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Report to the Chairman, Committee on Ways and Means, House of Representatives

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401(k) PENSION PLANS

Extent of Plans' Investments in Employer Securities and Real Property

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United States
General Accounting Office
Washington, D.C. 20548

Health, Education, and
Human Services Division

B-276106

November 28, 1997

The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Policymakers and the pension community are concerned about 401(k) plans—tax-deferred individual retirement benefit accounts—in which decisions regarding how to invest plan assets, particularly employee contributions, are made exclusively by employers. This concern was prompted mainly by two cases in which employers invested a large portion of the 401(k) plan assets in their companys' securities or real property.[1] Subsequent business reversals then forced the employers into bankruptcy reorganization or liquidation. In one case, employees lost their jobs and almost all their pension benefits because the value of the employer's securities decreased significantly. The other case, involving real property, is still in bankruptcy liquidation, and the final effect on pension benefits is unknown.

Concerns about the loss of jobs and retirement benefits prompted your office to ask us to (1) provide information on the extent to which 401(k) plan assets are invested in employer securities and real property, (2) examine the protection and any possible problems associated with the recent amendments to title I of the Employee Retirement Income Security Act of 1974 (ERISA), and (3) identify alternate mechanisms that might safeguard the retirement benefits of participants in 401(k) plans in which the employer decides how to invest assets.

To determine the extent to which the assets of 401(k) plans were invested in employer securities and real property, we analyzed the Form 5500 database maintained by the Department of Labor's Pension and Welfare Benefits Administration (PWBA). Under ERISA, employers have to file a Form 5500 annually to report certain financial, participant, and actuarial data for each of their pension plans. We analyzed data for plan year 1993,[2] which was the most recent year for which final plan-specific data were available for our review. To examine the protections provided by and any

[1]Real property acquired by the plan and leased to an employer of employees covered by the plan or to an affiliate of such employer.

[2]Plan year refers to the calendar, policy, or fiscal year for which the records of the plan are kept. All years cited in this report are plan years; 1993 forms were filed for plan years beginning in calendar year 1993.

possible problems associated with the recent amendments to ERISA, we discussed the amendments with officials of the Departments of Labor and the Treasury developed a model to measure the extent of protection offered by a 10-percent limitation on the use of employee contributions to purchase employer securities and real property, and examined Form 5500 data. To determine what alternate mechanisms could be considered to safeguard plan participants in employer-directed 401(k) plans, we identified strategies that already are authorized by federal law and identified mechanisms that experts suggested. We performed our review in Washington, D.C., from November 1996 through September 1997 in accordance with generally accepted government auditing standards. (See app. I for details on our scope and methodology.)

Results in Brief

Only 2,449 of about 160,000 401(k) plans owned employer securities or real property in 1993. Collectively, these plans owned $53 billion of employer securities and real property and covered 5.3 million plan participants. In most of these plans, plan participants directed the investment of their own contributions. Plans for which the employer solely decided how to invest assets totaled 756. In these plans, employees exercised no control over how their 401(k) plan assets were invested; the employer made all the investment decisions. These plans covered 1.4 million participants and had $12.3 billion invested in employer securities and real property.

In August 1997, the Congress amended title I of ERISA to provide that not more than 10 percent of employee contributions be invested in employer securities and real property by defined contribution 401(k) plans requiring that employee contributions be invested in this way.[3] This change increases protection for 401(k) plan participants. The 10-percent limitation rule alone does not, however, prevent plans from investing employee contributions in employer securities and real property whose value is declining. In addition, some of the information needed to implement and enforce the new legislation is not readily available. Proposed changes to the Form 5500, if implemented, may remedy some of the data deficiencies.

Other mechanisms are available to policymakers if alternate safeguards are needed in the future. These mechanisms include enhanced reporting and disclosure, prescribed education programs, adoption of the

[3]The amendment provides that unless one of three exemptions is met, not more than 10 percent of employees' contributions and the earnings thereon may be invested in employer securities and real property. The ERISA 10-percent limitation rule for employer-directed 401(k) plans becomes effective in 1999.

diversification requirement used for employee stock ownership plans (ESOP), and use of independent fiduciaries to examine investment decisions.

Background

Employers provide retirement benefits using two basic types of plans—defined benefit plans and defined contribution plans. In a defined benefit plan, the employer determines the employee's retirement benefit amount using specific formulas that consider factors such as age at retirement, years of service, and salary levels. Employers are responsible for ensuring that sufficient funds are available to pay promised benefits. The amount an employer must contribute to a defined benefit plan varies from year to year depending on changes in factors such as workforce demographics or investment earnings. Employees covered by a defined benefit plan are also protected by a federal plan termination insurance program administered by the Pension Benefit Guaranty Corporation (PBGC).

In a defined contribution plan (also known as an individual account plan), the employer establishes an individual account for each eligible employee and generally promises to make a specified contribution to that account each year. Employee contributions are sometimes allowed or required. Each defined contribution plan specifies whether the plan participants, the employer, or both will make decisions about how the funds in the accounts are invested. Regardless of who makes the investment decisions in a defined contribution plan, the employer is not responsible for ensuring that a specified amount is available upon an employee's retirement. An employee's retirement benefit from such a plan depends on the total employer and employee contributions to the account as well as the investment returns that have accumulated in the account by the time the employee retires. In a defined contribution plan, the employee assumes the risk for the investments.

Defined contribution plans include thrift savings plans, profit-sharing plans, and ESOPs. Such plans that allow employees to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of the Internal Revenue Code are generally referred to as 401(k) plans. Investment income earned on a 401(k) plan accumulates tax free until an individual withdraws the funds.

Table 1 shows the number of plans, plan assets, and plan participants for 1993 for single-employer defined benefit and defined contribution plans.

Table 1: Single-Employer Defined Benefit and Defined Contribution Plans, 1993

Type of plan	Number of plans	Assets (billions)	Participants (millions)[a]
Defined benefit plans	69,888	$1,017.0	31.7
Defined contribution plans			
ESOP	8,054	199.6	7.0
401(k)	159,196	492.1	20.4
Other	397,142	296.2	9.2
Total[b]	**634,280**	**$2,005.0**	**68.4**

[a]Includes double counting of participants who are in more than one plan.

[b]Because of rounding, sums of individual items may not equal totals.

ERISA imposes certain requirements and restrictions on those who manage and administer private pension plans. These fiduciary rules apply to both defined benefit and defined contribution plans and require, among other things, that plans diversify their investments and, more specifically, invest no more than 10 percent of total plan assets in employer securities and real property. Currently, ERISA exempts 401(k) plans from the diversification requirement and the 10-percent limitation rule. Accordingly, 401(k) plans can invest in employer securities and real property generally without restriction. (See app. II for more details on federal fiduciary rules on investment of plan assets.)

In August 1997, the Congress amended title I of ERISA to protect plan participants in 401(k) plans that require that employee contributions be invested in employer securities and real property. Section 1524 of the Taxpayer Relief Act of 1997, which takes effect in 1999, will extend the ERISA 10-percent limitation rule on investments in employer securities and real property to that portion of these 401(k) plans consisting of employee contributions and the earnings thereon unless they meet one of three exemptions. A 401(k) plan is exempt if the fair market value of the assets of all the defined contribution plans the employer maintains is no more than 10 percent of the fair market value of the assets of all the employer's pension plans. A 401(k) plan is also exempt if it requires that not more than 1 percent of an employee's compensation be invested in employer securities and real property. Finally, ESOPs are exempt.

Relatively Few 401(k) Plans Invested in Employer Securities and Real Property

Less than 2 percent of 401(k) plans invested in employer securities and real property in 1993. Because many of the 401(k) plans that owned employer securities and real property were large plans, however, the number of participants covered and the value of employer securities and real property were substantial. Participant-directed plans had about 3.9 million participants and about $40.7 billion in employer securities and real property. Employer-directed plans covered 1.4 million participants and had $12.3 billion invested in employer securities and real property.

Large 401(k) Plans Owned Most of the Employer Securities and Real Property

Only 2,449 of the 159,196 401(k) plans that filed a Form 5500 for 1993 reported that they had invested in employer securities or real property. As shown in table 2, a relatively few large 401(k) plans owned most of the employer securities and real property. In this regard, 109 plans with 10,000 or more participants owned over $34 billion (nearly 65 percent) of the $53 billion of employer securities and real property owned by all 401(k) plans. These large plans also covered most of the participants in 401(k) plans that owned any employer securities or real property. Plans with more than 10,000 participants covered 57 percent of participants. Plans with 1,000 or more participants covered 92 percent of the participants and owned 95 percent of employer securities and real property.

Table 2: 401(k) Plan Investments in Employer Securities and Real Property by Plan Size, 1993

Plan size (based on number of participants)	Number of 401(k) plans	Number of 401(k) plans that owned employer securities and real property	Assets of 401(k) plans that owned employer securities and real property (billions)	Amount of employer securities and real property owned (billions)	Participants in 401(k) plans that owned employer securities and real property
Less than 100	135,324	726	$1.0	$.3	32,242
100-249	13,900	428	1.7	.4	71,882
250-499	4,843	292	2.1	.6	106,696
500-999	2,410	281	4.9	1.3	201,141
1,000-4,999	2,236	509	28.6	8.7	1,120,657
5,000-9,999	277	104	24.1	7.4	746,617
10,000 or more	206	109	113.4	34.2	2,989,124
Total	**159,196**	**2,449**	**$175.8**	**$53.0**	**5,268,359**

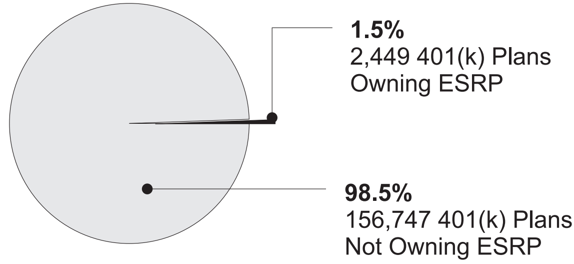
Note: Because of rounding, sums of individual items may not equal totals.

Because of the influence of large plans, the $53 billion of employer securities and real property owned represented about 11 percent of all

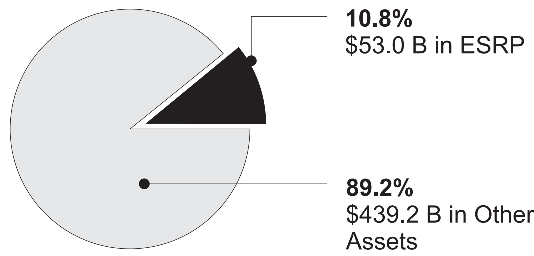
401(k) plan assets, and the 5.3 million participants represented almost 26 percent of the participants in all 401(k) plans. (See fig. 1.)

Figure 1: Investments by 401(k) Plans in Employer Securities and Real Property, 1993

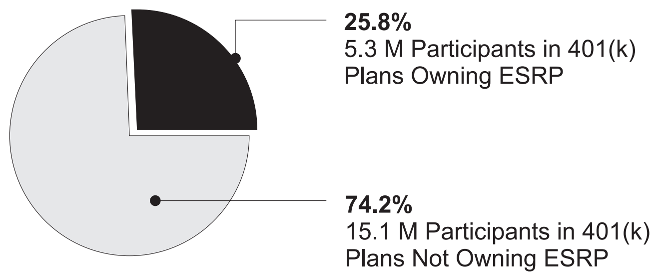
Plans



Assets



Participants



ESRP = Employer Securities and Real Property

Employer real property investments represented only $381 million (less than 1 percent) of the $53 billion in employer securities and real property owned by 401(k) plans. Eleven large 401(k) plans[4] owned employer real property in 1993. Individual plan holdings ranged from a low of about $4,000 to approximately $340 million; however, two plans owned 96 percent of the employer real property. These two plans collectively owned about $365 million of employer real property, with separate holdings of $340 million and $25 million. For these two plans, employer real property represented 56 and 87 percent of their plan assets, respectively. For the other nine plans, employer real property generally represented 15 percent or less of total plan assets.

One possible reason for the relatively low number of 401(k) plans that owned employer securities and real property is that many plans may not allow such investments. Periodically, the Bureau of Labor Statistics (BLS) conducts a survey of private nonfarm establishments with 100 or more workers and develops information on the types of investments that pension plans may make. BLS estimates that 49 percent of employees in thrift savings plans (which BLS officials said are a proxy for 401(k) plans) were in plans in 1993 that permitted ownership of employer securities.[5] Another reason may be that many employers sponsoring 401(k) plans are too small to issue their own company securities.

Most 401(k) Plan Participants Directed Investment of Their Own Contributions

Important to the issue of the need for protections for 401(k) plan investments are the number of 401(k) plans that are employer directed and the number of participants in those plans. In an employer-directed plan, the employer—rather than the plan participant—decides how to invest participant contributions as well as the company's own matching contributions, if any. In a participant-directed plan, the participant determines how to invest his or her contributions and may also determine how to invest the employer's matching contributions. Information on employer-directed plans is important because it indicates the maximum number of individuals with no control over the investment decisions affecting their 401(k) plan assets. These individuals may be vulnerable to their employers' investing significant amounts of their 401(k) plan assets in employer securities or real property.

[4]These are plans with 100 or more participants. Plans with fewer than 100 participants do not report employer security and real property investments separately.

[5]Employee Benefits in Medium and Large Private Establishment, U.S. Department of Labor, BLS, (Washington, D.C.: Nov. 1994).

Form 5500 filings for 1993 indicate that about 35 percent of the 159,196 401(k) plans were employer directed. These plans, which totaled 55,411, accounted for about 27 percent of the participants and 27 percent of the assets of all 401(k) plans. The remaining 103,785 plans were participant directed and accounted for 73 percent of the participants and 73 percent of the assets of all 401(k) plans.[6,7] (See table 3.)

Table 3: Number of Participants and Assets in Employer-Directed and Participant-Directed 401(k) Plans, 1993

Type of 401(k) plan	Number of plans	Participants (millions)	Assets (billions)
Employer-directed	55,411	5.6	$133.8
Participant-directed	103,785	14.8	358.3
Total	**159,196**	**20.4**	**$492.1**

Although each of the employer-directed plans could theoretically have invested in employer securities and real property in 1993, only 756 plans (1.4 percent) actually did so. Because some of these 756 plans were large plans, they covered a disproportionately high percentage (25 percent) of all participants in employer-directed plans. In total, these plans had 1.4 million participants and $12.3 billion invested in employer securities and real property.

About the same proportion of participant-directed plans invested in employer securities and real property. In total, 1,693 of 103,785 participant-directed plans (1.6 percent) owned this type of asset. Again, because some of these plans were large, they represented a much larger percentage (26 percent) of participants in participant-directed plans. These plans had 3.9 million participants and $40.7 billion invested in employer securities and real property. (See table 4.)

[6]The number of participants in participant-directed plans may have been larger than that reported by filers of the Form 5500. A BLS survey of employee benefit plans indicates that in 1993 86 percent of employees were at establishments that have participant-directed plans, a somewhat higher percentage than the 73 percent indicated by filers of the Form 5500.

[7]As part of this review, we also obtained information from IRS on 401(k) plans that became effective in 1994 and 1995. An analysis of these data shows that most 401(k) plans established in those years were participant-directed plans. Of the 45,993 401(k) plans established in 1994 and 1995, 33,951 (or 74 percent) were participant directed.

Table 4: Employer-Directed and Participant-Directed 401(k) Plans Investing in Employer Securities and Real Property, 1993

Type of 401(k) plan	Number of plans that owned employer securities and real property	Participants (millions)	Amount of employer securities and real property owned (billions)	Median amount
Employer-directed	756	1.4	$12.3	$599,612
Participant-directed	1,693	3.9	40.7	873,231
Total	**2,449**	**5.3**	**$53.0**	**Not applicable**

Most Employer-Related Investments Associated With Supplemental 401(k) Plans

Also important to the issue of the need for additional protections for 401(k) investments is whether a plan is the primary retirement plan or a supplemental one offered by the employer to eligible employees.[8] A supplemental plan provides income in addition to that provided by a primary plan but may nonetheless represent a significant portion of an individual's total retirement income.

Form 5500 filings for 1993 indicate that the number of primary and supplemental 401(k) plans that actually owned employer securities and real property was roughly the same. Of the total of 2,449 401(k) plans, 1,302 (or 53 percent) were primary plans and the remaining 1,147 (or 47 percent) were supplemental plans. The 1,147 supplemental plans, however, owned 90 percent of all employer securities and real property and covered 81 percent of the participants in 401(k) plans that owned this type of asset. (See table 5.)

[8]PWBA uses a computer program to analyze and classify pension plans as either primary or supplemental. A 401(k) plan is primary if (1) it is the only plan provided by the sponsor; (2) it is one of two or more identical 401(k) plans provided by the sponsor and 401(k) plans are the only type of plan provided; (3) the sponsor provides a 401(k) plan and other defined contribution plans, but the 401(k) plan covers more participants than any of the others; or (4) the sponsor provides a 401(k) plan and a defined benefit plan, but the name of the defined benefit plan indicates it is a supplemental or past service plan. PWBA classifies a 401(k) plan as a supplemental plan if the employer provides another defined contribution plan covering more participants or the sponsor provides a defined benefit plan whose name does not indicate a supplemental or past service plan.

Table 5: Primary and Supplemental 401(k) Plan Investments in Employer Securities and Real Property, 1993

Type of 401(k) plan	Number of plans	Number of plans that owned employer securities and real property	Participants in plans that owned employer securities and real property (millions)	Amount of employer securities and real property owned (billions)	Median amount owned
Primary	137,152	1,302	1.0	$5.4	$320,861
Supplemental	22,044	1,147	4.3	47.5	2,615,086
Total	**159,196**	**2,449**	**5.3**	**$53.0**	**Not applicable**

Note: Because of rounding, sums of individual items may not equal totals.

Investment in Employer Securities and Real Property Generally 10 Percent or More of Plan Assets

Of the 2,449 plans that invested in employer securities and real property in 1993, 1,679 (69 percent) had 10 percent or more of their assets invested in this type of asset. These 1,679 plans included 1,211 that had between 10 and 50 percent of assets invested in employer securities and real property and 468 that had 50 percent or more invested this way. (See table 6.)

Table 6: 401(k) Plan Investments in Employer Securities and Real Property by Percentage of Plan Assets Invested in Such Assets, 1993

Percentage of plan assets invested in employer securities and real property	Number of plans	Participants (millions)	Total invested in employer securities and real property (billions)
Less than 10	770	1.3	$2.5
10-29	746	1.8	10.7
30-49	465	1.1	16.9
50-69	217	.5	11.5
70-89	156	.4	9.6
90-100	95	.1	1.8
Total	**2,449**	**5.3**	**$53.0**

Note: Because of rounding, sums of individual items may not equal totals.

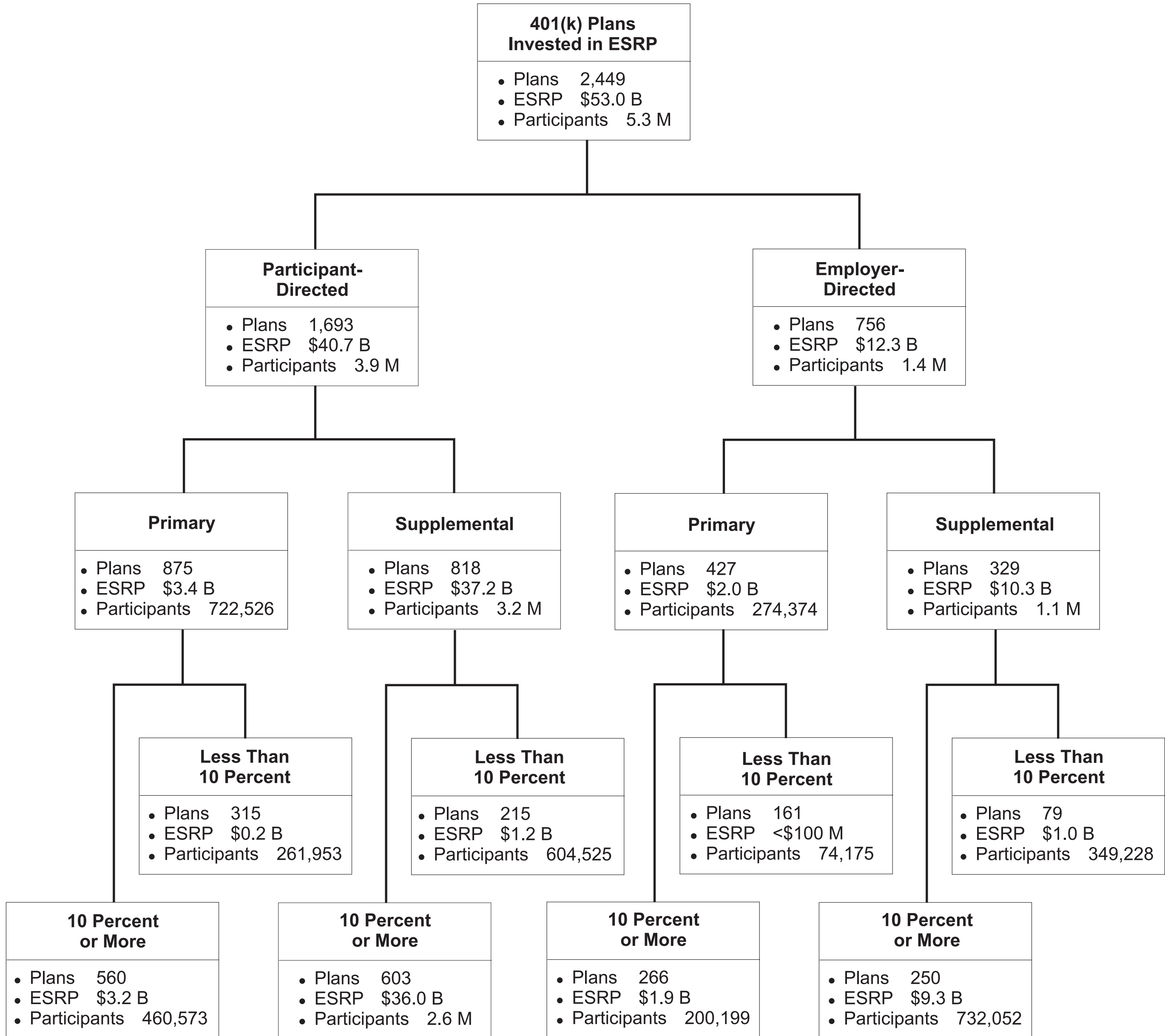
As table 6 illustrates, plans that had smaller percentages of assets invested in employer securities and real property had the most participants. Fifty-nine percent of the participants were in 401(k) plans that had less than 30 percent of their assets invested in employer securities and real property; almost 81 percent were in plans that had less than 50 percent invested this way.

Plan size appeared to relate somewhat to the percentage of plan assets invested in employer securities and real property. Plans with fewer than 100 participants and plans with over 5,000 participants tended to invest a higher percentage of their total assets in employer securities and real property. The percentage of the plans' assets invested in employer-related assets, however, generally did not exceed 30 percent of total plan assets. (See app. III for more information on investment in employer securities and real property by different sized plans.)

Many Participants Have No Control Over Investments in Employer-Directed Plans

Despite the concentration of participants and employer securities and real property in participant-directed supplemental plans, 756 employer-directed plans in 1993 had almost 1.4 million participants and about $12.3 billion invested in employer securities and real property. Participants in these plans reportedly had no choice in how the assets of their 401(k) plans, including their own contributions, were invested. Over 932,000 of these individuals had 10 percent or more of their 401(k) plan assets invested in employer securities or real property. (See fig. 2.)

Figure 2: Characteristics of 401(k) Plan Investments in Employer Securities and Real Property, 1993



ESRP = Employer Securities and Real Property

New Legislation Will Provide Additional Protection, but Administrative Problems Exist

Enacting section 1524 of the Taxpayer Relief Act of 1997 was one of several actions that the Congress could have chosen to help safeguard the assets of participants in 401(k) plans requiring employee contributions to be invested in employer securities and real property. With enactment of this legislation, beginning in 1999, the provisions of the ERISA 10-percent limitation rule (which, before the Congress passed section 1524, applied only to defined benefit plans) will be applied to that portion of employer-directed 401(k) plans consisting of employee contributions and the earnings thereon unless the plans meet one of three exemptions. The new legislation will prevent employer-directed plans that have more than 10 percent of employee contributions invested in employer securities and real property from investing more employee contributions in assets of this type.

The 10-percent limitation rule alone, however, cannot prevent a plan from investing employee contributions in employer securities and real property whose value is declining. In addition, certain information needed to implement and enforce the section 1524 provisions is not readily available. Changes have been proposed to the Form 5500,[9] which, if implemented, may remedy some of the data deficiencies we identified before section 1524 goes into effect in 1999.

ERISA 10-Percent Limitation Rule Cannot Always Protect Participants

As has always been the case with defined benefit plans, the 10-percent limitation rule alone cannot always protect plan participants. All defined benefit plans that rely on the 10-percent limitation rule for protection also have to use other federal ERISA fiduciary rules, such as the diversification, prudent man, and exclusive benefit rules to protect plan participants. (See app. II.)

Participants in employer-directed 401(k) plans with employer securities and real property investments at or near 10 percent of employee contributions and the earnings thereon are theoretically vulnerable to employers' further investment in such assets. For illustrative purposes, assume that a plan in which the employer directs the investment of both the employee and employer contributions has 10 percent of employee contributions invested in employer securities. If the value of those employer securities declines to less than 10 percent of employee contributions, the employer may use employee contributions to buy additional employer securities until the 10-percent limit is once again reached.

[9] Federal Register, Sept. 3, 1997.

This situation occurs when employer securities underperform compared with other assets in which employee contributions are invested. More specifically, additional employee contributions can be invested in employer securities when (1) the value of employer securities declines and other plan investments increase or remain constant, (2) the value of other plan investments appreciates and the value of employer securities appreciates less or does not change, or (3) other investments decline and the value of employer securities and real property declines more.

In each of these cases, if the value of employer securities falls significantly below 10 percent of employee contributions, all new employee contributions could be invested in declining, nonperforming, or underperforming employer securities or real property. When the value of employer securities declines significantly compared with other nonemployer securities and real property plan investments, other securities in which employee contributions are invested could be sold to generate funds to buy employer securities. In such instances, however, these actions may be subject to review under the exclusive benefit or prudent man fiduciary rules.

Employer-Directed Plans Cannot Be Identified With Certainty

Section 1524 provisions apply to plans in which the employer requires employee contributions to be invested in employer securities or real property. The information currently provided on the Form 5500, however, is not reliable enough to identify such plans with certainty.

The current Form 5500 has a section in which the filer enters a code to indicate that the plan is participant directed. If a filer does not enter the code, the plan is considered to be an employer-directed plan. According to the Form 5500 instructions, a participant-directed plan is "a pension plan that provides for individual accounts and permits a participant or beneficiary to exercise independent control over the assets in his or her account (see ERISA section 404(c)."[10] PWBA officials told us that they believe some filers were not completing this section because the filers were misinterpreting the Form 5500 instructions. That is, filers of plans other than 404(c) plans were not sure if they should complete this section. Therefore, some participant-directed plans were incorrectly classified as employer directed (the default if the section is not completed). Even when

[10]Section 404(c) of title I of ERISA and 29 CFR subsection 2550.404c-1 prescribe certain requirements for an individual account plan in which the plan participant or beneficiary exercises investment control over the account's assets. The regulation mandates disclosure of such items as a description of investment alternatives, designated investment managers, a description of transaction fees, and other information.

the filer completes the section, the form provides no way of indicating whether the participants direct the investment of employee contributions, employer contributions, or both.

Revisions proposed to Form 5500 by officials of the Departments of Labor and the Treasury and of PBGC have three "feature codes" to better identify participant- and employer-directed 401(k) plans. These three codes will allow PWBA to more accurately determine which plans are employer directed or participant directed and what portion of the account the participants control.

Exemptions Cannot Be Verified

An employer-directed 401(k) plan is exempt from the section 1524 amendments if the fair market value of all the assets of the individual account plans the employer maintains is not more than 10 percent of the fair market value of the assets of all the employer's pension plans. Under ERISA, the term "employer" means the employer sponsoring the plan and all the members of any controlled group of corporations to which the employer belongs. ERISA defines a controlled group as a group of corporations under common control (for example, a parent corporation and subsidiaries) in which the parent owns at least 50 percent of the voting stock.

A plan filing a Form 5500 is not required to indicate its membership in a controlled group or identify the members of any controlled group to which it belongs. Likewise, information on controlled group composition is not currently available from the Department of Labor or the Internal Revenue Service (IRS). Therefore, it is not possible to assign individual plans to their respective controlled groups and determine if the individual account plans of the controlled group represent more than 10 percent of the assets of all the pension plans of that controlled group. Moreover, none of the proposed changes to the Form 5500 will identify members of a controlled group of corporations.

Extent of Employer Securities and Real Property Investments Cannot Be Readily Identified

Although the section 1524 provisions apply to 401(k) plans that require that employee contributions be invested in employer securities and real property, it may be difficult to determine the amount of employer securities and real property owned by these plans. This is because a 401(k) plan that pools its assets with those of other plans for investment purposes reports only one asset amount on the Form 5500. This amount represents its interest in the pooled arrangement but provides no information about

separate investments, such as employer securities and real property. Although PWBA contracts with a private firm to spread these single amounts into separate investments, including employer securities and real property, some cannot be spread. Some of the plans whose assets are not spread may be 401(k) plans and may own employer securities or real property.

The new Form 5500 will provide more information on the type and amount of assets a plan owns through a pooled investment arrangement. Under the proposal, a plan will continue to file its own Form 5500. In addition, reports for each pooled arrangement to which it belongs will be made in separate Form 5500 reports to PWBA. The Form 5500 for each pooled arrangement will show investments in stocks, bonds, employer securities, and the like. Attachments to the Form 5500 will provide the name, employer identification number, plan number, and monetary interest of each plan or other entity belonging to the pooled arrangement.

Other Mechanisms Available to Safeguard Participants in Employer-Directed 401(k) Plans

We identified other mechanisms that would be available to policymakers if additional safeguards are needed in the future. Two mechanisms—enhanced reporting and disclosure and prescribed education programs—identified during our review could be administratively implemented under existing authority provided in title I of ERISA. Two other mechanisms—adoption of the diversification requirement used for ESOPs and use of independent fiduciaries to examine investment decisions—would require the Congress to add or amend statutory requirements.

Enhanced Reporting and Disclosure

One such mechanism would use authority already granted to the Secretary of Labor to require that 401(k) plans provide information on the plan's investment in employer securities and real property to plan participants. Although this mechanism could be applied only to employer-directed 401(k) plans requiring that employee contributions be invested in employer securities and real property, the same mechanism could also benefit participants in all 401(k) plans.

ERISA requires that the plan administrator provide each plan participant with a summary of the pension plan information reported to the Department of Labor on the Form 5500. The summary annual report (SAR) must contain the information and be in the format prescribed by the Secretary of Labor. Currently, the Secretary does not require that the SAR contain information about employer securities and employer real property

that the plan owns. The Secretary could require a revised and expanded SAR that would disclose the amount of employer securities owned by the plan, its current or fair market value, the percentage of the plan assets it represents, and whether the employer securities are publicly traded on a national exchange or privately held. Finally, plan participants could be provided some statement about the employer's financial condition and other information to be more fully informed about their holdings and any potential risk associated with them.

If needed, plans with a specified threshold of employer securities and real property could provide additional reports to PWBA officials. In this regard, additional reporting might focus on the specific nature, scope, and percentage of investment in those securities or real property; whether the securities are publicly traded or privately held; and whether they are valued at share or par value. Plans exceeding the threshold could also be required to report to PWBA if the shares of employer securities or the value of employer real property held by the 401(k) plan would decline precipitously within some specified time period. Reporting of this information to PWBA could enable the agency to more strictly scrutinize the plans and seek earlier enforcement efforts when appropriate to preserve a plan's assets and secure the retirement income of plan participants. The enhanced reporting to PWBA would be similar to that currently provided to the PBGC under certain situations.[11]

Education Programs

Another mechanism would be to require an educational program for plan participants in 401(k) plans that hold any or a prescribed threshold of qualifying employer securities and real property. The educational requirements for 401(k) plans with employer securities and real property might require that participants in the affected plans be told about or given materials informing them about (1) investment concepts, such as risk and return, diversification, dollar cost averaging, and compounded return; (2) historic differences in rates of return among different asset classes (for example, stocks, bonds, employer securities, or cash); (3) estimating future retirement income needs; (4) determining investment time horizons, including models involving hypothetical individuals with different time horizons and risk profiles; and (5) assessing risk tolerance. Participants

[11]Under section 4043 of title IV of ERISA, within 30 days after a plan administrator or contributing sponsor for a defined benefit plan knows or has reason to know that a reportable event has occurred, he or she must notify the PBGC that such an event has taken place. The reportable event in this instance could conceivably be the plan's acquisition of a percent of employer securities or real property above a certain threshold or a precipitous decline in the value of the employer's stock or real property.

could also be provided questionnaires, worksheets, software, and similar materials to give them a way to estimate future retirement income needs and assess the impact of different asset allocations on retirement income.

Even with the benefits of increased participant knowledge, enrolling plan participants in educational programs would have little or no impact on the level of employer securities and real property investments if such investments are typically controlled by the employer. Nevertheless, such a program might broaden plan participants' perspective and enable them to make better judgments about their retirement income security.

Use of ESOP Diversification Requirements

A third approach would extend the ESOP diversification requirements to employer-directed 401(k) plans requiring employer securities and real property investments. The Internal Revenue Code requires ESOPs to provide the means for "qualified participants" nearing retirement to diversify part of their ESOP account balance for stocks acquired after 1986. In general, beginning with the plan year following the participant's reaching both age 55 and completing 10 years of plan participation, the plan must allow the participant to diversify at least 25 percent of the total account. Five years later, the participant must be allowed to diversify at least 50 percent of the account. Alternatively, the ESOP may distribute to the participant the amount that could be diversified.

In all likelihood, this provision's effectiveness in protecting participants whose employer's stock or real property is declining in value would be minimal because the provision would not protect plan participants who had not reached age 55 and completed 10 years of plan participation. This latter impediment could be overcome by requiring periodic "open seasons" in which plan participants could diversify investments.

Examination of Investment Decisions by Independent Fiduciaries

A final option would be to require an independent fiduciary to examine and make decisions about whether and to what extent amounts of employer securities and real property could be contributed by the plan sponsor. Such a mechanism has been used frequently by PWBA to better protect plans in possible conflict-of-interest situations. An independent fiduciary could more discreetly and expertly examine whether or not the plan would be inordinately subjected to financial loss by certain levels of investment in employer securities and real property.

The independent fiduciary would have broad authority to limit, remove, or conceivably add employer securities and real property to the mix of investments for that plan to better protect plan participants' retirement income. In essence, the independent fiduciary would be an unaligned third party who could review the plan's holdings and transactions to better ensure the proper diversification of plan assets and the value of holdings to improve the financial security of plan participants in such arrangements. The independent fiduciary would act as an honest broker seeking to minimize plan losses, maximize its profits, and eliminate instances of self-dealing which might otherwise threaten the plan's financial security.

Although using this approach would minimize the possibility of self-dealing by the employer or the employer's representative, it might add administrative cost otherwise not incurred by employer-directed plans.

Agency Comments and Our Evaluation

In commenting on a draft of this report, the Assistant Secretary for Pension and Welfare Benefits expressed overall agreement with our report findings. Our findings on the scope of employer securities and real property investments by 401(k) plans were considered to be "generally consistent with PWBA's own, albeit less comprehensive, analysis of the Form 5500 Series data in this area."

The Assistant Secretary also indicated that the mechanisms we identified for consideration by policymakers if future alternatives to the enactment of the section 1524 provisions are needed to protect participants in employer-directed 401(k) plans merit further consideration. In this regard, the mechanisms discussed in our report will be studied when the Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans, which is also conducting a review of 401(k) plan investments in employer securities and real property, completes its study and makes recommendations to the Secretary of Labor. Our report findings and the Advisory Council's recommendations will be used to determine what further action may be appropriate regarding employer securities and real property investments by 401(k) plans.

The Assistant Secretary also had technical comments about our report. These focused on our discussion of (1) the PWBA contractor's ability to fully identify the extent of employer securities and real property owned by 401(k) plans in 1993 and (2) the improvements proposed in the ongoing revision of the Form 5500 to provide more information on the type and

amount of assets owned by plans through pooled investment arrangements. We made changes to the final report, where appropriate, after further discussions with PWBA officials about these issues. (See app. IV.)

Observations

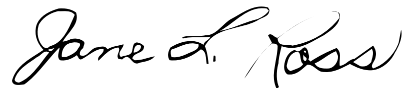
Although it is always possible for some employers sponsoring 401(k) plans to go bankrupt in the future, the potential for a large number of workers to lose benefits because their 401(k) plan is invested in a bankrupt employer's securities or real property is not widespread. For the latest year for which data are available, fewer than 2,500 of the nearly 160,000 401(k) plans that filed Form 5500s reported that they owned employer securities and real property. In addition, most participants in 401(k) plans that owned employer securities and real property had participant-directed 401(k) plans that PWBA identified as supplemental to other pension plans the employer offered.

Nonetheless, 756 401(k) plans had 1.4 million participants in 1993 in which the employer directed the investment of all plan assets. Participants in employer-directed 401(k) plans will always be somewhat vulnerable to investment decisions over which they have no control. However, beginning in 1999, the recently enacted section 1524 provisions in title I will prevent employer-directed plans that have more than 10 percent of employee contributions invested in employer securities and real property from investing more employee contributions in assets of this type.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Secretary of the Treasury, the Commissioner of the Internal Revenue Service, the Director of the Office of Management and Budget, and other interested parties.

Please contact me on (202) 512-7215 or Fred E. Yohey, Jr., Assistant Director, on (202) 512-7218 if you have any questions about this report. Major contributors to this report are listed in appendix V.

Sincerely yours,



Jane L. Ross
Director, Income Security Issues

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Abbreviations

BLS	Bureau of Labor Statistics
ERISA	Employee Retirement Income Security Act of 1974
ESOP	employee stock ownership plan
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation
PWBA	Pension and Welfare Benefits Administration
SAR	summary annual report

Scope and Methodology

The Chairman of the House Ways and Means Committee asked us for information on the Employee Retirement Income Security Act of 1974 (ERISA) rules governing investments by 401(k) plans. After subsequent discussions with the chairman's office, we agreed to address the following questions: (1) To what extent are 401(k) pension plan assets invested in employer securities and real property? (2) What potential problems may be associated with implementing and enforcing the title I amendments? and (3) What mechanisms could safeguard the retirement benefits of participants in employer-directed 401(k) plans that invest in employer securities and real property?

To determine the extent to which the assets of single-employer defined benefit and defined contribution plans were invested in employer securities and real property, we analyzed the Internal Revenue Service (IRS) Form 5500 computerized database maintained by the Department of Labor's Pension and Welfare Benefits Administration (PWBA). Under ERISA, all private employers are required to annually report certain financial, participant, and actuarial data for each of their defined benefit and defined contribution plans. Our data analysis was limited to the most recent plan year (plan year 1993) for which final plan-specific data were available.

The data we developed differ from that produced by PWBA and published in its Abstract of 1993 Form 5500 Annual Reports. Although PWBA's data are based on analyses of all large plans with 100 participants or more combined with a representative sample of 5 percent of small plan (fewer than 100 participants) filers, our report data are based on the analyses of data submitted by each large and small pension plan contained in the databases that PWBA provided for our review. In addition, we worked extensively with IRS to identify all known 401(k) plans in the Form 5500 database.

We did not independently verify the accuracy of the research databases because IRS and PWBA check the data for accuracy and consistency. Importantly, the data we analyzed were accurate only to the extent that employers exercised appropriate care in completing their annual Form 5500 reports.

To examine the protections provided by and any potential problems associated with the recent amendments to ERISA, we discussed the amendments with officials of the Departments of Labor and Treasury. We also developed a model to show the amount of employee contributions that could be invested in employer securities and real property assuming a

10-percent limitation on such investments and various changes in the value of employer securities and other investments. Finally, we determined whether available Form 5500 data were adequate to implement and enforce the new amendments.

To determine what rules and other mechanisms could be considered to better protect plan participants in employer-directed 401(k) plans, we identified alternative strategies already authorized by federal law. In addition, we identified or learned about mechanisms suggested by experts that could be considered to protect pension plan assets—and ultimately future retirement benefits—of plan participants and their families. The organizations with whom we discussed these strategies are the American Association of Retired Persons; 401(k) Association; Profit Sharing/401(k) Council; ERISA Industry Committee; Association of Private Pension and Welfare Plans; American Institute of Certified Public Accountants; Investment Company Institute; Employee Benefit Research Institute; and Financial Executives Institute as well as officials from the Department of the Treasury, IRS, and PWBA. We also spoke with a former Minority Counsel for the Senate Committee on Labor and Public Welfare (1970 to 1975), who is a nationally recognized expert on private pension plan issues.

We performed our review in Washington, D.C., from November 1996 through September 1997 in accordance with generally accepted government auditing standards.

Federal Fiduciary Rules on Investing Pension Plan Assets

The Employee Retirement Income Security Act of 1974 (ERISA) imposes fiduciary rules on the conduct of those charged with managing or administering a pension plan, including investing plan assets. All pension plans are subject to these rules; however, significant exemptions exist for defined contribution plans, including 401(k) plans.

ERISA Fiduciary Investment Rules Apply to Defined Benefit and Defined Contribution Plans

According to title I of ERISA, pension plan fiduciaries—people exercising discretionary authority or control for managing pension plans or disposing of their assets—have a duty to act solely in the interest of plan participants and beneficiaries regarding the pension plans they manage or administer. Under this broad general requirement, ERISA requires a fiduciary to observe the following rules:

- The "exclusive purpose" rule. The fiduciary must have an individual loyalty to participants and beneficiaries to provide benefits and defray reasonable expenses in administering the plan.
- The "prudent man" rule. The fiduciary must act with the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person, acting in a like capacity and familiar with such matters, would use in the same sort of situation.
- The "diversification" rule. The fiduciary must diversify the plan's investments by type, geographic area, dates of maturity, and industrial classification to minimize the risk of large losses. The diversification rule attempts to minimize the risk of large losses that might occur from an overconcentration of plan assets in any of these four areas.
- The fiduciary must observe the requirements of, and act in accordance with, the documents and instructions governing the plan.

In addition to the fiduciary rules, ERISA also specifies a number of prohibited transactions. A fiduciary is barred from engaging in such transactions if he or she knows or should know that ERISA prohibits them. The types of transactions prohibited by ERISA are those involving an inherent conflict of interest between the plan and people associated with the plan ("parties-in-interest").

For example, ERISA prohibits fiduciaries from allowing a plan to engage in a transaction for selling or leasing any property; lending money or extending credit; furnishing goods, services, or facilities between the plan and a party-in-interest; or transferring any plan assets to a party-in-interest. ERISA also prohibits fiduciaries from dealing with a plan's assets for their

own personal interest and involving the plan in transactions with parties whose interests are adverse to the plan's participants or beneficiaries.

Finally, ERISA has a rule that places a 10-percent limitation (10-percent limitation rule) on acquiring and holding qualified employer securities and qualified employer real property. The 10-percent limitation rule states that a plan may not acquire any qualified employer securities or real property if immediately after the acquisition the aggregate fair market value of such assets exceeds 10 percent of the fair market value of the plan's total assets. Employer securities and real property that appreciate in value after acquisition to 10 percent or more of total plan assets do not have to be sold.

Eligible Defined Contribution Plans Are Exempt

Although the fiduciary rules discussed above apply to both defined benefit and defined contribution plans, specific exemptions do exist for eligible defined contribution plans. Such plans may include profit-sharing plans, thrift savings plans, money purchase plans, and employee stock ownership plans as well as 401(k) plans with some restrictions after the passage of the Taxpayer Relief Act of 1997. The Congress' decision to exempt these defined contribution plans may reflect recognition that certain defined contribution plans have always invested in employer securities or real property.

Concerning acquiring and holding employer securities and real property, defined contribution plans are specifically exempt from the general diversification requirement and from the prudence requirement to the extent that the prudence requirement would require diversification. Accordingly, fiduciary rules do not require defined contribution plans to diversify plan assets. Nor are defined contribution plans required to follow ERISA's 10-percent limitation rule on investments in employer securities and real property as long as the transactions are for adequate consideration and no commissions are charged. So, qualifying defined contribution plans may currently acquire or hold as much employer securities and real property as they want.

Additional Data on Pension Plans' Investments in Employer Securities and Real Property

This appendix contains additional information on pension plans' investments in employer securities and real property. Table III.1 shows plan year 1993 data on investments in employer securities and real property among defined benefit, employee stock ownership plans (ESOP), other defined contribution plans, and 401(k) plans. Table III.2 shows the percentage of 401(k) plan assets invested in employer securities and real property by plan size.

Overall Investment in Employer Securities and Real Property

Only 10,191 of the 634,280 single-employer defined benefit and defined contribution pension plans that filed a Form 5500 for plan year 1993 owned employer securities or real property. Total value of these employer-related investments, including both securities and real property, was approximately $162 billion. ESOPs, which are required by law to purchase and hold employer stock, were the main owners of this type of asset. In fact, ESOPs owned about $91 billion of employer stock, which amounted to more than all other types of plans combined. The second largest owners were 401(k) plans, with 2,449 plans owning about $53 billion. Defined benefit plans and defined contribution plans (other than ESOPs and 401(k) plans) owned considerably less. (See table III.1.)

Employer-related investments consisted almost exclusively of employer securities. Of the $162 billion of employer securities and real property owned, only $598 million was identified as employer real property. Overall, we identified only 86 large plans that owned employer real property, including 9 ESOPs, 11 401(k) plans, 44 defined benefit plans, and 22 other types of defined contribution plans.

The 10,191 plans that invested in employer securities and real property covered about 16.6 million workers. This included approximately 5.4 million in ESOPs, 5.3 million in 401(k) plans, 4.9 million in defined benefit plans, and about 1 million in other defined contribution plans.[12]

[12]Some double counting may have occurred. A worker may be covered by more than one plan (for example, a defined benefit plan and a 401(k) plan).

Table III.1: Summary Schedule of Pension Plan Investments in Employer Securities and Real Property by Plan Type, 1993

Plan type	Number of plans that owned employer securities or real property	Employer securities owned (billions)	Employer real property owned (billions)	Combined[a] (billions)	Total employer securities and real property owned (billions)
Defined benefit	826	$7.3	$.1	$.1	$7.5
Defined contribution					
ESOP[b]	5,576	87.8	<.1	3.6	91.4
401(k)	2,449	52.3	.4	.3	53.0
Other	1,340	9.7	<.1	.3	10.1
Total	**10,191**	**$157.1**	**$.6**	**$4.4**	**$162.0**

Note: Because of rounding, sums of individual items may not equal totals.

[a]This is a combined total of employer securities and real property owned by small plans. Plans with fewer than 100 participants do not report amounts of employer securities and real property separately.

[b]Includes 613 ESOPs with a 401(k) feature. In total, these 613 ESOPs had approximately 2.1 million participants and $54 billion of their $100 billion of plan assets invested in employer securities and real property in 1993.

Percentage of 401(k) Plan Assets Invested in Employer Securities and Real Property by Plan Size

The size of 401(k) plans appeared to relate somewhat to the percentage of plan assets invested in employer securities and real property. In this regard, plans with less than 100 participants and plans with over 5,000 participants tended in 1993 to invest a higher percentage of their total plan assets in employer securities and real property.

The entries in each cell in table III.2 represent the percentage of plans of the size shown in column one that have the percentage of plan assets shown at the top of the column invested in employer securities and real property. For example, the first cell shows that 28 percent of the plans with less than 100 participants have up to 9 percent of plan assets invested in employer securities or real property.

Table III.2: Percentage of Plan Assets Invested in Employer Securities and Real Property by Plan Size, 1993

	Percentage range										
Plan size (participants)	>0-9	10-19	20-29	30-39	40-49	50-59	60-69	70-79	80-89	90-100	Number of plans
Less than 100	28	15	12	12	8	6	3	5	4	8	726
100-249	37	17	14	10	8	3	4	3	1	2	428
250-499	36	19	13	8	10	5	4	3	1	2	292
500-999	36	16	15	9	8	4	4	4	1	3	281
1,000-4,999	32	18	13	9	9	6	4	4	2	2	509
5,000-9,999	23	20	15	11	10	7	5	6	1	3	104
10,000 or more	17	20	20	13	9	6	6	4	5	1	109

Note: Because of rounding, sums of individual items may not equal totals.

Comments From the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

Jane L. Ross
Issue Area Director, Income Security Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Ross:

Thank you for the opportunity to review and comment on your draft report to the Honorable Bill Archer, Chairman of the Committee on Ways and Means, House of Representatives, entitled "401(k) Pension Plans - Extent of Plans' Investments in Employer Securities and Real Property." According to the draft, the report was prompted by concerns about 401(k) plan investments of participant contributions by employers in employer securities and employer real property. As recognized by the draft report, legislation amending ERISA has, since the initiation of your review, been enacted to address similar concerns.[1]

The first part of the draft report assesses the scope of 401(k) plan investments in employer securities and real property. The report concludes, based on an analysis of data from the 1993 Form 5500 Series, that less than 2 percent of all 401(k) plans had investments in employer securities and real property in 1993 and, of that 2 percent, only 756 plans (covering 1.4 million employees) hold employer securities and real property investments (valued at $12.3 billion) directed solely by the employer. The draft further indicates that 401(k) plan investments in employer securities and employer real property are concentrated in supplemental not primary retirement plans. These findings are generally consistent with PWBA's own, albeit less comprehensive, analysis of the Form 5500 Series data in this area.

With regard to the discussion appearing on page 24 of the draft report, we note the following. First, that part of the discussion, in the first full paragraph, indicating that "[s]ome of the 21,733 plans whose $143 billion of assets could not be spread may be 401(k) plans and may own employer securities or real property" leads one to conclude that an effort was made to spread to those assets. In fact, PWBA's contractor selected a sample of 5,485 plans from which it was able to spread 83% of the pooled fund assets. The contractor did not attempt to spread the assets of the 21,733 non-sample plans.

---

[1] ERISA section 407(b), as amended by The Taxpayer Relief Act of 1997, generally establishes a 10% limit on the investment of participant 401(k) plan contributions in employer securities and employer real property when such investments are not made at the direction of the participant. The application of the 10% limit is subject to various statutory exceptions.

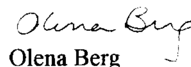
-2-

Second, that part of the discussion, in the second full paragraph, relating to the Department's proposed revisions to the Form 5500 Series is not entirely accurate in its description of the filings proposed for "direct filing entities" (e.g., common and collective trusts, pooled separate accounts, and master trusts). In general, the reports of "direct filing entities" will not accompany a plan's annual report, but will be made as a separate report to the Department. A detailed discussion of the proposed "direct filing entity" requirement is set forth in the preamble discussion accompanying the proposed Forms, at 62 *Federal Register* 46557, a copy of which is enclosed.

The second part of the draft report identifies certain mechanisms that the drafters indicate "would be available to policymakers if alternate safeguards are needed in the future." These mechanisms for employer-directed 401(k) plans investing in employer securities or real property include: expanding disclosure of employer security/employer real property related information through the summary annual report and/or participant education programs; expanding reporting of employer security/employer real property related information to the Federal government - although it is not clear that such reporting could be instituted in the absence of legislation; amending ERISA to establish ESOP-like diversification requirements for participants attaining age 55; and amending ERISA to require that an independent fiduciary examine and make decisions regarding employer securities and real property held by the plan. While we are not prepared to endorse a particular course of action at this time, we do believe the identified mechanisms merit further consideration. In this regard, the Department's Advisory Council on Employee Welfare and Pension Benefit Plans also is conducting a review of 401(k) plan investments in employer securities and real property and, upon completion of that review, will be preparing recommendations for consideration by the Secretary. Upon completion of the Council's consideration of this matter, we will be undertaking a careful review of both the Council's recommendations and the mechanisms identified in the draft report in an effort to determine what further action may be appropriate with respect to employer securities and real property investments by 401(k) plans. The information contained in your report will facilitate the Department's consideration of these issues.

Again, thank you for the opportunity to comment on your draft report.

Sincerely,



Olena Berg

Enclosure

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