

# **Designing The Investment Program For Defined Contribution Accounts Under Social Security**

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## **Abstract**

**This paper examines three different models for an investment program under a privatized Social Security system. At one extreme is a model which proposes full-access to investment products and markets. At the other extreme is a model which imposes strict government controls on investment options and professionals. In the middle is a model which is almost fully-privatized in terms of investment options but imposes additional constraints on investment professionals. The paper concludes with an evaluation and synthesis of the models presented.**

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# ***SOCIAL SECURITY PRIVATIZATION***

## *Defined Contribution Accounts: Designing The Investment Program*

### **I. Introduction**

In early 1997, the 1994-1996 Advisory Council on Social Security presented its findings and recommendations regarding the future of the Social Security program in face of widespread concern over its long-term financing.<sup>1</sup> Included in its report were three models of how the Social Security program might be changed. The first, the “Maintain Benefits” plan retains the current defined benefit format of the program. It would continue to pay Social Security benefits in the form of an annuity for life while modifying the way that benefits are earned and contributions are invested. The other two plans, the “Individual Accounts” (“IA”) plan and the “Personal Security Accounts” (“PSA”) plan also retain the defined benefit format of the program but reduce it in size and importance to a basic floor benefit. Both these plans, however, advocate a major structural change in the program through the addition of defined contribution accounts. Both the IA and the PSA plans would provide a second tier of benefits funded through contributions to a personal account established for each individual.

This paper considers the proposed addition of defined contribution accounts to the Social Security program from the perspective of investments. Both plans contemplate that individuals will be responsible for choosing the investments for their accounts. They differ only as to the investment options available. The purpose of defined contribution accounts is to build individual wealth that can be converted into income at retirement. Contributions are made over time to accounts. Those contributions are invested, and the value of an account at any point in time equals the amount of contributions *plus* their investment gains or losses and *minus* expenses charged to the account and its investments. The larger the account balance at retirement, the larger the income in retirement. With the objective of maximizing account balances in mind, the single most important feature of a privatized Social Security program will be its investment program. The available investment alternatives, and the choices made among those alternatives, will determine whether defined contribution accounts can produce sufficient savings to replace the benefits currently provided under Social Security and, thus, ultimately the success of Social Security privatization.

The purpose of this paper is to examine some critical design elements for an investment program under Social Security. In doing so, it considers a number of important issues. What role should the private sector play? What role does the government play? What investment choices should be permitted? Who decides? Are new laws and regulations necessary? Are new investment products or entities necessary? Who protects the individual? What remedies should be available?

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<sup>1</sup> See *Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations*, Washington, D.C.: GPO, 1997.

After a brief description of the IA and PSA plans and the U.S. financial services industry, the paper presents three alternative models for such an investment program. The first model proposes open access to a full range of investment products and markets. The third model, in contrast, requires the federal government to prescribe and regulate a limited number of investment options. The second model occupies a middle ground, permitting a wide range of investment products while imposing additional constraints and responsibilities on investment professionals. The final sections of the paper evaluate the models and illustrate how their key elements could be combined to produce a comprehensive investment program under Social Security.

## **II. Proposed Defined Contribution Accounts under Social Security**

**The IA Plan:** The proponents of this plan advocate gradually decreasing the growth of the traditional Social Security benefit over time by gradually raising the age of eligibility for full retirement benefits and the computation period for benefits. In addition, over time, the current benefit formula would become less generous. A second tier of benefits would be created by requiring each worker to make an additional 1.6% contribution of after-tax pay up to the limit for the Social Security payroll tax to an IA. This additional contribution would be held by the federal government and invested at the direction of the worker in a limited number of investment funds sponsored by the government. The contributions and investment earnings would accumulate over time and, at the appropriate retirement age, be converted into a benefit paid, just like today's Social Security benefit, in the form of a stream of income for life. The amount of the benefit would be the sum of the basic tier one benefit plus the size of the annuity purchased with IA accumulations.

**The PSA Plan:** The PSA plan also proposes a two tier system of benefits. The first tier replaces the current Social Security benefit with, when fully-phased in, a universal but small, flat retirement benefit to full-career workers which would be the equivalent of \$410 monthly in 1996.<sup>2</sup> The age of eligibility for full benefits would also be accelerated. A second tier benefit would be created by reallocating 5% of the current 6.2% payroll tax to a PSA for each individual. A PSA would be individually-owned and privately-managed. The federal government would neither hold these funds nor prescribe investment options. Under the current proposal, individuals could begin distributions from their accounts at age 62. Workers would not be required to purchase an annuity with their accounts but the proposal provides no other details about permitted forms of distribution. Presumably, choice of distribution, like choice of investment, would be left to individuals.

**Investment Programs:** One of the fundamental differences between the IA plan and the PSA plans is their proposed investment programs. Under both plans, workers have investment discretion over their accounts. But the federal government would specify, design and operate the investment

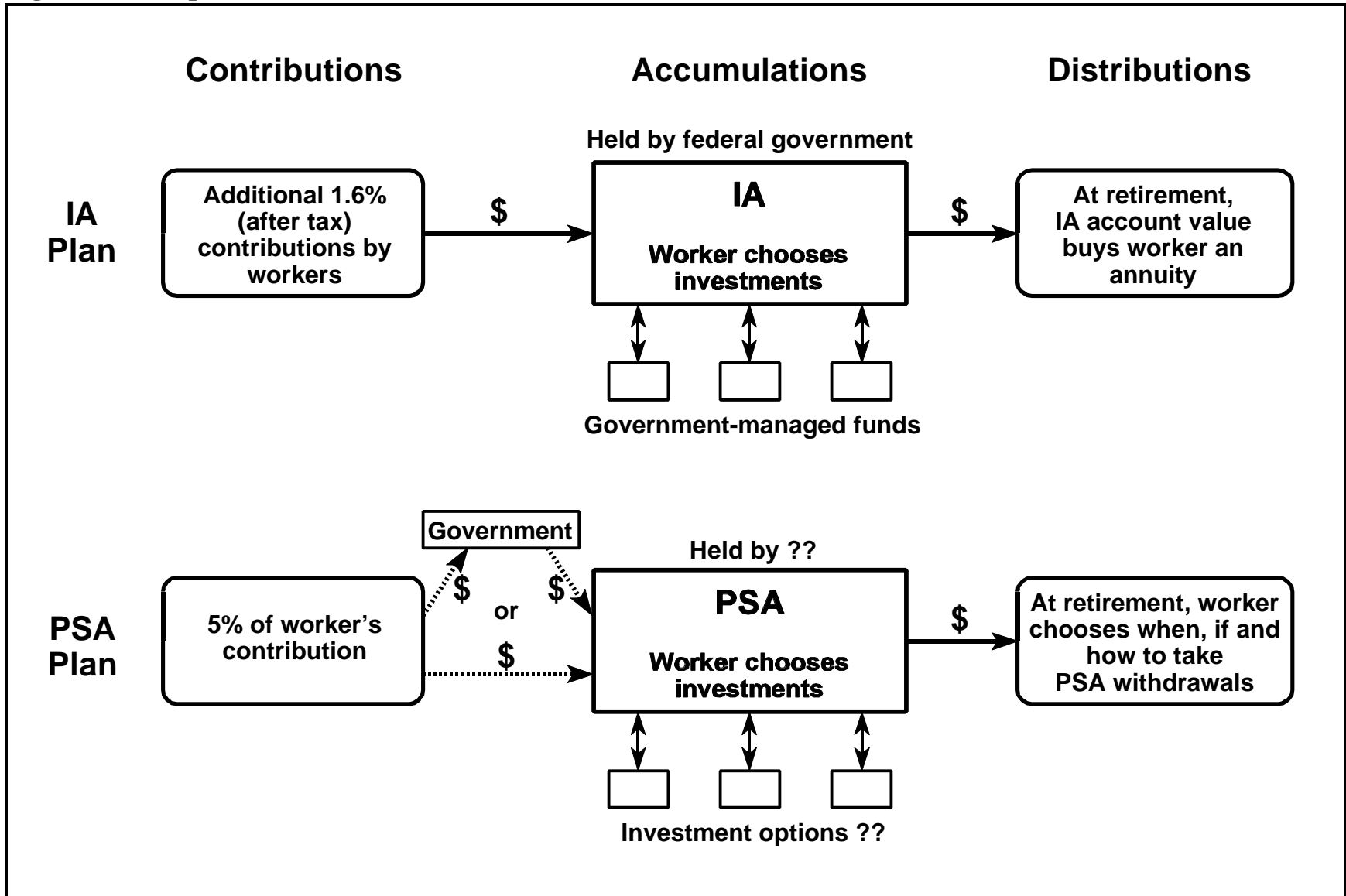
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<sup>2</sup> The proposal provides a gradual phase-in period. Workers under age 25 in 1998 would receive only tier one benefits and the balance in their PSAs. Workers age 25 to 54 in 1998 would receive their accrued benefit under the current system, a prorated share of the tier one benefit, and the balance in their PSAs. Current retirees and workers age 55 and older in 1998 would be covered under the existing Social Security system.

options available in the IA plan. The role of the private sector, and particularly that of the financial services industry, would be minimized to that of a non-discretionary investment manager for the investment options or ultimate annuity provider under contract to the government. The PSA plan, in contrast, contemplates the full involvement of the private sector although the plan itself does not specify how those accounts would be held and what investment choices would be.

Figure One below provides a brief description of the IA and PSA plans.

**Figure 1. Comparison of IA and PSA Plans**



### III. Preliminary Considerations for an Investment Program

**Some Basic Assumptions:** The IA plan includes a well-defined investment program in which the federal government chooses, designs, and manages the permissible investment choices. Those choices would be limited to a small number of mutual fund type vehicles which would not invest directly in individual securities or bonds. Instead, because of fears of undue government influence, the funds would be constructed as index funds whose performance would generally mirror the performance of the relevant market segment on which the index was based. Under the PSA plan, the design of the investment program remains as open issue. For purposes of considering how that program might look, this paper makes the following assumptions.

**! PSA accounts should have a unique legal identity.** Like an IRA or a Roth IRA, a PSA should be a special type of account subject to special rules. It should have a formal structure under a governing legal document such as a trust or custodial account agreement containing its necessary terms and conditions. While this requirement is important from a legal perspective, it also serves to assure some measure of uniformity to PSAs and their administration. An individual should easily be able to open a PSA as a specially-defined type of account, and PSAs offered by different types of providers should look very similar.

**! PSAs should only be available from recognized financial institutions.** Limiting access, at least initially, to banks, mutual fund companies, life insurance companies, or brokerage houses has a double purpose. First, it is designed to simplify the investment process by linking individuals with financial service industry professionals. Although, as described below, the available investment choices may differ depending upon which institution holds the PSA, implementing those choices would be a routine matter for any of these institutions. The second purpose for this requirement is to minimize the regulatory impact and implementation costs of the PSA plan on the financial services industry. The intention is to build a program that fits into the existing organization of the financial services industry in the U.S. as much as possible.

**! The investment program will recognize that Social Security funds are special.** They are part of a federal mandatory savings program covering almost all Americans, and they are intended for the special purpose of providing a floor of retirement income. While wealth creation is the ultimate goal of the program, the safety and security of those funds from an investment perspective is also a paramount consideration. Protecting those funds from fraud, abuse and mismanagement, particularly by investment professionals, should be an important consideration.

**! The size of PSA accounts will be problematic.** The amount contributed to a PSA every year will be relatively small. For example, if the plan were in effect in 1998 the maximum amount contributed would be roughly \$3,000, more than the maximum \$2,000 permissible annual contribution to an IRA but less than one-third of the maximum permissible \$10,000 annual contribution to a 401(k) or 403(b) plan. Most contributions will be much smaller. Costs and fees associated with account maintenance and investment activity may adversely affect the ability of small PSAs to accumulate capital for retirement income.

**U.S. Financial Institutions and Markets Generally:** Creating an investment program for Social Security requires, as a threshold matter, recognizing the abundance of financial resources available. The United States is the beneficiary of large, diverse and efficient capital markets. There are about 20,000 registered investment advisers.<sup>3</sup> There are nine major stock exchanges, two of which are national in scope. Stocks are also traded on the over-the-counter NASDAQ stock market which is not organized as a formal exchange. As of 1995, there were about 2,700 stocks and 560 bonds listed on the New York Stock Exchange and 6,400 securities listed on NASDAQ.<sup>4</sup> In 1996, there were about 6,300 mutual funds and 151 million mutual fund shareholder accounts.<sup>5</sup> In addition, as of 1996, there were almost 10,000 commercial banks, 2,000 savings institutions and 11,000 credit unions.<sup>6</sup> Finally, in 1995, there were roughly 1,700 life insurance companies.<sup>7</sup> In 1990, banks and thrift institutions, mutual funds and life insurance companies accounted for roughly 7.4 trillions of dollars in assets with commercial banks and thrift institutions holding \$4.9 trillion, life insurance companies holding \$1.4 trillion and mutual funds holding \$1.1 trillion. By 1996, the assets held by those financial institutions had grown to 12 trillions of dollars but the relative ranking of institutions had changed. During that time commercial banks and thrift institutions remained the largest financial intermediary holding about 6 trillion in assets, an increase of some 124% over 1990 and life insurance company assets grew to 2.2 trillion, an increase of about 160% over 1990. Assets held by mutual funds, however, increased by about 320% from 1990 as mutual funds became the second largest financial intermediary, holding about 3.5 trillions of dollars in assets.<sup>8</sup>

Participation by individuals in the financial services industry is substantial. Some 41% of American families own stocks directly or indirectly.<sup>9</sup> As of April 1996, an estimated 63 million individuals, making up about 37 million households (and representing 37% of all U.S. households), owned mutual funds.<sup>10</sup>

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<sup>3</sup> R. Bryan Wilson, Jr., *Practitioners Beware: Fees and Fast Food Don't Mix*, *Trusts & Estates*, No. 8, Vol. 136, July 1997, p. 36.

<sup>4</sup> *Statistical Abstract of the United States, 1997*, 117<sup>th</sup> Edition, Washington, D.C.: U.S. Department of Commerce, October 1997, pp. 528 and 529.

<sup>5</sup> *Ibid.*, p. 530.

<sup>6</sup> *Statistical Abstract of the United States, 1997*, 117<sup>th</sup> Edition, Washington, D.C.: U.S. Department of Commerce, October 1997, p. 14.

<sup>7</sup> *Ibid.*, p. 533.

<sup>8</sup> See *Mutual Fund Factbook, 1997*, Washington, D.C.: Investment Company Institute, 1997 ("ICI I"), p. 2.

<sup>9</sup> *Ibid.*, p. 529.

<sup>10</sup> *Mutual Funds - SEC Adjusted Its Oversight In Response To Rapid Industry Growth*, GAO/GGD-97-67, Washington, D.C.: General Accounting Office, May 28, 1997, p. 3.

**Retirement Assets and the Financial Services Industry Today:** One of the distinguishing characteristics of the financial services industry in the U.S. is the presence of large pools of capital dedicated to retirement savings. In the U.S., the market for retirement assets is huge. For example, the IRA market has grown from about \$26 billion in 1981 to \$1.3 trillion in 1996.<sup>11</sup> The defined contribution plan market at the end of 1996 was \$1.8 trillion.<sup>12</sup> 401(k) plans which predominate in the defined contribution market were estimated to have had assets of more than half a trillion dollars by that time. By the end of 1995, the 403(b) sector was estimated to have about \$285 billion in assets while assets in 457 plans were estimated at \$40 billion.<sup>13</sup>

Management of those assets is dominated by 3 types of financial service providers: banks; mutual fund companies and insurance companies. It is difficult to obtain market share data by type of plan but, by one rough estimate of just the 401(k) market, mutual fund companies manage about 38%, insurance companies manage about 30%, banks manage about 25%, and institutional money managers manage about 7% of the assets in this market.<sup>14</sup> During the 1990s, the 401(k) market has become increasingly dominated by the mutual fund industry as both life insurance companies and banks have rapidly lost market share.<sup>15</sup> The growth of the mutual fund industry in the 1990s described above is in large part attributable to the growth in the defined contribution plan market. In 1996, for example, the industry held, in addition to nearly half of all IRAs assets, \$334 billion in 401(k) plan assets (up from \$54 billion in 1992), \$137 billion in 403(b) assets (up from \$65 billion in 1992), and \$9 billion in 457 plan assets (up from \$3 billion in 1992).<sup>16</sup> Insurance companies, in contrast, dominate the 403(b) market although the mutual fund industry has recently been making

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<sup>11</sup> Brian Reid and Jean Crumrine, *Retirement Plan Holdings of Mutual Funds, 1996*, Washington, D.C.: Investment Company Institute, 1997 ("ICI II"). The increase in IRA assets is largely attributable to rollovers from qualified plans rather than any increased popularity of contributory IRAs.

<sup>12</sup> *Ibid.*

<sup>13</sup> Explained more fully in Chapter IV below, a 401(k) plan is a defined contribution, tax-qualified plan which enables employees to save for retirement on a pre-tax basis. For-profit and tax-exempt employers, other than state and local government entities, are permitted to offer 401(k) plans. A 403(b) plan is also a tax-qualified, defined contribution plan which an employer that is a public school system or a tax-exempt organization under I.R.C. §501(c)(3) may offer. Many 403(b) plans permit employee savings on a pre-tax basis much like a 401(k) plan. See ICI II, footnote 11 above, p.2, footnote 5 for the statistics cited above. See also C. Chris Lau, *Opportunities Abound For Insurers In Tax-Sheltered Annuities Market*, Best's Review (Life/Health), Vol. 97, No. 1, May 1996, pp. 38-40.

<sup>14</sup> See Amy Friedman, *Insurers Lose 401(k) Market Share to Mutual Funds*, National Underwriter (Life/Health/Financial Services), Vol. 99, No. 47, November 20, 1995, p. 3.

<sup>15</sup> See Friedman, footnote 14 above and Steven Brostoff, *Warning Signals in Retirement Markets*, National Underwriter (Life/Health/Financial Services), Vol. 101, No. 49, December 8, 1997, p. 15.

<sup>16</sup> See ICI II, footnote 11 above.

inroads.<sup>17</sup> In the IRA market, mutual funds are major players. At the end of 1996, the mutual industry held \$632 billion in IRA assets (up from \$226 billion in 1992) or nearly half of all estimated IRA assets.<sup>18</sup> But commercial banks with \$143 billion in IRA assets, thrift institutions with \$72 billion, insurance companies with \$105 billion and brokerage houses with \$483 billion (in self-directed accounts) also held substantial IRA assets.<sup>19</sup>

**Regulatory Landscape of the Financial Services Industry:** The diversity of the U.S. financial services industry has generated an intricate and overlapping regulatory system. The federal system in effect today largely took shape in the 1930s and 1940s in response to the financial crisis of the Great Depression.<sup>20</sup> As one recent report characterized that structure,

To use a transportation analogy, the twentieth-century model of financial policy has, for the most part, set a slow speed limit, specified a few basic models for cars, separated different kinds of cars into different lanes, and demanded that no one leave home without a full tank of gas and a tune-up.<sup>21</sup>

The U.S. financial services industry has historically been composed of several different types of entities providing specialized services which at one time were functionally distinct. Under the regulatory system initially created during the New Deal, specialized agencies, laws and regulations were established for each type of entity. Over time, as entities evolved and assumed new functions, additional federal agencies, laws and regulations were created. In many cases, financial entities are subject to a dual system of federal and state regulation. Table 1 below lists the major entities of the U.S. financial services industry and their primary regulators. As is readily apparent, the regulatory structure present today is both complex and overlapping. Financial institutions are often regulated by multiple federal agencies as well as by both federal and state agencies. The life insurance industry, however, is an anomaly. It remains largely a creature of state law and regulation.

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<sup>17</sup> See Lau, footnote 13 above.

<sup>18</sup> See ICI II, footnote 11 above.

<sup>19</sup> See ICI I, footnote 11 above.

<sup>20</sup> Several major laws from the 1930s and 1940s continue to play a dominant role in regulating today's financial markets. They are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 with respect to securities, the Glass-Steagall Act of 1933 with respect to commercial and investment banking, and the McCarran-Ferguson Act of 1945 with respect to state control of life insurance companies.

<sup>21</sup> Robert E. Litan with Jonathan Rauch, *American Finance for the 21<sup>st</sup> Century*, Washington, D.C.: U.S. Department of the Treasury, November 17, 1997, p. 5.

**Table 1. Major Components of the U.S. Financial Services Industry**

<b>Type</b>	<b>Regulators</b>
Depository institutions (e.g. banks and thrifts)	Federal Reserve Office of the Comptroller of the Currency (federally-chartered) State banking regulators (state-chartered)
Life insurance companies	State insurance regulators
Mutual fund complexes	S.E.C. Commodities Futures Trading Commission Stock Exchanges NASD (fund distributors)
Brokerage firms	S.E.C. State securities regulators Commodities Futures Trading Commission Stock Exchanges NASD
Broker/dealers Investment advisers	S.E.C. State securities regulators Commodities Futures Trading Commission Stock Exchanges NASD

As a corollary to the regulation of financial institutions and markets, a secondary layer of regulation governs different types of investment products and services. Until very recently, the lines between the major players in the financial services industry - banks, mutual fund companies and life insurance companies - used to be demarcated clearly in terms of the products they offered. For most of their history, banks and thrifts, the major depository institutions, were restricted to offering such products as checking and savings accounts and timed deposits such as certificates of deposit. The permissible products are determined by the law of the jurisdiction of incorporation. For example, federally-chartered banks are regulated under federal laws, primarily by the Office of the Comptroller of the Currency, while state-chartered institutions are regulated by state banking authorities. Depending on the type of charter and the type of account, one of the unique benefits that banks could offer their customers was insurance from the federal government for deposits up to \$100,000. Life insurance companies, in contrast, were and still are primarily regulated under state law, and the sale of their products is primarily controlled by state law. Life insurance products are not directly insured but many states provide some protection for insurance products under state guarantee funds. These funds are neither state-funded nor state-managed. They are merely associations of insurance companies whose members can be assessed to cover the default or bankruptcy of a fellow member in certain circumstances. In terms of the retirement market, life insurance companies for many years

primarily offered fixed income investments such as annuities or guaranteed investment contracts. Mutual fund companies are almost entirely a creature of federal law regulated by the Securities and Exchange Commission and provide neither federal insurance nor any state guarantee funds to their shareholders.

But in the 1980s, the lines between the major players in the financial services industry began to blur as the industry became increasingly homogenized. As Table 2 below indicates, the traditional distinctions among financial services entities and the types of products they offer no longer are clear.

**Table 2. Common Investment Products**

<b>Type</b>	<b>Who Sells</b>	<b>Who Regulates</b>
Certificates of Deposit	Banks Brokerage Firms	See Table 1
Traditional Annuity <sup>22</sup>	Banks Life Insurance Companies Life Insurance Companies affiliated with Mutual Fund Complexes Brokerage Firms	See Table 1 I.R.S.
Variable Annuity <sup>23</sup>	Banks Life Insurance Companies Life Insurance Companies affiliated with Mutual Fund Complexes Brokerage Firms	State insurance laws; S.E.C. I.R.S.
Mutual Funds <sup>24</sup>	Banks Life Insurance Companies Mutual Fund Complexes Brokerage Firms	See Table 1 I.R.S.
Individual stocks/Bonds	Banks Brokerage Firms	See Table 1

For example, in the 1980s, insurance companies increasingly began to offer variable in addition to fixed annuities. As variable annuities became more popular, insurance companies began to look a

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<sup>22</sup> The term “traditional annuity” means a product sold by an insurance company which promises a guaranteed lifetime form of payment. The insurance company invests the premiums paid along with its assets in its general account in order to generate the capital required to fulfill its obligations to its customers and other creditors.

<sup>23</sup> Variable annuities are a blended mutual fund/insurance company product. The product provides an insurance company “wrapper” which offers some of the insurance components of a traditional annuity such as a guaranteed lifetime form of payment or death benefit. But the product also offers a number of investment funds which are separate accounts of the insurance company and usually organized as mutual funds. Investors choose how their contributions will be allocated among the available investment funds. The performance of the selected funds determines the return on the investment received by investors and ultimately the amount of retirement income.

<sup>24</sup> A mutual fund is an investment product with a distinct legal identity, usually in the form of a trust, that pools money from its shareholders and invests in a diversified portfolio of securities under professional management. The three basic types of mutual funds are stock (equity), bond and income, and money market funds.

lot like mutual fund companies as they offered more investment products that not only looked like mutual funds but were legally organized as such as well. At the same time, mutual fund families organized their own insurance companies and marketed similar blended products by cloning their retail funds and offering them with an insurance company wrapper. Banks, not to be outdone, began to offer both mutual funds and annuities to their customers. Finally, banks and mutual funds began to compete with brokerage firms for the sale of individual stocks and bonds by organizing their own brokerage affiliates. Brokerage firms also made arrangements with other entities to provide their customers with annuity products, mutual funds and certificates of deposit.

**Regulation and the Individual Investor:** It is important to note that the current regulatory system in the financial services industry contains almost no rules for one important participant: the individual investor. Under the laws governing publicly-traded securities, there are no rules defining permissible investments. There are no rules setting financial thresholds for investments. There are no rules controlling the investment behavior of individuals. Individuals are free to select the investment product and professional of their choice without government interference or oversight. The regulatory system is primarily dedicated to creating a level playing field for investors. For example, the purpose of the major securities laws is: (1) to require full disclosure of all material facts related to a particular investment; (2) to prevent fraud and misrepresentation; and (3) to maintain a fair and honest market for the trading of securities.<sup>25</sup> Provided that those standards are met, individuals alone are responsible for their investment decisions. The regulatory system does not pass on the merits of a particular investment or guarantee its success. It merely requires that individuals are provided with sufficient information about that investment to make an informed investment decision. Similar philosophies prevail in the banking and insurance industries. Investment products, investment markets and investment professionals are regulated; individual investors are not.

#### **IV. Alternative Models for an Investment Program**

**Model One - The American “No Special Rules” Model:** The first model is called the American “No Special Rules” Model. A PSA under this model would look a lot like a brokerage account and would be subject to the same rules. There would be no direct restrictions on the investment choices available, and PSA owners would be free to invest in any form of investment which the financial institution holding their accounts could make available to them. PSA owners would also be able to move their accounts from one institution to another to take advantage of different types of investment products. For example, a PSA investor would be free to choose among a mutual fund, a life insurance product, a certificate of deposit, a limited partnership interest, or an individual stock or bond and so forth, provided that the financial institution holding the account could offer these forms of investment. If a particular institution didn’t offer an annuity product, the PSA owner would be free to move the account or open another account at another institution which did. Under this model, PSA investors would have the same free choice among investment options as

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<sup>25</sup> For a broader analysis of this topic, see Howell E. Jackson, *Problems in the Regulation of a Multi-Sectoral Financial Services Industry: An Exploratory Essay* (unpublished essay) and Howell E. Jackson and Ed Symons, *The Regulation of Financial Institutions*, West Publishing, 1977.

other types of investors. In addition, this model would impose no special constraints on investment professionals or investment products. The PSA investor would get no less but no more protection than any other investor under the existing regulatory structure in the U.S. capital markets. The following table describes some of the essential characteristics of Model One.

**Table 3. Characteristics of the American “No Special Rules” Model**

!	existing regulation of financial markets and financial services industry
!	new regulation only for defining structure and operation of PSAs
!	PSAs held at recognized financial institutions
!	any investment option offered by recognized financial institution is permissible

**Model Two - The American “Some Special Rules” Model:** The second model represents a slightly more restrictive approach to the investment program that might become available under a privatized Social Security program. It is called the American “Some Special Rules” Model and is based upon the model which governs the private pension system, and to a lesser extent, IRAs in the U.S. Much like the private pension system model and Model One, this model takes the existing organization and regulation of the U.S. capital markets as a starting point. It does not impose additional regulation on financial markets or investment products. Neither does it impose restrictions on the individual investor as to permissible types of investments. It does, however, assume that PSA investors and PSA funds are entitled to some special protection. It provides those protections by imposing additional standards of conduct on investment professionals and others who handle PSA funds. In addition, it provides special remedies for PSA investors in certain circumstances. Under Model Two, the PSA investor would receive more protection than most other investors in the U.S. capital markets. The following table describes some of the essential characteristics of Model Two.

**Table 4. Characteristics of the American “Some Special Rules” Model**

<p>! Model One</p> <p><i>PLUS</i></p> <p>! additional constraints on investment professionals regarding compensation, self-dealing and conflicts of interest</p> <p>! special remedies for PSA accountholders</p>
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**Model Three - The Latin American “Very Special Rules” Model:** The third model, here called the Latin American “Very Special Rules” Model, is the predominant model among countries who have privatized their Social Security programs, at least in part, through the adoption of defined contribution accounts. The movement to convert an old age social insurance scheme, at least in part, into a defined contribution format began in 1980 in Chile. In the 1990s, a number of Latin American countries such as Peru, Argentina, Columbia, Mexico, Uruguay and Costa Rica, have followed Chile’s lead. The models adopted in these countries share many common features, including their investment structure.<sup>26</sup> In brief, the model consists of a number of special investment funds defined and regulated, but not administered, by the government. The government approves and regulates the investment providers authorized to sponsor such funds, and workers choose among those providers when investing their accounts. The following table summarizes the key characteristics of the investment model adopted under the Latin American approach.

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<sup>26</sup> See Armando Barrientos, *Pension Reform and the Individual Capitalisation Pension Scheme Stampede in Latin America*, University of Hertfordshire Business School, Working Paper Series, Economics Paper 17 (1977).

**Table 5. Characteristics of the Latin American “Very Special Rules” Model**

!	fund managers approved by government
!	special purpose funds, usually retirement only
!	minimum capital and reserve requirements set by law
!	strict regulation of fund holdings in terms of permissible assets, issuers and risk levels
!	guaranteed minimum rate of return
!	reserve requirements
!	mandatory disclosure requirements
!	commissions and fees often fixed by law
!	restrictions on transfers between funds

## **V. Evaluation of Models**

This paper has presented three different models for an investment program under a privatized Social Security system, offering a range of possibilities. This section of the paper provides a brief evaluation of each model, intended to highlight some of their primary advantages and disadvantages.

**Model One:** Chapter II has shown that in the United States there are a number of favorable factors which would support open access by individuals to a wide range of investment products and markets in a privatized Social Security investment program. The U.S. financial services industry is second to none in its ability to provide diverse and efficient capital markets, multiple investment products, well-developed regulatory structures, and extensive professional experience with the investment of retirement assets. Does this indicate that under these circumstance a Model One-type program could be easily implemented or readily successful? Not necessarily. Even under ideal circumstances, implementing an investment program for defined contribution accounts on the scale required by Social Security would be a problematic undertaking. Under Model One, for example, millions of people whose prior exposure to the world of investing, if any, has been limited to a checking or savings account will find themselves in the thick of the most diverse and sophisticated financial services industry in the world.

Implementing an open-ended investment program such as Model One under Social Security would seem to be a recipe for disaster. But, over the last twenty years, a natural experiment has been underway in the private pension system that has quietly been educating individuals about saving and investing for retirement. Experience gained from the private pension system could ease the transition to a Model One-type program. But the largest unknown in the equation is the ability of individual investors to navigate the U.S. financial services industry on their own, without additional government support and protection. This section of the paper attempts to address that issue by asking three questions: (1) do individuals understand how defined contribution accounts work; (2) are individuals adequately prepared to invest their own accounts; and (3) does the regulatory and product complexity of the U.S. financial services industry pose a major problem.

**Do individuals understand how defined contribution plans work?** In the private pension system, the Tax Code has for many years authorized corporations to provide defined contribution plans for their employees, largely in the form of profit-sharing and money purchase plans. In 1958, addition of Section 403(b) to the Tax Code created a special type of defined contribution plan for employees of non-profit and charitable organizations which was extended to employees of public educational institutions, including colleges and universities. In 1978, I.R.C. §457 was enacted to regularize the treatment of plans for employees of state and local governments which had formerly been governed by the doctrine of constructive receipt rather than by an explicit tax statute.<sup>27</sup> I.R.C. §457 established special rules for this type of defined contribution plan, including limits on salary deferrals where previously there had been none. By 1980, then, almost all types of employers had the opportunity to provide defined contribution plans for their employees. In addition, since 1974 when enactment of the Employee Retirement Income Security Act of 1974 (“ERISA”) introduced IRAs under I.R.C. §408, individuals have also had the opportunity to establish individual defined contribution plans, although the Tax Code provides far less generous contribution and deduction limits to IRAs than it does for employer-sponsored defined contribution plans.<sup>28</sup>

Within the last 15-20 years, defined contribution plans have begun to dominate the private pension system. In 1975, for example, defined contribution plans represented only 28% of all private plan assets and 35% of contributions. But by 1993, defined contribution plans comprised 46% of all private plan assets and 66% of contributions.<sup>29</sup> Defined contribution plans as a percentage of all pension plans grew from 67% in 1975 to 87% in 1992, and the percentage of participants in such plans grew from 29% to 60% during that time period. In addition, between 1984 and 1993, the percentage of employers offering only defined benefit plans decreased from 24% to 9% and the percentage of all employers that offered only defined contribution plans increased from 68% to

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<sup>27</sup> The Tax Reform Act of 1986 extended these plans to employees of non-governmental tax-exempt organizations.

<sup>28</sup> I.R.C. §408 was expanded, effective in 1979, to permit employer plans in the form of simplified employee plans (“SEPs”) based upon the IRA model.

<sup>29</sup> *EBRI Databook on Employee Benefits*, 4<sup>th</sup> Edition, Washington, D.C.: Employee Benefits Research Institute, 1997, p. 97 (“EBRI I”).

88%.<sup>30</sup> During this period many smaller employers terminated defined benefit plans, many larger employers adopted a defined contribution plan in addition to an existing defined benefit plan, and many employers previously without a plan, particularly smaller employers, adopted a defined contribution plan as their sole plan.<sup>31</sup> Even though defined benefit plan participation remained steady during these years because large employers continued to maintain their existing plans, any “growth” in the private pension system during these years can be attributed to the increased popularity of defined contribution plans.

Although defined contribution plans were originally designed to be a vehicle for employer contributions, they have become increasingly important over the last 10-15 years as a vehicle for individual retirement savings.<sup>32</sup> Plans such as 401(k) plans, 403(b) plans for certain tax-exempt employees and 457 plans for state and local government and other tax-exempt employees have enabled participants to save for their retirement on a tax deferred basis. In 1983, only 7.1 million workers were covered by these types of plans. By 1993, that figure had grown to 38.9 million workers.<sup>33</sup> The most spectacular growth has occurred in 401(k) plans themselves. During the period 1984 to 1993, the number of 401(k) plans alone increased almost 900%. By 1993, almost 24% of all defined contribution plans were 401(k) plans which, in addition, covered 52% of all active private pension plan participants.<sup>34</sup> Such plans, however, are typically sponsored by large and medium-sized employers. In 1993, only 12% of workers in companies with 10-24 employees were offered a 401(k) type plan.<sup>35</sup> Moreover, within a particular plan, employee participation is not uniform. Fully one-third of workers who are eligible to participate in such a plan don't.<sup>36</sup>

IRAs, however, have not shared in the growing popularity of participant contribution plans. In fact, participation in IRAs has fallen from 16.9% in 1983 to 12.5% in 1988 and then further to

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<sup>30</sup> See *Private Pensions: Most Employers That Offer Pensions Use Defined Contribution Plans*, (Letter Report, 10/03/96, GAO/GGD-97-1).

<sup>31</sup> See EBRI I, p. 81.

<sup>32</sup> For many years, employees of state and local governments and tax-exempt organizations had the ability to make salary-deferral contributions under special rules applicable only to them. Employees of for-profit companies were not so fortunate. Because of uncertainty over the tax treatment of contributions by participants to corporate plans, plan participants were generally permitted, if at all, to make contributions with after-tax dollars. But beginning in 1980, I.R.C. §401(k) was enacted which granted corporate employees the ability to make contributions from pre-tax dollars.

<sup>33</sup> *Fundamentals of Employee Benefit Programs*, 5<sup>th</sup> Edition, Washington, D.C.: Employee Benefit Research Institute, 1997, p. 93 (“EBRI II”).

<sup>34</sup> EBRI I, p. 115.

<sup>35</sup> EBRI I, p. 107.

<sup>36</sup> See footnote 30 above.

8.1% in 1992.<sup>37</sup> Due to statutory restrictions on their availability and deductibility since 1974, IRAs apparently have suffered from competition with 401(k) plans where permissible contributions are much larger, deductible and often available for an employer matching contribution. Roth IRAs, newly available in 1998, have initially been very popular and may reverse this trend. Under a Roth IRA, contributions are not tax-deductible but accumulations are otherwise tax-free.<sup>38</sup>

On balance, the question “do individuals understand how defined contribution plans work?” gets a “yes, but” answer. The proliferation of defined contribution plans has acquainted millions of plan participants with the mechanics of individual accounts and how contributions and earnings produce retirement income. In addition, the popularity of 401(k)-type plans is teaching individuals to develop self-initiated, long-term savings programs for retirement. But the private pension system is not available to everyone. Since about 1972, participation rates have been fairly flat with only about 49% of all workers and 56% of all full-time workers covered by a plan.<sup>39</sup> Moreover, participation is not evenly distributed. Men more than women, employees of large rather than small employers, whites more than blacks, full-time more than part-time workers, highly-educated more than less-educated employees, and high earners more than low earners participate in pension plans.<sup>40</sup> The demographics of participation in 401(k)-type plans and IRAs are similar. Workers with higher incomes, workers who attended college, full-time and longer-service employees, and male workers tend to take greater advantage of these types of plans than their counterparts.<sup>41</sup> While the experience provided by the private pension system provides an extremely important basis of support for a defined contribution component under Social Security, it is important to acknowledge that significant numbers of workers covered by Social Security will have had little or no prior experience with a defined contribution plan.

**Are individuals adequately prepared to invest their own accounts?** Participant control of investments has become a popular feature of defined contribution plans within the last five years. Although many defined contribution plans have always permitted participants to choose investments for at least a portion of their accounts, there were no generally accepted standards for how such plans should be structured for many years. Many plans valued accounts and permitted investment changes infrequently, and information provided about investment options was often minimal. But in 1992, the Department of Labor finally released regulations under ERISA §404(c) which set certain standards for participant-directed investment programs. Those standards include, in general,

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<sup>37</sup> See EBRI I, p. 126. This figure represents contributory IRAs, not IRAs whose assets have been rolled over from a qualified plan.

<sup>38</sup> See Vanessa O’Connell, *Strategies To Try During Roth IRA Rush*, The Wall Street Journal, February 26, 1998, p. C1, reporting that IRA sales at Charles Schwab are up 200% this year with 50% of the contributions going to Roth IRAs and up 30% at Fidelity with about a 66% representation for Roth IRAs.

<sup>39</sup> See footnote 30 above.

<sup>40</sup> *Ibid.*

<sup>41</sup> EBRI I, pp. 107-123. See also footnote 30 above.

requiring a core set of at least 3 investment alternatives, informed participant choice, and at least quarterly investment changes.<sup>42</sup> Participants in plans which meet the 404(c) standards take responsibility for their investment choices and their consequences, relieving other plan fiduciaries from liability for such choices. Since 1992, employers in large numbers have taken advantage of the 404(c) regulations by giving participants investment discretion over their accounts. For example, a recent study of over 700 defined contribution plan sponsors in 1996 found that the employer retained investment control in only 3% of the reporting plans. Fully 84% of the reporting plans gave employees investment control over all funds contributed to their accounts while 13% permitted investment control over only a portion.<sup>43</sup>

As 404(c) plans have become popular, they also seem to have become an effective device for educating participants about investing. Employers are not required to educate participants about investments under the 404(c) regulations but because relief from fiduciary liability requires informed investment choice many do. In addition, investment providers have made investment materials and services available, often at no cost, as a marketing tool to employers and to encourage plan participation by employees. The Department of Labor has encouraged such developments and recently issued guidance on permitted methods for educating participants in 404(c) plans about investments.<sup>44</sup> As a result, employers are increasingly offering programs and resources on investing for 404(c) plan participants. A recent survey of over 500 employers by a benefits consulting firm found that 86% of plan sponsors had investment and savings education programs for their employees and another 7% planned to offer such programs. More than half offering such programs said they did so either as part of their compliance efforts under ERISA §404(c) or because employees requested them.<sup>45</sup> In addition, employers increase their communications to encourage participation and provide information about investments. One 1995 study found that 90% of surveyed employers use personalized account statements, company newsletters and benefits brochures, 89% hold group meetings and 50% use interactive voice response systems to educate employees about their plans and

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<sup>42</sup> Under ERISA, the plan sponsor or some other fiduciary is normally responsible for investing the assets of a plan in accordance with standards set forth in ERISA and subject to personal liability for violating those standards. ERISA §404(c) provides relief from those fiduciary responsibilities to the extent that participants direct the investments of their own accounts under regulatory guidelines issued by the Department of Labor. If a defined contribution plan satisfies those guidelines, the plan sponsor or other fiduciary responsible for designating investment alternatives available under the plan will not be held responsible for account losses resulting from participants' exercise of investment discretion, although they do retain residual liability for having selected the menu of investment alternatives.

<sup>43</sup> The numbers reported are from the 1996 annual Survey on Employee Savings Plans conducted by the benefits consulting firm of Foster Higgins. See *BNA Pension & Benefits Reporter*, Vol. 23, No. 50, p. 2918, December 16, 1996.

<sup>44</sup> See *Pension and Welfare Benefits Administration Interpretive Bulletin 96-1*, June 11, 1996. This guidance has been helpful in clarifying which types of investment education and assistance programs provided to plan participants will not be considered to be "investment advice" with resulting fiduciary liability.

<sup>45</sup> The numbers reported are from a study by Buck Consultants, Inc. See *BNA Pension & Benefits Reporter*, Vol. 23, No. 9, February 26, 1996.

investments.<sup>46</sup> These educational materials and programs apparently work well to increase plan participation and investment experience among employees. One study, for example, has found that financial education programs have “a strong positive effect on workers’ saving patterns”, particularly among non-highly compensated employees, and “employer-provided retirement education produces wholesale changes in saving behavior, and not just small changes at the margin.”<sup>47</sup>

One consequence of the maturing of 404(c) plans is that as participants become educated about investments, they demand a larger and more diversified menu of investment options under their plans. Although the regulations under ERISA §404(c) require only three diversified investment alternatives, plans are offering far more than the minimum number. One study reported that in 1997, on average, employees had 8.2 investment choices under 401(k) and other self-directed plans which is more than double the 3.5 options reported in 1990. That trend is expected to continue with the number of options rising to 11 or 12 in the next few year.<sup>48</sup> In fact, it is likely that many 404(c) plans will soon be offering almost unlimited investment options through self-directed brokerage options which allow participants to invest in any readily available mutual fund or individual stock or bond as such options, now found in about 3% of plans, become more popular.<sup>49</sup>

The answer to the question “are individuals adequately prepared to invest their own accounts?” is a qualified “maybe”. The last five years has witnessed an extraordinary increase in the amount of investment education and level of investment experience achieved by individuals participating in 404(c) defined contribution plans. For those individuals, a Model One-type investment program may well be appropriate. But millions of individuals covered by Social Security will not be similarly prepared. As a threshold matter, any investment program under Social Security would have to include substantial educational resources for such individuals. Whether the success of 404(c) defined contribution plans can be achieved in a broad-based program like Social Security under a Model One-type investment program, even if sufficient resources were available, is still an open question.

**Does the regulatory and product complexity of the U.S. financial services industry pose a major problem?** Until recently, investors faced some clear-cut choices when deciding how to invest their funds. They could choose a savings account from a bank, an annuity from an insurance company, a mutual fund from a family of funds or individual stocks and bonds through a broker. But

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<sup>46</sup> See *BNA Pension & Benefits Reporter*, Vol. 22, No. 49, December 11, 1997, p. 2717 reporting the results of a survey by Foster Higgins’ Investment Services Consulting Group.

<sup>47</sup> Harris Chorney, Jill Goldman, Olivia S. Mitchell and Anthony M. Santomero, *The Competitive Performance of Life Insurance Firms in the Retirement Asset Market*, Working Paper, the Financial Institutions Center of The Wharton School of the University of Pennsylvania, April 1997, p. 6.

<sup>48</sup> See *BNA Pension & Benefits Reporter*, Vol. 24, No. 50, December 22, 1997, p. 2806, reporting the results of a survey by human resources consultants William M. Mercer Inc.

<sup>49</sup> *Ibid.*

all of these financial institutions are now investment supermarkets providing all types of products to their customers. Table 6 below provides a description of those characteristics for certain investment products.

**Table 6. Characteristics of Common Investment Products**

<b>Type</b>	<b>Who Insures/ Guarantees</b>	<b>Protection of Principal</b>	<b>Guaranteed Return</b>
Certificates of Deposit	FDIC	yes	yes
Traditional Annuity	state guarantee funds	not relevant	yes
Variable Annuity	maybe some state guarantee insurance	sometimes	no
Mutual Funds	none	no	no
Individual stocks	none <sup>50</sup>	no	no
Individual bonds	issuing entity	yes, except in case of default <sup>51</sup>	yes, except in case of default

Investment products which look very similar may have very different risk characteristics. For example, a certificate of deposit purchased from a bank and a guaranteed investment contract purchased from an insurance company look very similar. Both instruments promised a certain rate of return for a fixed period of time. But the certificate of deposit will be backed by federal deposit insurance which protects the principal investment, usually up to \$100,000. No such protection applies to the insurance contract. In the event of default, the consumer can only look to the state guarantee fund which may not cover that type of contract, that particular consumer or the full loss of principal. At the same time, investment products purchased from a single institution may have very

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<sup>50</sup> While these forms of investment are not insured or guaranteed, there is some protection available against broker fraud or failure. The Securities Investor Protection Act of 1970 established the Securities Investor Protection Corporation (“SIPC”) to protect investors from losses if their brokerage firms fail. The SIPC ensures that investors will receive securities held for their account in street name up to a limit of \$500,000 (including up to \$100,000 in cash) per customer and is funded through assessments on participating brokerage firms. Brokerage firms often arrange for insurance to cover their customers in amounts greater than the SIPC minimum.

<sup>51</sup> Although bonds generally promise return of principal at maturity and a fixed flow of income, bondholders may not receive all the promised payments if the issuer goes bankrupt.

different risk characteristics not understood by the consumer. Banks, for example, now sell mutual funds, individual stocks and bonds and annuities in addition to their insured products. But many bank customers are unaware or do not understand that these products, even though sold by a bank, are not protected by the federal deposit insurance program.<sup>52</sup> In other cases, customers have been the victim of deceptive sales practices by banks in which they were persuaded to roll over proceeds from insured certificates of deposits into risky bond mutual funds after having been assured that the funds were also backed by government guarantees.<sup>53</sup>

The answer to the question “does the regulatory and product complexity of the U.S. financial services industry pose a major problem?” is an unqualified “yes.” As investors become more sophisticated, the complexity of the marketplace becomes less of an issue. But the problem is not purely one of investor inexperience. Given the recent changes in the financial services industry, the marketplace for investment products can be confusing for the average investor who has neither the legal nor the financial expertise sometimes needed to distinguish among different types of products. It is recognized, however, that American financial policy and the regulation of financial markets are no longer well-served by the model developed in the 1930s, and efforts to rationalize the current regulatory structure are underway. For example, in 1996, the National Securities Market Improvement Act of 1996 was enacted, representing the most significant overhaul of the securities regulatory structure in decades. In addition, in 1997, Congress considered but eventually failed to act on more far-reaching reforms for the financial services industry. Whatever the merits of that particular legislation, it is a welcome sign that action may be taken soon which will rationalize the regulation of the financial services industry and thereby simplify the investment marketplace for the average investor.

**Summary:** There are some positive factors supporting a Model One-type investment program under Social Security. For example, the private pension system in the U.S. in the last twenty years has acquainted significant numbers of workers with defined contribution plans and their role in producing retirement income. It has educated those individuals about the importance of saving for retirement and, most importantly, stimulated interest in investing. In the U.S., as a result of these trends, large groups of workers have developed substantial experience in investing retirement assets. The rapid development of 404(c) plans has recently accelerated the accumulation of such experience and is likely continue to do so in the future. But not all employees have benefitted from this trend. Less than 50% of employees have exposure to a pension plan. Among those that do, it is typically the more highly-educated and higher income employees who take advantage of them and have developed some investment expertise. Ironically, it is usually these employees who rely the least on

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<sup>52</sup> See Steve Cocheo, *Uninsured Products Draw Federal Heat*, ABA Banking Journal, Vol. 85, No. 12, December 1993, p. 9 and Ruth Simon, *Investors Are Still Misled By Their Banks*, Money, Vol. 23, No. 12, December 1994, pp. 42-45.

<sup>53</sup> See Michael Schroeder, *NationsBank to Settle Securities Charges*, The Wall Street Journal, May 5, 1998, p. B15, which reported that Nationsbank recently agreed to pay almost \$7 million to the SEC, Comptroller of the Currency and NASD to settle civil charges that it misled 13,000 customers, most of them elderly, into investing in two risky bond funds with proceeds from their certificates of deposit.

Social Security for income adequacy in retirement. The population of individuals who depend the most on Social Security for retirement income will, on average, be unprepared to assume personal responsibility for their own investment decisions. At a minimum, a Model One-type program could not be implemented without a substantial educational and support program for this population. There are also a number of negative factors. Ironically, the diversity and strength of the financial services industry in the U.S. is itself a problem. It is unlikely that the average Social Security investor will possess the skills required to navigate the regulatory and product complexity of the investment marketplace easily. On balance, it is difficult to imagine that a Model One-type program would be the first choice of most people.

**Model Two:** An additional argument against a Model One-type program is that it has long been recognized that retirement assets raise special regulatory issues. First, they represent financial assets created for the special purpose of accumulating capital for retirement income. Second, millions of American, the majority of whom are not sophisticated investors, rely upon them for a secure income in retirement. Third, they form large pools of capital which are a lucrative source of compensation for investment professionals. Fourth, they are invested for long periods of time during which the products in which they are invested require monitoring for performance and suitability. Even if a Model One-type program which featured open access to investment products and markets were the preferred choice, a strong argument could be made the program should also include additional protections for the Social Security investor. The following discussion examines the need for additional protection by asking three questions: (1) will the fees and expenses associated with investment products be problematic; (2) should the risks of excessive compensation and conflicts of interest be minimized; and (3) should special remedies be made available to Social Security investors.

**Will the fees and expenses associated with investment products be problematic?** It is well-recognized that a defined contribution plan exposes individual accounts to market risk, that is, to unexpected changes in the value of investments due to market fluctuations. But it is less well understood that accounts will also be exposed to a variety of risks just by being in the market, for example, the risk of excessive fees and expenses being charged to investments and accounts. Even if the fees and expenses charged are merely those standard in the industry, they may adversely affect the ability of an account to accumulate substantial capital for retirement. This is so because the amount contributed to a PSA every year will be relatively small. For example, if the plan were in effect in 1998 the maximum amount contributed would be roughly \$3,000, more than the maximum \$2,000 permissible annual contribution to an IRA but less than one-third of the maximum permissible \$10,000 annual contribution to a 401(k) or 403(b) plan. Most workers will, of course, be contributing far less than the maximum to their PSAs.

In general, PSAs will be subject to two primary types of charges: (1) expenses associated with account maintenance and record-keeping; and (2) fees associated with investment of account assets. All PSAs will presumably be subject to account maintenance-type charges, unless waived by the institution holding the account. Investment-related charges should vary depending upon the type of investment held in the account. For example, purchases and sales of stocks and bonds are generally subject only to brokerage charges while fees associated with certificates of deposit are built into the

promised rate of return. Traditional annuities are subject to fees for the insurance component of the product; other fees are built into the promised rate of return. In commingled investment pools such as a mutual fund, shareholders pay for the costs of professional management and other expenses of the pool. Variable annuities can be subject to two sets of fees, those associated with the insurance wrapper and those associated with the underlying investment options. The following table provides a very simplified description of some of the most common investment-related fees that may apply to the types of investments most likely to be held in a PSA.

**Table 7. Typical Fees**

	Certificates of Deposit	Traditional Annuities	Variable Annuities	Mutual Funds	Individual Stocks & Bonds
<b>Fees subtracted from individual accounts:</b>					
Front-end sales charge <sup>54</sup>	no	yes	yes	yes	no <sup>55</sup>
Contingent deferred sales charge <sup>56</sup>	no	yes	yes	yes	no
Redemption/surrender fee <sup>57</sup>	no	yes	yes	yes	no
Exchange fee <sup>58</sup>	no	no	yes	yes	no
Premium tax <sup>59</sup>	no	yes	yes	no	no
Annual account maintenance fee	no	no	yes	yes	yes
<b>Fees subtracted from the investment pool:</b>					
Operating expense fees <sup>60</sup>	no	no	yes	yes	no
Investment management fees <sup>61</sup>	no	no	yes	yes	no
12b-1 fees <sup>62</sup>	no	no	yes	yes	no
Mortality and expense risk charges <sup>63</sup>	no	yes	yes	no	no

<sup>54</sup> One-time fee usually used to compensate broker; limited to 8.5% in funds with no asset-based sales charge and to 6.25% in funds with such charges under NASD rules.

<sup>55</sup> But brokerage commissions are charged on purchases and sales.

<sup>56</sup> One-time fee paid when shares are sold as an alternative way to compensate broker; usually is a sliding scale fee which declines over a period of years and then disappears.

<sup>57</sup> Another one-time fee paid when fund shares are sold.

<sup>58</sup> Applies when funds are transferred between funds in the same family.

<sup>59</sup> Taxes assessed by certain states on insurance contracts.

<sup>60</sup> Costs of operating the fund (offices, staff, equipment, transaction costs such as brokerage commissions, trustees fees, attorneys fees, mailing expenses, etc.).

<sup>61</sup> Fees of investment adviser, usually an affiliate within the mutual fund family, for managing investment portfolio.

<sup>62</sup> Charge to pay for marketing, advertising, distribution costs of fund; also used to pay sales people. Can't exceed .75% of fund's average net assets per year. Service fee of up to .25% may also apply in a no-load fund of average net assets per year to compensate sales people.

<sup>63</sup> Periodic charge levied under insurance contracts to compensate insurance company for bearing certain mortality and expense risks.

This table illustrates two types of charges. The first set of fees is applied directly against account assets, usually as a percentage of such assets. The second is most commonly found in pooled vehicles such as a mutual fund and is applied against the pool itself. Mutual funds and other pooled investment products based on the mutual fund model such as variable annuities are popular because they enable a small investor to obtain professional management and diversification for retirement account assets. But the investor also pays a proportionate share of the expenses of the pool. These expenses are deducted directly from the pool, rather than the account. They are reflected indirectly in the account because they lower the value of the mutual fund shares themselves. The first type of fee is usually very visible to the investor as it is reported on account statements as a deduction from contributions to or distributions from the account. The second type of charge is usually visible only to the investor who reads the annual fund prospectus carefully as it is not usually reported on account statements. Investment-related fees are a lucrative source of revenue for the financial services industry. For example, it is estimated that the revenue potential for providing investment management, administrative, record-keeping and communications services to 401(k) plans is between \$4 and \$6 billion a year. Less than \$1 billion of that revenue is attributed to record-keeping and administrative fees. The real money, about \$3 billion in 1995, is made through asset management.<sup>64</sup>

In order to estimate the impact of such charges on PSAs, it is useful to review 401(k) plan data.<sup>65</sup> It should be noted, however, that many plans do not assess such maintenance-type fees against accounts because either the investment provider waives them if the assets held in the plan are sufficiently large. The employer may also pay those fees rather than charge them to the plan. In 1996, one survey of about 700 plans found that 84% of plan sponsors paid legal and plan design fees, 77% paid employee communications costs, 75% paid audit costs, 67% paid record-keeping costs and 61% paid trustee fees. About 38% of plan sponsors even paid investment management costs themselves rather than charge them to the plan.<sup>66</sup> Available statistics indicate that fees charged in the 401(k) market are variable and tend to decrease with the size of the plan. For example, in 1997, for a small plan with 25 participants and \$750,000 in assets, the annual per participant cost was benchmarked at about \$500 without taking trustees' fees into account and slightly over \$500 with those fees included. Investment expenses account for almost 75% of total plan costs with an average total investment expense of 1.28% of assets. In a relatively large plan with 1,000 participants and \$30 million in assets, the annual per participant cost was benchmarked at about \$340, with or without

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<sup>64</sup> See Penny Lunt, *The Outlook for Banks in the 401(k) Business*, ABA Banking Journal, Vol 87, No. 11, November 1996, pp. 69-70 and *401(k) Assets Climb; Survey Analyzes Market*, Employee Benefit Plan Review, Vol., 51, No. 1, July 1996, p. 60.

<sup>65</sup> The fees charged to defined contribution accounts has recently received a great deal of attention over concerns that they have become excessive. The Department of Labor which has regulatory authority over ERISA fiduciary standards applicable to most such plans held hearings on the issue late in 1997 and in 1998 released a booklet designed to inform consumers about the types of fees likely to be imposed on 401(k) accounts. The booklet, *A Look at 401(k) Plan Fees*, is available from the Department of Labor website at [www.dol.gov/dol/pwba](http://www.dol.gov/dol/pwba).

<sup>66</sup> See *Average Account Balances in Defined Contribution, 401(k) Plans Now Exceed \$75,000*, Employee Benefit Plan Review, Vol. 52, No. 5, November 1997, p. 16 and Jeffrey Goldfarb, *Employers Offer Added Savings Options; Equities More Popular, Mercer Survey Finds*, BNA Pension & Benefits Reporter, Vol. 24, No. 50, December 22, 1997, p. 2806.

trustee expense, and investment expenses account for almost 90% of total plan costs with an average total investment expense of 1.02% of assets. Among the largest plans, for example, a plan with 2,000 participants and \$60 million in assets, the annual per participant cost was benchmarked at about \$330, with or without trustee expense, and investment expenses account for almost 98% of total plan costs with an average total investment expense of .98% of assets.<sup>67</sup> These statistics, however, are based upon an average account size of \$30,000. Under the PSA plan, it will take years for accounts to reach this size.<sup>68</sup>

It may well be that these benchmark figures cited above are good estimates for the PSAs. They range from slightly less than 1% to slightly more than 1.25% per account per year. Front-end load fees tend to run between 3% to 5%. Redemption/surrender fees charged by mutual funds average between 4% and 5%; the average charge under an annuity contract generally starts around 7%. Annual account maintenance fees range between \$25 and \$40 a year.<sup>69</sup> Fees charged against mutual fund asset pools for operating and management expenses can vary widely (from 0.25% for index funds to over 2% for international funds) but generally average about 1.32%.<sup>70</sup> Mortality and expense risk charges average about 1.25% per year.<sup>71</sup> But because fees and loads are often waived for 401(k) plans and IRAs, PSAs may have a much higher fee structure. A recent study commissioned by the Department of Labor found a wide range in the fees charged by investment providers in the 401(k) marketplace with significant economies of scale available primarily to larger plans. For example, investment providers will typically negotiate fee-reduction agreements with larger plans for investment expenses which represent the largest expense, ranging from 75% to 90%, in plan administration.<sup>72</sup>

Although none of these charges appears to be excessive, the accumulation of charges assessed against a small account can significantly affect its investment return. By one estimate, the effect of just a 1% investment management fee can be significant. In the case of a worker who works for 40 years, has wage growth of 2.1% per year and a portfolio that earns 4% a year, a 1% management fee

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<sup>67</sup> See *Averages Book: 401k Provider Directory*, 3<sup>rd</sup> Edition, Baltimore, Maryland: HR Investment Consultants, 1997.

<sup>68</sup> For example, it would take a worker whose annual PSA contribution is \$2,000 over 10 years to accumulate such an account balance, assuming no fees and a 7% annual investment return.

<sup>69</sup> See Marianne Bhonslay, *How Much is that Fund Really Costing You?*, Medical Economics, Vol. 74, No. 22, November 10, 1997, pp. 145-149. See also Stephen Blakely, *What You Need To Know About Annuities*, Nation's Business, Vol. 85, No. 11, November, 1997, pp. 40-43.

<sup>70</sup> See Marianne Bhonslay, footnote 69 above.

<sup>71</sup> See Stephen Blakely, footnote 69 above.

<sup>72</sup> See *Study of 401(k) Plan Fees and Expenses*, available only through the Department of Labor's website at [www.dol.gov/dol/pwba](http://www.dol.gov/dol/pwba).

would cost the worker 20% of the potential accumulation in his or her account.<sup>73</sup> Another study looked at the cumulative impact of fund costs on a \$10,000 initial investment by comparing three types of funds: the lowest-cost equity funds, usually market index funds, charging about 0.2% of assets annually; the average-cost funds with a 1.5% charge; and the high-cost funds charging 2.2% annually. Expressed as a percentage of that initial \$10,000, the charges against the lowest-cost funds would be 2.8%, 19.8% for the average-cost funds and 28.1% for the highest-cost funds over a 10-year period. Expressed somewhat differently, the \$10,000 would be charged \$280 over 10 years in the lowest cost fund, \$1,980 in the average-cost fund and \$2,810 in the highest-cost fund.<sup>74</sup>

The answer to the question “will the fees and expenses associated with investment products be problematic?” is an unqualified “yes.” Fees and expenses are likely to present more of a problem for PSAs than they currently do for 401(k) plans which have several advantages over PSAs. First, while 401(k) plans have many individual accounts, the accounts are subject to uniform plan rules which simplifies their administration. Second, even with many small individual accounts, the assets of a particular plan may be sufficiently large for investment efficiencies. Consequently, these defined contribution plans are attractive to investment providers who will often offer reduced administrative fees or waive investment-related charges such as front end loads. The management fees obtained through the investment of these large pools of assets are usually sufficient to justify reducing or eliminating other fees. In addition, the 401(k) market is highly competitive. Investment providers will often offer special fee structures, usually based on the asset size of the plan, just to get the assets under management.

It’s not clear that this will be the case for PSAs. The accounts will be small and based on a one-worker/one-account or one-worker/multiple accounts model. Unless there is some pooling of administrative or investment services available under the PSA, there will be real costs associated with these accounts that investment providers will find difficult to absorb. Small accounts are expensive to administer, particularly if contribution information is not provided through paperless data or if contributions are small or made irregularly.<sup>75</sup> At the same time, there are real costs associated with certain investments, such as costs incurred by a mutual fund in buying and selling securities for the fund, that are borne by all shareholders. As a matter of equity, it will be difficult to reduce or waive these costs for PSA investors only without placing other shareholders in the position of subsidizing PSA accounts at the expense of their own. In addition, it is not so clear that the PSA market will be highly competitive. Investment providers are unlikely to offer special fee structures for PSAs alone, although they may do so for particular customers who also possess sizable assets in a brokerage or

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<sup>73</sup> Peter Diamond, *Economics of Social Security Reform - An Overview*, paper presented at the National Academy of Social Insurance Conference, January 29-30, 1998, p. 13.

<sup>74</sup> See John C. Bogle, *Who’s In Charge Here: Asset Allocation or Cost?*, remarks before the Financial Analysts Seminar sponsored by the Association for Investment Management and Research, Northwestern University, July 20, 1997.

<sup>75</sup> See Robert C. Pozen and John M. Kimpel, *Investment and Administrative Constraints on Individual Social Security Accounts*, paper presented at The Pension Research Council 1997 Symposium on Prospects for Social Security Reform, May 12 and 13, 1997.

IRA account invested through them.

**Should the risks of excessive compensation and conflicts of interest be minimized?** The history of pension plans suggests that retirement assets are peculiarly vulnerable to the risks of mismanagement and abuse by investment professionals. The U.K., for example, has recently witnessed a troubling episode in the selling of personal pensions. Personal pensions are individual retirement savings plans for individuals without an employer-sponsored pension plan. In addition, individuals could opt-out of their employers' plans and establish a personal pension for themselves in its place. Personal pensions are largely funded through a government contribution (with bonus) of about 8.5% of earnings up to the ceiling on National Insurance contributions.<sup>76</sup> Individuals can also elect to make discretionary contributions to their personal pensions. The personal pension, sold by insurance companies, has a lucrative fee structure including commission charges between 10% and 20% of annual premiums.<sup>77</sup> Over time, it has become clear that investment professionals missold personal pensions to large numbers of individuals who would have been better off staying in their employers' plan. A November 1994 report identified some 500,000 individuals who had been misled by investment professionals into adopting a personal pension, and the costs of making those individuals whole has been estimated at £4 billion.<sup>78</sup>

The U.S. private pension has struggled with similar types of abuses. In 1962, following a number of scandals involving the administration and investment of private pension fund assets, existing federal pension law was amended to make theft, embezzlement, bribery, and kickbacks of plan assets federal crimes.<sup>79</sup> This remedy proved to be inadequate, however, because the law provided no strong enforcement mechanisms. In 1974, following additional scandals, the Employee Retirement Income Security Act of 1974 ("ERISA") was enacted to establish strong standards of conduct for individuals who handle pension plan assets and an enforcement system against abuses. First, ERISA requires that compensation paid for services provided to a plan must be reasonable.<sup>80</sup> Second, as one of its most important reforms, ERISA created a set of fiduciary standards to be applied to those who have discretion over plan assets.<sup>81</sup> These standards were thought necessary

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<sup>76</sup> Richard Disney and Paul Johnson, *The United Kingdom: A Working System of Minimum Pensions?*, preliminary draft, Kiel Week Conference on Redesigning Social Security, Kiel Institute of World Economics, June 26-27, 1997, p. 10.

<sup>77</sup> See David Blake, *Pension Choices and Pensions Policy in the United Kingdom*, Chapter 10 in Salvador Valdes-Prieto, Ed., *The Economics of Pensions: Principles, Policies, and International Experience*, New York: Cambridge University Press, 1997, Appendix B.

<sup>78</sup> Disney and Johnson, footnote 74 above, p.26.

<sup>79</sup> The 1962 amendments were made to the Welfare and Pension Plan Disclosure Act of 1958.

<sup>80</sup> ERISA §408(b)(2).

<sup>81</sup> Those standards include duties to act for the exclusive purpose of plan beneficiaries and defraying plan expenses. Plan investments are to be made according to the prudent man rule and diversified to minimize the risk of large losses, unless it is clearly prudent not to do so. ERISA §404(a).

because

fiduciary rules are ... important in regulating pension trustee behavior. In particular, the risk always exists that the trustee of an employee benefit plan will take self-interested action (for example, siphoning assets from the pension fund) that will operate to the detriment of the beneficiaries ... Fiduciary rules (and criminal laws) deter this type of behavior.<sup>82</sup>

ERISA defines a fiduciary as anyone who exercises discretionary authority or control over a plan, its assets, or its management or who renders investment advice for a fee.<sup>83</sup> Fiduciaries who violate ERISA are personally liable for making the plan whole. Third, the issue of conflicts of interest regarding plan assets was deliberately addressed. ERISA imposes prohibitions on certain transactions among affiliated parties, even if those transactions would financially benefit the plan. This concern arose over

the difficulty of securing an adequate system of control over fiduciary-commercial relationships in the context of pension fund management ... these relationships tend to subordinate the strict professionalism expected of fund managers to business pressures and ... inevitably, certain fund managers are bound to yield to these pressures and cause trust fund abuse in a manner which is not always accessible to timely discovery.<sup>84</sup>

In the absence of an acceptable standard for determining which business practices presented a permissible conflict of interest involving plan assets and which did not, ERISA took the position that certain transactions exemplifying a conflict of interest such as purchases and sales of plan assets or loans or extensions of credits involving plan assets among affiliates must be flatly prohibited. ERISA fiduciaries also may not use plan assets for their own benefit or in a way which is adverse to the interests of the plan or its participants.<sup>85</sup> Anyone who violates these restrictions must report the transaction to the government, undo the transaction itself and pay a 15% excise tax (100% if not paid on a timely basis) on the value of the transaction, not just on the amount of profit.<sup>86</sup>

The answer to the question “Should the risks of excessive compensation and conflicts of interest be minimized?” is also an unqualified “yes.” If the U.K. had imposed restrictions similar to those found under ERISA on the sale of personal pensions, the current scandal could largely have

<sup>82</sup> Daniel Fischel and John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1119 (1988).

<sup>83</sup> ERISA §3(21).

<sup>84</sup> Senate Report No. 93-127, Retirement Income Security For Employees Act of 1973, 93<sup>rd</sup> Congress, 1<sup>st</sup> Session, p. 32. This Act was a proposed version of the law which was enacted as ERISA in 1974.

<sup>85</sup> See ERISA §§404 and 406.

<sup>86</sup> I.R.C. §4975.

been avoided. Investment professionals in the U.S., while not overly fond of ERISA and its sometimes cumbersome requirements, are clearly aware that they are subject to special rules when they handle assets of pension plans. They understand that their compensation can come under scrutiny. They understand that advice given with respect to investing plan assets is subject to strict standards, and violations of those standards can be personally expensive. They also understand that they should be wary of conflicts of interest, and they must not use plan assets to generate additional fees for themselves or to benefit anyone other than a plan beneficiary. Whether or not ERISA's particular rules are appropriate for the PSA plan, it seems reasonable to assume that imposing similar rules on investment professionals with respect to excessive compensation, self-dealing and conflicts of interest would be an important safeguard against misuse and abuse of PSA assets.

**Should special remedies be made available to Social Security investors?** As noted above, the U.S. financial markets are subject to substantial layers of regulation. Government agencies supervise the major investment markets as well as investment professionals. In addition, federal and state laws and regulations set standards of operation and conduct for both. For the most part, this system works well. The S.E.C., for example, rigorously monitors markets and professionals for securities laws violations and vigorously prosecutes abuses. But one weakness of the present system of regulation is that it is often difficult for individual investors to obtain redress when mistakes are made or abuses occur. For example, an individual may be sold an investment by a broker which the broker knew or should have known was inappropriate for that individual. Or, an individual who has given an investment adviser or broker discretionary authority to trade on his or her behalf may find that the account has been "churned", that is, that securities have been bought and sold more for the purpose of generating commissions for the adviser than profits for the customer. Or, an investment may be misrepresented to an individual who might believe that he or she is investing in a relatively safe security when the investment is speculative at best. Or, an investor may be persuaded to exchange one investment for another, for example, be lead to exchange one annuity contract for another, without being told that the primary reason for the exchange is that the new contract will pay higher commissions to the broker.<sup>87</sup>

Obtaining redress under the securities laws is difficult for the individual investor. In order to pursue a claim, the investor in most circumstances must hire an attorney. Initially, the problem involves making a legal determination as to the type and severity of the violation. What was done? Who did it? What was the standard of care? Was adequate disclosure made to the individual investor? Does the investor have a private right of action? Assuming a basis for a claim has been found, the next step is procedural. Should the investor complain to the brokerage firm or the supervising agency or both? Is the investor required to arbitrate a claim or can he or she proceed

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<sup>87</sup> It is difficult to estimate the amount of investment adviser and broker misconduct. One recent study of members of the Association of Investment Managers found that almost 25% of respondents reported observing or experiencing unethical behavior by a colleague. The most frequent violations were (1) failing to use diligence and thoroughness in making investment recommendations; (2) writing investment reports with predetermined conclusions; and (3) communicating (but not trading) on inside information. In addition, about 20% of respondents reported having been asked to do something unethical, usually by a more senior colleague. See Theodore E. Veit and Michael R. Murphy, *Ethics violations: A survey of investment analysts*, Journal of Business Ethics, Vol. 15, No. 12, December 1996, pp. 1287-1297.

directly to litigation? If litigation is the preferred and available route, should the individual pursue the claim alone or is this the type of violation for which a class action law suit is available? Although it is possible that claims may be settled short of litigation through the intervention of a government agency or through negotiation with the broker or the brokerage firm, they often are not. Pursuing such claims can be expensive and time-consuming for the individual investor with uncertain prospects of actually being made whole.

The drafters of ERISA recognized the difficulty that individuals have in such circumstances and provided a special set of remedies for plan participants beyond those available under the securities laws for other types of investors. First, ERISA assigns enforcement duties over the fiduciary provisions of ERISA to an additional government agency, the Department of Labor. Second, ERISA provides plan participants with special claim and appeal procedures so that any grievance must be pursued initially with plan officials. Participants also have authority to file private actions to enforce rights under the terms of the plan and to seek injunctive relief or obtain other appropriate equitable relief for ERISA violations.<sup>88</sup> Participants may also file claims directly with the Department of Labor which also has the authority to seek equitable or legal relief for ERISA violations. One benefit of these provisions is that plan participants who feel their rights have been violated have an opportunity to obtain redress at an early stage without the expense of hiring a lawyer or pursuing expensive litigation. One drawback of this system which is designed to encourage early settlements of disputes within the context of the plan is that relief available through litigation is limited. Participants who eventually pursue litigation and are successful recover only the benefit to which they were entitled. They are generally not entitled to receive extra-contractual relief such as compensation for pain and suffering or other consequential damages, although they may, in the discretion of the court, receive attorneys fees.

The special remedies crafted under ERISA work reasonably well, at least in terms of enforcing participant rights under a plan. They offer relatively quick procedures for settling disputes and enforcing participant rights at the plan level with additional relief provided through agency supervision and action as well as private litigation. Because of the limitation on extra-contractual damages and attorneys fees, there is no plaintiffs bar under ERISA and relatively few frivolous lawsuits. Whether the remedies work as well in terms of redressing investment-related grievances by participants has yet to be seen as the case law under ERISA §404(c) is just beginning to develop.

The answer to the question “should special remedies be made available to Social Security investors?” is also an unqualified “yes.” The PSA investor with a small account and limited other resources is unlikely to benefit from the remedies available to investors under the securities laws. Additional remedies are likely to be required to safeguard such investors and their accounts. ERISA provides an example of a system of remedies that might be made available under the PSA plan. The difficulty will be in designing such a system for the PSA where there is no employer involved in setting up and maintaining the accounts or charged with supervising the available investment options.

**Summary:** Model Two builds on the strengths of Model One while adding some desirable

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<sup>88</sup> ERISA §502(a).

additional protections for PSA investors. The primary question is how to put the intended investment safety net in place. In the private pension system, employers, the Department of Labor and other fiduciaries have identifiable roles and responsibilities in managing and protecting plan assets for participants. It is unlikely that employers will be willing to assume a similar burden for a government-mandated plan such as a PSA. At the same time, it is difficult to assign fiduciary roles in the private sector under the PSA. Should those duties be placed on the financial institution offering such accounts or the investment manager of a PSA investment option? They may also be unwilling to assume such a burden for the PSA which is expected to produce millions of relatively small accounts. The profit margins associated with PSA accounts may be so low that financial institutions might be unwilling even to take on the administrative burden of the PSA plan. Adding fiduciary exposure to their burden may significantly limit the availability of the PSA plan. Finally, it is unclear whether a federal agency, and if so, which one, should take primary responsibility for protecting Social Security investors. Should it be the S.E.C., the Social Security Administration, the Department of Labor, the Treasury, or the I.R.S.? Which agency has the resources and expertise to take on this responsibility? Model Two assumes that an appropriate investment safety net can be implemented but designing it will undoubtedly be difficult.

**Model Three:** Model Three is interesting largely because of what it doesn't do. It really doesn't privatize the investment options of the program. The government regulates the investment options, the government approves the managers, the government regulates the portfolio of investments and the government specifies a minimum rate of return. In many respects, it resembles the IA investment plan where the federal government is intended to play a similar role. The only analog in the United States to this type of model is the Thrift Savings Plan, a 401(k)-type plan, which the federal government sponsors for its own employees where those employees have investment discretion over their accounts. There, the government through a special investment board has established and operated a limited number of index funds as the plan's investment menu. But the federal government under that plan is operating in its capacity as plan sponsor for its own employees. In the case of the Latin American model, the governments are operating primarily in the capacity of chief regulator of each nation's floor social insurance program. Further, the investment choices made by the government as employer in the Thrift Savings Plan are dictated to a large extent by concerns over excess government intrusion and control over private capital markets. In the Latin American model, the investment structure seems largely dedicated to securing the safety of these social security funds. The structure proposed by Model Three is clearly very different from any investment program currently available in the U.S. either to private investors or through the private pension system. This section examines Model Three by asking two questions: (1) is it feasible to transplant this model to the U.S.; and (2) how well would it be received.

**Is it feasible to transplant Model Three to the United States?** Model Three, unlike Models One and Two, doesn't build on the existing financial markets in the U.S. Instead, it proposes a separate structure of investment products and providers which is isolated and distinct from all others. Nevertheless, it is possible that Model Three could be shoe-horned into the existing regulatory system in the U.S. At a minimum, existing laws would have to be enacted to authorize special purpose retirement funds, to specify which investments providers could make them available

to Social Security investors, and to establish a government or quasi-governmental agency to serve as a review board for the program..

One way to authorize these special funds would be to amend the Investment Company Act of 1940, the primary securities law for mutual funds, to define a special purpose mutual fund solely for Social Security investors. Securities and tax laws currently provide special criteria which certain types of funds, such as money market funds, must meet before they can advertise themselves as such. A special purpose PSA fund would likely require more precise specification, however, than existing law routinely provides. The composition of a special purpose PSA fund's portfolio would be strictly defined in addition to such other required characteristics as minimum capital and reserve requirements and guaranteed rates of return. In addition to creating a new type of fund, it might also be possible to survey the existing universe of mutual funds and to designate several already available types of funds as suitable for investment by Social Security investors. Those funds could be made available "as is" so that Social Security investors could invest in them along with the general public. Alternatively, a special class of securities within these funds could be created and be made available solely to Social Security investors.

It is also feasible that existing securities laws could be amended to establish special requirements for investment managers and broker/dealers who would be authorized to offer and operate these special purpose funds and set disclosure standards for investors. Determining which financial institutions would be permitted to offer such funds might require amending existing banking (at the state and federal levels) and insurance (at the state level) laws as well. Determining the rights of PSA investors and their remedies would also require new laws and regulations.

The most difficult implementation issue, however, is to determine what role the government would play in determining the appropriate investment menu under a Model Three-type program. The government does not play an equivalent role today either for private investors or in the private pension system. A secondary, and also difficult issue, is what agency would assume the role of choosing and supervising that investment menu and approved investment managers. Should it be the Department of Labor, the Securities and Exchange Commission, the Social Security Administration or the Internal Revenue Service? These agencies each have some experience in regulating retirement assets, although not on the scale required by a Model Three-type program. Or should an independent review board be chosen? If so, who should be appointed and what powers should they have?

The answer to the question "is it feasible to transplant Model Three to the United States?" is "probably not." It is certainly feasible to transplant certain aspects of Model Three to the U.S. by adapting current regulatory structures. On the other hand, Model Three would also require substantial amounts of new laws and regulations as well as new regulators in order to be implemented. It is unclear whether the regulatory burden and costs of a Model Three-type program would justify the benefits it might offer to Social Security investors.

**Would Model Three be well received?** The answer to this question is also "probably not." Model Three would benefit PSA investors by providing a uniform investment product which is

closely-supervised by the government. At the same time, it would insulate PSA investors from many of the risks present in the market and provide security for the safety of these Social Security funds. The drawback of such a model is that it mandates a one-size-fits-all fund. It is not likely to be appealing to individuals who are used to making their own investments choices, either with their personal assets or through the private pension system. After all, millions of American are now accustomed to taking investment responsibility for their retirement savings. One lesson from the private pension system is that as individuals become more familiar with investing their own funds, they demand more investment options. Model Three is therefore likely to be unpopular with individuals who will wonder why they can't be trusted to chose the investments for these mandatory savings while their discretionary savings which will generate most of their retirement income are not subject to such severe constraints.

**Summary:** Intuitively, this model is not a good fit for the United States. It was developed, and apparently works very well, in countries without complex capital markets and a mature life insurance industry. In fact, in those countries utilizing this model, the accumulation of capital in those funds is leading to the development of capital markets and insurance industries where previously there were none. In the United States, the opposite situation prevails. The United States does have complex capital markets and a mature life insurance industry. Moreover, unlike the countries using the Latin American model, the United States has very large pools of capital assets dedicated to producing retirement income largely created through employer-sponsored retirement and savings plans. Further, the United States has substantial experience in investing those assets through the financial services industry without government oversight or regulatory structures purely dedicated to retirement assets. If the U.S. were creating a private pension system for the 1950s, this is the type of model that might be chosen. But it seems too limited and inflexible for the year 2000. It fails to take advantage of the vibrancy and diversity present in the U.S. capital markets and contradicts the norm of individual choice and responsibility for retirement savings which is increasingly accepted in American society.

## **VI. Synthesis of Models**

The models discussed in this paper do not exhaust the range of possibilities. They merely illustrate some alternatives along a spectrum of choices. As a conclusion to this paper, it is perhaps useful to offer a synthesis of the models presented. The intention is not to propose a single grand model but to emphasize the themes that have emerged from the preceding discussion. They are:

*On the positive side:* It is feasible to add a defined contribution component to Social Security where individuals have investment discretion over their accounts because

- ! The U.S. financial services industry has an abundance of financial resources to offer,
- ! The financial services industry has substantial experience investing retirement assets,
- ! The private pension system has given millions education and experience in investing.

*On the negative side:* It will be difficult for individuals to navigate the regulatory and product complexity of the U.S. financial services industry without assistance. Any investment program should include

- ! Educational programs,
- ! An investment safety net concerning fees, excessive compensation, conflicts of interest, and special remedies.

These themes can be further broken down into the discrete building blocks for an investment program under Social Security found in Table 8 below.

**Table 8. Building Blocks for a PSA Investment Program**

<b>Financial Markets and Institutions</b>	<b>Investment Products</b>	<b>Investment Professionals</b>	<b>Individual Preparation and Protection</b>
<ul style="list-style-type: none"> <li>! utilize existing regulatory structure where feasible</li> <li>! create special PSA accounts</li> <li>! permit only recognized financial institutions to offer PSAs</li> </ul>	<ul style="list-style-type: none"> <li>! utilize existing products where feasible</li> <li>! create optional special purpose PSA mutual funds with portfolio and cost controls</li> </ul>	<ul style="list-style-type: none"> <li>! impose constraints on excessive compensation</li> <li>! penalize self-dealing</li> <li>! mitigate conflicts of interest</li> </ul>	<ul style="list-style-type: none"> <li>! educate individuals about investing</li> <li>! create a special system of remedies</li> <li>! set disclosure standards and requirements</li> </ul>

Most of these building blocks raise only issues of implementation and enforcement, and while reasonable people may differ as to their importance they are not otherwise controversial. The one building block which could become a stumbling block is the investment menu. At issue is the proper balancing of two norms: the need to safeguard Social Security funds for retirement and the right of individuals to choose the investments for their own accounts. A Model One-type program assumes individual free choice is the greater good and leaves investment discretion as well as responsibility with the individual. A Model Three-type program gives the need to protect Social Security funds its highest priority, even if it requires constraining individual choice severely. Both types of models will have their vigorous proponents who are likely to view this as an issue of principle for which there is no compromise.

Table 8 suggests a possible solution borrowed from the private pension system. Plans which permit participants to choose the investments for their accounts are generally required to offer at least three “core” investment alternatives, each of which is diversified internally.<sup>89</sup> The core alternatives must also have materially different risk and return characteristics. The purpose of requiring a core set of alternatives is: (1) to enable participants to achieve portfolios with the aggregate risk and return characteristics appropriate for them; (2) to require the available core options to be diversified in the aggregate in a way that minimizes the overall risk of the portfolios; and (3) to give participants choices among options which are diversified in the aggregate in such a way as to minimize the risk of large losses. The core set of alternatives under the ERISA 404(c) regulations substantially resembles the types of investments permitted under a Model Three-type program. They provide safeguards for Social Security funds but without the intrusive government regulation required by such a program. From a practical perspective, it should not be difficult to define special Social Security funds and require investment providers to offer them as a core set of investment alternatives to Social Security investors.

At the same time, however, it is important to recognize that individuals like to have choice and control with respect to their investment decisions, particularly where they alone will bear the consequences. Most 404(c) plans offer, often by participant demand, a large number of funds. Moreover, a popular option now is the open-ended plan where participants can invest their accounts in any publicly-traded security through individual brokerage accounts held in the plan. The wave of the future in the private pension system is a Model One-type program. It will be difficult, as a policy matter, not to permit such individual investment discretion in a defined contribution component under Social Security. Assuming that a core set of investment options would be available to Social Security investors, it may also be necessary to provide them with the opportunity to opt out of the standard menu into the open-ended type of program represented by Model One. If it can also be assumed that the additional protections of a Model Two-type program were in place, this may represent the best compromise that Social Security can achieve between the competing demands of individual choice and financial prudence which are inherent in any defined contribution plan where participants have investment discretion.

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<sup>89</sup> See 29 C.F.R Part 2550, §2550.404c-1.