TESTIMONY

STATEMENT
OF
THE SPARK INSTITUTE
BEFORE
THE COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
FEBRUARY 5, 2002

Introduction

My name is Stephen M. Saxon and I am testifying on behalf of The SPARK Institute. I am a principal in the Washington, D.C. law firm of the Groom Law Group, Chartered, where I work with The SPARK Institute and other clients on ERISA fiduciary issues relating to employee benefit plans.

The SPARK Institute is the legislative and educational arm of SPARK, the Society of Professional Administrators and Recordkeepers. SPARK represents the spectrum of organizations serving the retirement services market, including banks, administrators, insurers, mutual fund complexes and securities dealers. The more than 250 SPARK member institutions currently provide services to more than 95 percent of the defined contribution assets in the United States.

My testimony is intended to provide this Committee with a greater understanding of the law that governs the offering of company stock as an investment in defined contribution plans.

What are ERISA's Policy Goals?

Protecting retirement benefits is one of the key objectives of ERISA and federal tax laws governing private pension plans. But it has never been the only one. From the outset, Congress recognized and sought to promote the benefits of expanding employee ownership of America's corporations. Thus, in the case of plans designed to hold company stock, there may be dual objectives.

ERISA has always recognized that the offering of employee benefits to employees is totally voluntary. Thus, another key goal of federal pension policy – achieved principally through tax incentives – is to promote the offering of retirement benefits even while protecting them. The basic decision of whether and in what fashion to offer benefits is a business decision or what we call a “settlor” function. It is not a "fiduciary" decision subject to regulation under ERISA.

Of course, federal law does impose parameters on how an employer may design its plan. Some of these parameters are there to protect benefits, others, such as participation and vesting rules, are designed to promote fairness in dealing with employees, and some rules have other goals such as preventing tax abuses.

What are the General ERISA Duties?

ERISA imposes strict rules of conduct on all persons who serve as fiduciaries to employee benefit plans. These include: a duty of loyalty, or, more specifically, a duty to act “solely in the interest” of the plan and its participants and beneficiaries and for the “exclusive purpose” of paying plan benefits and defraying plan expenses; a duty of prudence, which is often referred to as the “prudent expert” standard because it imposes a professional standard of care; a duty to diversify plan assets so as to minimize the risk of large losses; a duty to follow the written terms of the plan; and, finally, a duty not to engage in certain transactions that are prohibited by virtue of defined relationships without regard to their merits.

What are the Legal Guidelines for Plans' Investments in Company Stock?

ERISA permits defined contribution plans to be structured to invest in company stock in a variety of ways. First, a plan may invest "primarily" in company stock and, as such, it might qualify for special treatment as an employee stock ownership plan ("ESOP"). Second, a plan, such as a 401(k) plan, may require that some or all employer contributions be made in the form of employer stock. Third, a plan may allow participants voluntarily to invest their own salary deferral contributions in employer stock. A single plan may incorporate more than one of these design elements. For example, a 401(k) plan may provide for employer contributions to be made in the form of company stock and also allow participants to allocate all or a portion of their salary deferrals to a company stock account.

Certain special tax rules apply to ESOPs and other plans that hold employer securities. For example, dividends paid by on company stock held by an ESOP may be deductible by the employer; special deduction limits and contribution limits apply to ESOPs that borrow to acquire company stock ("leveraged ESOPs"); and the distribution of company stock can get favorable tax treatment if made in a lump sum. The tax law does, however, place certain special restrictions on ESOPs. ESOPs must permit participants who have reached age 55 and 10 years of service to diversify a portion of their account, and participants have the right to demand distributions of their accounts be made in company stock

ERISA contains two key exceptions from the general fiduciary rules for plans that are designed to invest in company stock. First, there is an exemption from the ERISA duty to diversify plan assets with respect to investments in company stock. Second, defined benefit plans are limited to holding 10 percent of their assets in company stock, but individual account plans, like 401(k) plans, are exempt from this limitation.

Who May Be Accountable for Investing in Company stock?

As I indicated, designing a plan to invest in company stock is not, in the first instance, a fiduciary function subject to ERISA regulation. But, ERISA does regulate the implementation of the plan's terms. The primary obligation for this will frequently fall upon the employer, an investment committee appointed by the employer, or an outside trustee. Other service providers including directed trustees, custodians, recordkeepers, and the like typically do not act as fiduciaries and, as such, generally are not responsible for the offering of company stock.

How Does a Fiduciary Reconcile Investing in Company Stock with ERISA's General Fiduciary Obligations?

As I noted, there may be a tension between the ERISA-sanctioned goals of promoting employee stock ownership and the general fiduciary duties under ERISA. On the one hand, a fiduciary has an express duty to adhere to the terms of the plan document which may allow for, or require, investment in company stock, and can be sued for breach of this duty if it does not do so. On the other hand, except for the duty to diversify, the plan's fiduciaries remain subject to ERISA's exclusive purpose and prudence obligations and can also be sued for the failure to satisfy these obligations.

Recently, several courts have considered how to reconcile these two duties. In the case of an ESOP, the Third and Sixth Circuit Courts of Appeal have found that

ERISA creates a "presumption" that following the plan terms and investing in company stock is prudent.[1] At least one lower court last year extended this presumption to stock bonus plans. The presumption may be rebutted by showing that continuing to invest in, or to hold, company stock was an abuse of discretion.

What is the Impact of a Lockdown or Blackout Period?

One of the factual allegations in the Enron litigation is that Enron switched 401(k) plan administrators and imposed a "lockdown" or "blackout period" on participants' trading in Enron stock. This raises the questions of what is a lockdown, how does it fit into the foregoing ERISA scheme, why is it important, and what could have been done to provide additional protections for plan participants?

A lockdown is a planned "freeze" of all trading activity within a plan necessary to effect a "conversion" or transfer of records and assets from one service provider to another. In order to effect conversions, plan assets must be reconciled at both the participant level and trust level. This can be a complicated process that may take some time to complete. For example, for any one participant in a plan, numerous, different accounts must be maintained. There may be a deferral account holding the participant's salary deferrals, an account for the employer's matching contributions based on the deferral amount, and an employer profit sharing contribution. There may be profit sharing or matching contributions from a prior employer that need to be separated because the old plan had a special feature like an annuity option that needs to be protected. There could be IRA contributions or after-tax contributions that need to be segregated. For each participant, each of these accounts will be invested in the various mutual funds or other investments offered under the plan. Or they could be invested in company stock. Sometimes participants invest in an even broader spectrum of investments through a self-directed brokerage account. In a conversion, every penny in each of these accounts must be accounted for and reconciled in order to effect the transfer properly.

It has been estimated that over 20,000 conversions occur every year. Conversions typically occur when there is a plan merger or spin off or when it becomes necessary to change service providers. Even with sophisticated computer recordkeeping, our present-day financial systems and technology cannot accommodate a change of recordkeeping and custody of assets without allowing several days or weeks to accomplish the task. There is no standard length of time for the lockdown period. It could take a day or two, or it could take several months. The length of the lockdown period is a function of at least two major factors: The status or condition of the records and assets, and technology. Plan service providers are well aware of the need to effect conversions efficiently and with a minimum disruption to participants. Within the retirement services industry, the ability to effect conversions is an important factor in maintaining a competitive edge.

Given this, I would like to make the following observations. First, ERISA does not contain any specific rules relating to conversions or lockdowns. Nothing in ERISA mandates that participants be allowed to direct trades on a daily basis. Second, nothing in ERISA mandates that participants be allowed to direct trades *at all*. Consequently, the existence of the lockdown, in and of itself, does not violate any specific ERISA duty. Third, conversions or lockdowns typically occur as a natural consequence of plan sponsors' fiduciary decision to change service providers. Where a change in providers is necessitated by poor performance, a lockdown is unavoidable. In deciding to effect a conversion through a change in providers, a plan sponsor must satisfy the prudence and other fiduciary responsibility provisions of ERISA. Accordingly, if a lockdown is imposed, or timed, for reasons other than the best interest of the plan and its participants, ERISA already provides a remedy for breach of fiduciary duty.

Conclusion

In concluding my remarks, I want to address briefly the fundamental question about how we can avoid problems like Enron in the future. Is legislation the answer? The SPARK Institute has not yet concluded that legislation is necessary. However, recognizing that we have a voluntary pension system in this country, that employers who sponsor plans are free to contribute or not, and that such contributions can be made in cash or stock, we have to focus on the effect any legislation will have on our retirement system as a whole.

Whether we need legislation or not, it is evident that Enron demonstrates the need for more and better investment education for plan participants. This is demonstrated poignantly in the Washington Post article from Sunday, January 20, 2002, profiling various employees of an Enron subsidiary. These employees, all of whom were nearing retirement age, had amassed substantial 401(k) account balances by allocating all of their plan assets into employer stock. A few attended a participant investment education briefing where the consultant urged the workers to diversify. Some understood the message and even diversified their portfolios for a short time. Ultimately, many switched all of their 401(k) account balances back into company stock. This made me think that if the Boehner bill on investment advice had passed, perhaps a better, stronger message to diversify would have reached more employees and the outcome would have been different. Thus, aside from the truly unfortunate outcome of this article, there is a kernel of hope that if investment education is made available, and it is made available on a regular basis, the message will be understood, and the correct choices will be made.

On behalf of the SPARK Institute, I am grateful for the opportunity to share our views with you and I would be happy to answer any questions that you have.

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[1] Moench v. Robertson, 62 F.3d 553 (3rd Cir. 1995), *cert. denied*, 516 U.S. 1115 (1996); and Kuper v. Iovenko, 66 F.3d 1447 (6th Cir. 1995).