TESTIMONY

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BEFORE THE
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
ON
RETIREMENT SECURITY: 401(K) CRISIS AT ENRON

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Thank you Mr. Chairman and Members of the Committee for providing me with the opportunity to testify today. My name is Erik Olsen, and I am a member of the Board of Directors of AARP. AARP is the largest organization representing the interests of older persons. Of our 35 million members, about one-third are still working. AARP appreciates the opportunity to present our views and recommendations for policy changes that should be enacted to make retirement plans more secure and to protect the retirement savings of American workers.

Background

The financial collapse of the Enron Corporation illustrates weaknesses in our pension laws and the need to update the legal and regulatory framework to reflect changes in pension coverage since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974. ERISA was established in the wake of large corporate failures that left their workers without promised pensions. ERISA established minimum vesting, participation and funding standards, required plan termination insurance for defined benefit plans, prohibited certain transactions, and established standards for fiduciary conduct. These protections were designed to ensure that workers would not lose pensions they had worked for and earned throughout their lifetimes. While we have experienced profound changes in the types of pension coverage – as well as many other aspects of the private retirement system – over the past 25 years, the law has not changed to fully reflect these changes. The collapse of Enron, and the large numbers of employees who have seen their pension accounts dramatically reduced, only amplifies the need for change.

The percentage of the private sector workforce covered by an employer-sponsored pension plan has remained around 50 percent since the early 1970s. While the number of covered workers has remained relatively unchanged, there has been a substantial shift in the type of coverage from defined benefit to defined contribution plans, including an increase in the establishment of defined contribution plans to provide supplemental coverage to employees already participating in defined benefit plans.

While the number of defined benefit pension plans has declined, the number of 401(k) plans has grown dramatically. Section 401(k) of the Internal Revenue Code did not exist in 1974, and plans named for this tax code section did not really began their growth until the early 1980's. In just over two decades, there are now an estimated 350,000 401(k) plans, covering 42 million workers, and holding an estimated $2 trillion in assets. However, for the most part, the basic framework of pension security underlying the nation's pension system has not been updated to reflect these trends and developments.

In the traditional defined benefit plan, the employer invests all plan assets, bears the risk of investment, and provides a guaranteed benefit to participants. In addition, the Pension Benefit Guaranty Corporation (PBGC) guarantees payment of benefits should a company

go bankrupt with insufficient assets to pay benefits. However, many of the extensive ERISA protections and safeguards originally provided to defined benefit plans simply do not extend to the different structure of 401(k) and other defined contribution plans. For example, in 401(k) and other individually directed account plans, the individual controls the investment allocation and bears the risk of investment loss. The individual must invest well in order to ensure an adequate level of retirement benefits, and there is no PBGC guarantee protection. Unfortunately, millions of workers are simply not prepared to handle this dramatic shift in investment responsibility and risk for their retirement savings.

The sudden and dramatic collapse of Enron has demonstrated that neither ERISA nor any other federal statute provides American workers with the protections or guidance commensurate with the financial risk they are asked to bear in managing their defined contribution plans.

Although Enron's bankruptcy is the largest and most dramatic to date, other companies have experienced major financial troubles resulting in a steep drop in stock price and a corresponding decline in the value of workers' 401(k) accounts. The plight of the employees of Color Tile Corporation captured congressional attention in 1996 when that company filed for bankruptcy. Eighty-five percent of the employees' assets in that company's 401(k) plan were invested in Color Tile real estate. Employees lost most of their retirement savings. However, legislation to address the problem in Color Tile was narrowed significantly during the legislative process, leaving more problems for the future.

While only a small percentage of companies face such dramatic downturns, such downturns are inevitable. For example, the price of a share of Lucent Corporation common stock declined by 91 percent between 1999 and 2001. Some employees, according to news articles, had as much as 80 percent of their Lucent 401(k) plan balances invested in Lucent stock, although the workers were afforded 16 investment options. Another recent example is the Polaroid Corporation, which filed for bankruptcy in October 2001. Approximately 40 percent of the company's 401(k) plan assets were invested in the stock of the company.

Individual account plans such as 401(k) plans have become important components of our private retirement income framework. The phenomenal growth of these plans over the past two decades is a tribute to their success in gaining acceptance among the American population. However, AARP believes it is important that we begin to address some of the problems associated with defined contribution plans, beginning with the systemic problem of the over-concentration of employer stock in those plans that have employer stock as an investment option. In each of the firms noted above, workers' retirement assets were simply not properly diversified. Despite the fact that the single most important rule for investing is diversification, the assets of the 401(k) plans of each of the bankrupt companies -- as well as hundreds of other companies today -- were overly concentrated in the stock (or real property) of the plan sponsor.

The time has come for Congress to enact a better framework for employees in defined contribution plans. Ultimately, this will mean better plan security, and better assurances that our highly tax supported retirement system meets the long-term goal of providing an adequate retirement income. Our testimony today will focus on several areas that warrant immediate Congressional attention and action: disclosure, risk and diversification, investment advice and remedies under the law.

Disclosure

Among the allegations concerning Enron is that participants did not receive complete, accurate and timely information concerning their plan and the employer stock in which they invested. The shift of risk and responsibility to employees makes it imperative that

employees receive complete, accurate and timely disclosure of information to help them make more informed decisions about their retirement security. This includes defined contribution benefit statements on no less than a quarterly basis, detailing the status of participants' investments and investment activity. Similarly, defined benefit plans should be required to furnish regular benefit statements to participants on an automatic basis, without the current-law requirement that the participant first request the statement.

Employees must also be given prompt and accurate information about their company's financial performance. Employees should not only receive this information on a regular basis, but they should also be affirmatively informed when there is new information or a material change. This information should be required automatically, without requiring employees to request it. Although most courts agree that a failure to provide material information even without an inquiry is a breach of fiduciary duty, the Fifth Circuit (where Enron is located) has called this proposition into question. We believe that any legislation should affirm the position that a majority of courts have taken.

Other improvements in disclosure are needed to help address the problems that are highlighted by the Enron debacle. If a plan intends to implement a temporary suspension, limitation, or "lockdown" of participants' normal ability to exercise control over their plan accounts, it must provide participants with ample advance notice. In addition, the Department of Labor should be directed to facilitate effective disclosure by publishing a model benefit statement that plan administrators could use or adapt. In addition to information on the participant's accrued and vested benefits, the statement would include information on the percentage of the participant's account that is invested in employer stock (and real property), on the importance of diversification, and other information relevant to the employee.

In addition, in order to minimize the risk of errors in determining pension benefits, participants who are ready to receive a distribution of their benefits should have the right to request an explanation of how the benefits were calculated. Such disclosures will help participants to confirm that they are in fact receiving the full benefits to which they are entitled.

Diversification of Risk

The Enron, Lucent, Polaroid, and other unfortunate cases illustrate the danger of defined contribution plan participants over-investment in company stock. There is no more basic and fundamental principle of sound investment practice than diversification. That is why few financial planners or investment advisors would recommend investing more than a limited percentage of a client's portfolio in a single stock. This is true even where the portfolio is not the plan on which the individual's retirement security depends, and is especially true when that single stock is also the one on which the individual's job security and wage check depends.

It is hardly surprising, therefore, that ERISA's fiduciary standards, based on the common law of trusts, generally require that retirement assets be invested as a prudent expert would invest them, including diversification "so as to minimize the risk of large losses." ERISA section 404(a)(1). However, when ERISA was enacted in 1974, certain exceptions to the fundamental principle of prudent diversification were included. One exception gives plan sponsors and other fiduciaries a measure of relief from fiduciary responsibility for investments that were self-directed by plan participants in accordance with the statute. Another exception allows employers to design most individual account plans to invest up to 100% of plan assets in the stock or real property of the sponsoring employer.

ERISA recognized employer stock as a plan investment that involves a conflict of interest for the employer. However, the law excused most defined contribution plans from the 10% limit it imposed on pension plan investment in employer stock. This was done as an

accommodation to a limited existing practice in the very different pension system that was then in effect. In the early 1970s, well before the advent of the 401(k) plan, defined contribution plan coverage was far more limited than it is today. Defined contribution plans tended to be thought of as supplemental to the basic employer pension protection afforded by traditional defined benefit plans. A large fraction of the defined contribution plans at that time were more highly regulated money purchase pension plans or were profit sharing plans that, in either case, were funded mostly by employer (not employee) contributions. The investment of these employer contributions generally was not directed by the employee. In addition, when ERISA was enacted, retirement plan investment in employer stock was far less prevalent than it later became. Accordingly, the focus of ERISA's regulation of investments was on what was then the main type of plan, the defined benefit pension plan, and on employer contributions the investment of which was directed by the plan sponsor or its designated professional investment managers or advisers.

Much has changed. Over the years, plan sponsors have shifted the responsibility for funding retirement plans increasingly from the employer to the employee through 401(k) salary reduction arrangements, and have concurrently shifted to employees both the investment risk and the responsibility for directing the investment of their accounts. At the same time, to a far greater extent than ERISA's framers imagined, the defined contribution plan system has become heavily invested in employer stock. These trends have converged to result in a very different situation from the one Congress confronted in 1974: millions of workers now rely mainly or heavily on employee-funded defined contribution plans that require employees to direct their own investments and that, in may cases, encourage employees to invest in employer stock. Corporate financing needs, special tax incentives directed to employer stock, management's interest in placing stock in friendly hands, and other factors have skewed the playing field and resulted in the over-concentration of defined contribution plan assets in company stock.

In fact, when it comes to employer stock, the current 401(k) system as a whole fails any broad test of diversification. There are far too many plans in which employees hold large concentrations of company stock. The Profit Sharing/401(k) Council of America found in its recent annual survey that company stock accounted for about 39 percent of all 401(k) plan assets. The level of concentration is highest in plans with 5,000 participants or more. In these plans, company stock accounts for 40 percent or more of plan assets, and data published by the Employee Benefit Research Institute suggest that heavy investment in company stock is more prevalent among lower-income workers.

In particular, it is this combination of trends – toward 401(k) plans fueled largely by employee contributions, increasing self-direction of investments by employees, and the rise of specially tax-preferred employer stock as an investment choice heavily favored by the system and by employers – that was least foreseen by the framers of ERISA. Thus the focus of ERISA's fiduciary protections relating to employer stock was limited to the prevalent type of plan, the defined benefit pension plan (and money purchase pension plans). ERISA currently prohibits these plans from investing more than 10% of plan assets in the employer's stock or real estate. This diversification requirement limits the risk to the funded status of the plan in the event of a catastrophic drop in the value of the plan sponsor's stock.

Currently, 401(k) plans, other profit sharing and stock bonus plans, and employee stock ownership plans (ESOPs) acquire company stock in two ways: (1) through employer contributions, including those employer contributions that match employee contributions, and (2) through the investment of employee contributions on a pretax (401(k)) or, less frequently, an after-tax basis. Current law allows a plan sponsor to compel employees to invest up to 10 percent of their employee contributions in employer stock as a condition of participating in a 401(k) plan. Many plans also restrict the ability of participants to shift employer contributions from company stock into other investments offered by the plan until the participant reaches a specified age (such as 50 or 55) or years-of-service milestone. These barriers to prudent diversification of both employer and employee

contributions should be removed in order to protect employees from excessive risk of losing their retirement savings in circumstances that tend to threaten their job security as well. Participants must have the right to reduce their exposure to employer stock in the interest of diversification.

The need for diversification rights extends to ESOPs as well as other plans. Although ESOPs are designed to be primarily invested in employer securities, they are required under current law to provide participants limited rights to diversify employer shares in their accounts. But those rights are too restrictive. Unless the plan sponsor chooses to grant more generous rights, ESOP diversification rights apply only to participants who are at least age 55 and have at least ten years of participation in the plan, lasts only for a period of six years, and apply each year only to a portion of the shares in the individual's account. ESOPs have expanded and evolved far beyond their traditional forms and have acquired an array of valuable tax incentives. Instead of receiving an ESOP only as a supplement to one or more retirement plans, however, employees in many companies are now expected to rely on an ESOP for a major portion of their employer-provided retirement savings. In many corporate settings, the ESOP has been presented as the main or only retirement plan. Accordingly, it is long past time to revisit and broaden the minimum standards for ESOP diversification.

Both the diversification rights for employees in defined contribution plans generally and the expansion of current-law diversification rights in ESOPs need to be designed in a manner that takes into account the voluntary nature of our private retirement system. Legislative changes must be sensitive to the potential impact on employer incentives to continue maintaining these plans and to make employer matching and nonmatching contributions.

While rights to diversify out of employer stock investments are important and necessary, they are not sufficient to protect workers. As evidenced by the high concentration of employer stock in 401(k) plans, our pension system and corporate culture have tax incentives and behavioral tendencies that in effect have "stacked the deck" in favor of heavy investment in employer stock. This is true even when employees are free to choose.

Enron is a case in point. It appears that most Enron 401(k) participants were free to sell most of their Enron shares during most of the decline in the share price. According to press reports, the Enron plan restrictions on diversification by employees under age 50 applied only to the company shares in which employer contributions were invested. The employee contributions, which appear to have accounted for most of the assets in most of the accounts, were free to be diversified. Thus Enron 401(k) plan participants reportedly were technically free to diversify a majority of their Enron shares, except during the temporary "lockdown" period.

Clearly, there have been well-publicized reasons to believe that employees' voluntary retention of Enron shares might have been exacerbated by special circumstances – including allegedly misleading information and inadequate disclosures – that would not be expected to occur in most other companies. But there are many other instances where many or most plan participants who are not precluded from diversifying have in fact remained over-concentrated in their employers' stock in the absence of any apparent corporate misinformation or misconduct. The reasons employees tend to over-concentrate in company stock have to do with both tax advantages and less tangible factors.

First, the tax rules encourage plan participants to invest in employer stock because employees generally receive special preferential tax treatment when they take distributions of employer stock from a qualified plan. (Provided that certain conditions are satisfied, the "net unrealized appreciation" of employer stock while held by the plan – the gain from the time the plan acquired the shares until it distributed them – is taxed at favorable long-term capital gain rates, deferred until the stock is disposed of by the

distributee.) Second, and more important, many employers have powerful tax incentives to encourage heavy employee plan investment in employer stock, even when inconsistent with prudent diversification of retirement savings. Plan sponsors can obtain a number of valuable tax incentives if they label the plan (including a 401(k) plan) – or a portion of the plan – an ESOP and meet the conditions of ESOP status. It appears that most defined contribution plan sponsors that are seriously interested in converting the plan's employer contribution to an ESOP are able to do so, where the relevant portion of the plan is primarily invested in employer stock.

One key tax incentive for ESOPs is the dividend deduction under section 404(k) of the Internal Revenue Code. While a corporation ordinarily cannot claim a federal income tax deduction for dividends it pays on its stock, dividends are deductible when paid on employer stock held in an ESOP (provided that the treatment of the dividends satisfies certain conditions, which were recently liberalized in last year's tax cut legislation). This dividend deduction can generate very substantial tax savings to the employer. In addition, employers that sponsor ESOPs can claim a number of other special tax incentives beyond the valuable tax benefits normally accorded qualified retirement plans, including special provisions for "leveraged" ESOPs that can make corporate financing easier or more advantageous and higher tax deductions for employer contributions to their plans, among others.

Finally, both employers and employees have powerful non-tax incentives that tend to lead to over-concentration of plan investments in employer stock. There is, of course, the effect of simple inertia: many employees who have full investment choice do not devote adequate attention or analysis to their plan investment strategy. If the employer contributes stock, many employees may not take the initiative to change the investment.

Building on this phenomenon, there is evidence suggesting that employees often tend to follow the employer's lead with respect to investment in employer stock (as well as other investments) by interpreting the employer's decision to contribute company stock to the plan as an implicit endorsement by the company of its stock as a wise investment choice for a large portion of employees' account balances. Employees may also feel that loyalty to the company demands or suggests that they invest their retirement accounts heavily in employer shares (or may feel that this is the company's view of what loyalty demands). And loyalty aside, some employees may feel more comfortable investing in the one company they know best rather than in other businesses, believing that their company is a safe investment compared with the unknown risk of a diversified stock portfolio. These decisions ignore, of course, the imprudence of compounding retirement savings risk with job security risk.

Employers also may prefer to contribute stock to the plan instead of cash because, while each type of contribution is tax deductible, only the stock contribution is costless in terms of cash flow. Employers' motives for encouraging heavy plan investment in employer stock also include, in some instances, a desire to place a substantial number of shares in friendly hands for defense against hostile takeovers or proxy contests (or perhaps in the hope that plan participants will tend to be slower than other shareholders to sell in a falling market). In addition, the employer may believe that employees who hold substantial quantities of employer stock will tend to identify more closely with the goals of management and shareholders, to be more loyal to the company, and to be more productive workers. Indeed, consistent with fair and accurate disclosure and compliance with all applicable laws, management has every reason to encourage the work force at all levels to believe in the company and to have confidence in its future. But the measures necessary to motivate employees may also encourage employee exuberance or optimism regarding the company's stock that could further explain the imprudent over-concentration in that investment.

Some of these motives, together with the tax incentives for maximizing plan investment in employer stock, exacerbate management's conflict between its fiduciary duties to the company's shareholders and its fiduciary duties to the plan participants. Because of these

realities, many employees who have the right to diversify do not do so, even if they receive adequate information and advice regarding the importance of investment diversification. The playing field between employer stock and more diversified investments is not level. That being the case, the question is whether the law should incorporate measures to affirmatively lead to greater diversification. We believe it should.

There is a legitimate and substantial public policy interest in ensuring that the assets of ERISA-governed, trusteed, tax-qualified retirement plans are invested in a prudent, diversified manner, so as to minimize the risk that the tax advantages accorded to those assets will fail to achieve their intended purpose of providing additional economic security in retirement. The tax expenditure for qualified plans is the largest single federal tax expenditure. The tax system subsidizes qualified employer-sponsored retirement plans in an amount estimated to exceed $90 billion a year. See Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006, JCS-1-02 (Jan. 17, 2002). The high tax subsidy for the pension system is for the purpose of providing adequate savings for retirement. It is therefore appropriate for the law to include measures that will achieve this purpose. In the case of personal, non-plan funds, individuals are free to invest in any way they choose. But the law should provide for the assets of trusteed, tax-qualified retirement plans to be invested in a prudent, diversified manner, in order to accomplish their intended purposes.

We believe that any approach to reducing the excessive concentration of plan investments in company stock should be appropriately sensitive to the voluntary nature of our private pension system. Workers' retirement security should be protected while seeking to minimize any disincentive for the employer to contribute to the plan. One way to achieve this may be to afford plan sponsors choices by which to achieve the public policy goal of protecting participants from the financial risk associated with high concentrations in employer stock.

Some have proposed placing caps or percentage limits on the amount of company stock a plan participant can hold in a 401(k) account. Others have recommended prohibiting a plan sponsor from using company stock to make matching contributions to the plan. We agree with the ultimate goal of these proposals – that of improving diversification by reducing the over-concentration of stock in the hands of employees. We believe, however, that there are other approaches. We believe a preferable approach should avoid placing a disincentive on the employer's own contributions to their employees, while at the same time recognizing that the combination of employer-provided stock and employee elective purchases of company stock are what ultimately create such high concentrations. In fact, studies show that where an employer provides stock as a matching contribution, employees are even more likely to elect employer stock as an investment option with their own elective contributions.

One option that would increase diversification without providing a disincentive to the employer is to provide the employer with the choice: the employer can continue to make matching or non-matching contributions in stock, or the employer can include employer stock as an option for employee elective deferrals in the plan. Under this approach, we can continue to allow employers – without limit – to make matching or non-matching contributions with company stock. However, in such cases, the employer would not be permitted to provide company stock as an investment option for elective contributions. Where the employer did not provide stock directly to the employees, the employer could continue to offer employer stock as an investment option in the plan. This approach would result in a greater degree of diversification over time without discouraging businesses from establishing new plans or contributing employer stock directly to employees. This approach is also consistent with employees' ability to self-direct their investments among the limited menu of investment options that employers provide under the plan.

Investment Advice and Education

Most 401(k) plan participants have little experience in, or understanding of, investment fundamentals. While almost half of all households now have some money in equities or mutual funds – up over 50 percent in the past decade – many of these are new investors. In addition, many have no other investments aside from their retirement plan. This is particularly true for those households below the median income, who are far less likely to have any money in an equity fund. Even for those who have entered the investment marketplace, too few have the time, or have taken the time, to learn the basics of investing.

A recent survey conducted for AARP ("Consumer Behavior, Experience and Attitudes: A Comparison By Age Groups," conducted by Princeton Survey Research Associates, March 1999) sought to provide a snapshot of the public's basic investment knowledge by asking four questions:

- Whether the FDIC covers losses from mutual funds purchased at banks,
- Whether no-load mutual funds involve sales charges or other fees,
- Whether diversification increases or decreases the risk of the investments, and
- Whether full-service brokers and financial planners are compensated on the quality of their advice or on the amount and type of investments they sell to clients?

The unfortunate findings are that not many Americans are knowledgeable about financial investments. Only 11 percent of respondents answered all questions correctly, while only 25 percent correctly answered three of four and less than half (46 percent) answered two questions correctly. Perhaps most significantly for the issues at stake today, just over one-third could correctly answer whether diversification reduces risk.

Lack of information is not necessarily the problem; the amount of financial information available today is greater than ever before. Magazines, newspapers, daily financial news programs, on-line services, and various types of software make available more information than most individuals could want or need. In addition, the plan itself often makes available many different forms of information, including videos, seminars and booklets on plan options and hypothetical investment portfolios. What the individual investor often lacks, however, is the ability to sort through the information. As noted, too many investors or would-be investors lack both the time and the knowledge to determine which information is important, accurate and appropriate for their own individual situation. These issues are especially true in the case of self-directed plans.

The Department of Labor, through Interpretive Bulletin 96-1, provided a helpful step by encouraging greater investment education for plan participants. The guidance provides examples of "safe harbors," -- such as asset allocation models based on hypothetical individuals with different time horizons and risk profiles -- that do not rise to the level of specific advice and thus do not trigger fiduciary liability under ERISA. These asset allocation examples and model portfolios, permissible under current law, already provide individuals who take the time to sift through the information with a good roadmap to the investment alternatives under their plan.

However, this information continues to be insufficient, and often still too complex, for many participants. Many participants simply want to be told more specifically where to invest their plan funds. As a result, some employers and plan service providers have sought to provide more specific and individualized investment advice to plan participants. AARP agrees that such individualized advice can be helpful, but such advice must be subject to ERISA's fiduciary rules, based on sound investment principles, and protected from conflicts of interest.

ERISA Rightly Prohibits Advice Subject to Conflict of Interest

Participants deserve to have access to quality investment advice, and that advice should be free from financial conflicts of interest. ERISA has long recognized that financial conflicts of interest give rise to divided loyalties, and thus pose the risk that actions will not be taken in the sole interest of plan participants. Advice providers who also stand to benefit financially depending on the type of advice that is given face just such a conflict. Preserving ERISA's ban on such conflict of interest transactions is necessary to ensure that the advice provider is acting for the "exclusive benefit" of plan participants.

The *Retirement Security Advice Act, H.R. 2269,* passed by the House last year, would replace ERISA's prohibition on such conflicts of interest with a disclosure requirement, and would allow investment advice where a conflict exists so long as such conflicts are disclosed. AARP believes disclosure alone is not sufficient protection, nor is it the best approach in today's marketplace.

As noted, too many participants are already overwhelmed with the investment information they are currently receiving. Disclosing yet more information, which the individual would have to both understand and properly weigh, will be least helpful to the unsophisticated investor. Even with the disclosure of potential conflicts, the participant is not left with much real choice. The individual either chooses to accept advice that is subject to a conflict, or the individual can choose no advice at all. Providing pension participants with qualified advice is simply not the best approach.

In fact, the Committee on Compensation Practices – also known as the "Tully Commission" (named for its Chairman, Daniel Tully of Merrill Lynch) – which was formed by the SEC to review conflicts of interest in the brokerage industry, reported in 1995 that "the prevailing commission-based compensation system inevitably leads to conflicts of interest among the parties involved." The report further stated that "…conflicts of interest persist and have been underscored by some widely publicized incidents in which the actions of certain brokerage firms and their representatives clearly damaged the interests of their clients." This is not to suggest that all advice that may entail conflict is inevitably bad advice. However, such advice, given by an advisor with a financial stake in the recommended product, needlessly subjects that advice to potential bias and interests other than the sole interest of the participant. In addition, participants must understand and weigh yet another factor in determining whether to follow that investment advice.

Congress held hearings last year on yet another example of the problematic influence of conflict in the financial markets. The hearings followed on the heels of press coverage of the conflicts in Wall Street firms between analysts' ratings on companies and the firms' own financial interests in promoting their investment banking business. Indeed, despite the recent market downturn from an over-inflated market, only one percent of analysts' reports had "sell" ratings. In fact, one study concluded that "the recommendations by underwriter analysts show significant evidence of bias." The New York Times noted the need for regulations to "protect investors from conflicted advice that undermines the integrity of the nation's financial markets."

ERISA Permits Independent Advice

If advice subject to conflict were the only avenue available, then such an alternative would deserve greater attention. However, plans currently have other options to provide investment advice. Financial institutions and other firms may provide advice to participants on products in which they <u>do not</u> have a financial interest, and plans may choose to make such advice available. In fact, a recent 401(k) benchmarking survey indicated that the number of firms using Web-based investment advice is growing rapidly. The survey indicates the service is now available to about one out of every five plans. In addition, the number of large financial service providers who have developed alliances with an independent investment advisor is also growing, and most of the large

401(k) providers now have an independent investment advisor available. (The use of independent advisors is not the only available alternative under current law. In addition, the Department of Labor may grant exemptive relief, as it has done in some instances, provided that certain conditions are included to protect plan participants.)

In light of these other alternatives, it is premature to weaken ERISA's longstanding conflict of interest rules that have served both participants and pension plans well. As we have noted, the application of individualized investment advice to plan participants is in its early stages. As a result, Congress should first encourage the growth of and greater competition among independent and non-conflicted advice providers. Indeed, Congress can further encourage employers to provide such advice by clarifying that the employer would not be liable for specific investment advice so long as the employer undertook due diligence in selecting and monitoring the advice provider. A recently introduced bipartisan Senate bill, S. 1677, takes just that approach.

In Interpretive Bulletin 96-1, the Department of Labor indicated that the designation of an investment advisor to plan participants would not, in and of itself, give rise to fiduciary liability that is the result of the individual's exercise of control. However, as with any service provider, the plan fiduciary would be responsible for the prudent selection and periodic monitoring of the advisor. Currently, the rules applicable to an advisor should be similar to that of any plan service provider. The Department of Labor has indicated the plan fiduciary must engage in an objective process to obtain information to adequately assess the qualifications of the provider, the quality of the services offered, and the reasonableness of the fees. In addition the Department has indicated such process should avoid self-dealing, conflicts of interest, or other improper influence.

The Department has stated that as applied to the selection of an investment advisor, a fiduciary should take into account the qualifications of the advisor, including registration under any applicable federal and state securities laws, the extent to which the advisor acknowledges its fiduciary status under ERISA to participants, and the extent to which the advisor can provide informed, unbiased, and appropriate investment advice to participants. An employer would also be required to periodically review the performance and qualifications of the advisor, including any comments or complaints about the services.

AARP believes we should encourage employers to provide advice under these basic fiduciary standards, and thus permit employers to offer investment advice without significant risk of liability. Encouraging independent unbiased investment advice will better enable employees to improve their long-term retirement security while minimizing the potential for employee dissatisfaction and possible litigation. We believe it is in the best interest of both the plan and plan participants to pursue these avenues prior to carving out an exemption to one of ERISA's basic prohibitions and opening the door to the potential for conflicted advice.

Remedies

Another glaring problem of the ERISA framework is the inability of employees to properly enforce their pension rights to make whole their losses as a result of wrongdoing. Under the current federal pension law, employees have limited, if any, remedies to make whole their losses for any fiduciary violations by their employer and for the improper actions of other parties involved in these violations. As a result, there can also be no deterrent message sent to other violators.

Current law permits individuals to sue fiduciaries for breaches of fiduciary duty under two sections of ERISA. Under Section 502(a)(2), a participant may sue for "appropriate relief under section 409." Section 409 provides for relief only to the plan itself for losses caused by or profits made by the fiduciary, and other equitable relief such as removal of

the fiduciary. In *Massachusetts Mutual Life Insurance Co. v. Russell*, the Supreme Court held that compensatory and punitive damages were not available under Section 502(a)(2). Accordingly, under Section 502(a)(2), only persons acting as a fiduciary may be sued; and they may be sued only for losses to the plan or profits made by the fiduciary. For example, in Enron, neither Mr. Lay nor Arthur Anderson may be found to be fiduciaries. And, only direct losses caused to the plan as an entity or profits made by the fiduciary based on its actions may be compensated.

Section 502(a)(3) acts as a "catch-all" provision for injunctive or "other appropriate equitable relief." Unlike Section 502(a)(2), Section 502(a)(3) permits individuals to sue for relief. *Varity Corp. v. Howe*, 516 U.S. 489 (1996). And, Section 502(a)(3) may provide for relief against non-fiduciaries (such as Mr. Lay or Arthur Anderson) if they knowingly participate in a breach of fiduciary duty. *Harris Trust & Savings Bank v. Salomon Smith Barney*, 530 U.S. 238 (2000). However, the relief available under section 502(a)(3) is limited to equitable relief. The Supreme Court has narrowly interpreted equitable relief to be limited to the forms of relief that were traditionally available in equity such as restitution, mandamus and injunctions. *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993). In *Great-West Life and Insurance Annuity Co. v. Knudson*, 122 S.Ct. 708 (2002), the Supreme Court recently reaffirmed its interpretation of ERISA that equitable relief does not provide make-whole relief and does not provide monetary relief, unless an individual can trace the property taken from the individual.

Thus, under section 502(a)(3), Enron participants who sue on behalf of themselves may be left with no remedy against Mr. Lay and no remedy against Arthur Anderson because even though the value of the funds dropped enormously, no money was actually stolen from their accounts. The plan participants may have no remedy under ERISA for any deliberately misleading information or other misdeeds because a remedy based on the difference between the value of their Enron stock today and the value of some other investment or series of investments is legal damages, not equitable relief.

This is not a new problem and this is not unique to Enron. Current pension law, as interpreted by the courts, has developed so participants and beneficiaries have rights without remedies, which of course are no rights at all. For example, in *Farr v. U.S. West Communications, Inc*., 151 F.3d 908 (9th Cir. 1998), the court held that it was a breach of fiduciary duty where the fiduciaries knew that participants would incur potential adverse tax consequences of a benefit election and the fiduciaries consciously decided to withhold that information from the participants. The court held that the participants had no remedy because the amount of additional taxes the participants had to pay due to the conscious failure to disclose this material information was damages -- a legal remedy. Similarly, in *Kerr v. Vatterott and Co.,* 184 F.3d 938 (8th Cir. 1999), the court held that the difference between what the participant could have earned in his 401(k) account and what was actually earned is not equitable relief, but legal damages, and thus not recoverable.

It is ironic, and crying for amendment, that the federal law that was designed to protect the retirement security of participants and beneficiaries may provide no protections at all in a situation like Enron. The pension law has been interpreted to provide fewer protections than many other federal and state laws. Even if there is outright fraud, or you are caught with your hand in the cookie jar, there's no effective way to send a message that wrongdoing is not tolerated with the American public's retirement monies. Given the large numbers of plans in existence today, the Department of Labor simply does not have the resources to do the type of effective job needed for enforcement. It is therefore critical that employees' self-enforcement rights are improved. In fact, it should also be made clear that an employer's failure to disclose material information is a breach of fiduciary duty. Unfortunately, the Department has not taken the position that there is an affirmative duty to disclose material information.

As part of any pension reform effort, it is therefore essential that we allow employees to actually recover losses due to fraud and other violations of the law. Without the tools to protect their own retirement funds, other changes in the law may have little value.

Conclusion

In conclusion, we urge Congress to act this year to enact changes that will better protect workers' pensions. The President in his State of the Union address called for "new safeguards for 401(k) and pension plans." He also stated that: "Employees who have worked hard and saved all their lives should not have to risk losing everything if their company fails." AARP agrees and believes we should act now to improve disclosure, improve diversification and reduce risk, and improve remedies for those who are harmed. While the President has already offered a number of useful steps on disclosure and limiting restrictions on diversification, we must go further to address the fundamental problems created by the high concentrations of employer stock in some plans. Only with more comprehensive changes can we ensure greater retirement security for workers in today's pension environment.