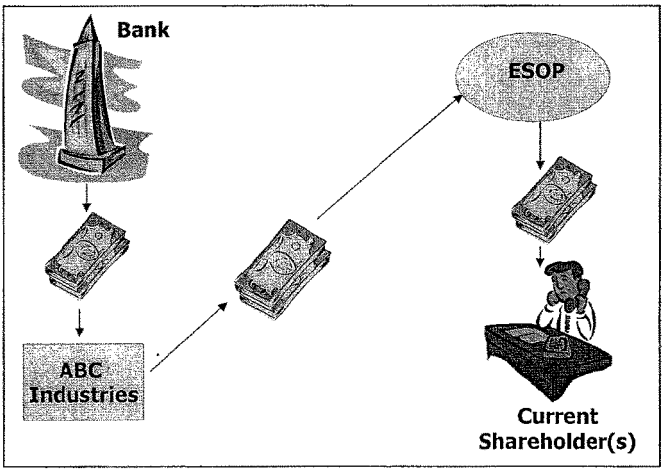
6. *Finance an Acquisition or a Divestiture:* Because of the ability to meet employee benefit objectives while providing capital, ESOPs are used to finance acquisitions and to facilitate divestitures. This use is seen in both public and private companies.

7. *Anti-takeover Tool:* This use is most common in public companies. Under the corporate laws for certain states, it is possible to avoid a take-over bid by having sufficient stock in *friendly* hands. An ESOP can be considered friendly hands.

   Private companies use an ESOP for the same purpose because the additional complexities created by having an ERISA plan as an owner can discourage potential buyers.

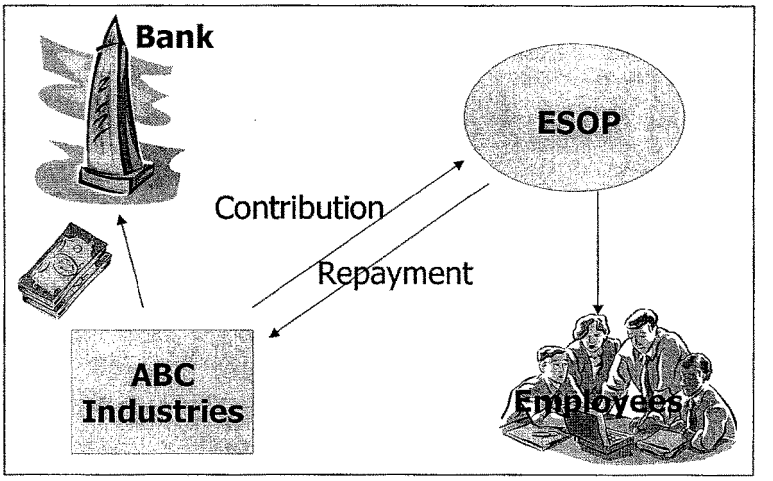
Basic Leveraged ESOP Structure

The most typical ESOP form is a leveraged ESOP. Here the corporation forms the plan. The plan borrows funds (typically from the employer). The plan purchases stock.



[19] IRC Section 302(2) triggering dividend treatment rather than capital gain.

The company makes annual payments to the plan. Such payments are contributions, dividends or both. The plan trustees use these funds to repay the loan. As the payments are made, shares are released from collateral and allocated to the benefit of the plan participants. Typically such allocations are based upon W-2 wages.



ESOP Success Stories

There are hundreds of anecdotal tales of ESOP victories – the loading dock worker in North Carolina who retired in the 1980's with over $700,000 in his ESOP account. The secretary from a Midwest printing company who died in 1986 with over $3 million left in her ESOP account after living off her account since retirement a decade earlier. These are fabulous stories, but they don't paint a complete picture. Since ERISA passed, however, there have been a number of studies, attempting to measure the success of these arrangements.

A significant study to date was conducted by another witness to these hearings. Dr. Douglas Kruse and Dr. Joseph Blasi of Rutgers University. They concluded that ESOP companies outperformed their non-ESOP peers in a number of ways – sales growth, employee growth and survival. Of interest, a side conclusion was that the ESOP companies provided a more comprehensive set of employee benefits, than their non-ESOP comparables.

In 2001, for the tenth consecutive year, The Employee Ownership Foundation found that a majority of surveyed ESOP companies cite an overall increase in productivity and performance. Nearly two - thirds of the firms surveyed (65%) stated that they performed

better in 2000 than in 1999. In addition, 75% saw an increase in sales from 1999 to 2000 and 63% saw profitability increase in 2000. Another 52% reported utilizing some sort of formal ESOP communications program.

Research done by the Washington State Department of Community, Trade and Economic Development of over 100 Washington not publicly-traded ESOP companies compared to 500 not publicly-traded non-ESOP companies showed that the ESOP companies paid better benefits, had twice the retirement income for employees, and paid higher wages than their non-ESOP counterparts.[20]

Professor Hamid Mehran of the J.L. Kellogg Graduate School of Management, Northwestern University, researched nearly 400 publicly traded companies with significant ESOPs both before and after the adoption of the ESOP, compared to non-ESOP companies in similar lines of businesses, showed that the rate of return for the ESOP companies was 2.7% higher, 60% of the ESOP companies experienced share price increases upon announcement of the ESOP program, and 82% indicated that the ESOP had a positive impact on business results.

In 1995, Douglas Kruse of Rutgers University examined the studies of others on the correlation between ESOPs and productivity growth. Kruse found that "positive and significant coefficients [are found] much more often than would be expected if there were no true relation between ESOPs and productivity."[21]

In 1995, the U.S. Department of Labor released a study entitled "The Financial and Non-Financial Returns to Innovative Workplace Practices: A Critical Review." This study found that companies that seek employee participation, give employees company stock and train employees could positively affect American corporations' bottom lines.

Even the GAO gave a qualified approval to active ESOPs. In 1987 the GAO studied 110 firms. They did not conclude that the ESOP had any direct impact on profitability, but they did conclude that where management included active employee involvement such improvements could be cited.

Effect of Differences Between Public and Private Company ESOPs

There are two fundamental differences in the operation of ESOPs in public companies and private companies -- cash and value.

Cash: As noted above, participants have the right to demand a distribution in stock. Where the stock is not actively traded on an established securities market, the participant must be provided a means of converting the stock into cash at current value. The law says that if the ESOP doesn't distribute cash, then the plan sponsor has to provide a put option. In either event, the cash to

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20 Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State, Kardas, Peter A., Scharf, Adria L., Keogh, Jim, November, 1998.
21 Kumbhakar and Dunbar's 1993 study of 123 public firms and Mitchell's 1990 study of 495 U.S. business units in public firms.

fund distributions nearly always comes from the plan sponsor. It comes in one of the following forms:

- Cash contributions in excess of what is required for debt service.
- Cash in the plan from dividends.
- Cash purchases of stock out of the plan.
- Direct corporate cash to honor the put back of the stock following distribution.

This is a uniquely private company problem. Public companies with an active market can distribute stock and allow the participant to take it from there. The participants then have the privilege of selling shares on the public marketplace whenever they wish, rolling them into an IRA whose trustee can hold or sell, etc.

Reliable and predictable cash flow is critical to the continuing success of any business venture. Unexpected claims against this cash flow can create disruptions in business activities to the detriment of all shareholders, both within and outside the ESOP. Thus, the detailed rules and built in waiting periods outlined earlier regarding the diversification privilege, the distribution form and distribution timing add comfort to the management of a privately held ESOP sponsor. These rules allow management to predict when the demand on corporate resources to fund retirement benefits is likely to occur and to plan for them accordingly.

Any change in the privileges of ESOP participants, that add a greater degree of unpredictability to these cash calls or that substantially accelerate these cash demands without adequate warning is likely to be adverse to the interests of all parties.

Value: Both the income tax and ERISA rules expect that securities that are not actively traded on an established securities market will have their value updated not less frequently than annually. For most private company ESOPs this is accomplished through an independent appraisal. That appraisal is to be performed by a person or entity that is trained in such effort and that takes into account the relevant factors that create value for a particular enterprise. The valuation process assesses how much a willing buyer would pay a willing seller for the business. This might be based upon earnings, cash flow, book value, the fair value of tangible or intangible assets, etc. Such valuations generally involve a site check on assets, extensive interviews with management, a review of customer lists or supplier lists to check for excessive dependency upon any single entity, etc.

This means that a well-advised ESOP company should reflect a value based upon economic realities for a long-term investment. The share value used for non-public ESOPs is aimed at a long-term buy and hold perspective; an investor's perspective. This is a dramatic contrast to recent events in the public marketplace that has been greatly influenced by speculative trading in hopes, dreams and fantasies.

Financial Reporting Considerations of ESOPs

Financial reporting by sponsors of leveraged ESOPs is described in AICPA Statement of Position 93-6. The issuance of this standard substantially reduced the variability previously seen

in the financial statements of ESOP sponsors. Under this model, for shares acquired after December 31, 1992, the following consequences apply:

- Compensation cost is measured by the average fair value of the shares allocated, released or committed to be released with respect to that year's activity.
- The ESOP's debt is reflected on the books of the plan sponsor whose resources will be used to repay the debt either through contributions or dividends.
- Dividends paid on shares that are held as collateral in the ESOP are part of compensation cost.
- Disclosures are required regarding the existence of the ESOP, the amounts allocated to participants, put option terms, etc.

As a result of this standard, financial statements reflected as a current period expense the opportunity cost of the shares being awarded to that year's participants for that year's services.

What do ESOP Companies Need in Today's Economy?

Like any other business owner, the employee owners of ESOP companies need certainty. These are uncertain times. The current rules governing ESOPs are very complex. Some provisions have been in the law for 25 years or more with little or no interpretive guidance from the IRS or Department of Labor. Plan sponsors are left making a *good faith effort* with the risk of being wrong when viewed with 20/20 hindsight.

This environment results in the following suggestions:

- The first focus of change in the retirement plan rules should be on investment education and assistance. It is clear from Enron and other recent experiences with participant directed 401(k) plans – employees are generally unsophisticated investors. They need a better understanding of risk management, diversification, etc.
- This education should include specific recognition of the role of employer securities in a retirement planning scenario. It is no accident that ESOPs are "Employee Stock Ownership" plans. They are not generally referred to as "retirement" plans, even though covered by the same legislation. They have a savings attribute, but really a different motivation. The consequence of this concentration in company stock in these plans needs to be recognized and balanced in a broader retirement strategy.[22] For example, an ESOP participant with significant ownership in a closely-held manufacturing company may want to avoid similar investment types when planning his or her 401(k) plan portfolio.
- Diversification is a privilege granted to participants in a true ESOP. However, it involves the employee making a choice – diversify or not. For private companies, uncertainty exists as to the amount of information that must be disclosed to make such choice and

[22] See "Employee Ownership as a Retirement Plan" by Corey Rosen of the National Center for Employee Ownership, www.nceo.org/library/retire.html

how such disclosure is to be made without the employer being held liable for *influencing* this choice.

- For the private company, diversification requires that the employer make cash resources available to provide liquidity in the plan. That cash comes out of operations. Significant changes in the diversification standards could cause a liquidity drain on these companies that puts the entire company at risk. Thus, any suggestion of changes to the diversification rules must include a rational transition period.

Other ESOP Statistics

Public/Private Split: At this time there are roughly 11,500 ESOP plans in this country. Of these, the vast majority is in private companies. The percentage of ESOPs in Public Companies varies depending upon the definition used of what is an ESOP. The range is 5% to 9% or from about 600 to 1,000 plans.

Distribution of ESOPs by Percentage Ownership of Sponsor

Category[23]	0-10%	11-30%	31-50%	51-100%
Private co. ESOPs	20%	35%	25%	20%
Public co. ESOPs	62%	34%	3%	1%

Table of Largest ESOP Companies by Number of Participants

Company[24]	Location	Plan	Industry	No. of Employees
United Parcel Service	Atlanta, GA	401k	Package delivery	344,000
Publix Supermarkets	Lakeland, FL	ESOP, stock purchase	Supermarkets	109,000
United Airlines	Chicago, IL	ESOP	Airline	95,000
Hy-Vee	W Des Moines, IA	ESOP	Supermarkets	46,000
Science Applications Intl.	San Diego, CA	ESOP, others	R&D, computer systems	41,000
Tharaldson Motels	Fargo, ND	ESOP	motel mgt	18,000
Dyncorp	Reston, VA	ESOP	IT/technical services	23,000
Parsons Corp.	Pasadena, CA	ESOP	Engineering/ Construction	12,000
CH2M Hill, Inc.	Denver, CO	Stock purchase	Engineering, construction	12,000
Lifetouch	Minneapolis, MN	ESOP	Photography	12,000

[23] Data for this table were drawn from surveys in Ohio and Michigan in 1994 and 1990, a 1993 Watson Wyatt survey, a 1996 Hewitt Associates survey, a 1995 NCEO survey of 401(k) plans, a 1998 NCEO survey of companies with broad-based stock option plans, and NCEO databases.

[24] NCEO compiled this list in May 2001.

Company[24]	Location	Plan	Industry	No. of Employees
			studios	
Brookshire Brothers	Lufkin, TX	ESOP	Supermarkets	9,200
Amsted Industries	Chicago, IL	ESOP	Heavy mfr	9,100
Austin Industries	Dallas, TX	ESOP	Construction	7,700
Journal Communications	Milwaukee, WI	Stock purchase	Newspapers, media	7,400
W.L. Gore Associates	Newark, DE	ESOP	Gore-tex	7,000
Nypro	Clinton, MA	ESOP	Plastics mfr	6,500
Herff Jones	Indianapolis, IN	ESOP	Manufacture awards & gifts	6,087
Ferrell Companies	Liberty, MO	ESOP	Gas distribution	6,000
Davey Tree Expert Co.	Kent, OH	ESOP	Tree service	6,000
WinCo	Boise, ID	ESOP	Supermarkets	6,000
Houchens Food Store	Bowling Green, KY	ESOP	Supermarkets	5,000
Schreiber Foods	Green Bay, WI	ESOP	Supermarkets	4,070
Andersen Corp.	Bayport, MN	ESOP	Window mfr	4,000
Food Giant	Sikeston, MO	ESOP	Supermarkets	3,800
B.C. Rogers Poultry	Morton, MS	ESOP	Poultry	3,800
Vance International	Oakton, VA	ESOP exec.	Security	3,651
General Medical Group	Richmond, VA	ESOP	Medical equipment	3,350
Arthur D. Little	Cambridge, MA	Profit sharing	Consulting	3,100
Columbia Forest Prods	Portland, OR	ESOP	Plywood	3,000
American Cast Iron Pipe	Birmingham, AL	Stock trust	Iron forge	3,000
Medicalodges	Coffeyville, KS	ESOP	Nursing homes	2,600
HDR, Inc.	Omaha, NE	ESOP	Engineering	2,600
Tidyman's Warehouse Foods	Spokane, WA	ESOP	Supermarkets	2,500
Abt Associates	Cambridge, MA	ESOP	Consulting, research	2,415
Norcal Waste Systems	SF, CA	ESOP	Waste disposal	2,318
National Spinning Company	New York City, NY	ESOP	Textiles	2,300
Tandycrafts	Ft. Worth, TX	ESOP	Crafts	2,200
Schuck & Sons Construction	Glendale, AZ	ESOP	Construction	2,062
Rosendin Electric	San Jose, CA	ESOP	Electrical contractor	2,000
USIS	Annandale, PA	ESOP	Background checks	2,000
Hot Dog on a Stick	Solano Beach, CA	ESOP	Fast food outlets	2,000

Company[24]	Location	Plan	Industry	No. of Employees
Sundt Corp.	Tucson, AZ	ESOP	Construction	1,929
Bureau of Natl. Affairs Inc.	Washington, DC	Stock purchase	Publisher	1,915
Zandex	Zanesville, OH	ESOP	Nursing homes	1,900
Woodman's	Janesville, WI	ESOP	Supermarkets	1,800
Hensel-Phelps Inc.	Greeley, CO	ESOP	Construction	1,800
Erickson's Diversified Corp.	Hudson, WI	ESOP	Supermarkets	1,775
Merkert Enterprises	Canton, MA	ESOP	Food broker	1,700
Dahl's Inc.	Des Moines, IA	ESOP	Supermarkets	1,700
Mobile Tool Int'l	Westminster, CO	ESOP	Platforms mfr	1,700
Okonite Company	Ramsey, NJ	ESOP	Wire, cable mfr	1,700
Aspen Systems Corp.	Rockville, MD	ESOP	Computer services	1,646
Dunn Edwards Paint Company	Los Angeles, CA	ESOP	Paint mfr	1,500
Greenheck Fan	Schofield, WI	ESOP	Industrial fans	1,500
Kolbe and Kolbe	Wausau, WI	Stock bonus	Window mfr	1,500
Swank Inc.	Attleboro, MA	ESOP	Leather goods	1,430
Carter's Inc.	Charlotte, MI	ESOP	Supermarkets	1,400
Kleinfelder	Walnut Creek, CA	ESOP	Engineering	1,400
Charles Machine Works	Perry, OK	ESOP	Backhoes	1,400
Matthews International	Pittsburgh, PA	Stock purchase	Marking devices	1,350
Burns & McDonnell Engr. Co.	Kansas City, MO	ESOP	Engnrs., archtcts	1,300
John Henry Company	Lansing, MI	ESOP	Printing	1,299
Mulay Plastics	Addison, IL	ESOP	Plastics	1,275
Bollman Hat	Adamstown, PA	ESOP	Hat maker	1,200
Acadian Ambulance	Lafayette, LA	ESOP	Ambulance svcs	1,115
Bradford White	Ambler, PA	ESOP	Heating equipment	1,060
Cable Constructors	Iron Mountain, MI	ESOP	Broadband networks	1,034
BHA Group	Kansas City, MO	ESOP	Pollution equip	1,025
Woodward Communications	Dubuque, IA	ESOP	Newspapers	1,001
Ebby Halliday Realtors	Dallas, TX	ESOP	Real estate	1,000
Reliable Stores	Columbia, MD	ESOP	Dept stores	1,000
Rieth-Riley Construction	Goshen, IN	ESOP	Asphalt mfr	1,000
Cal Air, Inc.	Whittier, CA	ESOP	Engnrs, construction	1,000

Company[24]	Location	Plan	Industry	No. of Employees
Mutual Savings Life	Decatur, AL	ESOP	Insurance	990
Springfield Remanufacturing	Springfield, MO	ESOP	Engine remfr	950
Stiefel Labs	Coral Gables, FL	ESOP	Pharmaceuticals	905
Travel and Transport	Omaha, NE	ESOP	Travel agency	900
STV Engineers	Pottstown, PA	ESOP	Engr, archtr	900
Transhumance Holding Company	Davis, CA	ESOP	Meat packing	850
Russ' IGA	Lincoln, NE	ESOP	Supermarkets	850
Rockford Products Corp.	Rockford, IL	ESOP	Install fasteners	840
Blue Tee Corporation	New York, NY	ESOP	Manufacturing & distribution	835
Decorative Surfaces	St. Louis, MO	ESOP	Coated fabrics	806
ASC	Chantilly, VA	ESOP	Cable mfr	800
Roberts Industries	Des Plaines, IL	ESOP	Steel tubing mfr	800
Golder Associates	Atlanta, GA	Stock purchase	Engineering	800
Brown and Caldwell	Concord, CA	ESOP	Engineering	800
Border States Electric	Fargo, ND	ESOP	Wholesale elect sppls	783
Swales Aerospace	Beltsville, MD	ESOP	Aerospace	750
American Excelsior	Arlington, VA	ESOP	Sawmill products	743
Mayville Engineering	Mayville, WI	ESOP	Metal stampings	740
Chatsworth Products	Westlake Village, CA	ESOP	Data storage	700
The Mosser Group	Fremont, OH	ESOP	Construction	700
John McMullen Associates	Arlington, VA	ESOP	Naval engrng	700
National Forge	Irvine, PA	ESOP	Forge	700
Superior Consolidated Inds.	Peoria, IL	ESOP	Parts assembly	700
Walman Optical	Minneapolis, MN	ESOP	Optical supplies	680

Sources of additional Information

National Center for Employee Ownership
http://www.nceo.org/reference/research.html
ESOP Association of America
http://www.esopassociation.org/pubs/index.html
Foundation for Enterprise Development
www.fed.org

Committee on Education and the Workforce

Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: Rebecca J. Miller

	Yes	No
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the Committee).		X

2. Please list any federal grants or contracts (including subgrants or subcontracts) which you have received since October 1, 1999:

I was a special government employee from 2/99 to 11/01 as a member of the ERISA Advisory Council. No other grants or contracts, subgrants or subcontracts.

	Yes	No
3. Will you be representing an entity other than a government entity?	X	

4. Other than yourself, please list what entity or entities you will be representing:

See attached

5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4:

See attached

6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 1999, including the source and amount of each grant or contract:

None

	Yes	No
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list:		No.

Signature: Rebecca J. Miller Date: 2/12/2002

Please attach this sheet to your written testimony.

Attached to and made part of the Witness Disclosure Requirement, "Trust in Testimony" form for Rebecca J. Miller

February 12, 2002

I am here at the invitation of the committee to provide background and insight on Employee Stock Ownership plans. The invitation was offered due to my depth of experience in this area. My employer did not propose me for this task, nor solicit this invitation in any way.

Notwithstanding that as an executive with the firm, it is difficult to separate my comments from the firm. As such, I have completed the remainder of this form as if I was representing the firm.

I am a partner with McGladrey & Pullen, LLP. We are a public accounting partnership. We have no non-CPA owners.

I checked with our government contract office and we have had no contracts for the Federal government or its agencies during that time frame.

I am also a managing director with RSM McGladrey, Inc. This is a wholly owned subsidiary of H&R Block, Inc. To the best of my knowledge, neither Block nor any of its subsidiaries had any contracts, grants, subcontracts or subgrants during this period. However, be advised that this is a large organization and only a limited amount of time was available for me to conduct any such inquiry. All I can say is that I have inquired and I have not been involved in any such activities on behalf of H&R Block, Inc. or its affiliates.

APPENDIX C - WRITTEN STATEMENT OF JACK L. VANDERHEI, Ph.D., CEBS, PROFESSOR, DEPARTMENT OF RISK, INSURANCE, AND HEALTHCARE MANAGEMENT, THE FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, TESTIFYING ON BEHALF OF EMPLOYEE BENEFIT RESEARCH INSTITUTE

T-133

Written Statement
for the
House Education and Workforce Committee

Subcommittee on Employer-Employee Relations

Hearing on

"Enron and Beyond: Enhancing Worker Retirement Security"

Tuesday, February 13, 2002

The Role of Company Stock in 401(k) Plans[1]

by

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The views expressed in this statement are solely those of Jack VanDerhei and should not be attributed to Temple University or the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

1 Introduction

Chairman Johnson, members of the subcommittee. I am Jack VanDerhei, a faculty member in the Risk, Insurance and Healthcare Management Department, Fox School of Business and Management, Temple University, and research director of the Employee Benefit Research Institute Fellows Program.

1.1 Background

Although the topic of company stock investment in 401(k) plans has recently been the focus of considerable interest, the concept of preferred status for employee ownership has been part of the U.S. tax code for more than 80 years.[2] When the Employee Retirement Income Security Act (ERISA) was passed in 1974, it required fiduciaries to diversify plan investments for defined benefit plans and some types of defined contribution plans. However, ERISA includes an exception for "eligible individual account plans" that invest in "qualifying employer securities."[3] An Employee Stock Ownership Plan (ESOP) normally qualifies for this exception, as do profit-sharing plans.[4]

Profit-sharing plans with cash or deferred arrangements (more commonly referred to as 401(k) plans) grew in number from virtually no plans in 1983[5] to a point where by 1997 (the most recent year for which government data are currently available) they accounted for 37% of qualified private retirement plans, 48% of active employees, and 65% of new contributions.[6]

The concept of legislating diversification for qualified retirement plan investments in company stock was first applied to ESOPs via a provision enacted as part of the Tax Reform Act of 1986.[7] Employees who are at least age 55 and who have completed at least 10 years of participation must be given the opportunity to diversify their investments by transferring from the employer stock fund to one or more of three other investment funds.[8] The right to diversify need be granted only for a 90-day window period following the close of the plan year in which the employee first becomes eligible to diversify and following the close of each of the next five plan years. This right is limited to shares acquired after 1986[9] and is further limited to 25% of such shares until the last window period, when up to 50% of such shares may be eligible for diversification.

The Taxpayer Relief Act of 1997 applied a limit on mandatory investment of 401(k) contributions in employer stock. This was a more modest version of a proposal by Sen. Barbara Boxer (D-CA) to impose a separate limitation of 10% of plan assets on the mandatory investment of 401(k) contributions in qualifying employer stock and real property.[10]

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the dividend deduction for ESOPs to include dividends paid on qualifying employer securities held by an ESOP that, at the election of participants or beneficiaries, are: 1) payable directly in cash; 2) paid to the plan and distributed in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan; or 3) paid to the plan and reinvested in qualifying employer securities.[11] A 401(k) plan with a company stock fund that regularly pays dividends may consider designating a portion of the plan that includes the company stock fund to be an ESOP in order to take advantage of this deduction.[12]

At Enron, 57.73% of 401(k) plan assets were invested in company stock, which fell in value by 98.8% during 2001.[13] The decrease in share price and eventual bankruptcy filing of Enron resulted in huge financial losses for many of its 401(k) participants. This has prompted several lawsuits as well as congressional and agency investigations into the relative benefits and limitations of the current practice. In addition, the practice of imposing "blackout" periods when the 401(k) sponsor changes administrators has recently been called into question in light of the Enron situation.[14]

Certainly, the Enron situation has caused the retirement income policy community to focus increased attention to the desirability of current law and practices regarding company stock in 401(k) plans, resulting in much debate. Presumably, any recommendations to modify current pension law would attempt to strike a balance between protecting employees and not deterring employers from offering employer matches to 401(k) plans. Some have argued that if Congress were to regulate 401(k) plans too heavily, plan sponsors might choose to decrease employer contributions or not offer them at all. Previous research[15] has shown

that the availability and level of a company match is a primary impetus for at least some employees to make contributions to their 401(k) account. Others have argued that individuals should have the right to invest their money as they see fit.

1.2 Objectives Of The Testimony

My testimony today will focus on "The Role of Company Stock in 401(k) Plans," drawing on the extensive research conducted by the Employee Benefit Research Institute and on the EBRI/ICI 401(k) database. Portions of this testimony borrow heavily from a recent publication I co-authored with Sarah Holden of the Investment Company Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," *EBRI Issue Brief*, November 2001.

1.3 Sources Used In This Testimony

In an attempt to put together the most complete picture possible for this testimony, three different sources were utilized:

- Administrative data from the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project were used to assess the relative frequency of 401(k) plans offering company stock and the percentage of company stock held in participant portfolios.
- A survey of more than 3,000 members of the International Society of Certified Employee Benefit Specialists was used to collect data on the age restrictions for being able to cash in company stock, the prevalence of lockdowns, and the reaction of benefit professionals to various proposals for modifying the current system.
- Enhancements to the EBRI/ERF Retirement Income Projection Model were programmed to allow simulation of the potential financial impact of eliminating company stock from the investment menu of 401(k) plans.

The first two sources are detailed below and the simulation model is described in Section 7.2.

1.3.1 EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Several EBRI and Investment Company Institute (ICI) members have provided records on active participants in 401(k) plans they administered from year-end 1996 through year-end 2000. These plan administrators include mutual fund companies, insurance companies, and consulting firms. The universe of plan administrators varies from year to year; thus, aggregate figures in this report generally should not be used to estimate time trends, unless this report indicates otherwise. Records were encrypted to conceal the identity of employers and employees but were coded so that both could be tracked over multiple years.

The 2000 EBRI/ICI database contains 35,367 401(k) plans with $579.8 billion in assets and 11,827,256 participants. Most of the plans in the database are small, whether measured by the number of plan participants or by total plan assets. Indeed, 44% of the plans in the database have 25 or fewer participants, and 32% have 26–100 participants. In contrast, only 5% of the plans have more than 1,000 participants. Because most of the plans have a small number of participants, the asset size for many plans is modest. About 32% of the plans have assets of less than $250,000, and another 33% have plan assets between $250,001 and $1,250,000. However, participants and assets are concentrated in large plans. For example, 76% of participants are in plans with more than 1,000 participants, and these same plans account for 84% of all plan assets.

1.3.2 ISCEBS Survey

This survey was conducted in an attempt to provide a context to the current debate on company stock in a timely fashion, and it is not a statistically representative survey of the 401(k) industry; rather, this survey is a nonrandom polling of benefits professionals who are knowledgeable about the subject matter and able to respond to the survey quickly.

On January 15, 2002, a fax-back survey was sent to 3,346 members of the International Society of Certified Employee Benefit Specialists (ISCEBS).[16] Respondents were asked to respond by January 23rd and to answer the questions for the largest (in terms of participants) client they worked for (if they were a

consultant or service provider for 401(k) plans); otherwise, they were asked to answer for their employer's firm.

The survey instrument was divided into six parts. Part I asked for personal information relating to respondents' type of benefits expertise, age, and number of years in the benefits industry. Part II asked for information on the client/employer—including industry, number of employees, and whether it offered a defined benefit plan and/or a 401(k) plan. For those that did offer a 401(k) plan, additional information was collected about company stock investment options, whether employer contributions are required to be invested in company stock, average percentage of company stock in the employees' accounts, restrictions on selling the company stock, and blackout periods. Part III examined the employees' perceptions of the Enron situation. Part IV examined the respondents' views on the appropriate limits for investment in company stock and the government's role. Part V requested information on the respondents' perceptions on public policy issues related to company stock in 401(k) plans, and Part VI asked the respondents to speculate on likely reactions to various legal/legislative developments.

For purposes of this report, all respondents whose client/employer did not sponsor a 401(k) plan have been screened out, providing 375 usable responses after excluding surveys with missing information.

2 Size Of The 401(k) Universe

As of 1997, the most recent year for which published government data is currently available, there were 265,251 401(k) type plans with 34 million active participants holding $1.26 trillion in assets. Contributions for that year amounted to $115 billion and $93 billion in benefits were distributed.[17] By year-end 2000, it was estimated that approximately 42 million American workers held 401(k) plan accounts with a total of $1.8 trillion in assets.[18]

3 Investment Options And The Manner In Which They Influence Employee Behavior

Preliminary research analyzing 1.4 million participants drawn from the 2000 EBRI/ICI database suggests that participants are not influenced by the sheer number of investment options presented. On average, participants face 10.4 distinct options, but, on average, choose only 2.5.[19] In addition, the preliminary analysis found that 401(k) participants are not naïve—that is, when faced with "n" options they do not divide their assets among all "n." Indeed, less than 1% of participants followed a "1/n" asset allocation strategy.

4 The Concentration Of Company Stock In 401(K) Plans

4.1 Percentage Of 401(K) Plans And Participants With Company Stock

Figure 1 shows that for the 1996 version[20] of the EBRI/ICI database, only 2.9% of the 401(k) plans included company stock (1.4% of the plans had company stock but no guaranteed investment contracts (GICs)[21] while 1.5% of the plans had both company stock and GICs). However, the plans that do have company stock are generally quite large and represented 42% (17% of the participants had company stock but no GICS while 25% had both options) of the 401(k) participants in the database that year (see Figure 2). In terms of account balances, plans with company stock account for 59% of the universe (23% of the assets were held in plans that had company stock but no GICS while 36% of the assets were held in plans that had both options, see Figure 3). The fact that plans with company stock had higher average account balances was no doubt partially due to the bull market preceding this time period but may also be a function of the plan's generosity parameters and average tenure of the employees.

4.2 Company Stock As A Percentage Of Total 401(K) Balances

The overall percentage of 401(k) account balances in company stock has remained consistently in the 18–19% range from 1996–2000 (Figure 4). The age distribution for year-end 2000 is somewhat of an inverted "U" shape with younger and older participants holding slightly less than participants in their 40s (where the value peaks at 19.7%, see Figure 5)

Although often quoted, this figure is somewhat misleading given that a sizeable percentage of the 401(k) participants are in small plans that do not generally include company stock in the investment menu. The top panel in Figure 6 shows similar asset allocations as figure 5; however, the results are reported by plan size. The average asset allocation in company stock is:

- Less than 1% for plans with fewer than 500 participants,
- 3.8% for plans with 501–1,000 participants,
- 8.7% for plans with 1,001–5000 participants, and
- 25.6% for plans with more than 5,000 participants.

The bottom two panels in Figure 6 provide a similar analysis; however, only plans that include company stock are analyzed. In this case, plans that offer company stock but not GICs have an average of 31.8% of the account balances invested in company stock while the figure decreases to 27.7% for plans that also include GICs. Once the influence of the investment menu is controlled for, the impact of plan size is less significant.

The bottom two panels in Figure 7 illustrate the impact of salary on company stock allocation for the subset of the EBRI/ICI database for which we have the requisite information. For both plans with and without GICs, there appears to be an inverse relationship between the level of salary and the percentage of 401(k) balance invested in GICs, although the relationship is much less significant in the former case. The extent to which this is due to non-participant-directed matching contributions making up a larger percentage of annual contributions for lower-paid individuals awaits further investigation.[22]

4.3 Distribution Of Company Stock Allocations

Several legislative proposals have called for an absolute upper limit on the percentage of company stock that an employee will be allowed to hold in his or her 401(k) account. Figure 8 provides the year-end 2000 company stock allocation for the EBRI/ICI universe of plans offering company stock. A total of 48% of the 401(k) participants under age 40 in these plans have more than 20% of their account balances invested in company stock. The percentage decreases to 47% for participants in their 40's, 45% for those in their 50's and drops to 41% for participants in their 60's.

5 Employee Reaction When Employers Mandate That Matching Contributions Be Invested In Company Stock

Typically, in a 401(k) plan, an employee contributes a portion of his or her salary to a plan account and determines how the assets in the account are invested, choosing among investment options made available by the plan sponsor (employer). In many plans, the employer also makes a contribution to the participant's account, generally matching a portion of the employee's contribution. Some employers require that the employer contribution be invested in company stock rather than as directed by the participant.[23] Participants in these plans tend to invest a higher percentage of their self-directed balances in company stock than participants in plans without an employer-directed contribution. Company stock represents 33% of the participant-directed account balances in plans with employer-directed contributions (Figure 9, middle panel),[24] compared with 22% of account balances in plans offering company stock as an investment option but not requiring that employer contributions be invested in company stock (Figure 9, lower panel).

When total account balances are considered, the overall exposure to equity securities through company stock and pooled investments is significantly higher for participants in plans with employer-directed contributions. For example, investments in company stock, equity funds, and the equity portion of balanced funds represent 82% of the total account balances for participants in plans with employer-directed contributions, compared with 74% of the total account balances for participants in plans without employer-directed contributions. This higher allocation to equity securities holds across all age groups.

6 Evidence From The ISCEBS Survey Results

Although the survey collected information on several aspects of company stock in 401(k) plans,[25] the items that appeared to be most pertinent to this hearing dealt with restrictions on sale of company stock

from employer contributions, blackout periods, and the ability of independent financial advice to mitigate the perceived problems resulting from employees investing voluntarily in company stock.

6.1 Employer Contributions: Investment in Company Stock and Restrictions on Sale

- 43% of those having a company stock investment option in a 401(k) plan reported that employer contributions were required to be invested in company stock.
- Among those plans that have a company stock option, large plans are more likely to require employer contributions to be invested in company stock: 49% of large plans vs. 38% of small plans.
- Of the 401(k) plans where employer contributions were required to be invested in company stock:
  - 13% reported no restrictions existed for selling the company stock.
  - 27% reported that they were restricted throughout a participant's investment in the plan.
  - 60% reported that they were restricted until a specified age and/or service requirement is met.

6.2 Blackout Periods

- 74% of the respondents' plans have undergone a blackout.
- Of those that have undergone a blackout, the distribution of the blackout period follows:
  - No delay/overnight/over weekend, 3%.
  - Between one day and two weeks, 27%.
  - Between two weeks and one month, 39%.
  - Between one month and two months, 26%.
  - More than two months, 5%.
- Blackout periods appear to be somewhat shorter for large plans than for small plans.
- The duration of the blackout period appears to be invariant to whether or not there is a company stock option; however, the duration does appear to be slightly longer when employer contributions are required to be invested in company stock.

When asked if they thought it was fair to impose a blackout period on participants in cases when there was *no* company stock:

- 10% said yes.
- 9% said no.
- 79% thought it was a necessary by-product of the conversion.
- 2% had no opinion.

When asked the same question but when there *was* company stock:

- 7% said yes.
- 16% said no.
- 72% thought it was a necessary by-product of the conversion.
- 1% had no opinion.

6.3 Would Independent Financial Advice Solve The Perceived Problems Resulting From Employees Investing In Company Stock?

The majority of respondents (58%) agreed that problems resulting from employees investing their own contributions in company stock would be mitigated if employers were allowed to provide independent financial advice to their employees. Only 27% of the respondents disagreed with this statement (15% were neutral).

7 What Would Happen To Employees If Company Stock Were Not Permitted In 401(K) Plans?

Well before the plight of Enron 401(k) participants had made the headlines, personal finance and investment advisors had long touted the benefits of diversification.[26] While the trade-off of a diversified portfolio of equities for an individual stock may be of limited advantage for employees, what many of the commentators in this field have disregarded is the potentially beneficial attendant shift in asset allocation

resulting from the inclusion and/or mandate of company stock, especially for young employees that otherwise exhibit extremely risk-averse behavior in the determination of equity concentration for their 401(k) portfolio.

Figure 10 illustrates a distribution of expected annual returns for a diversified equity portfolio (the S&P 500 index is used in this example) vs. what would be expected from an individual stock. The computations assume a long-term average return of 11% for both a diversified portfolio and an individual stock but a standard deviation of 19.6% for the former compared to 65% for the latter.[27] The lines intersect at the 50th percentile and, as expected, both have an average (mean and median) return of 11%. However, the potential outcomes – both good and bad – are much more extreme for the individual stock at the ends of the distribution. For example the inter-quartile range representing the "middle" one-half of the expected outcomes ranges from a loss of –2.2% to a gain of 24.2% for the S&P 500, while the same statistic ranges from a loss of –32.8% to a gain of 54.8% for an individual stock.

In essence, Figure 10 demonstrates the trade-offs when one looks only at diversified equity vs. company stock. Both investment alternatives provide the employee with the same average (in the long run), but it is obviously much more risky to have the latter. However, it may be argued that this focus is too narrow from a public policy perspective, even if limited solely to employee behavior.[28] Perhaps a more accurate way to analyze potential constraints on the use of company stock (at least the employer matching contributions) in 401(k) plans is to perform a financial cost/benefit analysis of the first order effects. Standard finance theory can solve for whether the additional return is worth the additional risk (based on individual-specific risk parameters) but that is not the point here. What I am attempting to determine is whether this trade-off **does** exist, and it is not simply a matter—as some have suggested—of more risk for no additional return.

What I will attempt to demonstrate in the following section is that although forcing the employer match into company stock obviously increases the standard deviation of expected results relative to a diversified equity portfolio, for each of the last five years the EBRI/ICI data base has demonstrated that, left to their own choices, the employee's asset allocation would have lower concentrations in equity (defined as diversified equity plus company stock plus 60% of balanced funds) and therefore have a lower expected rate of return.

I start with some stylized examples of how the inclusion of company stock may work to the benefit of employees in general and expand the analysis by simulating the expected change in 401(k) account balances if company stock were prospectively eliminated from 401(k) plans for birth cohorts from 1936–1970. These results may be useful in analyzing previous charges that company stock should not be used in tax subsidized accounts.

7.1 Stylized Examples

Figure 11 analyzes the expected returns for the average 401(k) portfolios (not just the equity portion) held by participants in their 20s. It uses the same mean and standard deviation assumptions as Figure 10;[29] however, it incorporates the asset allocation differentials for plans with and without company stock . As expected, plans with company stock have a wider distribution of results at any probability level than those without company stock. The differential asset allocation has resulted in a 36 basis point advantage to these plans even though the same rate of return is assumed for diversified equities and individual stocks. Figure 12 provides a similar stylized example for 401(k) participants in their 60s. In this case, the expected annual advantage of participating in a 401(k) plan with company stock decreases to 34 basis points.

While these stylized examples may be useful pedagogical devices, they prove to be virtually worthless in attempting to assess the financial impact of eliminating company stock from 401(k) plans. Although a participant may currently be in a 401(k) plan that includes company stock, it is highly likely (particularly for a young employee) that he or she will leave that employer prior to retirement. Assuming this individual has one or more subsequent employers, the overall financial impact of a modification to the existing laws will depend on whether the future employers offer a 401(k) plan and, if so, whether the employee chooses to participate, the contribution rate for both the employer and employee, and the investment menu offered the employee. Moreover, a critical assessment of the employee's future retirement income must determine

whether or not the 401(k) balances stay with the current employer on job change, are rolled over to a new employer and/or IRA,[30] or are consumed prematurely.

7.2 Description Of Simulation Methodology

In an attempt to assess the first-order impact of eliminating company stock in 401(k) plans, I programmed a new subroutine to the EBRI/ERF RIPM to simulate the financial impact on 401(k) account balance.

The EBRI-ERF model is based on a four-year time series of administrative data from more than 10 million 401(k) participants and more than 30,000 plans, as well as a time series of several hundred plan descriptions used to provide a sample of the various defined benefit and defined contribution plan provisions applicable to plan participants. In addition, several public surveys based on participants' self reported answers (the Survey of Consumer Finances [SCF], the Current Population Survey [CPS], and the Survey of Income and Program Participation [SIPP]) were used to model participation, wages, and initial account balance information. This information is combined with U.S. Department of Labor Form 5500 data to model participation and initial account balance information for all defined contribution participants, as well as contribution behavior for non-401(k) defined contribution plans. Asset allocation information is based on previously published results of the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project and employee contribution behavior to 401(k) plans is provided by an expansion of a method based on both employee demographic information and plan matching provisions. A combination of Form 5500 data and self-reported results was also used to estimate defined benefit participation models; however, it appears information in the latter is rather unreliable with respect to estimating current and/or future accrued benefits. Therefore, a database of defined benefit plan provisions for salary-related plans was constructed to estimate benefit accruals. Combinations of self-reported results were used to initialize IRA accounts. Future IRA contributions were modeled from SIPP data, while future rollover activity was assumed to flow from future separation from employment in those cases in which the employee was participating in a defined contribution plan sponsored by the previous employer. Industry data are used to estimate the relative likelihood that the balances are rolled over to an IRA, left with the previous employer, transferred to a new employer, or used for other purposes.

A stochastic job duration algorithm was estimated and applied to each individual in the EBRI-ERF model to predict the number of jobs held and age at each job change. Each time the individual starts a new job, the EBRI-ERF model simulates whether or not it will result in coverage in a defined benefit plan, a defined contribution plan, both, or neither. If coverage in a defined benefit plan is predicted, time series information from the Bureau of Labor Statistics (BLS) is used to predict what type of plan it will be.[31] While the BLS information provides significant detail on the generosity parameters for defined benefit plans, preliminary analysis indicated that several of these provisions were likely to be highly correlated (especially for integrated plans). Therefore, a time series of several hundred defined benefit plans per year was coded to allow for assignment to the individuals in the EBRI-ERF model.[32] Although the Tax Reform Act of 1986 at least partially modified the constraints on integrated pension plans by adding Sec. 401(l) to the Internal Revenue Code, it would appear that a significant percentage of defined benefit sponsors have retained Primary Insurance Amount (PIA)-offset plans. In order to estimate the offset provided under the plan formulae, the EBRI-ERF model computes the employee's Average Indexed Monthly Earnings, Primary Insurance Amount, and covered compensation values for the birth cohort.

Previous studies on the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project have analyzed the average account balances for 401(k) participants by age and tenure. Unfortunately, the EBRI/ICI database does not currently provide detailed information on other types of defined contribution plans nor does it allow analysis of defined contribution balances that may have been left with previous employers. The EBRI-ERF model uses self-reported responses for whether an individual has a defined contribution balance to estimate a participation model, and the reported value is modeled as a function of age and tenure.

Previous research on employee contribution behavior to 401(k) plans has often been limited by lack of adequate data. This is primarily due to the types of matching formulae utilized by sponsors. While these formulae are often complicated due to the desire of sponsors to provide sufficient incentives to non-

highly compensated employees to contribute in order to comply with technical nondiscrimination testing, this complexity makes it virtually impossible to appropriately analyze the employee's behavior if one is forced to observe either aggregate plan data or use information on the plan contribution formulae provided by the participant. With the exception of studies based on administrative data, employee contribution behavior is typically assumed to be a function of employee demographic data and perhaps an employee's estimate of the employer matching rate or a proxy based on Form 5500 data. However, a significant percentage of the employee contribution behavior appears to be determined by plan-specific provisions. For example, the percentage of employees contributing up to either the maximum amount of compensation matched, the 402(g) limit, or the plan maximum was studied by EBRI in 1996. It would appear that a significant portion of the employee contribution is explained by these "corner points," which would not be picked up in the data described above. Recently EBRI provided preliminary findings[33] introducing new methodology to expand the usefulness of modeling these data, as well as a better understanding of contribution behavior by 401(k) plan participants. We utilize a sequential response regression model to allow for the differing incentives faced by the employees at various levels of contributions. Based on findings from 137 distinct matching formulae, we have estimated a behavioral model that is able to control for the tendency of employers to substitute between the amount they match per dollar of employee contribution and the maximum percentage of compensation they are willing to match. We decompose employee contribution behavior into a series of 1% of compensation intervals and therefore are able to model not only the marginal incentives to contribute at that interval but also the "option value" that making the contribution at that interval provides for the employee. Contribution behavior for defined contribution plans other than 401(k) plans is estimated from self-reported responses to public survey data.

Thus, the model already incorporates all the requisite assumptions to perform this analysis with one critical exception. There appears to be no information available with respect to the probability that an employee leaving a job offering a 401(k) plan with company stock will take a job in which the new employer also offers a 401(k) plan with company stock, etc. Therefore, I have run the model assuming first that there is complete correlation with respect to this phenomenon (e.g., once an employee is in a 401(k) plan with company stock, any subsequent 401(k) participation will also be in a plan with company stock). This is probably not a realistic assumption and will provide the largest estimate of lost 401(k) wealth. The second set of runs assumes complete independence with respect to the probability of temporally contiguous 401(k) plans having company stock. It is likely that this assumption understates the true magnitude of the losses and therefore should be used as a minimum estimate.

7.3 Simulation Results

The simulation was performed for birth cohorts between 1936 and 1970 and the results indicate the overall gain or loss from (prospective) retention of company stock in 401(k) plans (as opposed to company stock being entirely eliminated immediately). The estimated gain of retaining company stock is 4.0% of 401(k) balances assuming complete independence with respect to the probability of company stock in a subsequent plan and 7.8% assuming perfect correlation.

Figure 13 provides the results of the simulation by gender and pre-retirement income, assuming complete independence. Pre-retirement income was categorized as either high or low by simulating the income in the year prior to retirement and comparing it with the median income for participants in the same birth cohort. Males would gain more than females from retention of company stock for both levels of relative salary. Participants in the lower relative salary levels would stand to gain more than their higher paid counterparts for both genders.

Figure 13
Average Gain From Retention Of Company Stock As A Percentage Of 401(k) Balance, By Gender And Relative Pre-Retirement Salary (Assuming Complete Independence)

Pre-retirement salary relative to median for age cohort	Gender	
	Male	Female
Low	5.2%	3.5%
High	5.0%	1.6%

The distributional results for this population are shown in Figure 14. For example, at least 25 pct of the sample is expected to gain 5.1% or more if they were allowed to have company stock going forward, while at least 25% of the sample is expected to lose 10.8% or more if company stock continues to be permitted.

Figure 14
Distribution Of Gain From Retention Of Company Stock In 401(K) Plans As A Percentage Of Simulated 401(K) Balances Without Company Stock, Assuming Complete Independence

Percentile	Percentage gain
99%	75.8%
95%	32.6%
90%	18.7%
75%	5.1%
50%	-0.5%
25%	-10.8%
10%	-26.0%
5%	-35.7%
1%	-56.5%

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Endnotes

[1] Portions of this testimony borrow heavily from Sarah Holden and Jack VanDerhei,"401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," *EBRI Issue Brief* n. 239, November 2001.

[2] The first stock bonus plans were granted tax-exempt status under the Revenue Act of 1921. See Robert W. Smiley, Jr. and Gregory K. Brown, "Employee Stock Ownership Plans (ESOPs)," *Handbook of Employee Benefits*. 5th Ed., Jerry S. Rosenbloom, ed. (Homewood, Illinois: Dow Jones-Irwin, 2001).

[3] ERISA Sec. 407(b)(1).

[4] This is important because an ESOP is to be "primarily invested" in qualifying employer securities. See "Employee Stock Ownership Plans (Part II)," *Journal of Pension Planning and Compliance* (Winter 2000); John L. Utz; pages 1–34.

[5] Although cash or deferred arrangements have existed since the 1950's, the Revenue Act of 1978 enacted permanent provisions governing them by adding Sec. 401(k) to the Internal Revenue Code. While this was effective for plan years beginning after 1979, the proposed regulations were not released until November 1981. See Jack VanDerhei and Kelly Olsen, "Section 401(k) Plans (Cash or Deferred Arrangements) and Thrift Plans," *Handbook of Employee Benefits*, 5th Ed., Jerry S. Rosenbloom, ed.). Homewood, Illinois: Dow Jones-Irwin, 2001).

[6] U.S. Department of Labor, Pension and Welfare Benefits Administration. "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10* (Winter 2001). For a review of the academic literature analyzing these trends, see William Gale, Leslie Papke, and Jack VanDerhei, "Understanding the Shift Toward Defined Contribution Plans," in *A Framework For Evaluating Pension Reform* (Brookings Institution/TIAA-CREF/Stanford University), forthcoming. (www.brook.edu/es/erisa/99papers/erisa2.pdf)

[7] It should be noted that less than 5% of all ESOPs are in public companies. For an explanation of the challenges that stricter diversification rules may present to private company ESOPs, see Corey Rosen, "Should ESOPs Be Subject to Stricter Diversification Rules?" (www.nceo.org/library/boxer_corzine_bill.html)

[8] Alternatively, amounts subject to the right of diversification may be distributed from the plan. See Everett T. Allen, Jr., Joseph J. Melone, Jerry S. Rosenbloom and Jack L. VanDerhei, *Pension Planning: Pensions, Profit Sharing, and Other Deferred Compensation Plans* (8th ed), Homewood, Illinois: Richard D. Irwin, Inc., 1997.

[9] As a result, the impact of this change was *de minimis* during the significant market decline in the fall of 1997. See Jack VanDerhei, "The Impact of the October 1987 Stock Market Decline on Pension Plans," written testimony for U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, July 1988.

[10] The final version exempts from the 10% limits: (1) *de minimis* (i.e., as much as 1% of pay) mandatory investment provisions, (2) plan designs under which the Sec. 401(k) deferrals (regardless of amount) are part of an ESOP, and (3) plans in which the total assets of all defined contribution plans of the employer are not more than 10% of the total defined benefit and defined contribution plan assets of the employer. The limit applies prospectively with respect to acquisitions of employer stock. The investment of matching or other employer contributions continues to be exempt from any limits. See Louis T. Mazawey, "1997 Tax Law Changes Affecting Retirement Plans," *Journal of Pension Planning and Compliance* (Winter 1998): 72–86. For more detail on the original proposal, see Ann L Combs, "Taking Stock of the Boxer Bill," *Financial Executive* (Jan./Feb. 1997): 18–20.

[11] Hewitt, *Special Report to Clients*, July 2001, "Impact of EGTRRA on Employer Plans." (http://www.hewitt.com/hewitt/resource/wsr/2001/egtrra.pdf)

[12] Watson Wyatt Worldwide, "Retirement Plan Provisions: What, When and How Much?" (Washington, DC: Watson Wyatt Worldwide, 2001).

[13] "Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans," *IOMA's DC Plan Investing*, Dec. 11, 2001, p. 1.

[14] Currently, there is no statutory or regulatory limit on the length of time during which participants can be blocked from reallocating assets or conducting other transactions in a 401(k) plan. See Patrick J. Purcell, "The Enron Bankruptcy and Employer Stock in Retirement Plans," *CRS Report for Congress* (Jan. 22, 2002): 5.

[15] Jack VanDerhei and Craig Copeland, "A Behavioral Model for Predicting Employee Contributions to 401(k) Plans," *North American Actuarial Journal* (First Quarter, 2001).

[16] To earn the professional CEBS designation, an individual must have passed 10 rigorous national examinations, including one course devoted entirely to defined contribution plans and another on investments. More information is available at www.iscebs.org

[17] U.S. Department of Labor, Pension and Welfare Benefits Administration, "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10* (Winter 2001).

[18] Holden and VanDerhei (November, 2001), p. 3.

[19] Sarah Holden and Jack VanDerhei, "The Impact of Employer-Selected Investment Options on 401(k) Plan Participants' Asset Allocations: Preliminary Findings," May 2001, working paper.

[20] Readers should be cautioned that while the EBRI/ICI database appears to be very representative of the estimated universe of 401(k) plans, there has currently been no attempt to develop extrapolation weights to match up these plans with those reported on the Form 5500. See Holden and VanDerhei (November 2001), p. 6 for more detail.

[21] Guaranteed investment contracts (GICs) are insurance company products that guarantee a specific rate of return on the invested capital over the life of the contract.

[22] For recent EBRI/ICI research on the contribution activity of 401(k) plan participants, see Holden and VanDerhei, "Contribution Behavior of 401(k) Plan Participants," *EBRI Issue Brief* n. 238, October 2001.

[23] Source of contribution (employer versus employee) can be matched to fund information for a subset of the data providers in our sample. Of those plans in the 2000 EBRI/ICI database for which the appropriate data are available, less than 0.5% require employer contributions to be invested in company stock. However, most of the plans with this feature are large, covering 6% of participants and 10% of plan assets in the subset.

[24] For this group, the participant-directed portion of the account balances represents 65% of the total account balances.

[25] See Jack L. VanDerhei, "Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members," January 2002, for the full survey results (www.ebri.org).

[26] See Scott Burns, "Examining Your Gift Horse," *Dallas Morning News*, April 17, 2001, for an excellent example of the tradeoff of risk between the S&P 500 Index and an individual stock.

[27] Ibid. These values were taken from Feb. 28, 2001, data of Morningstar Principia and reported in Burns' article.

[28] For example, some have suggested that if company stock is prohibited or limited, some employers may reduce (or even eliminate) employer matching contributions.

[29] I have arbitrarily assumed all nonequity investments earn an annual rate of return of 6%. The results are not particularly sensitive to this assumption as long as the equity premium remains positive.

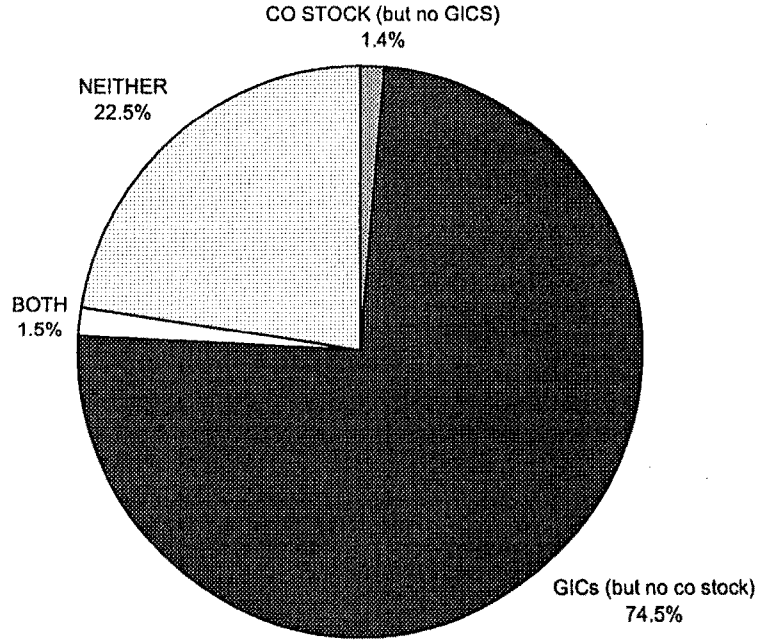
[30] This will decrease the likelihood of the previous employer's company stock being retained until retirement age.

[31] The model is currently programmed to allow the employee to participate in a nonintegrated career average plan; an integrated career average plan; a 5-year final average plan without integration; a 3-year final average plan without integration; a 5-year final average plan with covered compensation as the integration level; a 3 year final average plan with covered compensation as the integration level; a 5-year final average plan with a PIA offset; a 3-year final average plan with a PIA offset; a cash balance plan; or a flat benefit plan

[32] BLS information was utilized to code the distribution of generosity parameters for flat benefit plans.

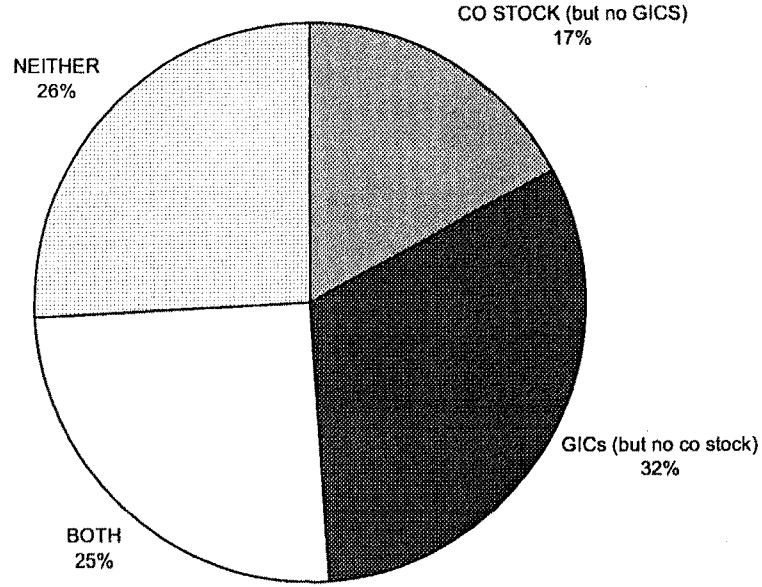
[33] Jack VanDerhei and Craig Copeland, "A behavioral model for predicting employee contributions to 401(k) plans," *North American Actuarial Journal* (First Quarter, 2001).

Figure 1: Percentage of plans by investment menu in the EBRI/ICI data base, 1996



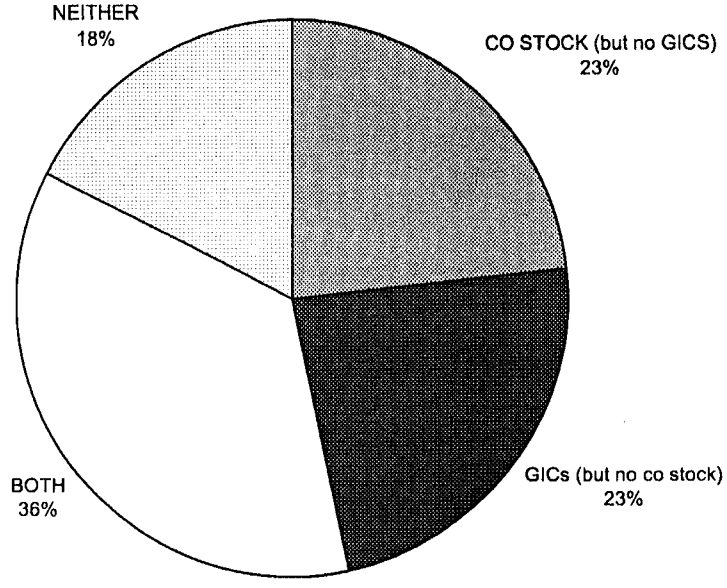
Source: Jack L. VanDerhei, "Participant Allocation Behavior in 401(k) Plans," 1999 ICI Retirement Plans Conference

Figure 2: Percentage of participants by investment menu in the EBRI/ICI data base, 1996



Source: Jack L. VanDerhei, "Participant Allocation Behavior in 401(k) Plans," 1999 ICI Retirement Plans Conference

Figure 3: Percentage of plan assets by investment menu in the EBRI/ICI data base, 1996

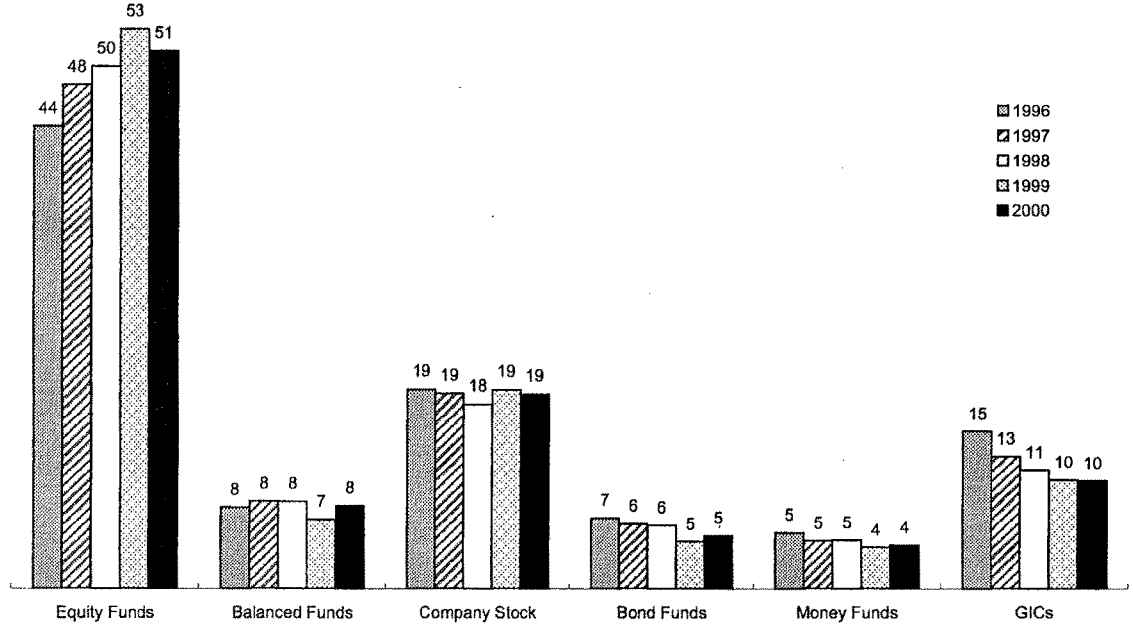


Source: Jack L. VanDerhei, "Participant Allocation Behavior in 401(k) Plans," 1999 ICI Retirement Plans Conference

Figure 4

Average Asset Allocation, 1996-2000

(percent of total assets)



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 5

Average Asset Allocation by Age, 2000

(percent of account balances)

Age Cohort	Equity Funds	Balanced Funds	Bond Funds	Money Funds	Guaranteed Investment Contracts	Company Stock	Other Stable Value Funds	Other	Unknown	Total
20s	61.4	8.6	4.3	4.3	4.0	15.4	0.5	0.7	0.5	100
30s	60.2	8.0	3.8	3.3	4.6	18.4	0.4	0.8	0.4	100
40s	54.8	8.0	4.2	3.8	7.5	19.7	0.6	1.0	0.4	100
50s	49.2	8.0	5.3	4.4	11.5	19.1	1.1	1.0	0.4	100
60s	39.8	8.0	7.7	5.4	19.3	16.3	2.2	0.9	0.4	100
All	51.3	8.0	5.1	4.2	10.4	18.6	1.0	0.9	0.4	100

Note: Components may not sum to 100 because of rounding.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 6

Average Asset Allocation by Plan Size and Investment Options, 2000

(percent of account balances)

Plan size by number of participants	Equity Funds	Balanced Funds	Bond Funds	Money Funds	Guaranteed Investment Contracts	Company Stock
ALL PLANS						
1 to 100	56.7	20.0	6.7	6.2	7.6	0.1
101 to 500	63.5	13.1	7.5	6.2	6.2	0.8
501 to 1,000	62.1	11.1	7.6	6.2	6.0	3.8
1,001 to 5,000	57.4	9.9	5.7	5.8	10.0	8.7
> 5,000	47.0	6.0	4.4	3.3	11.4	25.6
All	51.3	8.0	5.1	4.2	10.4	18.6
PLANS WITHOUT COMPANY STOCK OR GUARANTEED INVESTMENT CONTRACTS						
1 to 100	72.4	9.0	8.9	7.9		
101 to 500	71.5	9.7	9.2	6.9		
501 to 1,000	69.7	9.2	10.3	7.1		
1,001 to 5,000	68.9	10.7	9.0	8.5		
> 5,000	71.2	10.6	7.2	6.8		
All	70.4	10.1	8.8	7.5		
PLANS WITH GUARANTEED INVESTMENT CONTRACTS						
1 to 100	44.4	28.8	5.1	4.9	13.6	
101 to 500	49.1	20.6	4.1	4.7	18.4	
501 to 1,000	54.4	17.4	3.4	3.8	18.3	
1,001 to 5,000	57.3	11.3	3.0	3.0	22.9	
> 5,000	63.2	9.1	3.1	3.0	19.2	
All	56.7	14.3	3.5	3.5	19.4	
PLANS WITH COMPANY STOCK						
1 to 100	47.1	7.6	6.0	11.7		27.4
101 to 500	59.2	8.6	8.5	8.7		14.5
501 to 1,000	52.6	6.5	6.6	9.2		22.5
1,001 to 5,000	50.8	7.5	6.8	7.6		24.9
> 5,000	42.9	5.4	8.2	5.4		33.6
All	44.6	5.8	7.9	5.8		31.8
PLANS WITH COMPANY STOCK AND GUARANTEED INVESTMENT CONTRACTS						
1 to 100	48.2	15.8	3.3	5.5	12.1	13.0
101 to 500	48.1	12.4	3.3	3.0	17.7	11.5
501 to 1,000	39.9	8.8	2.1	3.7	18.4	25.2
1,001 to 5,000	45.1	9.2	1.9	2.3	22.8	16.6
> 5,000	43.2	5.1	2.0	1.6	18.4	29.0
All	43.4	5.6	2.0	1.7	18.9	27.7

Note: Minor investment options are not shown; therefore, row percentages will not add to 100 percent.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 7

Average Asset Allocation by Salary and Investment Options, 2000
(percent of account balances)

	Equity Funds	Balanced Funds	Bond Funds	Money Funds	Guaranteed Investment Contracts	Company Stock
SALARY						
PLANS WITHOUT COMPANY STOCK OR GUARANTEED INVESTMENT CONTRACTS						
$20,000 to $40,000	64.5	9.8	11.7	7.1		
>$40,000 to $60,000	71.0	9.5	11.3	5.2		
>$60,000 to $80,000	74.6	8.5	10.2	4.7		
>$80,000 to $100,000	75.3	8.7	9.6	4.3		
>$100,000	73.3	8.3	9.3	4.6		
All	70.4	10.1	8.8	7.5		
PLANS WITH GUARANTEED INVESTMENT CONTRACTS						
$20,000 to $40,000	47.7	21.7	3.7	4.6	20.2	
>$40,000 to $60,000	51.1	21.6	3.8	4.5	16.8	
>$60,000 to $80,000	55.0	19.4	3.4	4.1	15.7	
>$80,000 to $100,000	58.1	18.8	3.5	3.7	13.8	
>$100,000	57.7	20.5	3.2	4.0	11.7	
All	56.7	14.3	3.5	3.5	19.4	
PLANS WITH COMPANY STOCK						
$20,000 to $40,000	38.0	7.0	5.5	6.4		41.3
>$40,000 to $60,000	37.8	11.2	4.0	6.9		33.7
>$60,000 to $80,000	39.9	12.3	3.1	5.3		29.3
>$80,000 to $100,000	42.6	12.9	3.5	4.7		25.9
>$100,000	46.5	9.5	6.3	4.8		26.4
All	44.6	5.8	7.9	5.8		31.8
PLANS WITH COMPANY STOCK AND GUARANTEED INVESTMENT CONTRACTS						
$20,000 to $40,000	41.2	7.4	1.8	1.1	18.1	29.3
>$40,000 to $60,000	43.6	6.7	1.6	1.0	19.0	27.5
>$60,000 to $80,000	46.5	6.7	1.6	0.6	18.3	25.8
>$80,000 to $100,000	49.9	6.0	1.8	0.6	18.0	23.2
>$100,000	47.1	5.5	1.8	0.6	17.8	26.5
All	43.4	5.6	2.0	1.7	18.9	27.7

Note: Minor investment options are not shown; therefore, row percentages will not add to 100 percent.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 8: Asset Allocation Distribution of Participant Account Balances to Company Stock Among Participants in Plans Offering Company Stock by Age, 2000
(percent of participants in plans offering company stock)

	Zero	> 0% to 10%	> 10% to 20%	> 20% to 30%	> 30% to 40%	> 40% to 50%	> 50% to 60%	> 60% to 70%	> 70% to 80%	> 80% to 90%	> 90%
Total	34.5	11.2	8.1	7.4	6.1	5.2	4.5	3.2	2.5	2.0	15.3
AGE COHORT											
20s	39.2	6.1	6.7	7.9	6.9	5.7	4.9	3.2	2.4	1.7	15.2
30s	34.3	9.7	8.2	7.8	6.5	5.6	4.8	3.4	2.7	2.1	14.8
40s	33.0	11.8	8.4	7.4	6.2	5.4	4.6	3.4	2.7	2.1	15.0
50s	32.4	13.8	8.5	7.1	5.7	5.0	4.2	3.1	2.4	2.0	15.8
60s	37.5	14.1	7.6	5.9	4.6	3.9	3.3	2.6	2.1	1.8	16.6

Note: Row percentages may not add to 100 percent because of rounding.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 9

Impact of Company Stock on Asset Allocation by Age, 2000

(percent of account balances)

Age Cohort	Equity Funds	Balanced Funds	Bond Funds	Money Funds	Guaranteed Investment Contracts	Company Stock
PLANS WITH EMPLOYER-DIRECTED AND PARTICIPANT-DIRECTED BALANCES						
Total Balances (Employer-Directed and Participant-Directed)						
20s	31.8	5.0	0.6	3.1	3.6	53.7
30s	27.9	4.7	0.6	1.8	4.9	58.4
40s	26.0	4.7	0.9	2.8	6.4	56.9
50s	26.2	5.5	1.4	3.6	10.1	50.9
60s	25.0	6.3	2.3	7.2	15.3	41.4
All	26.2	5.2	1.2	3.5	8.8	52.9
Participant-Directed Balances Only						
20s	40.8	6.4	0.8	3.6	4.3	41.3
30s	42.0	7.0	0.8	2.4	6.6	39.0
40s	40.7	7.1	1.5	4.0	9.0	34.9
50s	37.7	7.5	2.0	5.1	12.6	32.0
60s	32.4	7.9	3.1	9.2	18.7	26.0
All	38.5	7.4	1.8	4.9	11.5	33.2
PLANS WITH COMPANY STOCK INVESTMENT OPTION BUT NO EMPLOYER-DIRECTED CONTRIBUTIONS						
Total Balances						
20s	53.9	9.1	2.6	6.6	6.6	18.4
30s	54.5	8.8	2.2	4.7	6.8	20.4
40s	49.4	9.4	2.4	4.8	9.6	22.2
50s	43.5	10.1	3.0	5.5	13.1	22.8
60s	34.2	10.5	3.6	7.3	20.0	22.8
All	46.1	9.7	2.8	5.4	11.8	22.2

Note: Minor investment in other stable value funds and "other" are not shown; therefore, row percentages will not add to 100 percent. Employer-directed balances are invested in the plan sponsor's company stock.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 10: CDF of expected returns: diviersified equity vs individual stock

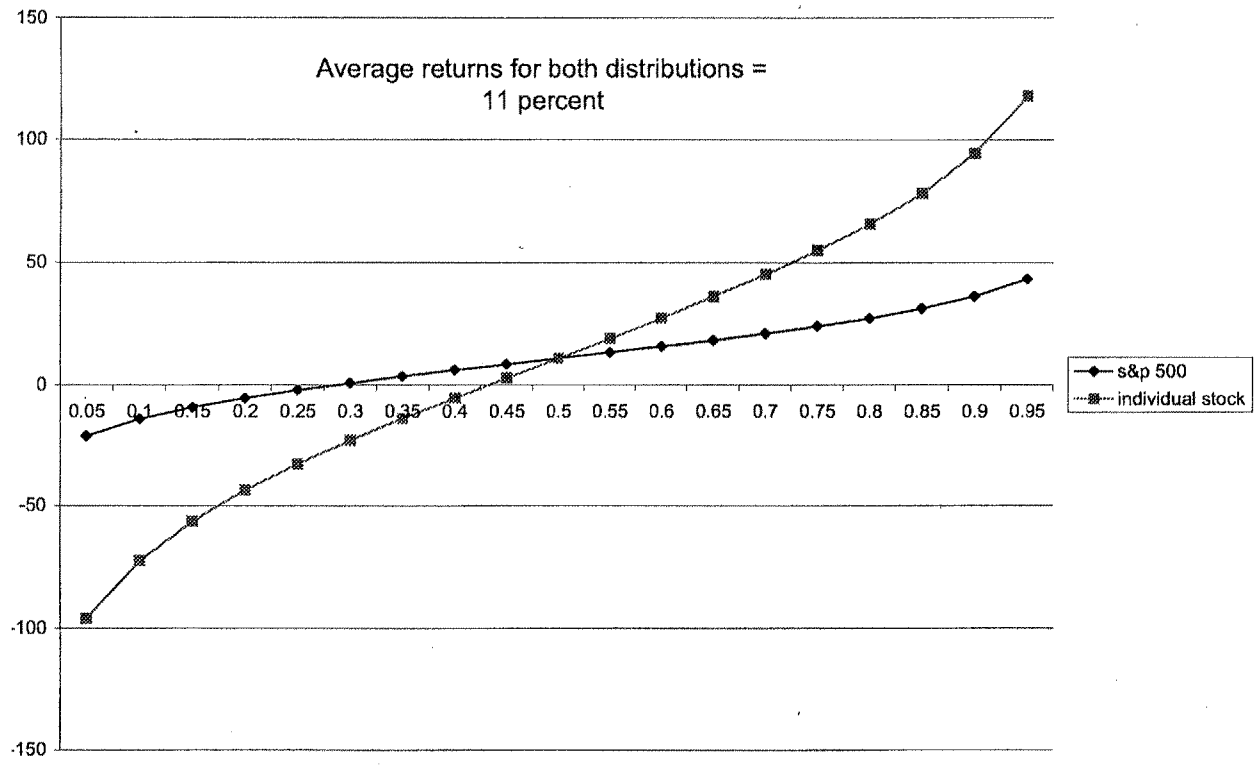


Figure 11: CDF of expected returns for 401(k) participants in their twenties: company stock vs no company stock

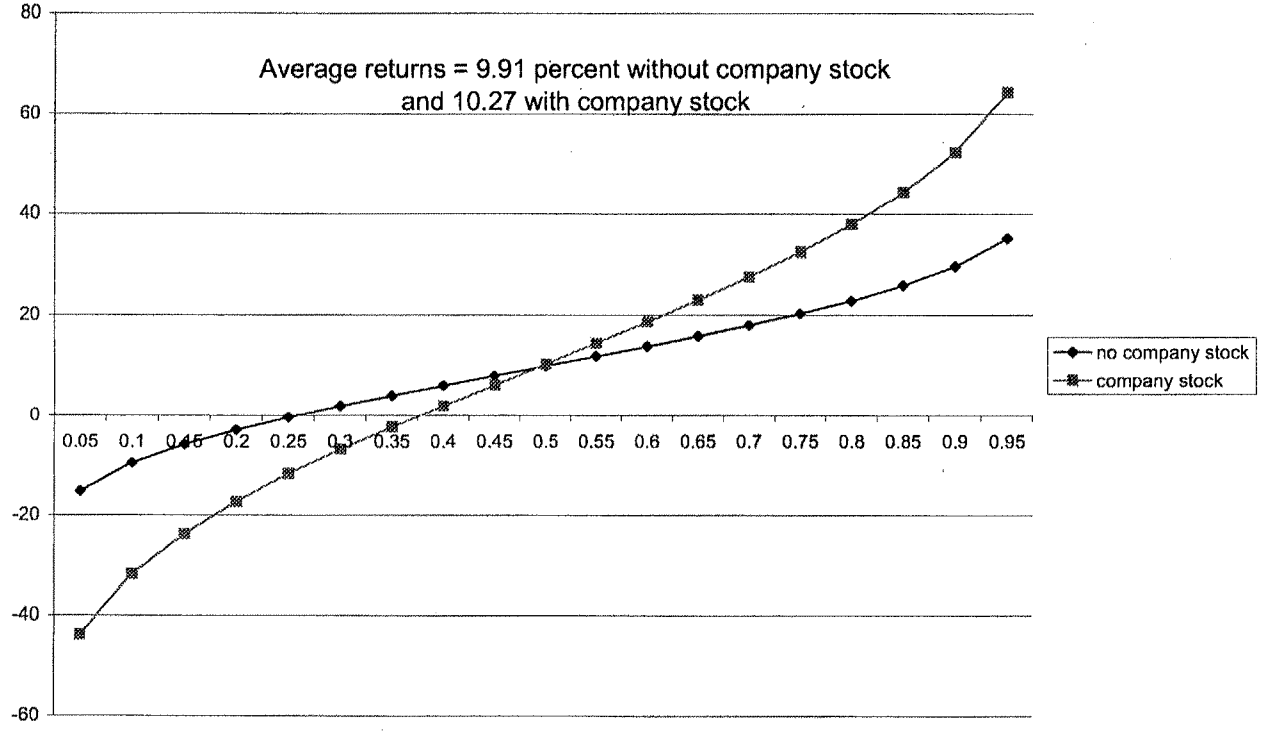
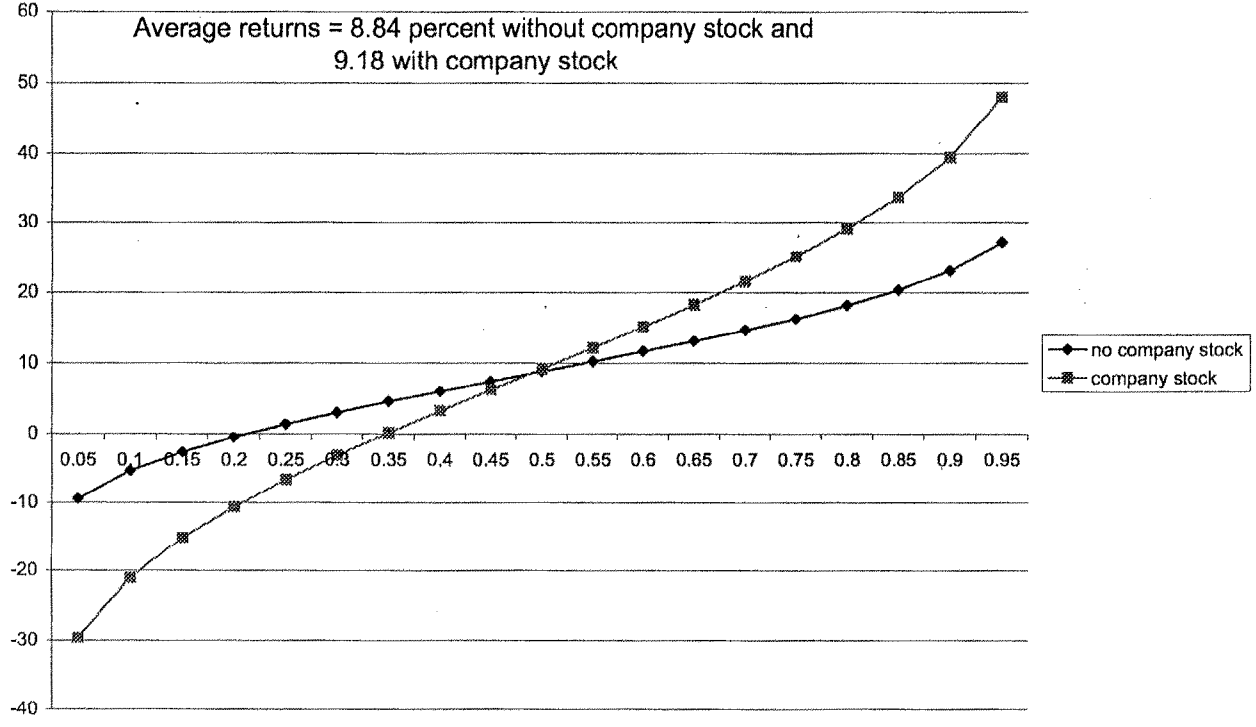


Figure 12: CDF of expected returns for 401(k) participants in their sixties: company stock vs no company stock



Committee on Education and the Workforce

Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name:		
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the Committee).	Yes	No X
2. Please list any federal grants or contracts (including subgrants or subcontracts) which you have received since October 1, 1999: "Development of Pension Prototypes for PENSIM, for U.S. Department of Labor," Pension and Welfare Benefit Administration, Office of Policy + Research		
3. Will you be representing an entity other than a government entity?	Yes X	No
4. Other than yourself, please list what entity or entities you will be representing: Employee Benefit Research Institute		
5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4: Research Director of EBRI Fellows program		
6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 1999, including the source and amount of each grant or contract: N/A		
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list: American Savings Education Council, Consumer Health Education Council	Yes X	No

Signature: _____ Date: 2/12/02

Please attach this sheet to your written testimony.

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Jack VanDerhei is a faculty member at Temple University's School of Business and Management (Department of Risk, Insurance, and Healthcare Management) and the Research Director of the EBRI Fellow's Program. He is currently the project director of both the Defined Contribution and Participant Behavior Research Program and the Retirement Security Research Program.

Dr. VanDerhei has more than 100 publications devoted to employee benefits and insurance but his major areas of research include (1) the financial and fiduciary aspects of private defined benefit and defined contribution retirement plans and (2) Social Security reform. Currently his research agenda primarily focuses on analyzing a proprietary longitudinal database of 10 million 401(k) participants from 30,000 plans. This has already resulted in publications with respect to participant contribution behavior, asset allocation, account balances and loan activity. Future publications will explore retirement preparedness and withdrawal activity.

He is the editor of Benefits Quarterly and Search for a National Retirement Income Policy (University of Pennsylvania Press), a co-author of Pension Planning: Pension, Profit-Sharing, and Other Deferred Compensation Plans (Irwin/McGraw-Hill) and a member of the Advisory Board of the Pension Research Council at the Wharton School and the National Academy of Social Insurance.

He received his BBA and MBA from the University of Wisconsin-Madison and his M.A. and Ph.D. from the Wharton School of the University of Pennsylvania.

APPENDIX D - WRITTEN STATEMENT OF DOUGLAS KRUSE, Ph.D., PROFESSOR, SCHOOL OF MANAGEMENT AND LABOR RELATIONS, RUTGERS UNIVERSITY, SOMERSET, NJ

Research Evidence on Prevalence and Effects of Employee Ownership

Testimony before the
Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
U.S. House of Representatives

February 13, 2002

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Employee ownership has attracted attention and interest for a wide variety of reasons. Much of the interest has focused on the potential for better economic performance, particularly through enhanced motivation and commitment from employees who have a direct stake in firm performance. Strong majorities of the public believe that employee-owners work harder and pay more attention to the quality of their work than non-owners, and are more likely than outside shareholders to vote their shares in the long-term interest of the company.[1] There have also been social arguments for employee ownership, based on its potential to broaden the distribution of wealth, decrease labor-management conflict, and enhance social cohesion and equality by distributing the fruits of economic success more widely and equitably (Gates, 1998). The idea of employee ownership has attracted support across the political spectrum, often being seen as a form of economic democracy that complements our political democracy.[2] Along with these positive views, however, there have been many concerns expressed about employee ownership—particularly that it can expose workers to excessive risk and may in some cases increase labor-management conflict and lower economic performance.

How much employee ownership exists in the United States, and what are the lessons from the accumulated evidence? There have been over 70 empirical studies on the effects of employee ownership in the past 25 years. These can be categorized into studies of: (a) employee attitudes and behavior; (b) firm performance; (c) employment stability, growth, and firm survival; and (d) employee wealth and wages. The studies have mostly been done on samples of United States firms and employees, although several have been done on firms in other Western industrialized countries. In this testimony I will first present data on the extent of employee ownership in the United States, and then briefly summarize the results from these studies and discuss some implications for public policy.

PREVALENCE OF EMPLOYEE OWNERSHIP

There are a variety of forms that employee ownership can take. Employee ownership is not a simple, unidimensional concept that permits an easy classification of a firm as "employee-owned," or of an employee as an "employee-owner." Four dimensions of employee ownership within a company are: 1) The percentage of employees who participate in ownership; 2) The percentage of ownership held within the company by employees; 3) The inequality of ownership stakes among employee-owners; and 4) The prerogatives and rights that ownership confers upon employees. These prerogatives and rights are determined in part by whether ownership is direct (where employees can freely buy and sell company stock) or indirect (where stock is held through an employee trust or cooperative), and in part by the voting rights and other forms of participation accompanying the ownership. In this testimony I use a broad definition of employee ownership, covering the variety of ways in which employees other than top managers can own stock in their companies. I do not cover research on the closely-related topics of profit sharing (in which employees can receive a share of company profits without an ownership stake)

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[1] Based on results from a 1986 BNA/NCEO/Bruskin poll, and 1989 and 1994 EBRI/Gallup polls, summarized in Kruse and Blasi (1999).

[2] Albert Gallatin, Thomas Jefferson's Secretary of the Treasury, made such arguments with regard to the closely-related idea of profit sharing, claiming that the "democratic principle upon which this nation was founded should not be restricted to the political processes but should be applied to the industrial operation" (quoted in U.S. Senate, 1939; 72).

and broad-based stock options (in which employees receive options to buy company stock at a fixed price which they can then sell for the market price).[3]

The most recent data from the Department of Labor pension database show that:

- **There are between 17 and 20 million U.S. employees participating in large ESOPs or other defined contribution plans holding employer stock.**

In the United States the main vehicle for employee ownership is the Employee Stock Ownership Plan (ESOP), which was first given recognition and special tax treatment as a form of pension plan in the 1974 ERISA law. As with other pension plans, ESOP administrators must file the federal Form 5500 each year for large plans (100 or more participants), and at least once every three years for small plans (fewer than 100 participants). Table 1 presents new calculations for large plans from the most recent Form 5500 database.[4] As can be seen, there are about 3.2 million participants in large non-401(k) ESOPs, and 4.8 million participants in large 401(k) ESOPs. There are an additional 225,000 participants in small ESOPs, for a total of 8.2 million ESOP participants, representing 7.7% of private-sector employees.[5]

Apart from ESOPs, there are 11.0 million participants in large non-ESOP 401(k) plans that hold employer stock, and 1.4 million participants in large profit sharing and other defined contribution pension plans that hold employer stock (Table 1). When added to the figures on large ESOPs, there are about 20.3 million participants in large ESOPs or pension plans that hold employer stock. This may include some double-counting of employees who are in more than one plan. A lower-bound estimate is that 16.8 million employees are participants in at least one of these plans, representing 15.8% of private-sector employees.[6] Employees may also own stock directly in their companies through stock purchase programs, or be members of worker cooperatives.[7] Combining the various methods of owning employer stock, survey evidence indicates that about one-fifth of American employees report holding stock in the company in which they work.[8]

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[3] For evidence on profit sharing see Kruse (1993) and Pliskin et al. (1997), and for evidence on broad-based stock options see U.S. Bureau of Labor Statistics (2000), Blasi et al. (2000), and Sesil et al. (forthcoming).

[4] These figures are based on the Form 5500 Research File for fiscal year 1998, made available by the Pension and Welfare Benefits Administration. Many of the plans report assets in common and collective trusts, which hold assets of several pension plans within a company. Failing to account for employer stock held by these trusts will understate the amount of employer stock in pension plans. Since the fiscal year 1998 data do not break out investments of these trusts, this analysis uses data from the regular and "spread" files of fiscal year 1996 (when the Pension and Welfare Administration had such data broken out) matched to 1998 data to impute employer stock in common/collective trusts in fiscal year 1998.

[5] Figures on small pension plans are not shown in Table 1, since the research file does not contain data on employer stock in small plans. There were 106.5 million employees of private companies in March 1999, from calculations using Current Population Survey data.

[6] The lower-bound estimate is based on summing only the participants in the largest plan in each company, eliminating any possibility of double-counting.

[7] Brickley and Hevert (1991) found that 8.9% of employees directly owned company stock in 1983. Only a very small percentage of U.S. workers are in worker cooperatives (see Craig and Pencavel, 1995, and Bonin et al., 1993).

[8] This is based on a December 1993 Gallup survey and January 1997 Princeton Survey Research Associates survey, summarized in Kruse and Blasi (1999). This does not include employees in stock option plans.

While a large number of U.S. employees own employer stock, almost all of this stock is in firms that are only minority employee-owned. Of U.S. companies with more than 10 employees, between 3000 and 4000 have a majority of stock owned by their employees.[9]

Several other important findings from these tables are:

- **Employer stock represents close to 20% of the assets of all defined contribution plans.**

  As can be seen in Table 1, $330 billion, or 19.8%, of the total $1.7 trillion of assets in defined contribution pension plans are invested in employer stock.

- **The average dollar value of employer stock per participant ranges from $10,140 to $27,244 across the different types of plans that hold employer stock.**

  The average employer stock per participant is $16,933 in non-401(k) ESOPs, $27,244 in 401(k) ESOPs, $12,040 in non-ESOP 401(k)'s with employer stock, and $10,410 in other defined contribution plans with employer stock (Table 1).

- **Employer stock in defined contribution pension plans is concentrated in plans maintained by publicly-held companies, and plans with 5000 or more participants.**

  As shown in Table 1, publicly-held companies represent a minority of total participants in defined contribution plans, but account for the bulk of employer stock and total plan assets. The percent of plan assets in employer stock is 9.7% in private companies and 28.0% in publicly-held companies. Similarly, Table 2 shows that the largest plans (with 5000 or more participants) account for most employer stock and plan assets, with a larger share of employer stock in plan assets than exists in smaller plans (26.1% compared to 8.7%).

- **About 70-75% of participants in plans that are heavily invested in employer stock are in companies that also maintain diversified pension plans, indicating that such plans tend to supplement rather than substitute for diversified plans.**

  Employees are especially exposed to financial risk when they have no other retirement funds, either from other employer plans or from their household savings. Table 3 shows the overlap of diversified and non-diversified plans maintained by employers. Among participants in large ESOPs, 66.2% are in companies also sponsoring defined benefit plans, 34.7% are in companies also sponsoring diversified defined contribution plans, and 75% are in companies that sponsor either of these diversified plans. The numbers are similar for non-ESOP plans that invest more than 10% of assets in employer stock—70% of these participants are in companies that also sponsor either type of diversified plan. While exactly comparable numbers for the full workforce are not available, employer survey data from the Bureau of Labor Statistics show that only 32% of all private-sector employees, and 50% of employees in medium and large establishments, participate in defined benefit pension plans (U.S. Department of Labor, 2001: Table 44).

Estimate by Corey Rosen of the National Center for Employee Ownership, Oakland, CA.

This is consistent with other evidence showing that private ESOP companies are about four times more likely than their industry counterparts to maintain defined benefit pension plans, and that public companies are more likely to adopt an ESOP if they already have a defined benefit plan.[10] Therefore it appears that participants in ESOPs and other plans heavily-invested in employer stock are more likely than other employees to be covered by defined benefit pension plans.

EMPLOYEE ATTITUDES AND BEHAVIOR

How does employee ownership affect employee attitudes and behavior? Employee ownership may have positive effects if employees value ownership in itself or perceive that it brings greater income, job security, or control over jobs and the workplace. On the other hand, it may have negligible or even negative effects if employees perceive no difference in their worklives, dislike the extra risk to their income or wealth, or have raised expectations that are not fulfilled.

There have been over two dozen published studies on employee attitudes and behavior under employee ownership in the past two decades. This section summarizes the key conclusions from reviewing 31 of these studies.[11] Most of the studies have made cross-sectional comparisons between employee-owners and non-owners (who may be in the same firm or in different firms), while a few have made longitudinal comparisons before and after the adoption or termination of employee ownership, and others have looked within groups of employee-owners to see how attitudes are related to different plan features or employee characteristics.

The studies surveyed here each addressed a number of topics, including: employee satisfaction (analyzed in 10 studies); organizational commitment and identification (12 studies); employee motivation (6 studies); attitudes toward union (3 studies); perceived and desired employee participation and influence in decisions (11 studies); satisfaction with an ESOP (3 studies); and behavioral measures such as turnover, absenteeism, grievances, tardiness, and injuries (7 studies).

The main conclusions from these 31 studies are as follows.

- **Most studies find higher organizational commitment and identification under employee ownership, while studies are mixed between favorable and neutral findings on job satisfaction, motivation, and other behavioral measures.**

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[10] The data on private companies is at http://www.nceo.org/library/esop_perf.html, and the study of ESOP adoption among public companies is in Kruse (1996).

[11] This is based on the 26 studies reviewed in Kruse and Blasi (1997), plus Grunberg et al. (1996), Pendleton et al. (1998), Keef (1998), Brown et al. (1999), and Logue and Yates (2001). The studies were selected based upon the criteria that they used systematic data collection from representative samples of employees, and used statistical techniques to rule out sampling error. Many but not all of the studies used multivariate analysis to hold constant the effect of other salient variables on employee attitudes or behavior.

It is rare to find worse attitudes and behavior under employee ownership—only one study found lower satisfaction among employee-owners compared to a nationwide sample, but this was in an ESOP company where the union had lost a bitter strike the year before.[12]

- **There is clearly no automatic improvement of attitudes and behavior associated with being simply an employee-owner.**

  A number of the studies find higher satisfaction, commitment, and motivation among employee-owners, but others find no significant differences between owners and non-owners, or before and after an employee buyout.

- **Where studies find improved attitudes under employee ownership, this is almost always due to the status of being an employee-owner, rather than to the size of one's ownership stake.**

- **Greater employee participation and influence in decision-making may help to generate feelings of ownership, but studies are mixed on whether employee-owners are more likely to perceive and desire greater participation in decisions.**

  Increasing employee participation and influence can make greater use of employee skills and knowledge, and may be an important complement of employee ownership that can improve attitudes and performance. The importance of participation is indicated by the finding of Pendleton et al. (1998) that opportunities for participation in decision-making were more important than ownership *per se* in generating feelings of ownership.

- **There is no evidence of decreased desire for union representation in employee ownership firms.**

  While some unions have resisted employee ownership out of concern that it may divide worker loyalties or make the union appear obsolete, others such as the Steelworkers, Pilots, and Machinists have negotiated for employee ownership stakes in concession situations. Both survey evidence and occasional strikes at employee ownership firms indicate that desires for union representation appear unaffected by employee ownership.

- **Employees generally like the idea of employee ownership.**

  A 1994 EBRI/Gallup national poll found that employees were more likely to prefer a share in company ownership than having additional cash in their paychecks now, and 80% said that employers should be allowed to contribute company stock to fund retirement plans (Kruse and Blasi, 1999).

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[12] Reminders by management that the strike would hurt ESOP account values brought the response "We don't vote; we don't control the company; we don't care." (Kruse, 1984)

FIRM PERFORMANCE

Employee ownership may improve firm performance by decreasing labor-management conflict and serving as a collective incentive to improve workplace cooperation, information-sharing, and organizational citizenship behavior. This may be limited by the free rider problem—when rewards are shared with co-workers, direct incentives for better work become weak as the number of co-workers expands. To counteract this problem and encourage higher performance, firms may combine employee ownership with employee participation in decision-making and other human resource policies to encourage a sense of ownership, draw more fully on worker skills and information, and create company spirit and higher work norms.[13]

Over 30 studies in the past 20 years have addressed the question of whether and how employee ownership affects firm performance. This section briefly summarizes the main conclusions from a review of 32 of these studies.[14] Some of these studies are of U.S. ESOPs only (comparing ESOP and non-ESOP firms either cross-sectionally, or before and after the adoption of an ESOP), while other studies look within groups of worker cooperatives and attempting to measure the effects of different cooperative features. Several studies examine other forms or combinations of employee ownership, using comparisons with non-employee-owned firms and/or comparisons based on employee ownership features within firms.

The major conclusions are:

- **Studies are split between favorable and neutral findings on the relationship between employee ownership and firm performance.**

  While the majority of studies could not reject the null hypothesis of no significant relationship between employee ownership and performance, our meta-analysis of the ESOP studies found that we could reject this null hypothesis overall based on the disproportionate number of positive and significant estimates (Kruse and Blasi, 1997).

- **Productivity improves by an extra 4-5% on average in the year an ESOP is adopted, and the higher productivity level is maintained in subsequent years. This one-time jump is more than twice the average annual productivity growth of the U.S. economy over the past 20 years.**

  The average estimated productivity difference between ESOP and non-ESOP firms is 6.2%, and the average estimated additional increase in productivity following adoption is 4.4%

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[13] Another theoretical objection to group incentive schemes such as employee ownership is that they can weaken managerial incentives to monitor workers closely (Alchian and Demsetz, 1972). Group incentives may, however, lead to better performance if workers have greater information about co-worker performance and group incentives elicit useful information-sharing and peer pressure (Nalbantian, 1987; Putterman and Skillman, 1988).

[14] Kruse and Blasi (1997) review 29 of these studies; the additional three are Smith et al. (1997), Ohkusa and Ohtake (1997), and McNabb and Whitfield (1998). As with the employee attitude studies surveyed above, these studies used systematic data collection across a large sample of firms (excluding individual case studies), and statistical techniques to control for other influences upon performance and rule out sampling error.

(relative to the increase among otherwise-similar firms in the same period).[15] This roughly corresponds to the productivity increase associated with a 25% increase in capital stock, and is more than twice the economy-wide annual productivity growth rate of 2.0% from 1980-2000.[16] A number of studies have attempted to control for self-selection bias resulting from the types of companies that adopt employee ownership plans, but these corrections have made little substantive difference in the results.[17]

EMPLOYMENT STABILITY, GROWTH, AND FIRM SURVIVAL

Closely related to firm performance are the issues of employment stability, growth, and firm survival. In employee ownership firms managers may try to stabilize employment to maintain a high-commitment workplace, and employees may exert formal or informal pressures to increase job security.[18]

There have been seven empirical studies on employee ownership and employment behavior. The results from these studies are:

- **Employee ownership is associated with greater employment stability, which does not come at the expense of lower efficiency.**

  This was the conclusion of a study tracking U.S. public companies with broad-based employee ownership plans holding more than 17% of company stock over the 1983-95 period, comparing them to otherwise-similar firms in their industries (Blair et al., 2000). The employment stability did not, however, appear to come at the expense of firm efficiency, given that the stock market performance of the employee ownership firms was slightly better than that of other firms. Similarly, a study of U.S. plywood cooperatives in the Pacific Northwest found that these cooperatives tended to adjust pay rather than employment as plywood demand changed, and these firms had higher average productivity levels than conventional plywood firms (Craig and Pencavel, 1992, 1993, 1995).[19]

- **Employee ownership was linked to faster employment growth in three of four studies.**

  Two studies comparing companies before and after the adoption of ESOPs found faster employment growth after ESOP adoption, particularly among firms that had greater levels of employee participation in decision-making (Quarrey and Rosen, 1993; Winther and Marens, 1997). Ohio ESOP companies also grew faster than their industry counterparts (Logue and

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15 See Logue and Yates (2001) for a detailed examination of the routes through which ESOPs can affect productivity and profits.

16 Based on figures for the nonfinancial corporate sector from U.S. Department of Labor (2001: Table 27).

17 In addition, evidence on the type of worker who chooses to work in group incentive plans indicates that the generally positive performance results are unlikely to be explained by worker self-selection (Weiss, 1987).

18 For example, a majority of Americans say that if they owned company stock and an outside investor was attempting a takeover, they would not sell even for twice the market value of the stock (1994 EBRI/Gallup poll summarized in Kruse and Blasi, 1999).

19 The study also found that these plywood cooperatives did not have the "perverse" response to demand shocks predicted in theory on labor-managed firms.

Yates, 2001), although the study tracking U.S. public companies from 1983 found similar employment growth between those with and without employee ownership.

- **Employee ownership is linked to higher rates of firm survival.**

  The study tracking U.S. public companies from 1983 found that those with substantial employee ownership stakes were 20% more likely than their industry counterparts to survive through 1995 (Blair et al., 2000). Similarly, Joseph Blasi and I recently tracked all privately-held companies with ESOPs in 1988, and found they had higher survival rates than closely-matched firms without ESOPs in 1988.[20] A long-term study of French worker cooperatives also found that they had high rates of survival (Estrin and Jones, 1992).

EMPLOYEE WEALTH AND WAGES

Do employees sacrifice other pay and benefits for a share in ownership, or do these purely add to worker income and wealth? There were a number of cases in the early 1980's in which unionized employees accepted employee ownership in exchange for concessions in pay or benefits. In addition, some employees have taken lower wages as part of employee buy-outs, such as occurred in the United Airlines case. Among the nearly 1000 public firms that developed employee ownership stakes of 4% or greater over the 1980's, however, there were only 40 reports of wage and benefit restructuring linked to employee ownership (Blasi and Kruse, 1991). There have been only three broad studies of employee compensation in relation to employee ownership. The overall finding is that:

- **Company stock appears to come on top of, and not in place of, other compensation.**

  A study of public companies in which broad-based employee ownership plans held at least 5% of company stock as of 1990 found that these companies had 8% higher average compensation levels than other comparable public companies (Blasi et al., 1996). Compensation levels increased with the percentage of stock held by employees. Closer studies of pay and benefits in ESOP and non-ESOP firms in Massachusetts and Washington state also found that the levels of pay and other benefits were similar between these two types of firms, so that ESOPs appear to come on top of other worker pay and benefits (Kardas et al., 1998; Scharf and Mackin, 2000). Therefore while some employees do accept lower compensation in exchange for employee ownership, the overall average pay of workers in these plans appears to be at least as high as—and may be higher than—that of other workers. This may partly reflect higher average productivity levels in employee ownership companies or the use of high wages in combination with employee ownership to motivate workers.

  These studies are consistent with the evidence presented earlier showing that ESOP companies are more likely to have defined benefit pension plans, so that plans heavily

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[20] Among 1176 private companies with ESOPs in 1988, 69.6% survived through 1999, compared to only 54.8% of non-ESOP companies in the same industry and of the same size (www.nceo.org/library/esop_perf.html)

invested in company stock appear generally to supplement, rather than substitute for, diversified pensions.

IMPLICATIONS FOR PUBLIC POLICY

The broad conclusions from over 70 studies of employee ownership in the past 25 years are as follows:

1. Studies are generally split between favorable and neutral findings on the effects of employee ownership on employee attitudes and firm performance, with very few negative findings.
2. On average, employee ownership is linked to 4-5% higher productivity levels, and greater employment stability, growth, and firm survival.
3. While employee ownership may often improve attitudes or performance, it clearly does not automatically improve these outcomes whenever it is implemented. The distribution of outcomes may be shifted in a positive direction, but the dispersion is probably as great among employee ownership firms as among other firms.
4. Employee-owners generally do not sacrifice pay or benefits in exchange for employee ownership, and in fact are more likely than other employees to have diversified retirement plans.

Based on these findings, employee ownership appears generally to provide benefits both to firms and to workers. It is obvious, however, that employee ownership companies sometimes fail, which destroys both the jobs and the employee ownership stakes of the employee-owners. It is very similar to the situation facing farmers and small business owners, who may lose both their livelihoods and a substantial portion of their assets if their farms or businesses fail. It is a staple of retirement planning that individuals should have a diversified retirement portfolio, particularly as they approach retirement age, so that a substantial swing in the value of one asset does not greatly impair their quality of life. Due to this consideration, one policy implication is that:

- **Employees who own substantial amounts of employer stock should constantly be reminded that such investments are not the basis for sound retirement planning—perhaps in boldly-lettered words on each plan statement they receive.**

  If employees do not have access to a defined benefit or diversified defined contribution plan from the employer, they should have access to investment advice from the employer or elsewhere in order to do sound retirement planning. Employer stock should be seen as a possible supplement to,.but not the basis of, retirement funds.

- **Like all owners, employees who own company stock should have good access to information on the state of the company, possibly in some cases through employee representatives or monitors in board or trustee meetings.**

Employee-owners may have very limited information on the overall state of the company and the financial risks associated with their ownership stake, which prevents them from doing sound financial planning. While individual employees can sometimes obtain better information in various ways (such as by attending shareholder meetings in public companies), the information has a public good character that leads to well-known disincentives for individual action. Employees as a whole may greatly benefit from information that may be costly for one individual to obtain, which can support a case for new policies to ensure information access. While I am not an expert on fiduciary rules and make no specific recommendation here, there should be careful thought given to ensuring and possibly expanding mechanisms for employees to gain necessary information on the state of the company. Such mechanisms might include employee representatives or monitors at board or trustee meetings, both to increase information flow for employees and to keep board members and trustees aware of their responsibilities to employees.

- **Cutting back on the ability of companies to provide stock to employees, and the extent to which employees can own employer stock, could destroy many of the potential benefits of employee ownership for firms and workers.**

  Employees clearly need good information and investment advice to ensure that they make intelligent decisions; once they receive such information and advice, they should not be prevented from accepting company stock from employers or investing their own assets in company stock. Obviously many individuals make well-informed choices to invest much of their assets in farms or small businesses that they operate, which are often very risky assets. Limiting workers' involvement in employee ownership plans due to a concern about their financial risk would be akin to preventing individuals from owning their own farms or small businesses. Substantial new restrictions on employee ownership of stock would very likely cut back a potentially lucrative benefit for employees, without providing anything of value in return since employees generally do not sacrifice pay or other benefits when they participate in employee ownership plans.

In conclusion, employee-owners represent a substantial portion of the U.S. workforce, and 25 years of research shows that employee ownership often leads to higher-performing workplaces and better compensation and worklives for employees. Given the potential economic and social benefits of employee ownership, public policy should seek to ensure that employee-owners have standard perquisites of ownership such as good information to enhance workplace and financial decision-making, but should not substantially restrict employees' ability to own company stock.

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TABLE 1. Employer Stock Held in Pension Plans: Comparison by Plan Type and Whether Company is Publicly-held

	Number of plans (1)	Number of participants (2)	Total employer stock held by plans (millions) (3)	Employer stock per Participant (4)	Total plan assets (millions) (5)	Employer stock as pct.of total assets (6)
All defined contribution plans						
All	50,769	50,933,238	$330,529.6	$6,489	$1,671,703.6	19.8%
Privately-held	46,664	30,609,811	$73,346.0	$2,396	$753,571.8	9.7%
Publicly-held	4,105	20,323,427	$257,183.6	$12,655	$918,131.8	28.0%
ESOP non-401(k) plans						
All	2,056	3,170,045	$53,677.1	$16,933	$69,635.8	77.1%
Privately-held	1,672	1,291,957	$26,358.4	$20,402	$34,900.0	75.5%
Publicly-held	384	1,878,088	$27,318.7	$14,546	$34,735.7	78.6%
ESOP 401(k) plans						
All	613	4,757,356	$129,609.8	$27,244	$332,712.8	39.0%
Privately-held	331	770,202	$10,310.1	$13,386	$29,110.1	35.4%
Publicly-held	282	3,987,154	$119,299.6	$29,921	$303,602.7	39.3%
Non-ESOP 401(k)'s with employer stock						
All	2,275	11,037,790	$132,899.4	$12,040	$472,176.1	28.1%
Privately-held	1,141	3,183,154	$31,794.0	$9,988	$115,436.7	27.5%
Publicly-held	1,134	7,854,636	$101,105.4	$12,872	$356,739.4	28.3%
Non-ESOP 401(k)'s without employer stock						
All	36,832	23,474,392	$0	$0	$567,223.1	0.0%
Privately-held	35,013	18,887,780	$0	$0	$419,586.3	0.0%
Publicly-held	1,819	4,586,612	$0	$0	$147,636.9	0.0%
Profit sharing and other defined contribution plans with employer stock (non-ESOP non-401(k))						
All	355	1,377,825	$14,343.3	$10,410	$47,501.5	30.2%
Privately-held	227	749,471	$4,883.4	$6,516	$20,111.4	24.3%
Publicly-held	128	628,354	$9,459.9	$15,055	$27,390.1	34.5%
Profit sharing and other defined contribution plans without employer stock						
All	8,633	7,115,015	$0	$0	$182,432.0	0.0%
Privately-held	8,275	5,726,432	$0	$0	$134,404.9	0.0%
Publicly-held	358	1,388,583	$0	$0	$48,027.1	0.0%

Based on federal Form 5500 data for all large pension plans (100+ participants) for FY98 (latest data available) from Pension and Welfare Benefits Administration, U.S. Department of Labor. Excludes terminated plans and those not reporting assets. Employer stock figures include imputations of employer stock in common/collective trusts based on 1996 spread files.
Compiled by Prof. Douglas Kruse, School of Management and Labor Relations, Rutgers University, Feb. 2002

TABLE 2. Employer Stock Held in Pension Plans: Comparison by Plan Type and Size of Plan

	Number of plans (1)	Number of participants (2)	Total employer stock held by plans (millions) (3)	Employer stock per participant (4)	Total plan assets (millions) (5)	Employer stock as pct.of total assets (6)
All defined contribution plans						
All	50,769	50,933,238	$330,529.6	$6,489	$1,671,703.6	19.8%
Fewer than 5000 participants	49,225	23,978,346	$53,408.5	$2,227	$610,788.8	8.7%
5000+ participants	1,544	26,954,892	$277,121.1	$10,281	$1,060,914.8	26.1%
ESOP non-401(k) plans						
All	2,056	3,170,045	$53,677.1	$16,933	$69,635.8	77.1%
Fewer than 5000 participants	1,964	1,054,331	$23,146.5	$21,954	$31,523.9	73.4%
5000+ participants	92	2,115,714	$30,530.6	$14,430	$38,111.8	80.1%
ESOP 401(k) plans						
All	613	4,757,356	$129,609.8	$27,244	$332,712.8	39.0%
Fewer than 5000 participants	452	441,996	$10,354.0	$23,426	$23,681.0	43.7%
5000+ participants	161	4,315,360	$119,255.8	$27,635	$309,031.8	38.6%
Non-ESOP 401(k)'s with employer stock						
All	2,275	11,037,790	$132,899.4	$12,040	$472,176.1	28.1%
Fewer than 5000 participants	1835	2,236,178	$16,728.6	$7,481	$84,036.2	19.9%
5000+ participants	440	8,801,612	$116,170.8	$13,199	$388,139.8	29.9%
Non-ESOP 401(k)'s without employer stock						
All	36,832	23,474,392	$0	$0	$567,223.1	0.0%
Fewer than 5000 participants	36240	15,968,776	$0	$0	$350,299.6	0.0%
5000+ participants	592	7,505,616	$0	$0	$216,923.5	0.0%
Profit sharing and other defined Contribution plans with employer stock (non-ESOP non-401(k))						
All	355	1,377,825	$14,343.3	$10,410	$47,501.5	30.2%
Fewer than 5000 participants	296	265,268	$3,179.5	$11,986	$12,335.1	25.8%
5000+ participants	59	1,112,557	$11,163.9	$10,034	$35,166.4	31.7%
Profit sharing and other defined Contribution plans without employer stock						
All	8,633	7,115,015	$0	$0	$182,432.0	0.0%
Fewer than 5000 participants	8433	4,010,982	$0	$0	$108,890.6	0.0%
5000+ participants	200	3,104,033	$0	$0	$73,541.3	0.0%

Based on federal Form 5500 data for all large pension plans (100+ participants) for FY98 (latest data available) from Pension and Welfare Benefits Administration, U.S. Department of Labor. Excludes terminated plans and those not reporting assets. Employer stock figures include imputations of employer stock in common/collective trusts based on 1996 spread files.

Compiled by Prof. Douglas Kruse, School of Management and Labor Relations, Rutgers University, Feb. 2002

Table 3: Overlap of Diversified and Non-diversified Pension Plans

	Percent of participants who are in companies that have:			
	Defined benefit pensions (1)	Diversified defined contribution pensions^ (2)	Either (1) or (2) (3)	Total participants (4)
1 ESOP participants	66.2%	34.7%	75.0%	7,927,401
2 Participants in non-ESOP plans that have more than 10% of assets in employer stock	67.7%	24.9%	70.4%	8,771,335

	Percent of employees who are covered by defined benefit pensions
3 All companies	32%
4 Small establishments	15%
5 Medium and large establishments	50%

^ No more than 10% of plan assets in employer stock

Sources:

Rows 1-2: Calculations using federal Form 5500 data for FY98 for large plans (100+ participants)

Rows 3-5: 2001 Report on the American Workforce, U.S. Department of Labor, Table 44.

Compiled by Prof. Douglas Kruse, School of Management and Labor Relations, Rutgers University

APPENDIX E - WRITTEN STATEMENT OF NORMAN STEIN, DOUGLAS ARANT PROFESSOR OF LAW, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, AL

STATEMENT OF NORMAN P. STEIN

BEFORE

HOUSE COMMITTEE ON EDUCATION AND THE WORKFORCE
SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

HEARING ON "ENRON AND BEYOND:
ENHANCING WORKER RETIREMENT SECURITY"

FEBRUARY 13, 2002

Mr. Chairman, Members of the Committee, I am Norman Stein, a professor of law at the University of Alabama. I thank you for the opportunity to share my views today on the Enron failure's catastrophic consequences to the retirement security of its workers and what lessons that failure has for the regulation of the private pension system in this country.

At the University of Alabama, I teach tax, employee benefits and other labor-related subjects. I write on the subject of employee benefits and currently am a member of the Department of Labor Advisory Council on Employee Welfare and Employee Retirement Plans, where I represent the general public. I am also the director of a pension-counseling clinic at University of Alabama, where students have an opportunity to help individuals with various pension problems. I will draw on some of the cases we have seen in my testimony today.

In my testimony I will reflect on three issues: 1) the problems of employee stock in defined contribution plans and the related concerns over employee responsibility for development, implementation, and management of a retirement investment strategy; 2) the difficulty of catching "Enron" problems before they happen; 3) the failures of the judicial system to remedy adequately such problems after they happen: and 4) the problems retirees will increasingly experience in managing their investment portfolio after they leave the job market. (I will focus on the first issue and try to briefly outline my other concerns.)

There are other issues facing the retirement system today—most notably stagnant coverage rates, which I believe cannot be improved through the current tax paradigm of lavishing tax benefits on affluent employees in the hope that this will result in plans covering most employees, something which I have previously called trickle-down benefit policy; and the equally serious problem of the trivial benefits that many lower and middle income employees drawn from the plans that do include them, but they seem beyond the scope of this hearing.

I. Employer Stock in Defined Contribution Plans

The Enron retirement program implicates numerous problems with the private pension system today, but the glamour issue, at least in the mirror of the media, has been the concern with the large concentration of employer stock in many employees' 401(k) accounts. When Enron failed, employee's lost not only their job security but their retirement security as well. How did this happen? In part it happened because the Enron designed its 401(k) matching program to saddle employees with too much employer stock and prevented them from diversifying until age 55. But this is not the half of it.

The more troubling fact is that many Enron employees invested their own 401(k) contributions in Enron stock—in effect, chose to chase a single rainbow hoping to find a pot of retirement riches at its end. But chasing rainbows is no way to plan for retirement.

In 1997 I testified before the Department of Labor ERISA Advisory Council, which was studying the issue of employer stock and real property in defined contribution plans. Color Tile and Carter-Hawley's 401(k) plans had each failed because they were overinvested in employer stock and employer real property. Senator Barbara Boxer had seen a modest proposal (very similar to President Bush's current proposal) torn to shreds by the pension industry, which is, let no one pretend otherwise, a special interest pleader. In place of the Boxer Bill, Congress enacted a watered-down measure that prohibited employers from requiring that employees invest more than 10% of their own elective contributions in employer stock.

We have now seen that this provision was as ineffectual in preventing disaster as its critics predicted. IIn my 1997 testimony, which I append to my statement today, I wrote "that as a policy matter, any statutory tolerance of a retirement plan's investment in employer stock or real property is too much tolerance. I make this argument not because I have any illusion that even its most elegant presentation might persuade the pension community or Congress of its merit, but because it is a counterweight to the often unexamined assumption that employees owning a piece of the firm is an unvarnished economic virtue."

The key arguments against permitting employee retirement investment accounts to hold more than small amounts of employer stock are simple enough. In the field of finance and investment, one of the marvelous discoveries of the 20th century was the value of a well diversified investment portfolio, which helps protect investors from the possibility of large loss and at the same time allows them to enjoy some of the premium return on relatively risky investments. In financial planning for retirement, where excessive risk-taking should be verboten, the value of diversification is a simple fact, not a debatable principle. Indeed, professional guidelines generally prohibit professional investment managers from investing more than 10% of a retirement plan's assets in a single asset.

Too much investment in a single security is bad, but too much investment in employer stock is worse. Why? The cliché, of course, is that an employee's investment capital and human capital should not be tired together. There is also now some behavioral evidence—Enron is a startling example—that suggests employees are inclined to overvalue the financial future of their employer in relation to the market as a whole. For every company that outperforms the market, there is another that underperforms it. And as in Enron's case, some firms over time will do both.

Despite Enron, and despite a unanimity of opinion among academics of widely varying ideological perspectives (Professors John Langbein, Susan Stabile, and Theresa Ghilarducci have all testified strongly against 401(k) plans holding employer stock during the last few weeks) and investment professionals, there is active resistance in the pension community to meaningful limits on how much employer stock an employee should be able to hold in his or her 401(k) plan. Before turning to some ideas I have on how to construct limits that will work and might be politically acceptable, let me address the arguments against meaningful limits. Keep in mind that most of the people who advance these arguments have now embraced (albeit unenthusiastically) the weak protections in the Bush proposal, although in 1997 they claimed that the similar protections proposed by Senator Boxer would introduce unacceptable havoc in the pension system and destroy many 401(k) plans.

Here are the main arguments:

1. Employees should have the choice to invest in employer securities. We can deal with the problem of too much investment in employer stock through educating employees on the value of diversification.

In other words, we know it is generally a mistake for employees to hold employee stock in their retirement plan, but we should permit individuals to do so despite this in the name of investor autonomy. Investor autonomy is fine and obviously there is a limit to how much the government can generally protect an investor against the consequences of their own myopia. But retirement plans are different: they are paternalistic devices intended to provide retirement income. ERISA places numerous restrictions on pension plans that do not apply to investment intermediaries or investors generally. If we can prevent thousands of employees from doing something we know is stupid, we should do it.

Why not educate instead of prohibit? The short answer is that education will cost money (it is not free), will impose indirect costs (employee time), is dependent on the quality of instruction and the aptitude of the student, will sometimes be ignored for reasons that behavioral economists are struggling to understand. Moreover, many firms want employers to invest in employer stock; it is crazy to think that such firms will spend money to educate employees on the value of avoiding the very investment they want their employees to make.

In short, while educational efforts may help some employees somewhat, legal limits will help all employees avoid the Enron disaster.

2. Besides, some employees do quite well in employer stocks.

And some gamblers win big in Donald Trump's casinos. Retirement policy should be more concerned with preventing avoidable disasters than permitting some employees to beat the market. Moreover, for every high-flying Enron there is a spectacularly crashing Enron.

3. If forbidden to make matching contributions in employer stock (or if employees are permitted to diversify too quickly), employers will stop making matching contributions at all.

The people who make this argument apparently harbor a questionable belief: that employers make matching contributions because they are good guys and not because the labor markets require them to provide retirement benefits to attract and retain workers. If employers stop making matches, they will find it more difficult compete for good employees. Moreover, many firms that have adopted safe harbor 401(k) plans and SIMPLE have to provide matching contributions in order to comply with the rules for those sections.

It is also bears mention that Enron (and other firms that defer the right to diversify employer stock) overvalued the stock that it contributed to employee accounts. Why? If Enron stock were selling at $75 and you or I purchased it on the open market, we would be buying a bundle of ownership rights: one of the most important of those rights is the right to sell when we choose. How much would we pay for a share of stock otherwise selling at $75 if it contained a restriction prohibiting us from selling for 15 or 20 years? Far less than $75.

4. Stock ownership aligns the interests of the firm and its workers.

First, let me say that I am not opposed to employees owning stock in their firm: I am only opposed to employees owning such stock in plans designed to secure for the employee a measure of income security in retirement. Such plans enjoy significant tax benefits and the government should be understood as an investment partner of plan participants, an investment partner whose goal is to help create that retirement security. Employer stock simply does not belong in a tax-subsidized retirement plan. If stock ownership is a worthwhile component of employee compensation, let the employer provide it without the generous tax benefits helping underwrite retirement programs.

Second, serious questions have been raised about the theory that significant amounts of stock ownership in fact make firms more productive. In some cases—Enron is only an example—excessive stock ownership can demoralize employees and can pit the interests of managers against other employees. I am currently involved in another case involving an ESOP in which management made some poor managerial decisions and a questionable acquisition of another company. This has led not to a happy and productive workforce, but any angry and frustrated one.

It should also be said that the interests of worker-shareholders are not necessarily identical to those of other shareholders. Just an obvious example: workers have an interest in the firm paying more than the markets require, other shareholders an interest in paying no more than the market requires.

I note that the objections I have noted apply equally to ESOPs—it is perverse that ESOPs enjoy an array of tax benefits available to no other retirement plan: we thereby encourage firms with tax subsidies to adopt the very worst type of retirement plan for their employees. One of the best things that this Congress could do would be to repeal

every special tax benefit for ESOPs and ask firms to compete for capital in the private markets rather than look to their own employees as a compliant source of capital. The investment market does a far better job of disciplining the business judgment of firms than their own employees.

* * *

There has been much debate on what type of rules to impose. My own view has not changed since I testified in 1997: retirement plans should hold no employer stock (other than as a part of a portfolio indexed to broad market criteria). But it is probably too late in the day for this to be a realistic possibility politically. But it is not too late for some additional limits on employer stock in retirement plans.

It is not my purpose here to summarize the different ideas on how to shape such limits, but I do want to mention two ideas that have not yet been thrown into the mix.

First, giving employees a diversification option for employer stock is not enough. We have learned from behavioral economists that inertia is a powerful force in human behavior and that many employees are unlikely to take affirmative action to diversify because of inertia. Richard Thaler of the University of Chicago and Shlomo Benartzi have done trailblazing work in 401(k) plans and negative matches. In order to counter inertia, they have designed a 401(k) plan model (the "SMART" plan) in which employees agree that they will up their contribution level in the future, each time they receive a raise. No further action is necessary.

This same principle can be applied to diversification: plans to which employers make matching contributions should be required to diversity those contributions within a certain time period (one year as under Boxer-Corzine, three years as under Bush?, two years as some type of compromise between the two measures) unless the employee affirmatively elects to keep the investment in employer stock. Similarly, diversification might become the default rule once the value of employer stock in a particular account exceeds a certain percentage of the employee's overall account balance. I note that I would prefer actual limits on employer stock, but if the right to diversify reflects the political limits on the possible, the types of provisions I am suggesting would help greatly and at least protect employees whose best judgment is hobbled not by myopia but by inertia.

Second, some concerns have been raised about the administrative difficulties of complying with some overall limit (for example, 20%) on the amount of employer stock in an investment account. Such a limit would require constant monitoring of accounts during the year to make sure the limit was not exceeded. To counter such concerns, we might adopt a start-of-year snapshot approach, in which an employee cannot allocate new contributions to employer stock if at the start of the year his or her account exceeds certain thresholds.

* * *

To some extent, the problems of too much employer stock is merely a symptom of a larger problem: today most employees are required to make individual decisions on how their retirement accounts should be managed. The evidence is that employees are not very good at designing investment strategies (and why should we expect that the

typical employee would be good at it?) Some employees are much too cautious; others are much too aggressive (as was the case for many Enron employees) in the management of their retirement plan investments. Twenty years ago, professional investment managers generally handled investments not only for defined benefit plans, but defined contribution plans as well.

I would suggest that trying to educate employees on how to manage their investments is a second-best but vastly inferior approach to retirement-plan investment management than having competent professional advisors determine investment strategies for the plan. If we depend on education, someone has to pay for it. If we depend on education and allow the brokers and mutual funds to do it, we invite conflicts of interest. If we depend on education, we will find that some employees simply lack the aptitude to learn investment skills and we will confront numerous behavioral issues that will keep some people from successfully applying those skills. Finally, if we depend on education to turn us into a nation of investors, we will be squandering hours of our nation's leisure or work time and heightening anxiety among many, as illustrated by the following:

The underlying design of ERISA was that its fiduciary standards would cause employers to engage competent investment managers and would cause those investment managers to apply their skills with prudence and for the benefit of the plan's participants. Section 404(c) of ERISA has encouraged employers to turn the professional investment function over to their employees. It is time to rethink how sensible this is.

II. Catching Problems Before They Become Disasters

Enron reveals something that many lawyers know: many people who run employee benefit plans do not understand what their fiduciary roles require or believe that violating their fiduciary obligations imposes only minor costs. If this is a problem at a company such as Enron, I can assure you that it is a problem at many small firms as well. Let me give you just one recent example from my pension clinic: we recently dealt with an employer who claimed that its bank trustee was the plan administrator, when in fact every document named it as the administrator. The personnel manager, a decent person, at a settlement conference, indicated that she did not know what a fiduciary was, did not know what rules governed a fiduciary behavior, and did not, of course, realize that she herself was a fiduciary.

The Department of Labor lacks the resources to ensure compliance with ERISA's many commands either through investigative and enforcement efforts, or through education. I would recommend that Congress, even in this time of national crisis, seriously consider whether the PWBA needs additional resources in order to safeguard the retirement security of this nation's workers, particularly in the smaller plan arena. It may also be that only insiders can see a disaster in the making and that some bounty, or qui tam, strategy might help ferret out problems at an early enough stage to correct them.

III. Participant Losses and Remedial Failures

ERISA imposes high fiduciary standards on those people with responsibilities for the health of retirement plans, but paradoxically does not require breaching fiduciaries (and those who participate in their breaches) to make participants whole. The Supreme Court has generally found that ERISA offers only crabbed and often utterly ineffective remedies to individuals who have been harmed by fiduciary breaches. In particular, legal remedies are generally not available to damaged participants and the remedies that are available sometimes offer no or only minor relief. Moreover, circuit courts have interpreted ERISA's attorney fee provisions in a way that results in many participants who do recover lost benefits pay for their attorneys, thus reducing their benefits. People who recover wrongfully denied retirement and health benefits are among the most vulnerable members of society: generally no longer able to work, often seriously ill, they find that their benefit are effectively reduced by their attorney's fees. This is not, I believe, what Congress intended when it included an attorney's free provision in ERISA. Similarly worded provisions in the civil rights statutes generally have been interpreted to mandate payment of fees to prevailing plaintiffs, but courts have held, in effect, that the pension and health benefits promised to America's workers are not important enough to justify similar mandatory awards to older Americans illegally denied the benefits they had earned through a lifetime of labor.

It should also be said that better remedies in ERISA, and mandatory attorney's fees to prevailing plaintiffs, might help focus plan sponsors and plan fiduciaries on their statutory obligations. Knowing that there are serious consequences to such violations will help reduce the number of violations.

I note here that courts and Congress try to achieve a balance between protecting employees and not discouraging employers from sponsoring plans in the first instance.

The calibrating of this balance has been left to the courts, which have tilted the scales too much in favor of the latter concern. It is time for Congress to strike a better balance than that achieved by federal judges, who must forge their version of the law in the context of individual cases. Congress has a more encompassing vantage and can consider the human costs that judges in interpreting naked statutory language must often ignore.

I also note that if we are concerned about making participants whole, we probably need to revisit the question of what is adequate bonding for a fiduciary.

IV. The Coming Problems of Account Management in Retirement

In the days of the great defined benefit plans, employees retired and received an annuity—a stream of income that they could not outlive. In addition, firms often amended such plans to increase benefits to help retired employees cope with post-retirement inflationary erosion of their benefits.

The trend toward defined contribution plans, to cash balance plans, and to lump sum benefit options in traditional defined benefit plans, threatens to create a new problem for retired Americans: how to manage the large sums of money they receive at retirement. Many Americans who receive such sums have little experience in budgeting and make startlingly inaccurate assumptions about how much they can withdraw annually. This is a serious problem that the DOL ERISA Advisory Council studied last year and its report, which should be released soon, should be on the reading list of all those concerned about the future of retirement in our nation.

* * *

If any good has come of Enron, it is that many serious retirement policy issues are now being carefully considered on both sides of the aisle. Let us hope that Enron was the canary in the cage that has alerted us to some of the problems that must be addressed. This will not be an easy process and one that will require good will, honesty, and compromise on all sides. I commend the committee for holding these hearings and look forward to its development of meaningful solutions to some of the problems we are discussing today.

I would be pleased to answer any questions you have about this statement.

APPENDIX F – SUBMITTED FOR THE RECORD, PWBA ADVISORY COUNCIL WORKING GROUP REPORTS FOR 1997, UNITED STATES DEPARTMENT OF LABOR, ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFITS PLANS: REPORT OF THE WORKING GROUP ON EMPLOYER ASSETS IN ERISA EMPLOYER SPONSORED PLANS, FINAL REPORT OF NOVEMBER 13, 1997

PWBA Advisory Council Working Group Reports for 1997
United States Department of Labor

Advisory Council on Employee Welfare and Pension Benefits Plans: Report of the Working Group on Employer Assets in ERISA Employer-Sponsored Plans

Final Report of November 13, 1997

Testimony of Norman Stein
Professor University of Alabama
and visiting professor University of California at Davis

Norman Stein is a Professor of Law at the University of Alabama. Mr. Stein advocated reforms to address the problems faced by participants in plans that are heavily invested in employer stock and real property.

Mr. Stein points out that most defined contribution plans may authorize investment of all of their assets in employer stock. In That regard, the plans are not subject to the diversification requirement of ERISA, but must follow the exclusive benefit rule, the prudence rule and the conformance rule. Unless the plan is an ESOP, there is no limitation on the type or class of stock, and voting rights need not be passed through to participants. A non-ESOP may also invest in certain marketable obligations of the employer.

On the other hand, defined benefit plans and money purchase pension plans may only invest 10% of plan assets in employer securities or real property, and there are other protective limits on the amount and quality of the holdings. Mr. Stein also described the protective features in ESOPs which are not available to participants in other defined contribution plans (diversification at age 55, put rights, pass through voting, and the higher quality of employer securities).

Mr. Stein lists the following objections to plan ownership of employer securities and real property:

Lack of diversification

- Lack of the basic shareholder right to sell the stock
- Lack of the right to participate in the control of the enterprise (due to lack of requirement for pass-through voting).
- Issues of fair valuation, when there is no readily available market.
- Risk of losing the value of the employee's qualified plan assets when the company is failing at the same time that the employee risks losing his or her job.
- Conflicts of interest between employee investors and other investors.
- Conflicts of interest and valuation issues create difficult enforcement issues for the government and expensive compliance costs for plans and employers.

Mr. Stein also addressed the two primary arguments that are given in support of holding company stock in qualified plans. Those arguments are (1) productivity gains from the alignment of interest of employers and employees and (2) some employers would not sponsor qualified plans if they could not invest a large part of the assets in company stock.

To the productivity argument, Mr. Stein points to the lack of any real documentation that productivity is linked to stock ownership. Also, when stock prices are falling, tension builds and there is a morale issue in the company.

The issue of whether some employers would sponsor plans without the ability to invest plan assets in company stock is more complex. The government provides large tax subsidies to employers who sponsors qualified plans. As such the government is an investor in the plans and has a right to say that certain types of plans are not deserving of the tax subsidies offered by qualified plans.

Policy Recommendations

- Give participants the right to diversify accounts that are heavily invested in employer stock and real property.
- Bar the use of company stock to satisfy the 401(k) safe harbor matching contribution on nondiscrimination.
- Require independent appraisals of closely held stock and employer real property, and make the appraisers plan fiduciaries.
- Set an absolute limit on the amount of employer securities and real property that can be held in a plan.

APPENDIX G – SUBMITTED FOR THE RECORD, STATEMENT OF THE PENSION REFORM ACTION COMMITTEE, EMPLOYEE OWNERSHIP INSTITUTE AND EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

STATEMENT OF THE PENSION REFORM ACTION COMMITTEE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

HEARING ON

"ENRON AND BEYOND: ENHANCING WORKER RETIREMENT SECURITY"

FEBRUARY 13, 2002

Introduction

The Pension Reform Action Committee (PRAC) is a joint venture of the Employee Ownership Institute and Employee-Owned S Corporations of America and is the only organization that speaks exclusively for America's private, employee-owned businesses on the issue of pension reform. PRAC believes that, as Congress looks to enact meaningful reforms in light of the repercussions of Enron, it is critical that policymakers adopt an approach that seeks to bolster, rather than inadvertently harm, the pension savings of workers in private employee-owned U.S. businesses.

Thousands of non-public companies across America are employee-owned. These companies, the vast majority of which are small- and medium-sized and/or family businesses, are a hallmark of American entrepreneurship. Through their growth, they have helped fuel the national economy by providing increasing numbers of jobs for millions of workers in fields ranging from trucking to tourism, from manufacturing to management consulting.

The principle of employee ownership, however, is threatened by certain legislative proposals that would make draconian changes to laws governing pension and defined contribution plans. Changes to current law regarding the ability of employees to diversify out of non-publicly traded company stock, or to impose limits on the amount of non-publicly traded company stock that can be held in an employee stock ownership plan (ESOP), could devastate the ability of employees in private companies to save for their retirement by jeopardizing the valuation and financial strength of their employer.

Private companies have unique concerns relating to diversification

Two particular features distinguish private from public business. First, the stock of a private business cannot be sold on the public market. When company stock is sold, *the only purchaser of the shares is the company itself.* Thus, any change to current law that facilitates substantial sales of private company stock will place an enormous strain on the capital of the company-buyer. Proposals to change existing diversification rules for non-publicly traded stock could threaten the viability of large numbers of private companies.

If Congress changes current law diversification rules for private companies, such changes will create a "put" on vast sums of capital in every private business in the country that gives company stock to its employees. This in turn will place an enormous strain on the capital of the company-buyer, potentially forcing up leverage ratios and reducing the company's ability to fund ongoing operations and growth.

If some of the proposals now introduced in Congress were enacted, Scot Forge, a small, private open die and rolled ring forging manufacturing company in Illinois, would have to buy back almost 80% of its outstanding stock requiring $88 million in cash the company does not have.

Many other private employee-owned companies would be forced to liquidate in order for eligible participants to diversify. A private company facing an enormous repurchase obligation could not only be forced to reduce its voluntary savings plans/matches, but may in fact be forced to reduce its workforce or take other drastic measures to stay in business. These results are prohibitive to the idea of employee ownership.

The second related distinction between public and private companies is that a private company's stock value does not derive from the public markets, but rather from a private valuation of the company's assets, liabilities and cash flow. *Regardless of whether the employees choose to divest of these shares*, any change to current law that facilitates the sale by employees of large amounts of private company stock creates a massive contingent liability for the company buyer. The automatic result of this liability is that the company's stock value will fall, *resulting in a devaluation of the employees' stock accounts*, thus harming the very savings account Congress ostensibly is seeking to protect.

Employers benefit

Private employee-owned companies are typically "open book" companies, where employees are informed investors in the company. Employee stock ownership allows all employees, rather than only high-level executives, to save and have a stake in the success of their company. Government and private studies document that employee ownership leads to increased productivity and compensation, worker satisfaction, and lower turnover - all keys to financial success and growth.

Aspen Systems Corporation (Aspen), a service company primarily fulfilling federal government contracts, is a private company wholly owned by the Aspen ESOP. Aspen would have been sold by its parent company had it not become employee-owned. The ESOP structure has allowed it to grow from $58 million in sales and 1,000 employees in 1993 to $124 million in sales and more than 1,600 employees in 2001. Aspen and its employees believe this growth is directly attributable to the "enhanced dedication and increased productivity" of its employee-owners.

Employee ownership also serves to keep jobs and companies in the United States. Appleton Papers in Appleton, Wisconsin is the world's leading producer of carbonless paper and the largest U.S. producer of thermal paper. Following more than 20 years of

foreign ownership, the U.S. employees recently elected to purchase the company from its European parent and move $107 million of 401(k) investments into company stock. Wall Street rewarded the strength of this company with the additional financing Appleton required.

Employees benefit

Private companies provide a wide array of savings plans - from 401(k) to profit sharing plans to ESOPs for millions of American workers. In the absence of such company-sponsored plans, many Americans, already facing record low (if not negative) savings, would have little, if any, meaningful savings amassed. This is critical particularly as Social Security can no longer be relied upon as the sole source of retirement funding.

Millions of employees have amassed substantial retirement savings and retired early as a result of owning shares of their company. Employees want to own company stock in their retirement plans knowing that their hard work results in easily measurable cash benefits to them.

To give an example from Rieth-Riley Construction Company in Goshen, Indiana, one long-time employee participated in the company's profit sharing plan (the only plan offered at the time) for 17 years and accumulated a balance of $35,000. The plan was terminated and the balance rolled over into the company's new 401(k) plan, which grew to $195,000. The employee's first allocation to the ESOP was made in 1986. After participating in the ESOP for roughly the same period of time as he had in the 401(k), this employee's ESOP balance grew to over $500,000 with only "sweat equity" required from the employee. As a Rieth-Riley representative describes it, "this is the American dream of ownership without the risk of personal assets."

Conclusion

The Pension Reform Action Committee hopes to work with the Committee to ensure that any pension reform considered this year protects both America's private companies and the retirement savings of millions of American workers in these businesses. To meet this goal, the unique nature of private companies and the benefits they provide to their employees must be considered separately. At this point, only one pension reform bill - introduced by Representatives Rob Portman (R-OH) and Ben Cardin (D-MD) - exempts private companies from new mandatory diversification rules. This distinction is critical to the viability of private employee-owned companies and the health of the retirement savings of their employees and must be preserved.

APPENDIX H – SUBMITTED FOR THE RECORD, STATEMENT OF THE ERISA INDUSTRY COMMITTEE (ERIC), WASHINGTON, D.C.

ERIC

THE
ERISA
INDUSTRY
COMMITTEE

STATEMENT ON

INVESTMENTS IN EMPLOYER STOCK

BY

EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS

SUBMITTED TO

THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

THE COMMITTEE ON EDUCATION AND THE WORKFORCE

OF THE UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 13, 2002

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THE ERISA INDUSTRY COMMITTEE

STATEMENT ON

INVESTMENTS IN EMPLOYER STOCK

BY

EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS

SUBMITTED TO

THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

THE COMMITTEE ON EDUCATION AND THE WORKFORCE

OF THE UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 13, 2002

The ERISA Industry Committee ("ERIC") is pleased to submit this statement regarding investments in employer stock by employer-sponsored defined contribution plans.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

In addressing the many issues raised by the Enron matter, Congress is faced with a difficult decision regarding the treatment of defined contribution plan investments in employer stock. As recent events demonstrate, although employees whose retirement benefits are based on the value of employer stock have the opportunity to enjoy substantial gains and an increase in their retirement benefits if the stock price appreciates, they also are exposed to the risk that the value of the stock will fall and a concomitant reduction in their retirement benefits.

On the other hand, voluntary employer-sponsored retirement plans, including plans that invest in employer stock, have been enormously successful in providing retirement benefits to employees. If Congress responds excessively to the risks associated with stock-based plans by imposing restrictions that prevent these plans from meeting employers' business needs, Congress will have addressed one risk by creating a different and more dangerous risk: that millions of employees will be unable to share in their employers' success. In addition, excessive legislative limits on investments in employer stock may cause employers to reduce their commitments to their plans, resulting in significant reductions in employees' retirement savings.

The task facing Congress is made more difficult because the issues do not relate solely to employer-sponsored retirement plans. Many of the issues relate to the accuracy, adequacy, and timeliness of the disclosures made to shareholders generally, including those who hold stock outside of an employer-sponsored plan. The way in which such disclosure issues are resolved could affect, and to some extent may obviate, Congress's decisions regarding the stock held by an employer-sponsored plan.

Employee accounts in employer-sponsored § 401(k) and other defined contribution plans are a major source of retirement savings for employees and their families. As of the end of 2000, approximately 42 million employees had accounts in § 401(k) plan accounts, representing $1.8 trillion in assets.[1]

At the same time, employer-sponsored retirement plans are voluntary arrangements. Employers are not required to sponsor retirement plans for their employees; they are not required to contribute to their profit sharing and stock bonus plans; and they are not required to make matching contributions to their § 401(k) plans. Total § 401(k) plan contributions are clearly higher, however, in plans where the employer matches employee contributions than in plans where there is no employer match.[2]

Employee stock ownership, stock bonus, and other stock-based plans are not only permitted by ERISA, they are strongly and affirmatively promoted by numerous provisions of law that have encouraged employers for nearly a century -- since 1921-- to maintain stock-based defined contribution plans for their employees.[3]

Employer stock plans serve the important purpose of aligning the interests of employees with the interests of the employer's business and encouraging employees to be attentive to the interests of the business. The following simple anecdote illustrates this point. After one company suffered losses because its delivery people regularly discarded expensive containers after they took the company's merchandise out of the containers and placed the merchandise on retailers' shelves, the company responded by printing the logo of its stock plan on the containers. The delivery people immediately got the point: they saw the connection between their returning the containers to the company for reuse and their own benefits from the company's stock plan. The company, and its employee-owners, saved millions of dollars a year as a result of this program.

Employee benefit plans thus serve important business purposes in addition to providing a safety net for retirement. A key business purpose is to attract and retain talented employees.

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[1] Sarah Holden & Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," Employee Benefit Research Institute Issue Brief at 3 (Nov. 2001).

[2] Sarah Holden & Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants," Employee Benefit Research Institute at 10 (Oct. 2001) "total contribution rates for participants in plans with employer contributions were 2.8 percentage points higher than total contribution rates for participants in plans without employer contributions" (footnotes omitted)).

[3] *See, e.g.,* Revenue Act of 1921, § 219(f) (tax exemption); Tax Reduction Act of 1975, P.L. 94-12, § 301, Tax Reform Act of 1976, P.L. 94-455, § 803 (tax credit), and Revenue Act of 1978, P.L. 95-600, § 141 (tax credits) (repealed); IRC §§ 401(a) & 501(a) (tax exemption), 404(k) (dividend deduction) and 1042 (tax-deferred sales).

Employers compete with each other for talented employees by, among other things, designing and offering benefit plans that respond affirmatively to current and prospective employees' wishes and needs, which often include highly-valued access to the employer's stock.

Employer stock plans give employees the opportunity to purchase employer stock economically, conveniently, and tax-efficiently. Employees highly value the opportunity to invest in employer stock, the stock they know best.

Employees have benefitted enormously from participating in employer stock plans. These plans have allowed employees to benefit from substantial appreciation in the value of the companies that employ them.

Congress should allow employees to make their own decisions regarding the diversification of their employee-directed accounts. Congress should not restrict an employee's right to allocate all or part of his employee-directed account to any investment offered by the plan, including employer stock.

Employees place great value on the freedom to make their own investment choices. Congress should not curtail their freedom.

Employees who participate in employer stock plans are protected by ERISA's fiduciary standards. ERISA requires the fiduciaries of these plans to act prudently and solely in the interest of participants and beneficiaries, while taking into account the fact that employer stock plans are, by their very nature, designed to invest in employer stock. ERISA requires plan fiduciaries to communicate truthfully with participants and beneficiaries about the plan.[4]

The vast majority of major employers sponsor both defined benefit plans and defined contribution plans for their employees. In these circumstances, the employer's defined contribution plan is only one component of the employer's comprehensive retirement program; employees do not rely on the defined contribution plan alone for retirement security. As a result, it can be quite misleading to measure the diversification of an employee's retirement savings by looking only at his § 401(k) account. A substantial portion of many employees' retirement savings is attributable to their benefits in the employer's defined benefit retirement plan under which benefits are determined by the plan's formula rather than the investment performance of the plan's assets.

The widely-reported losses suffered by participants in the plans of Enron Corporation has been attributed to the alleged misconduct of Enron officials. If the allegations are correct, the alleged misconduct goes well beyond a violation of ERISA's fiduciary standards. If the allegations of corporate misconduct are correct, they also suggest the possibility that federal securities laws have been violated.

New fiduciary standards or new restrictions on holdings of employer stock under ERISA are not well-suited toward curbing conduct of the kind that has been alleged.

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[4] *See Varity Corp. v. Howe*, 516 U.S. 489 (1996); *see also* 29 C.F.R. §§ 2550.404c-1(b)(2)(i)(B), -1(c)(2), -1(d)(2)(ii)(E)(4).

ERIC favors vigorous enforcement of the federal securities laws and ERISA to assure that employees, and investors in general, have the information they need to make informed investment decisions.

ERIC supports efforts to help employees to make their investment choices wisely. For example, ERIC supports changes in current law to make it more likely that employers will make investment advice available to plan participants.

Employers' willingness to contribute to their defined contribution plans is directly linked to the plans' ability to meet the needs of employers and their employees. New restrictions on defined contribution plans that prevent these plans from meeting the needs of employers and employees will cause these plans to contract and will curtail employees' retirement savings.

Congress should preserve an employer's freedom to require that its own contributions to a defined contribution plan be invested in employer stock. If employers are prohibited from requiring their contributions to defined contribution plans to be invested in employer stock, they are likely to curtail their contributions, thereby reducing employees' retirement savings.

Moreover, new restrictions on investments in employer stock by defined contribution plans will encourage employers to replace these plans with stock plans that are not subject to these restrictions, such as stock option and stock purchase plans. Stock option and stock purchase plans are not retirement plans and are not designed to promote retirement savings. They have quite different purposes and aims. Legislation that encourages employers to replace defined contribution retirement plans with stock option and stock purchase plans will reduce employees' retirement savings.

In any event, plans' existing investments in employer stock, which were made in reliance on current law, should not be disrupted. Investments that have been made in accordance with current law should not be up-ended by new legal requirements. If plans are required to dispose of their existing stock holdings, or are subjected to new diversification requirements, the market for the employer's stock is likely to be destabilized, harming the interests of stockholders in general and plan participants in particular.

Temporary suspensions in trading activity ("blackout periods") in participant-directed plans are often necessary to accommodate changes in plan administration, such as a change in the plan's record-keeper, a change in the plan's administrative system, or a merger with another plan. Blackout periods also occur for unanticipated reasons, such as a power outage, a computer failure, or terrorist activity.

Although many employee-directed defined contribution plans permit employees to change the way their accounts are invested on a daily basis, plans are not required to permit daily changes in investments, and the vast majority of employees do not make daily changes. Indeed, daily investment changes are often discouraged. Frequent trading is inconsistent with the plan's role a vehicle for long-term retirement savings.

ERISA's current fiduciary standards appropriately regulate plan administrators' decisions regarding (a) the need for a blackout period, (b) the duration of any blackout period, (c)

the need for, and timing and content of, a notice to plan participants regarding the blackout period, and (d) the timing of the blackout period itself.

Imposing additional legislative restrictions on blackout periods will discourage improvements in plan administration, to the detriment of plan participants. ERISA's fiduciary standards require that employers retain the discretion to change plan record-keeper and computer systems even if such changes require the imposition of a brief blackout period. Legislation that imposes excessive restrictions on blackout periods would do serious damage to defined contributions plans and to the employees who participate in them.

The issues under consideration are difficult. They should not be resolved without careful fact-finding and analysis. Hasty adoption of well-intentioned but ill-considered legislation risks harming the very employees the legislation is designed to protect: the employees who participate in voluntary employer-sponsored plans. We urge the Committee to study the facts and the issues in depth before making recommendations.

For our part, we intend to continue to study the issues and develop additional recommendations which we will communicate to you promptly.

We very much appreciate the opportunity to submit this statement. We look forward to working constructively with the Committee and its staff on these challenging and important issues.

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