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STATEMENT OF KAREN W. FERGUSON PENSION RIGHTS CENTER ON "RETIREMENT INSECURITY: 401(k) CRISIS AT ENRON"

BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
U.S. SENATE
FEBRUARY 5, 2002

Mr. Chairman, Members of the Committee, I am Karen Ferguson, Director of the Pension Rights Center, the nation's only consumer organization dedicated solely to protecting and promoting the pension rights of workers, retirees and their families. Accompanying me is Karen Friedman, the Center's Director of Policy Strategies. We thank you for the invitation to testify today.

Over the past 25 years, the Pension Rights Center has taken the lead in targeting inequities in the nation's retirement programs, and proposing realistic solutions. Working with a bipartisan coalition of retiree, labor, and women's groups we have secured the enactment of five federal laws that are providing much-needed benefits to millions of retirees, widows, and divorced spouses. We have also helped thousands of people with their pension problems, and worked with employees and retirees from companies around the country to help stop cutbacks in their pension and retiree health benefits. As you can imagine we have heard our share of tragic stories. But what makes Enron different is the magnitude of the saga, the number of people hurt, and the fact that it so dramatically highlights so many gaps in federal retirement laws that need to be addressed to adequately protect workers.

The story of Enron is unfolding daily. The company created a complex web of seeming improprieties replete with shell companies, sham partnerships and a host of other elaborate schemes devised for the purpose of hiding losses and creating financial statements that misled the workers into thinking that the company was highly profitable. According to excerpts from a special committee investigative report of the Enron Corporation's board detailed in this past Sunday's *New York Times*, "There was a culture of deception where every effort was made to manipulate the rules and disguise the truth as part of an effort by executives to falsely pump up earnings and earn millions of dollars for themselves in the process."

Millions of individual stockholders, investors in mutual funds, and participants in state retirement funds have been affected by Enron's demise. But no one has lost more than the Enron employees, who have lost their jobs, their confidence in the stock market, and most (or all) of their 401(k) money.

Enron workers thought of the company as family. They had put their life savings into their 401(k) plan because they trusted reports by Enron CEO Kenneth Lay and other company officials that the stock was soaring and the company was in stronger shape than ever. But while they were putting money into the 401(k), the company officials were selling Enron stock, presumably because they knew the company was in serious financial trouble. To make matters worse, even if they had known the facts, the portion of company stock they had received as "matches" to their 401(k) contributions was locked in until they reached age 50. Then, when the stock price continued to drop, they learned that they could not even shift their own contributions out of company stock because of a "blackout" imposed while the plan changed administrators. Through all of this the company had the audacity to tell employees not to worry because, "The Enron savings plan is an investment vehicle for long-term financial goals."

We now know that the only ones who planned to benefit in the "long-term" were company officials.

In the aftermath of the Enron tragedy, the Pension Rights Center has been inundated with calls and letters from reporters, policymakers and ordinary citizens who ask us, "What does this mean? Is retirement money safe? What can be done to prevent future Enrons? .

What is clear is that strong measures are needed to restore confidence in private retirement plans. Just as Studebaker's bankruptcy in the 1960s prompted Congress to pass the Employee Retirement Income Security Act (ERISA) in 1974, Enron's failure may be the catalyst needed to close the serious gaps in the law that this terrible tragedy has highlighted.

We are here today to suggest protections that will help assure that people's retirement money is safe. We will focus on measures to ensure that Enron-type situations cannot occur again, as well as on ways of making sure that individuals who have been harmed in such cases will be made whole. The Enron situation also raises broader issues, such as whether there is an over-reliance on 401(k) plans and other uninsured savings plans, and whether the shift to these do-it-yourself savings plans represents sound policy. I will address those issues at the conclusion of our statement.

Preventing Future Enrons. What needs to be done to ensure that the kinds of losses experienced by Enron employees cannot happen again?

First and foremost there must be strong measures to ensure proper diversification of investments within 401(k) plans. If an employer makes matching contributions in the form of its own company's stock (rather than cash), employees should be able to move out of that stock and into other 401(k) investments within a reasonable amount of time. The Boxer-Corzine bill,
S. 1838, the Pension Protection and Diversification Act, would allow such a shift after 90 days, once an employee is "vested" in the matching contributions. (Vesting normally occurs after three years of work.) Last week, the Bush Administration proposed that employees be able to move out of company matching stock after three years of work without a 90 day waiting period. These are important first-step measures, but to make these reforms stick, Congress must ensure that companies cannot circumvent these provisions by simply setting up Employee Stock Ownership Plans (ESOPs), plans funded entirely (or primarily) by employer contributions of company stock. It has become too easy for employers to set up what are called, "KSOPS," combinations of 401(k) plans and ESOPS.[1]

Employer groups take the position that if employees are allowed to freely shift out of company stock and into other plan investments, employers will stop matching their employees' 401(k) contributions. [2] This is unlikely since, as the Congressional Research Service recently pointed out, there are a variety of incentives to encourage employers to make matching contributions in stock.[3]

But allowing employees to move out of company stock that used as a match for employee contributions is only one part of the diversification problem. That is because employer matching contributions typically make up a relatively small part of the company stock held by 401(k)s. (In the case of Enron's 401(k), 11 percent of the company stock was attributable to employer matches.) There is also a need to limit the amount of employees' own 401(k) contributions that can be invested in company stock.

The simplest approach would be simply to apply the same limit 10 percent limit now imposed on traditional pension plans (and on 401(k)s where employers direct plan investments). After all, if this kind of diversification is required when employers (and the government) bear the risk of loss, why should less diversification be required when employees bear the risk? The Boxer-Corzine bill would apply a higher limit: Employees would be permitted to put up to 20 percent of their 401(k) assets in company stock. Another approach that has been suggested would be give employers the choice of either using company stock as a match, or offer it as an option for employee contributions.[4]

We have heard the argument that employees will balk against any restrictions on how much company stock they can invest in 401(k) plans – that they will view such limits as restrictions on "personal choice." In fact, limits of this kind would not restrict personal choice. Individuals are free to invest their personal money any way they wish. Congress has given contributions to 401(k)s special tax treatment in order to help them provide for a secure retirement. The revenue loss to the Treasury resulting from the tax subsidy for employer-sponsored retirement plans this year amounts to nearly $90 billion, the largest of all of the federal tax expenditures.[5] There is simply no justification for all taxpayers to pay higher taxes (or receive less in government services) to subsidize what is universally acknowledged to be highly risky investment strategies.[6]

There are other types of structural reforms that might help prevent future Enrons. These include measures aimed at avoiding conflicts of interest, such as those present in the Enron situation, and encouraging employees who suspect wrong doing to communicate their concerns to the government and others who may be in a position to protect employees.

For example, one long-overdue reform would be to ensure that the 401(k) plan's accountant is free to serve a watchdog function by being independent of the company, as contemplated by Congress in 1974. This would simply require overturning an Interpretive Bulletin issued by the Labor Department in 1975 that permits the accountant for the company to also be the plan's accountant. It would also be possible to require the appointment of an independent fiduciary to protect against conflicts of interest in 401(k) and other plans holding company stock. Another reform would be to set up a "bounty" program to reward whistleblowers who provide information to the Labor Department about unlawful actions by plan officials. Just as important, would be to strengthen legal protections for people who blow the whistle, and are punished by their companies for their efforts.[7]

Finally, the deterrents against unlawful behavior should be increased by allowing the government to recover punitive damages in civil actions when people involved in the running of a plan deliberately defraud employees, and increasing the criminal penalties. Under current law, in civil actions the most that is likely to happen is that a court will tell the wrongdoers to put the money lost by participants back into the plan. Plan fiduciaries convicted of criminal activities can be sentenced to up to five years in prison or fined, or both.[8]

Making Employees Whole.

The Enron employees are fortunate in having been able to find able lawyers to sue the company officials that ran their 401(k) plan, and to have the help of congressional committees and the media in ferreting out the officials' unlawful actions. But there is a very real danger that they will not be made whole for their losses because of short-comings in the laws.

If the people who ran the 401(k), the "plan fiduciaries," knew that the stock was plummeting while encouraging employees to load up on that stock, a court is very likely to find that they have violated their legal obligations to act solely in the interests of plan members, and to hold them personally liable to pay money back into the plan. But there is no requirement that they be insured. In Enron's case, there is a "fiduciary insurance" policy estimated to be about $85 million. But the Enron employees lost almost $1.3 billion – more than ten times the amount of the policy. An urgently needed reform measure is a requirement that everyone responsible for running private retirement plans, and investing plan money, be fully insured. Another reform would be to give employees with claims for fraud under a 401(k) plan the same standing in bankruptcy as secured creditors.

Equally important, if employees are to be made whole, the law must be clarified in a number of respects. For example, the law should specify that individuals acting unlawfully be required to restore losses to individual participants, not just to the plan. Similarly, it should make plain that company officials, such as Enron CEO Kenneth Lay, who make misleading statements to employees can be sued (if those misrepresentations cause losses to the employees), even if the officials claim that they had nothing to do with the running of the plan. The law should also make clear that employees can sue accountants, lawyers, actuaries and others who participate in unlawful actions that cause losses to employees. And, finally, courts should be able to award the same kinds of remedies and attorney's fees to employees suing under pension laws that they award under other worker protection laws.

Business lobbyists are claiming that adopting reform measures will lead to "over-regulation" of 401(k) plans, and discourage companies from offering them. In support of their arguments, they trace the decline of traditional pensions to congressional enactment of laws that made those plans fairer and more adequately funded. In fact, it is equally likely that the number of traditional plans declined because of reduction of regulation by administrative agencies, that invited the development of 401(k)s, the "raiding" of plan assets, and the expansion of plans that only benefit executives, so-called "nonqualified" deferred compensation plans. As the Enron investigations continue, it is increasingly apparent that the problem is "under-regulation," not over-regulation.

Broader Policy Issues. Although the focus of this hearing is on the losses in the Enron 401(k), it is important to realize that these losses had such a dramatic effect on Enron employees because of other factors. As described by the *Wall Street Journal*, Enron, like so many other companies, had taken advantage of the leeway provided by accounting practices, and lax federal regulation, to cut back on the employees' underlying pension plan.[9] In 1987, Enron froze that plan, which provided lifetime, risk-free benefits guaranteed by the federal government, and used its "surplus" assets to create a "floor offset" plan that effectively relied on company stock to provide benefits. Nine years later, that plan, in turn, was replaced by a barebones new type of pension plan (that cut the expected benefits of older employees), supplemented by the 401(k). All of these changes were highly technical maneuvers that, by dramatically reducing the company's pension liabilities thanks to an accounting rule, permitted it to show millions of dollars of increased "operating income" its corporate financial statements– thus boosting the profits reported to investors, and the value of executive stock options.

Of particular interest to this Committee may be the fact that, even if the employees had been aware of how they were being short-changed – and why – there would have been nowhere within the Executive Branch of the government for them to go. That is because there is no advocate within the Executive Branch to represent the interests of employees with pension policy concerns. There is no ombuds-type office charged with identifying gaps in the laws, or developing policies to close those gaps. There is also no one to speak for employees in interagency deliberations or to present their views to Congress. In this all-important respect, ERISA differs from other worker, consumer, and investor protection laws. We hope you share our view that now, 28 years after the enactment of the law, the time has come to create such an office.[10]

As far as we know, the Enron employees, like others around the country, did not protest the changes in their retirement plans in 1987 and 1996. The shift away from traditional pensions to 401(k)s and other savings plans has been very popular. It has been encouraged by Congress and the Administration, and heavily marketed by financial institutions and the financial media. Employers have welcomed the tremendous cost savings resulting from the shift, and employees have enthusiastically embraced the concept that they could become 401(k) millionaires. Little attention has been paid to the transfer of responsibility from employers to employees, or to the transfer of risk from pooled, professionally run arrangements backed by the government, to uninsured individual account arrangements, invested by ordinary workers who often, regardless of how much financial education they are offered, simply do not have the time, inclination, or expertise to enable them to make the "right" investment choices.[11]

We are concerned that just as Enron was a victim of its own hype, 401(k)s may be equally vulnerable. For years, the Pension Rights Center has taken the position while that 401(k) plans are a good supplement to other plans, they are lacking as a stand-alone arrangement. Yet currently one-half of 401(k) participants have the 401(k) as their only private retirement plan, and half of all 401(k) participants have less than $20,000 in their accounts. Add to that the recent fluctuations in the market, and the uncertainty of the economy, and there could be even greater cause for concern. We believe this is a great opportunity to have a far-reaching debate on whether our nation's private retirement policies are going in the right direction.

Last year, the Center convened an inclusive, bipartisan public policy forum called the Conversation on Coverage. Funded by the Ford Foundation and the W.K. Kellogg Foundation, the Conversation brought together a diverse array of voices – business, labor, consumer, retirees and women's organization – to launch a national dialogue on ways of increasing coverage for the 50 percent of the population without any kind of pension or savings plan. We now have a unique opportunity to expand the scope of the Conversation, and reexamine these issues in light of Enron. The Conversation's goal will be to develop plans that are in the best interests of employees and employers – looking at ways of combining the best features of traditional pensions plans – insured, lifetime payments – with the portability and ease of 401(k) plans. We invite Members of this Committee to join us in the Conversation.[12]

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

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[1] The Boxer-Corzine provision would allow participants in ESOPs to switch into other investments earlier than is now permitted. (At age 35 and 5 years of service, rather than the current, age 55 and 10 years of service.) An in-depth examination of ESOPs from a workers' perspective is urgently needed. Once rare, these plans, which Yale Law Professor John Langbein recently described to this Committee as "tools of corporate finance masquerading as pension plans," are increasingly substituting for other, more diversified retirement plans. Statement of Professor John H. Langbein, January 24, 2002

[2] They make the same argument in opposition to another proposal in the Boxer-Corzine legislation that would reduce the tax deduction given to company stock contributed by employers from 100 percent to 50 percent, to reflect the fact that stock contributions are considerably less valuable to employees than cash contributions, and to encourage companies to contribute cash rather than stock.

[3] "Contributions of company stock are preferred over cash contributions by some employers because (1) they do not affect the company's cash flow; (2) are not recorded as an expense on the company's income statement, so they do not reduce reported profits; and (3) are fully deductible for tax purposes at the share price in effect when they were contributed. Making contributions of stock also puts sshares into the hands of a group of people – the firm's employees – who are less likely to sell their shres either when there is a hostile tender offer for the company or when the firm's reported profits are less than expected." Patrick J. Purcell, "The Enron Bankruptcy and Employer Stock in Retirement Plans, January 22, 2002, pp CRS-4 – CRS-5. Matches generally are needed to attract top-level employees. They also help encourage more lower-paid employees to contribute to the plan, which increases the amounts that higher-paid employees can contribute under the Internal Revenue Code's "nondiscrimination" rules..

[4] It would also be possible to permit employees to have higher concentrations of company stock in their 401(k)s if they were also participants in other diversified plans, but this would be extremely complex to administer, and, as happened at Enron, the benefits provided by the other plans could be insufficient to provide sufficient retirement security in the event of a company bankruptcy.

[5] This subsidy, which includes the revenue loss resulting from public and private retirement plans other than Social Security (including Keogh plans) is larger than that provided for home mortgage interest and employer health insurance deductions. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2001-2005* Prepared for the Committee on Ways and Means and the Committee on Finance, April 6, 2001, p. 22.

[6] Financial planners routinely counsel clients against holding more than five percent of a single stock. When the stock is the in the company the employee works for, the risk of loss is compounded by the possibility that the employee may also lose his or her job.

[7] A bounty program currently administered by the Internal Revenue Service provides 10 percent of any recovery to individuals providing information about party-in-interest transactions which leads to the imposition of excise taxes.

[8] 18 U.S. Code Section 664.

[9] Ellen E. Schultz and Theo Francis, "Enron Executives' Benefits Kept on Growing As Retirement Plans of Employees Were Cut," January 23, 2002.

[10] A bill to create such an office was introduced by Senator Tom Harkin in the last Congress. The Pension Participant Advocacy Act of 2000, S.6475, was modeled on a similar type of office of Advocacy at the Small Business Administration, the National Taxpayer Advocate at the Internal Revenue Service and the Labor Department's Women's Bureau.

[11] In this connection it is important to note that the "investment advice" bill mentioned by President Bush as part of his Enron-related proposals, the Retirement Security Advice Act of 2001 (H.R. 2269), would do nothing to prevent future Enrons, and would, instead, create the potential for new kinds of conflicts of interest that could harm 401(k) participants. A far sounder approach to dealing with the non-Enron problem addressed by that bill is the Bingaman-Collins Independent Investment Advice Act, S. 1677.

[12] Additional information about the Conversation can be found at www.pensioncoverage.net.