

Deconstructing ERISA

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The Big News in Pensions.

- ▶ It's *NOT* 401k.
- ▶ It *IS* 404c.

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What is 404c?

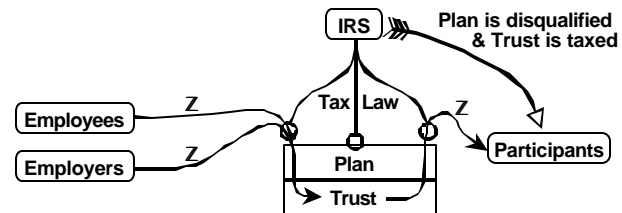
404c is

- ▶ a labor law statute in ERISA
- ▶ that applies to defined contribution plans
- ▶ where participants decide how to invest their accounts.

It provides an important exemption from ERISA's fiduciary rules.

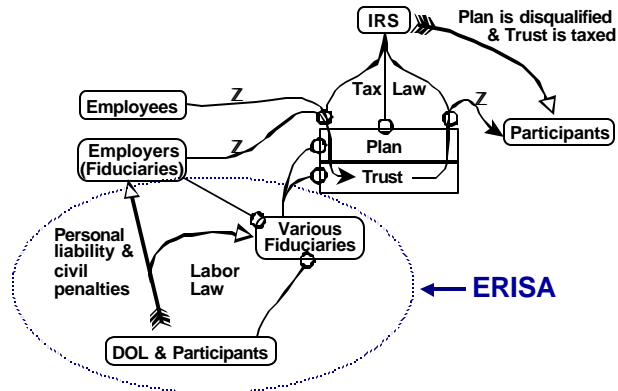
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Before ERISA, tax law governed pension plans.



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ERISA's contribution: fiduciaries and a new legal structure



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The 404c exemption.

If a plan satisfies the 404c regulations

- ▶ participants with investment control over their accounts are not fiduciaries, and
- ▶ no other fiduciary is liable “for any loss, or by reason of any breach, which results from” their exercise of control.

But 404c is not a complete exemption from ERISA's fiduciary rules.

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1992: Final 404c Regulations

A 404c plan must provide participants with:

- ▶ a broad range of investment alternatives
- ▶ appropriate frequency of investment instructions
- ▶ sufficient investment information to make informed investment decisions.

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But general fiduciary rules still apply.

Fiduciaries remain responsible for:

- ▶ choosing investment options
- ▶ monitoring their performance
- ▶ minimizing their fees
- ▶ providing information about the options and plan investment procedures

Significance:

- ▶ fiduciaries – ultimately the plan sponsor – remain liable.

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The stampede to 404c plans

Why?

- ▶ **increase in 401k plans**
- ▶ **marketing by mutual fund industry**
- ▶ **desire to reduce fiduciary exposure**

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Prevalence of 404c Plans in 1997

	profit-sharing	money purchase
total plans*	520,446	102,493
% 404c	49%	31%
total assets	\$1.5 trillion	\$144 billion
% 404c	65%	41%
total participants**	47 million	4 million
% 404c	68%	32%

* no terminated plans

** "active" participants

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Was fiduciary litigation a real threat before 404c?

NO!

- ▶ **individual claims are usually small**
 - ▶ **plaintiffs can only win benefits due**
 - ▶ **no punitive or pain and suffering damages**
 - ▶ **few awards of attorneys' fees**
- ▶ **NO ERISA PLAINTIFFS' BAR**

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Irony: class action lawyers discover ERISA through 404c.

404c plans offer:

- ▶ **large numbers of plaintiffs**
- ▶ **identical causes of action**
- ▶ **huge amounts of potential damages**
- ▶ **generous awards of attorneys' fees**

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New cases:

Franklin v. First Union (I)

- ▶ \$150 million in damages sought, 5,000 potential plaintiffs
- ▶ alleged fiduciary breaches: investment menu limited to proprietary funds; poor performance; high fees; inadequate disclosure

Franklin v. First Union (II)

- ▶ \$300 million in damages sought, 100,000 potential plaintiffs
- ▶ alleged fiduciary breaches: use of plan assets as seed money to enter 401k business; investment menu limited to proprietary funds; poor performance; high fees; inadequate disclosure
- ▶ RICO and other claims add potential treble damages and right to a jury trial

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New cases:

Gottlieb v. SBC Communications

- ▶ \$1.1 billion in damages sought; 40,000 potential plaintiffs
- ▶ alleged fiduciary breaches: forced sale of Airtouch stock and reinvestment in SBC stock to promote corporate interests; inadequate disclosure

Mehling v. New York Life

- ▶ “hundreds of millions” in damages sought, “tens of thousands” of potential plaintiffs
- ▶ alleged fiduciary breaches: use of plan assets as seed money to enter 401k business; investment menu limited to proprietary funds; poor performance; high fees; inadequate disclosure
- ▶ RICO claim adds potential treble damages

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Predictable consequences.

An ERISA plaintiffs’ bar

Litigation over

- ▶ investment menus/performance
- ▶ fees
- ▶ disclosure

And plan termination by employers?

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Is there an alternative?

- ▶ **The problem is not the regulations or the Department of Labor.**
- ▶ **The problem is ERISA itself.**

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Rationale for change.

- ▶ ERISA's fiduciary structure is out of step with today's defined contribution plans.
- ▶ Defined contribution plans are just another financial services industry product.
- ▶ 404c is the exception, not the rule.
- ▶ 404c plans may soon be just a collection of individual brokerage accounts.

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The role of the employer.

Employers are crucial to employee "saving."

- ▶ They make saving easy and convenient.
- ▶ They provide financial incentives to save.
- ▶ They provide investment education and financial planning services.
- ▶ They are critical intermediaries between employees and the financial services industry.

Their appropriate role?

- ▶ Facilitator – not fiduciary.

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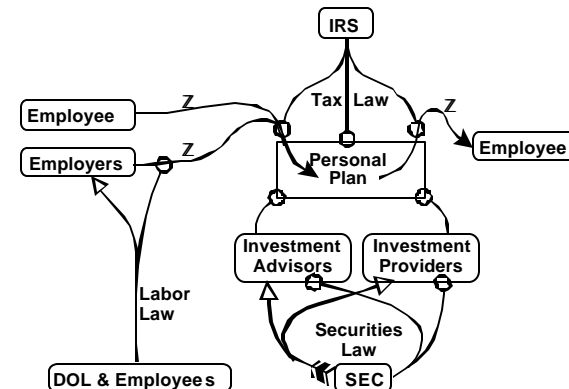
Deconstructing ERISA.

What might ERISA look like if we rearranged its pieces with the employer as a facilitator rather than a fiduciary?

It could look like this.

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Just one proposal.



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Key elements.

No employer plan umbrella:

- ▶ **Just individual accounts ← tax law**
- ▶ **At regulated financial institutions ← tax law**

Employer's role:

- ▶ **contributor ← tax law and ERISA**
- ▶ **facilitator**

Investments and advisors ← securities laws

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A personal plan is classic TIAA/CREF.

Employees:

- ▶ **a centralized account**
- ▶ **investment control**
- ▶ **no problems with portability**
- ▶ **no need for rollovers**

Employers:

- ▶ **facilitator of saving**
- ▶ **contributor**
- ▶ **no management responsibilities or costs**
- ▶ **no fiduciary liability**

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Policy Implications.

- ▶ **ERISA went in one direction in 1974**
- ▶ **But defined contribution plans went in another in 1992**
- ▶ **To get them back in sync will be difficult but necessary**
- ▶ **If the predictable consequences of the 404c regulations come to pass.**

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