

**PRESENT LAW AND BACKGROUND RELATING TO
EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS
AND OTHER RETIREMENT ARRANGEMENTS**

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 26, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



February 25, 2002
JCX-9-02

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing for February 26, 2002, on issues related to retirement security and defined contribution plans. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present law relating to employer-sponsored retirement plans (including defined contribution plans) and individual retirement arrangements, a discussion of issues relating to legislative proposals regarding investment of defined contribution plan assets, and background data on qualified retirement plans.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* (JCX-9-02), February 25, 2002.

I. DESCRIPTION OF PRESENT-LAW PROVISIONS RELATING TO RETIREMENT PLANS

A. Employer-Sponsored Qualified Retirement Plans²

1. Overview of employer-sponsored qualified retirement plans

(a) In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (“a qualified retirement plan”) is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions (e.g., employee elective deferrals to a cash or deferred arrangement, i.e., a 401(k) plan) are generally treated the same as employer contributions for tax purposes.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.³ One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In particular, a qualified retirement plan must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries (the “exclusive benefit rule”).

In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees. Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees;⁴ (2) the plan benefits a percentage of nonhighly

² The rules applicable to employer-sponsored qualified retirement plans and investments of assets in defined contribution plans are discussed in question and answer format in Joint Committee on Taxation, *Background Information Relating to the Investment of Retirement Plan Assets in Employer Stock* (JCX-1-02), February 11, 2002.

³ In some cases, special provisions apply to qualified retirement plans maintained by State and local governments. This document discusses the rules applicable to qualified retirement plans generally, without regard to such special provisions.

⁴ Under present law, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of \$90,000 (for 2002) or (b) at the election of the employer had compensation for the preceding year in excess of \$90,000 (for

compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees. Present law also contains a general nondiscrimination requirement which provides that a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits. Special rules apply to plans that primarily benefit key employees (called “top-heavy plans”).

The plan qualification standards also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified retirement plans. A limit of \$200,000 (for 2002) applies to the amount of a participant’s compensation that may be taken into account for qualified retirement plan purposes. Limits apply also to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.⁵

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from qualified retirement plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans is restricted.

Qualified retirement plans are also subject to regulation under the Employee Retirement Income Security Act of 1974 (“ERISA”). The ERISA rules generally relate to the rights of plan participants, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Internal Revenue Code and ERISA applicable to qualified retirement plans are identical or very similar. For example, both the Internal Revenue Code and ERISA impose minimum participation and vesting requirements.

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. The qualification requirements under the Internal Revenue Code are enforced by the IRS. If a plan fails to meet the qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.

2002) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee.

⁵ The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”) increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of the 2001 Act generally do not apply for years beginning after December 31, 2010.

Certain of the Internal Revenue Code rules relating to qualified plans are enforced through an excise tax rather than through disqualification. For example, a failure to satisfy the minimum funding requirements for defined benefit plans, discussed below, does not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Internal Revenue Code.

ERISA's requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

(b) Types of qualified retirement plans

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contributions plans, based on the nature of the benefits provided.

Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

Employer contributions to a defined benefit plan are subject to minimum funding requirements under the Internal Revenue Code and ERISA to ensure that plan assets are sufficient to pay the benefits under the plan. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Special minimum funding rules apply to certain underfunded plans and require higher contributions than the generally applicable funding rules. An employer is subject to an excise tax for a failure to make required contributions, unless the employer obtains a funding waiver. Benefits under a defined benefit plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (commonly called "401(k) plans" after the section of the Internal Revenue Code regulating such plans) are examples of defined contribution plans.

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance.

(c) Taxation of qualified retirement plan contributions and distributions

Employer contributions and employee pre-tax contributions to a qualified retirement plan are not includible in an employee's income. The tax treatment of such contributions is

essentially the same as that of deductible IRA contributions, discussed below. However, the limits on contributions to qualified retirement plans are much higher than the IRA contribution limits, so that qualified retirement plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified retirement plans than IRAs is that the tax benefits for qualified retirement plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and may reduce pressure on the social security system. For example, if pension benefits are inadequate, then more people will have to rely more on social security alone (with any personal savings) for retirement income. If this happens, it may raise more questions about the continued adequacy of social security benefits.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to another employer-sponsored retirement plan or IRA, and distributions of employer securities.

Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax. That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income.

(d) Prohibited transactions

Both the Internal Revenue Code and ERISA contain prohibited transaction rules that prohibit the employer, plan fiduciaries, and other persons with a close relationship to a qualified retirement plan from engaging in transactions with the plan. These rules are not targeted toward particular types of investments, but rather seek to prevent self-dealing transactions.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Certain transactions are exempt from prohibited transaction treatment. In addition, the Department of Labor may grant administrative exemptions in particular circumstances.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

(e) Qualified retirement plan annual reports and participant statements

A qualified retirement plan is subject to annual reporting requirements under both the Internal Revenue Code and ERISA. The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan. This report is made as a single submission to the Department of Labor, which forwards copies of the report to the Internal Revenue Service and the Pension Benefit Guaranty Corporation. The plan administrator must automatically provide participants with a summary of the annual report. In addition, on written request, a participant must be provided with a copy of the full annual report.

A plan administrator must also furnish a benefit statement to any participant who makes a written request for such a statement. This statement must indicate, on the basis of the latest available information, (1) the participant's total accrued benefit, and (2) the participant's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than one benefit statement during any 12-month period. The plan administrator must furnish the benefit statement no later than 60 days after receipt of the request or, if later, 120 days after the close of the immediately preceding plan year.

2. Defined contribution plans

(a) General types of defined contribution plans

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. A plan must designate the type of plan it is intended to be.

Profit-sharing plans were originally intended as a means of enabling employees to share in the profits of the employer's business. However, under present law, contributions to a profit-sharing plan are permitted regardless of whether the business has profits. A profit-sharing plan may provide for regular employer contributions each year or may provide that contributions are made each year at the discretion of the employer (called a "discretionary" profit-sharing plan). A profit-sharing plan must provide a definite formula under which contributions are allocated to participants and must specify the events upon which distributions will be made to participants, such as severance of employment. A profit-sharing plan may provide for in-service distributions, i.e., distributions may be made to participants before severance of employment.

A stock bonus plan is similar to a profit-sharing plan except that benefits are distributable in stock of the employer. The plan may provide for cash distributions, but must also allow participants to take distributions in the form of employer stock. In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

A money purchase pension plan must provide for a set level of required employer contributions, generally as a specified percentage of participants' compensation. Similar to a defined benefit plan, a money purchase pension plan is subject to the minimum funding requirements, discussed above. As a result, the employer is generally subject to an excise tax if

it fails to make the contributions required under the plan. A money purchase pension plan may not provide for in-service distributions except in the case of plan termination.

A target benefit plan is a money purchase pension plan that has some characteristics similar to a defined benefit plan and is thus sometimes referred to as a hybrid plan. A target benefit plan provides an individual account for each participant and also provides for a stated retirement benefit (the “target benefit”) to be funded by a participant’s account. Similar to a defined benefit plan, the contributions that the employer is required to make to the individual’s account are based on the amount needed, on an actuarial basis, to fund the target benefit. However, the employer is not obligated to ensure that the participant’s account is sufficient to provide the target benefit. To the extent that the earnings on the account are more or less than the earnings assumed in determining the employer’s contributions, the amount payable to the participant increases or decreases.

Within the three general types of defined contribution plans are plan designs that contain special features, such as a qualified cash or deferred arrangement (or 401(k) plan) or an employee stock ownership plan (an “ESOP”), discussed below.

(b) Selected types of defined contribution plans

Qualified cash or deferred arrangements (“401(k) plans”)

A 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a “qualified cash or deferred arrangement.”⁶ Thus, such arrangements are subject to the rules generally applicable to qualified retirement plans. In addition, special rules apply to such arrangements.⁷

Under a 401(k) plan, an employee may elect to have the employer make payments as contributions to a qualified retirement plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is \$11,000 for 2002.⁸ Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a 401(k) plan. As a result, the limit on elective

⁶ Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement.

⁷ State and local governments may not maintain 401(k) plans, but can maintain similar arrangements. As described below, educational institutions may maintain tax-sheltered annuities, which operate in a manner similar to 401(k) plans, i.e., they allow employees to make elective contributions. Similarly, many State and local governments maintain section 457 plans (described below) which in practice operate like 401(k) plans. These plans are not subject to the nondiscrimination rules applicable to 401(k) plans.

⁸ The dollar limit on elective deferrals increases to \$12,000 for 2003, \$13,000 for 2004, \$14,000 for 2005, and \$15,000 for 2006. After 2006, the limit is adjusted for inflation in \$500 increments.

deferrals is increased for an individual who has attained age 50 by \$1,000 for 2002.⁹ An employee's elective deferrals must be fully vested.

A special nondiscrimination test applies to elective deferrals under a 401(k) plan, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the “ADP” test). Employer matching contributions and after-tax employee contributions under a defined contribution plan are also subject to a special nondiscrimination test. (This test is called the actual contribution percentage test or the “ACP” test.)

Employers are not required to offer a match. Many employers provide a match because doing so makes it easier for the plan to satisfy applicable nondiscrimination rules by encouraging employees to make elective deferrals. For example, a plan could provide that the employer will make matching contributions equal to 50 percent of the employees’ elective contributions, up to a maximum of 3 percent of compensation.

In addition to or in lieu of matching contributions, some employers make “qualified nonelective contributions” for employees participating in a 401(k) plan, which may be taken into account applying the ADP test. Like matching contributions, such contributions may make it easier for plans to satisfy the applicable nondiscrimination rules. “Qualified nonelective contributions” are contributions that are made by the employer without regard to whether the employee makes elective contributions, that are 100 percent vested, and that meet certain other requirements.

Matching contributions and qualified nonelective contributions can be made to the same plan that contains the 401(k) cash or deferred arrangement or to another plan of the employer.

Under a safe harbor, a 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules. A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee’s elective deferrals up to three percent of compensation and (b) 50 percent of the employee’s elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for 401(k) plans are deemed to satisfy the ACP test. Certain alternative matching arrangements also can be used to satisfy the safe harbor.

⁹ The additional amount permitted for catch-up contributions increases to \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006. After 2006, the limit is adjusted for inflation in \$500 increments.

Employee stock ownership plans (“ESOPs”)

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer. An ESOP can be an entire plan or it can be a component of a larger defined contribution plan.¹⁰ ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of stock, and certain ESOP participants must be given the right to diversify a portion of their plan benefits.

In addition, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer stock. For example, an ESOP may be “leveraged,” i.e., stock held in an ESOP may be purchased with loan proceeds. In a leveraged ESOP, the ESOP typically borrows from a financial institution. The loan is typically guaranteed by the employer and the employer stock is generally pledged as security for the loan. Contributions to the plan are used to repay the loan. The employer stock is held in a suspense account and released to participants’ accounts as the loan is repaid.

Special tax benefits also apply to ESOPs. For example, the employer may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participants’ election.

(c) Types of contributions to defined contribution plans

In addition to different types of defined contribution plans, different types of contributions may be made to a defined contribution plan. Contributions fall into two general types: employee contributions and employer contributions. Further distinctions apply within each type.

Employee contributions can be made on a pre-tax or an after-tax basis. Employee elective deferrals under a 401(k) plan are pre-tax employee contributions. Pre-tax employee contributions are generally treated the same as employer contributions for income tax purposes. After-tax employee contributions are included in the employee’s income for the year the contributions are made.

Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pre-tax or after-tax contributions. Depending on the type of defined contribution plan and the plan terms, employer nonelective contributions may be

¹⁰ An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a 401(k) feature that permits employees to make elective deferrals. Such an ESOP design is sometimes referred to as a “KSOP.”

required or may be discretionary. Matching contributions are employer contributions that are made only if the employee makes contributions.

The type of contributions made to a defined contribution plan depends on the design of the plan. For example, a money purchase pension plan must provide for employer nonelective contributions, while a 401(k) plan provides for employee elective deferrals. Many plans provide for different types of contributions. A defined contribution plan must also provide for the method by which contributions are allocated to participants' individual accounts.

3. Investment of qualified retirement plan assets

(a) Risk of investment loss

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan.

In a defined benefit plan, investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits, as discussed above. The minimum funding rules also require periodic valuation of defined benefit plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.

Benefits under defined benefit plans are guaranteed (within limits) by the Pension Benefit Guaranty Corporation. In the event a plan terminates with assets insufficient to pay promised benefits, the Pension Benefit Guaranty Corporation will pay benefits up to the maximum guaranteed amount. For 2002, the maximum guaranteed benefit for an individual retiring at age 65 is \$3,579.55 per month, or \$42,954.60 per year.

In a defined contribution plan, the benefit the participant is entitled to is the account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Because the benefits due to participants in the event of a termination of a defined contribution plan are based on the assets held by the plan, defined contribution plans are not insured by the Pension Benefit Guaranty Corporation.

(b) General fiduciary rules and investment responsibility

Except with respect to certain investments in employer stock, discussed below, generally neither the Internal Revenue Code nor ERISA imposes restrictions on the specific investments that can be made with qualified retirement plan assets. Rather, ERISA imposes general standards applicable to the conduct of plan fiduciaries. In addition, except with respect to investment in employer stock and the ability of plan participants to direct investments, discussed below, defined benefit plans and defined contribution plans are generally subject to the same rules regarding the investment of plan assets.

ERISA generally provides that a person is a plan fiduciary to the extent the fiduciary exercises any discretionary authority or control over management of the plan or exercises

authority or control over management or disposition of its assets, renders investment advice for a fee or other compensation, or has any discretionary authority or responsibility in the administration of the plan. As a result, a person who makes investment decisions with respect to a qualified retirement plan is generally a plan fiduciary.

Generally, the plan trustee has exclusive authority and responsibility for managing and controlling plan assets and is thus responsible for investing plan assets. However, the plan may make the trustee subject to the direction of a named fiduciary, or the authority for managing plan assets may be delegated to an investment manager. An investment manager is a registered investment advisor, bank, trust company, or insurance company that is appointed by a named fiduciary of the plan with the power to manage, acquire, or dispose of plan assets. The investment manager must acknowledge in writing its status as a fiduciary.

ERISA contains general fiduciary standards that apply to all fiduciary actions, including investment decisions made by fiduciaries. ERISA requires that a plan fiduciary must discharge its duties solely in the interests of participants and beneficiaries and:

- for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration;
- with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with plan documents insofar as they are consistent with ERISA.

Violations of the fiduciary rules under ERISA are subject to enforcement through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

Plan investment decisions made by plan fiduciaries may in some cases violate the exclusive benefit rule under the Internal Revenue Code. However, not all fiduciary violations relating to plan investments are violations of the exclusive benefit rule.

(c) Special fiduciary rules for participant-directed investments in defined contribution plans

A defined contribution plan may permit participants or beneficiaries to make investment decisions with respect to their individual accounts. For example, it is common for 401(k) plans to provide participants with investment authority with respect to their own elective contributions.

Under a safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants if plan participants control the investment of their individual accounts. Many employers design plans to meet the safe harbor in order to minimize fiduciary responsibilities. If the safe harbor applies, a plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer stock made at the direction of the participant. Failure to

satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants. This safe harbor is commonly referred to as the “404(c) safe harbor” because it is contained in section 404(c) of ERISA.

In order for the safe harbor to apply:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option (the general volatility rule);
- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);
- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer stock to ensure that employees’ buying, selling, and voting decisions are confidential and free from employer influence.

In addition, the safe harbor applies only with respect to a transaction where a participant exercises independent control in fact with respect to the assets in his or her account. Whether a participant has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case. However, a participant’s exercise of control is not independent in fact if:

- the participant is subjected to improper influence by a plan fiduciary or the employer with respect to the transaction;
- a plan fiduciary has concealed material nonpublic facts regarding the investment from the participant, unless the disclosure of the information by the plan fiduciary to the participant would violate other law not preempted by ERISA; or
- the participant is legally incompetent and the responsible plan fiduciary accepts the participant’s instructions knowing this.

If the ERISA 404(c) safe harbor is being relied upon, then participants must be permitted to change investment decisions in a manner consistent with that safe harbor. Unless the ERISA 404(c) safe harbor is being relied upon, there are no specific rules regarding how often a plan must permit participants to change investments.

As a practical matter, timeframes for permitting participants to change investments are determined by the plan and are often tied to the plan’s administrative systems, including the frequency with which plan assets are valued. In addition, the plan will generally specify when a participant’s investment directions will be executed. For example, a transfer from one

investment to another may be made on the first day of the month after the month in which the participant requested the transfer.

(d) Rules relating to investments in employer stock

In general

In addition to the general ERISA rules relating to the investment of qualified retirement plan assets, special rules apply to the investment of plan assets in stock or other securities issued by the employer or an affiliate of the employer.¹¹ The assets of either a defined contribution plan or a defined benefit plan may be invested in employer stock. However, the rules relating to such investments differ for defined benefit plans and defined contribution plans, as discussed below.

Definition of employer stock

ERISA generally does not limit the type of employer stock that may be held by a qualified retirement plan. The Internal Revenue Code specifies the type of employer stock that may be held by an ESOP.

Under ERISA, a qualified retirement plan may hold only a “qualifying employer security.” Any stock issued by the employer or an affiliate of the employer is a qualifying employer security. In the case of a defined benefit plan (and money purchase pension plans other than certain pre-ERISA plans), in order for stock to be a qualifying employer security, the plan cannot hold more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class, and at least 50 percent of the aggregate amount of that stock must be held by persons independent of the issuer.

Under ERISA, qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness).

For purposes of ESOP investments, employer stock (referred to as “employer securities” or a “qualifying employer security”) is defined in the Internal Revenue Code to mean only:

- (1) publicly traded common stock of the employer or a member of the same controlled group;
- (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or
- (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

¹¹ Special rules apply also to the investment of plan assets in employer real property.

Limits on investments in employer stock

ERISA prohibits defined benefit plans (and money purchase pension plans other than certain pre-ERISA plans) from acquiring employer stock if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer stock.

Most defined contribution plans, such as profit-sharing plans, stock bonus plans, and certain pre-ERISA money purchase pension plans generally are not subject to any limit on the amount of employer contributions that can be invested (or required to be invested) in employer stock. In addition, a fiduciary generally is deemed not to violate the requirement that plan assets be diversified with respect to the acquisition or holding of employer stock in these plans.

In the case of a 401(k) plan, no more than 10 percent of elective deferrals can be required to be invested in employer stock. However, this restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer stock does not exceed more than one percent of any employee's compensation; (2) the fair market value of all individual account plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP. In addition, there is no limit on the amount of elective deferrals that an employee can choose voluntarily to invest in employer stock.

An ESOP is subject to a diversification requirement under which a participant who is age 55 and has 10 years of plan participation must be permitted to diversify the investment of the participant's account (i.e., invest the account in assets other than employer stock). The participant must be given a period each year for six years in which to diversify up to 25 percent (or 50 percent in the last year) of the participant's account, reduced by the portion of the account diversified in prior years. As an alternative to providing diversified investment options in the plan, the plan can provide for the portion of the participant's account that is subject to the diversification requirement to be distributed to the participant.

B. Other Employer-Sponsored Retirement Arrangements

1. SIMPLE retirement plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees (“SIMPLE”) retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least \$5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an “IRA”) for each employee or part of a 401(k) plan. If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans (including the top-heavy rules) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules continue to apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE retirement plan allows employees to make pre-tax elective contributions, subject to a limit of \$7,000 for 2002 (gradually increasing to \$10,000 for 2005). Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of \$500 for 2002 (gradually increasing to \$2,500 for 2006). These dollar limits will be indexed for inflation after 2006 in \$500 increments.

Employer contributions to a SIMPLE plan must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. Under a special rule applicable to SIMPLE IRAs, the employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than two out of any five years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a two percent of compensation nonelective contribution on behalf of each eligible employee with at least \$5,000 in compensation for such year, whether or not the employee makes an elective contribution.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the two-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

2. Simplified employee pensions (“SEPs”)

A simplified employee pension (“SEP”) is an IRA to which employers may make contributions up to the limits applicable to defined contribution plans. The employee is always 100-percent vested in employer contributions. All employees who satisfy certain participation requirements must be eligible to participate in the SEP. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least three of the immediately preceding five years, and (3) received at least \$450 (for 2002) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits.

Effective for taxable years beginning before January 1, 1997, certain small employers could maintain a salary reduction SEP (“SARSEP”) under which employees could elect to have contributions made to the plan or to receive the contributions in cash. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, employers may continue to make contributions to SARSEPs that were established before 1997 (in accordance with the rules in effect before 1997). In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.

3. Tax-sheltered annuities (“section 403(b) annuities”)

Tax-sheltered annuities (“section 403(b) annuities”) are another form of employer-based retirement plan that provide the same tax benefits as qualified retirement plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified retirement plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Employer contributions to a section 403(b) annuity are generally subject to the same nondiscrimination rules as contributions to qualified retirement plans. Contributions made by the employee under a salary reduction agreement (i.e., contributions that are comparable to elective deferrals under a 401(k) plan) are not subject to nondiscrimination rules similar to those applicable to 401(k) plans. Instead, all employees generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.¹²

Contributions to a tax-sheltered annuity are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals (and catch-up contributions) under a 401(k) plan.

¹² As with qualified plans, State and local governmental tax-sheltered annuities are not subject to nondiscrimination rules.

4. Eligible deferred compensation plans of State and local governments and tax-exempt entities (“section 457 plans”)

Compensation deferred under an eligible deferred compensation plan (a "section 457 plan") of a tax-exempt or State or local governmental employer is includible in income when paid (or otherwise made available in the case of a tax-exempt employer). The maximum annual deferral under such a plan generally is the lesser of (1) \$11,000 (for 2002)¹³ or (2) 100 percent of compensation (net of the deferral). A special, higher limit applies for the last three years before a participant reaches normal retirement age (the “section 457 catch-up limit”). Starting in 2002, in the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of \$1,000 for 2002 (unless the section 457 catch-up limit applies).

In general, amounts deferred under a section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant has a severance from employment with the employer, or (3) when the participant is faced with an unforeseeable emergency.

Amounts deferred under a governmental section 457 plan must be held in trust. Amounts deferred under a section 457 plan of a tax-exempt entity must remain the property of the employer, subject only to the claims of the employer’s general creditors.

With certain exceptions, section 457 generally applies to all deferred compensation of employees of tax-exempt and State and local governmental employers other than compensation deferred under a qualified retirement plan (or a tax-sheltered annuity). Section 457 does not apply to any bona fide vacation, sick leave, compensatory time, severance pay, disability pay, or death benefit plan. In addition, section 457 does not apply to qualified governmental excess benefit plans that provide benefits in excess of those that are provided under a qualified retirement plan maintained by the governmental employer.

Section 457 plans are not qualified retirement plans; rather, such plans have traditionally been more like unfunded, nonqualified deferred compensation arrangements of private, taxable employers. Present law does not limit the amount of deferred compensation payable under nonqualified deferred compensation plans of taxable employers because there is tension between the employer and the employee in that employers generally want a current deduction for compensation, whereas deferred compensation is not deductible until includible in employees’ income. This tension is not present in the case of deferred compensation plans of tax-exempt and governmental employers. Thus, section 457 limits the amount that can be deferred under such plans and provides other rules regarding such plans.

¹³ Starting in 2002, the same dollar limits apply to deferrals under a section 457 plan, including catch-up contributions under a governmental plan, that apply to elective deferrals and catch-up contributions under a 401(k) plan. Accordingly, the section 457 plan limits gradually increase through 2006 and are adjusted for inflation in \$500 increments thereafter.

Section 457 plans do not benefit from all the favorable tax rules applicable to qualified retirement plans because section 457 plans generally have not been subject to all of the same restrictions and rules as qualified retirement plans (e.g., section 457 plans are not subject to nondiscrimination requirements). However, recent changes in the rules relating to section 457 plans and qualified retirement plans of governmental employers have blurred the distinction between governmental section 457 plans and governmental qualified retirement plans. For example, assets of governmental section 457 plans must now be held in trust, rollovers are permitted between governmental section 457 plans and qualified retirement plans, and governmental qualified retirement plans are not subject to nondiscrimination rules.

C. Individual Retirement Arrangements (“IRAs”)

In general

There are two general types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contribution) differ.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of a certain dollar amount (\$3,000 for 2002)¹⁴ or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to the dollar limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. As a result, the maximum deduction for IRA contributions for an individual who has attained age 50 is increased by a certain dollar amount (\$500 for 2002).¹⁵ (These limits apply also to contributions to a Roth IRA.)

If an individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

<i>Taxable years beginning in:</i>	<i>Single Taxpayers</i>	<i>Phase-out range</i>
2002.....		34,000-44,000
2003.....		40,000-50,000
2004.....		45,000-55,000
2005 and thereafter.....		50,000-60,000

¹⁴ The dollar limit on IRA contributions is \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008. After 2008, the limit is adjusted for inflation in \$500 increments.

¹⁵ The additional amount permitted for catch-up contributions to an IRA is \$500 for 2002 through 2005 and \$1,000 for 2006 and thereafter.

Joint Returns

<i>Taxable years beginning in:</i>	<i>Phase-out range</i>
2002.....	54,000-64,000
2003.....	60,000-70,000
2004.....	65,000-75,000
2005.....	70,000-80,000
2006.....	75,000-85,000
2007 and thereafter.....	80,000-100,000

The adjusted gross income phase-out range for married taxpayers filing a separate return is \$0 to \$10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income between \$150,000 and \$160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions. An individual who has attained age 50 before the end of the taxable year may also make nondeductible catch-up contributions to an IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Early withdrawals from an IRA generally are subject to the same additional 10-percent tax that applies to early distributions from a qualified retirement plan. That is, includible amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of adjusted gross income, is used to purchase health insurance of certain unemployed individuals, is used for higher education expenses, or is used for first-time homebuyer expenses of up to \$10,000. The exception to the early withdrawal tax for distributions from a qualified retirement plan after the employee's separation from service after attainment of age 55 does not apply in the case of an IRA.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of a certain dollar amount (\$3,000 for 2002) or the individual's compensation for the year. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a Roth IRA up to a certain dollar amount (\$500 for 2002).

The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual

contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between \$95,000 and \$110,000 and for joint filers with adjusted gross income between \$150,000 and \$160,000. The adjusted gross income phase-out range for married taxpayers filing a separate return is \$0 to \$10,000.

Taxpayers with modified adjusted gross income of \$100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

II. ISSUES RELATING TO PROPOSALS REGARDING THE INVESTMENT OF DEFINED CONTRIBUTION PLAN ASSETS

A. Background

Recent events have focused public attention on defined contribution plans. Concerns have been raised regarding the extent to which such plans, particularly those that are invested in employer stock, provide adequate retirement income security. Numerous proposals designed to increase the level of retirement income security provided by defined contribution plans have been suggested. The proposals reflect a variety of concerns. For example, some proposals focus on plans that hold employer stock, others focus on plans that permit participants to choose investments, and others focus on defined contribution plans in general. Specific issues addressed include (1) whether limits should be placed on the amount of employer stock that can be held by a plan or in the account of any plan participant, (2) whether participants have sufficient opportunity to make or change investments, (3) whether participants have access to appropriate investment advice, and (4) whether additional protections should apply to defined contribution plans generally.

Following is a discussion of general issues relating to proposals designed to address the level of retirement income security provided by defined contribution plans, followed by a discussion of issues that arise under particular types of proposals.

B. General Issues Relating to Proposals Regarding Defined Contribution Plans

1. Investment in employer stock

Proposals regarding the investment of defined contribution plan assets in employer stock raise basic issues as to the role of employer stock in defined contribution plans.

The provisions of the Internal Revenue Code and ERISA have facilitated and encouraged the investment of defined contribution plan assets in employer stock. For example, such an investment is generally exempt from the fiduciary requirement under ERISA that plan investments be diversified. Certain defined contribution plans, such as stock bonus plans and ESOPs, are designed specifically to hold employer stock. In addition, statutory exceptions to the prohibited transaction rules allow ESOPs to acquire employer stock through leveraging. Special tax benefits are available to ESOPs, such as the deduction for dividends. Thus present law reflects the view that employer stock is not only a permissible investment for defined contribution plans, but also, at least to some extent, a favored investment.

Both employers and employees often find employer stock to be an attractive investment. Employers often use plans, particularly leveraged ESOPs, as a way of raising capital. Employees typically feel they have a stake in the business if they own stock of the company, thereby often leading to increased profitability. Employees like the opportunity to share in the profits of the company.

On the other hand, a large investment in employer stock creates a tension with a basic principle of investing - diversification. The risk that results from holding too large a portion of defined contribution plan assets in any single investment, including employer stock, may conflict

with concerns about retirement income security, particularly in cases where the defined contribution plan is the only or main employer-sponsored retirement plan available to employees.

2. Scope of new rules

In developing proposals regarding defined contribution plan assets in employer stock, the scope of any new rules must be determined. This issue arises in connection with (1) the types of plans to which the rules should apply, and (2) the types of contributions to which the rules should apply. Limitations on the scope of proposals may be considered desirable for a variety of reasons. However, employers generally make plan design decisions and it is often relatively easy to amend plan terms and structure. For example, if a new restriction applies to matching contributions but not certain other types of employer contributions, then the employer may replace the matching contributions with another type of contribution not subject to the new restriction. Thus, depending on the specifics of any particular proposals, exceptions may undermine the intended effect of any proposal.

Proposals may be drawn to apply only to certain types of defined contribution plans or plans with certain features, such as 401(k) plans or plans that permit employees to direct investments. Depending on the circumstances, such distinctions may have the effect of applying new rules only to certain contributions. For example, as discussed above, a so-called 401(k) plan is legally not a separate type of qualified retirement plan. Thus, if a proposal is intended to be limited only to such plans, the real issue is to what types of contributions the proposal is intended to apply. This issue is discussed below.

Proposals may be drawn to apply to defined contribution plans generally, but with specific exceptions. One issue that frequently arises with respect to proposals that focus on employer stock is whether to provide an exception for ESOPs, which are designed to be invested primarily in employer stock. Some may consider it inappropriate to provide exceptions for ESOPs, while others may wish to preserve a role for ESOPs in the qualified plan arena. There are possible middle grounds between these two approaches. For example, an exception could be provided for an ESOP that does not provide for employee contributions (including elective deferrals), qualified nonelective contributions, or matching contributions, or an ESOP that is maintained as a supplement to another qualified retirement plan, e.g., a defined benefit plan.

Proposals may also make distinctions based on the types of contributions to defined contribution plans rather than the type of plan. For example, many proposals are intended to apply only to 401(k) plans. As mentioned above, legally, there is no separate plan called a 401(k) plan. Rather, a plan commonly referred to as a 401(k) plan may provide for some or all of the following types of contributions: (1) employee elective deferrals; (2) employer matching contributions that are based on employee elective contributions; (3) qualified nonelective employer contributions that are used to satisfy the special nondiscrimination rules applicable to employee elective deferrals; (4) other employer contributions (e.g., discretionary employer contributions); (5) after-tax employee contributions; and (6) employer matching contributions with respect to after-tax employee contributions. It should also be noted that all the contributions related to elective deferrals are not necessarily made to the same plan. For example, employer matching contributions may be made to a different plan than are the employee elective deferrals.

Proposals may apply restrictions to only some of these types of contributions, or apply different restrictions to different types of contributions.

These distinctions reflect differing balances between the rights of employees to control their retirement savings and the desire to provide flexibility to employers in the design and operation their plans. Some argue that restrictions on employers' ability to provide contributions in the form of stock (or require plan assets to remain in employer stock) may cause employers to reduce their qualified retirement plan contributions, particularly matching contributions. Others argue that the incentives for employers to provide matching contributions, including in the form of stock, would outweigh the impact of any new restrictions.

3. Source of new rules

Qualified retirement plans are governed by both the Internal Revenue Code and ERISA. Accordingly, new rules for defined contribution plan can be provided through amendments to either or both. Enforcement mechanisms would generally depend on whether the Internal Revenue Code or ERISA applied.

New rules in the Internal Revenue Code could be structured as a qualification requirement for the plan. In addition, a new rule could be structured as a separate requirement subject to a tax sanction, such as an excise tax on the employer or other responsible party or a denial of a tax benefit. Present law contains numerous examples of all these approaches. In addition, in some cases, certain behavior is encouraged through the use of a tax incentive.

Current proposals that amend ERISA generally add new requirements or restrictions as modifications to the fiduciary rules.

4. Effective date and transition rules

In making any legislative proposals, an effective date and the need for transition rules need to be considered. The appropriate rule will depend on the nature of the proposal. For example, changes that will require significant adjustments on the part of plan sponsors and administrators or that will require administrative guidance from the IRS may need to have effective dates that are sufficiently far off in the future to allow time for implementation. Other proposals may not require significant lead time before they can be implemented. In some cases, transition rules may be needed to address particular situations. For example, some proposals place limits on the amount of employer stock that can be held by a plan and require plans to dispose of employer stock if the limits are exceeded. If such a restriction applies to assets currently held in plans, then some transition period may be appropriate to give plans sufficient time to shift investments, particularly in the case of closely held stock which is not publicly traded.

5. Effect of new rules on the qualified retirement plan system

Legislation regarding qualified retirement plans often involves reconciling competing policy objectives. On one hand is the desire to provide retirement income security; on the other is the voluntary nature of the system. That is, if requirements become too burdensome, employers may discontinue their plans or cut back on future benefits. This balance of policy

objectives frequently arises and may arise in connection with new rules regarding defined contribution plans. Some argue that government regulation impedes the growth of qualified retirement plan coverage. However, some studies show that considerations other than government regulation have a greater effect on an employer's decision whether to maintain a qualified retirement plan, such as the uncertainty of business revenue and employees' preference for higher wages or other benefits. The overall effect on retirement plan coverage is a consideration in connection with new rules.

C. Issues Relating to Specific Types of Proposals

1. Limits on investment in employer stock

One issue under current consideration is the extent to which investments under defined contribution plans are appropriately diversified. Of particular concern is the extent to which such plans have investments in employer stock. One way to address such concerns is to place limits on the amount that can be invested in employer stock. Two general approaches may be used in limiting defined contribution plan investments in employer stock: (1) place fixed limits on the amount that can be invested in employer stock, whether by employee choice or otherwise, and (2) limit the extent to which assets can be required to be invested in employer stock without participant consent. A basic difference in these approaches is whether there is a limit on the amount plan participants can choose to invest in employer stock.

Those who support a fixed limit argue that it is the best way to ensure diversification of assets. They argue that, without fixed limits, there is no way to prevent inappropriate concentrations in employer stock. For example, they argue that it is difficult to ensure that participants have adequate investment advice and that, even if they do, fixed limits are needed to protect against bad investment decisions.

Those who do not support a fixed limit argue that there is no set limit that necessarily applies to all cases and that any limit is arbitrary. They argue that depending on the particular facts, it may not be an inappropriate investment for a participant to have most or even all of his or her account balance invested in employer stock. In addition, they argue that limiting one type of investment option does not address the broader issue of what is an appropriate investment strategy for retirement plan assets.

Some argue in favor of promoting diversification by providing plan participants with greater control over the investment of their individual accounts. Proposals taking this approach require that participants be given the right to transfer their accounts out of employer stock and into other investments after a minimum period of service or after holding the employer stock for a minimum period. These proposals generally include provisions aimed at improving participants' access to information and advice about the plan and the investment of their accounts.

Proposals to restrict investment in employer stock may increase the need to dispose of employer stock held in a defined contribution plan. Administrative issues may arise as a result, particularly in the case of employer stock that is not publicly traded or in the case of a leveraged ESOP. Special rules may be needed to address these issues.

2. Blackouts and other issues regarding participant-directed investments

Proposals may address periods when participants are unable to direct the investment of their accounts, often called a "blackout" period. Such periods may occur for administrative reasons, for example, when a plan changes recordkeepers. In that case, the current recordkeeper must verify information related to participants' accounts, including the investments held in the accounts. The information must then be transmitted to the new recordkeeper, possibly verified again, and entered into the new recordkeeping system. Employees' ability to make changes is

restricted during the transition process in order to assure the accuracy of the information transferred to the new system. The duration of blackout periods varies, generally depending on administrative issues such as the number of participants involved and the accuracy of the old recordkeeping system.

Proposals regarding blackout periods may include requirements that advance notice be provided to participants and that participants be given an opportunity to make investment changes before the blackout begins, as well as limits on the duration of blackout periods, or restrictions on certain stock transactions outside the plan, such as sales by corporate officers. Such proposals reflect a concern that the rights of participants should be protected during administrative changes.

Issues related to these proposals include defining “blackout,” for example, whether it includes periods when employees normally cannot make investment changes or only interruptions of normal investment periods. New rules (including limits on the duration of blackout periods) may also take into account administrative issues, such as the mechanical limitations of the plan’s recordkeeping system. In addition, as a practical matter, it may not be possible to anticipate and address every issue that may arise in connection with a blackout.

Similar administrative considerations may arise with respect to proposals that provide new rules regarding other aspects of participant-directed investments, such as investment options and the frequency with which investment changes may be made. For example, the ability to make investment changes under a plan often depends on the frequency with which investments under the plan are valued.

3. Participant education and advice

Some proposals include provisions to facilitate greater education of participants with respect to investments and sound investment practices as well as advice with respect to the actual investment of participants’ individual accounts. Issues relating to these proposals include the scope of fiduciary duty with respect to education and advice and the need to avoid conflicts of interest with respect to investment advisors that also provide investment products.

4. Insurance for defined contribution plans

Some have concerns regarding the security of defined contribution plans as a whole, not just those that invest in employer stock. They argue that the present-law rules were developed when defined benefit plans were more prevalent and tended to be primary retirement plans. In light of a trend toward defined contribution plan coverage, some argue that it is appropriate to reduce the risks associated with defined contribution plans generally and to reduce the investment risks faced by participants in such plans.

One approach to addressing such concerns would be to establish an insurance program for defined contribution plans similar to that for defined benefit plans. A variety of major structural issues would have to be addressed in adopting such an approach, including what types of risks would be covered by the insurance, such as investment losses (or losses on certain investments, e.g., employer stock) or breaches of fiduciary duty; whether insurance would apply to the plan as a whole or with respect to individual participant accounts; and whether the amount

of coverage would be limited, e.g., coverage of a participant's account balance up to a dollar amount or up to the amount needed to provide a minimum level of retirement income.

Some have suggested that an insurance program covering investment losses in defined contribution plans could reduce the incentive for plan fiduciaries and participants to make careful investment decisions. Such questions of "moral hazard" have been addressed in the defined benefit insurance program through a variety of means. Similar issues would need to be addressed in the case of a defined contribution insurance program.

III. DATA RELATING TO QUALIFIED RETIREMENT PLANS

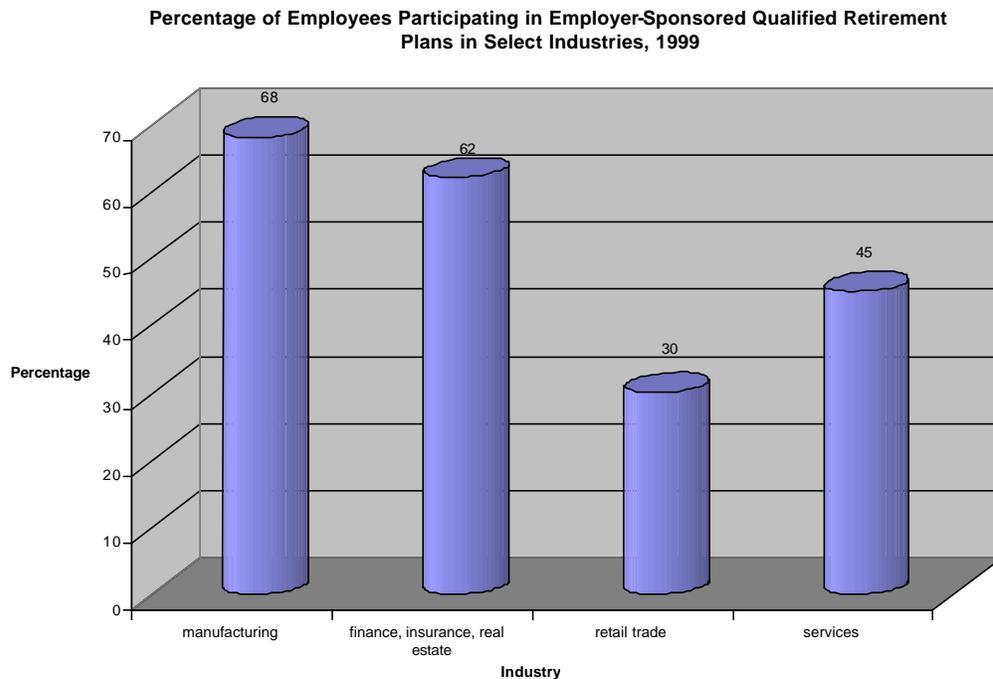
A. General Data on Qualified Retirement Plan Participation

The recent U.S. Department of Labor National Compensation Survey found that in 1999, 48 percent of private sector employees participated in employer-sponsored qualified retirement plans. The survey found that, among full-time employees, participation was 56 percent. Participation rates were higher among public sector employees. The Bureau of Census's Current Population Survey found that, in 1997, 87 percent of State and local government employees and 88 percent of Federal government employees participated in an employer-sponsored retirement plan.

The National Compensation Survey also found that, in 1999, among full-time employees in the private sector, 42 percent participated in an employer-sponsored defined contribution plan and 25 percent participated in an employer-sponsored defined benefit plan. Some employees participated in both.

Participation in employer-sponsored qualified retirement plans varies with firm size and industry. Figure 1 and Figure 2, below, present some of the findings of the 1999 National Compensation Survey and some of the variability of employee participation in employer-sponsored qualified retirement plans by industry and firm size.

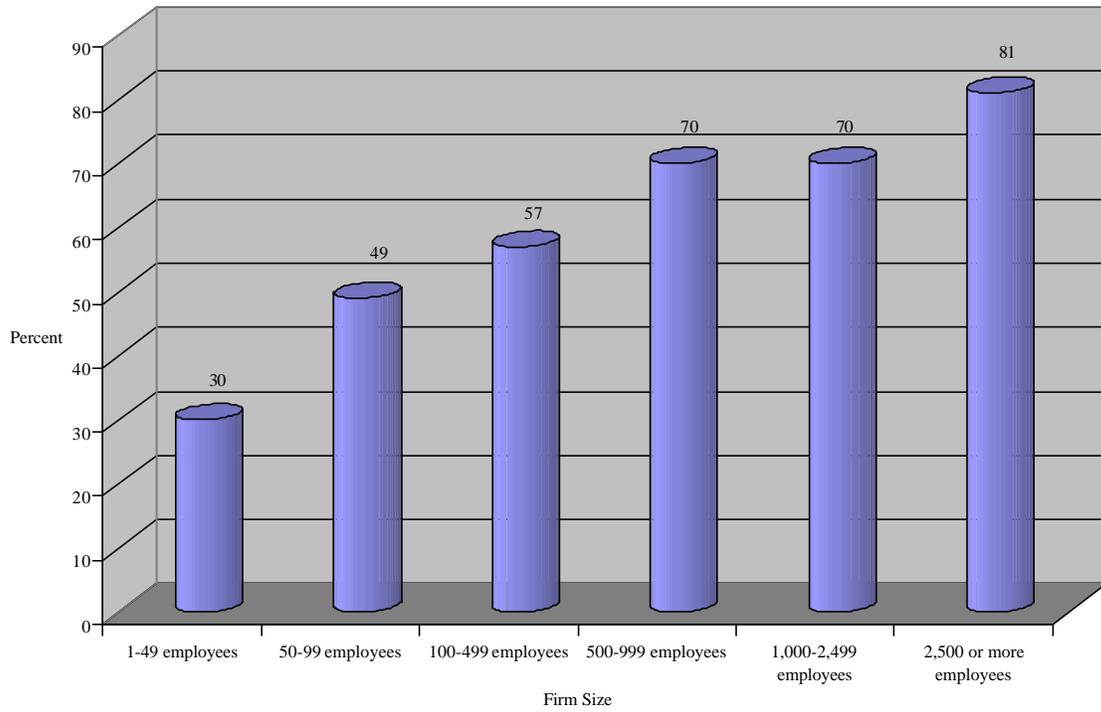
Figure 1



Source: Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry, 1999."

Figure 2

Percentage of Employees Participating in an Employer-provided Pension Plan by Firm Size, 1999



Source: Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry, 1999."

B. Data on Participation in Defined Benefit Plans and Defined Contribution Plans

In 1997, about 54 percent of workers in the private sector who participated in a qualified retirement plan were covered only by a defined contribution plan, 32 percent were covered by both a defined benefit plan and a defined contribution plan, and 14 percent were covered only by a defined benefit plan. An estimated 49 percent of private sector 401(k) enrollees worked for private firms sponsoring only 401(k) plans in 1997, an increase from 46 percent in 1996 and 44 percent in 1995.

Figure 3 through Figure 6, below, document the growth of private sector defined contribution plans, particularly 401(k) plans, relative to defined benefit plans. The data presented in these figures are based on Form 5500 filings. As illustrated in the figures below, the number of defined contribution plans and active participants in those plans have increased over time, while the number of defined benefit plans and the number of active participants in those plans have decreased. Further, the growth in defined contribution plans resulted from a large increase in 401(k) plans and participants, which offset a decrease in the number of non-401(k) defined contribution plans and participants that occurred over much of this period.

Figure 3

**Number of Qualified Retirement Plans
1978-1997**

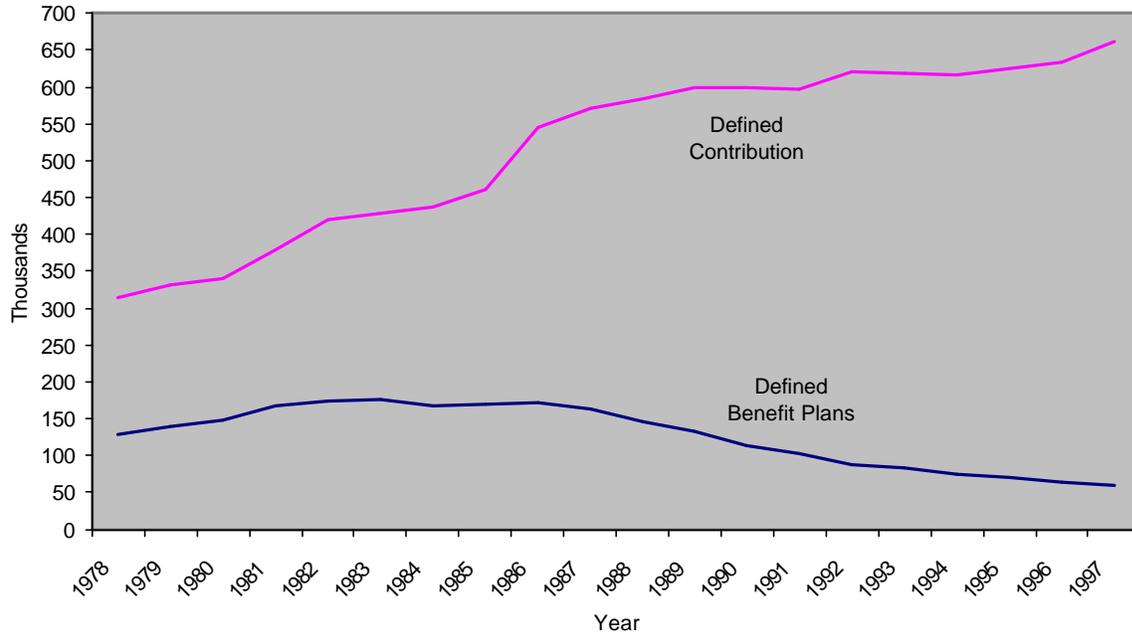


Figure 4

**Qualified Retirement Plan Active Participants,
1978-1997**

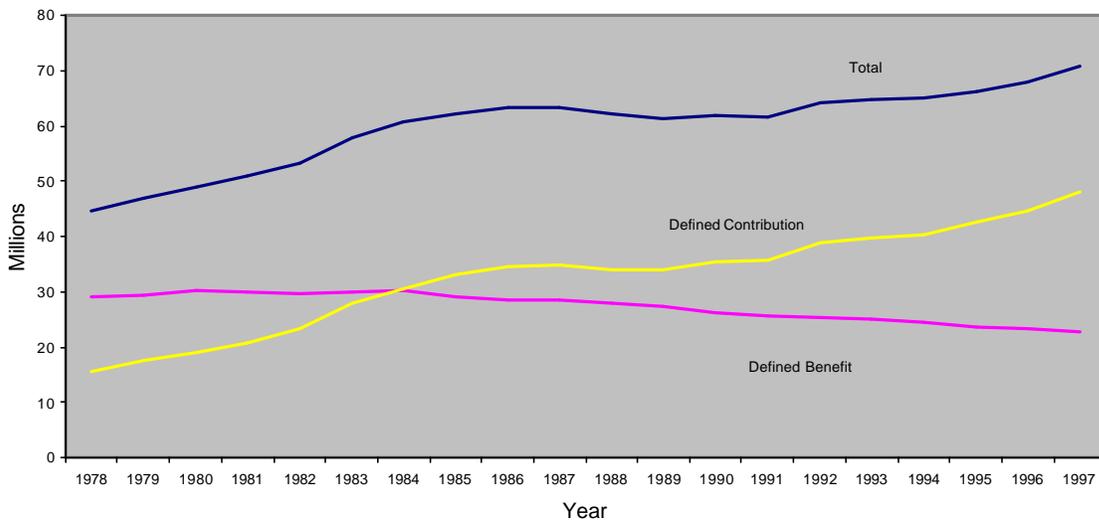


Figure 5

**Number of Defined Contribution Plans
1984-1997**

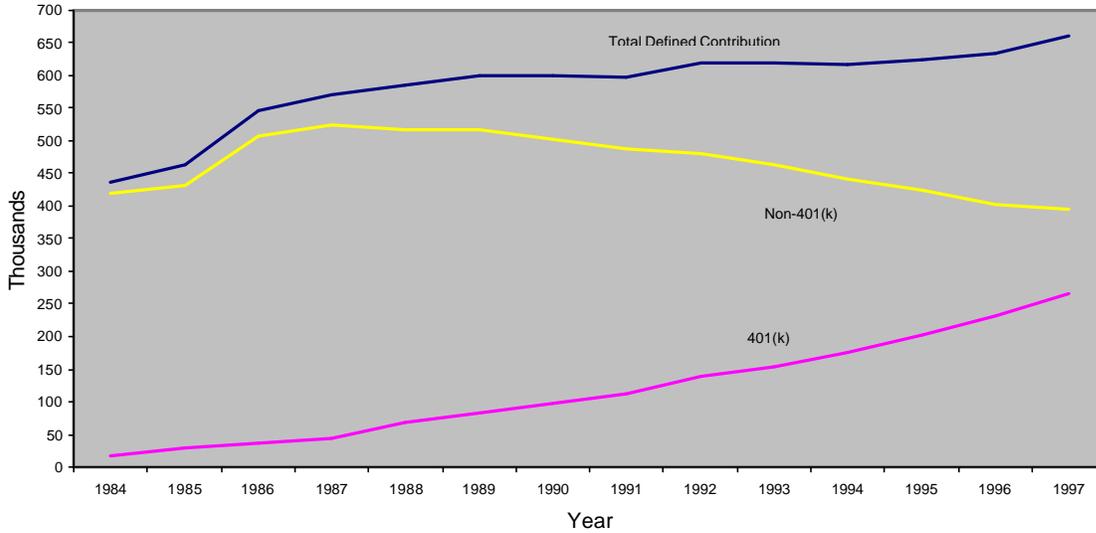
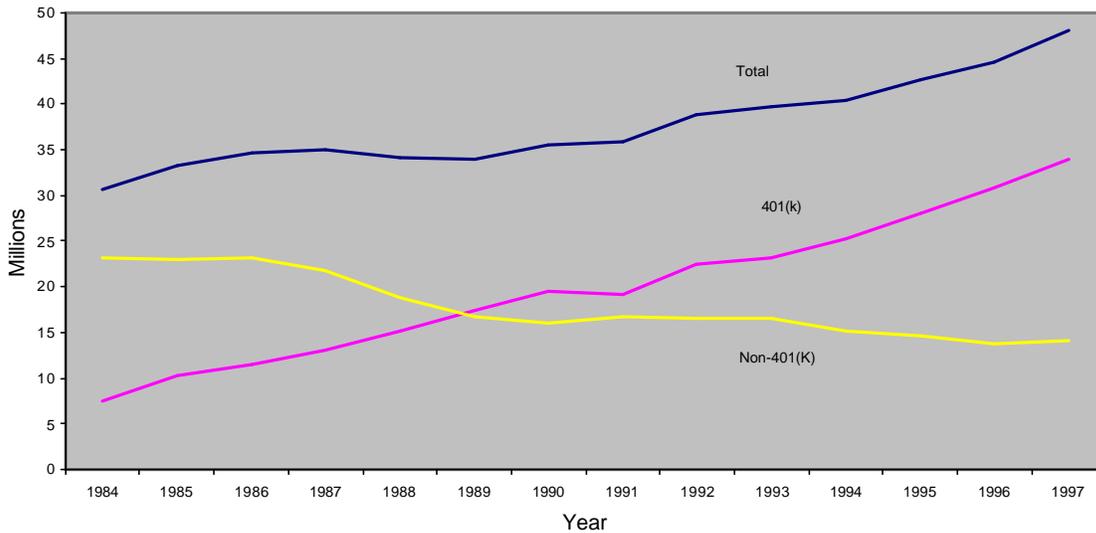


Figure 6

**Active Participants in Defined Contribution Plans
1984-1997**



Source for Figures 3 through 6: United States Department of Labor, Pension and Welfare Benefits Administration. Abstract of 1997 Form 5500 Annual Reports. Private Pension Plan Bulletin No. 10, Winter 2001.

C. Data on Qualified Retirement Plan Assets

Figure 3 and Figure 4, above, document the increase in the number of defined contribution plans and the number of participants in defined contribution plans, as well as the concomitant decline in the number of defined benefit plans and the number of participants in defined benefit plans. However, the assets held in both types of plans increased substantially from 1988 through 2000. As of December 31, 1988, data from the Federal Reserve Board of Governors showed that defined benefit plans held assets valued at \$812.8 billion and defined contribution plans held assets valued at \$594.7 billion. As of December 31, 2000, data showed that defined benefit plans held assets valued at \$2.06 trillion and defined contribution plans held assets valued at \$2.53 trillion.

Despite the declining number of plans and participants, the market value of assets held in defined benefit plans increased every year throughout the period 1988 through 2000 except in 1990 and 2000. The market value of assets held in defined contribution plans increased in every year throughout the period 1988 through 2000 except in 2000. Figure 7, below, shows the increase in market value of assets held in defined benefit plans. Figure 8, below, shows the more rapid increase in the market value of assets held in defined contribution plans that would be expected with the growth in number of participants in such plans. In addition to retirement assets held in defined benefit and defined contribution plans, between 1988 and 2000 the market value of assets held by individuals in IRAs and Keogh accounts (i.e., qualified retirement plans for self-employed individuals), increased from \$452 billion at the end of 1988 to \$2.65 trillion at the end of 2000.¹⁶

¹⁶ Board of Governors, United States Federal Reserve System, *Flow of Funds*, December 7, 2001.

Figure 7

**Market Value of Assets Held In Defined Benefit Plans,
1988-2000**

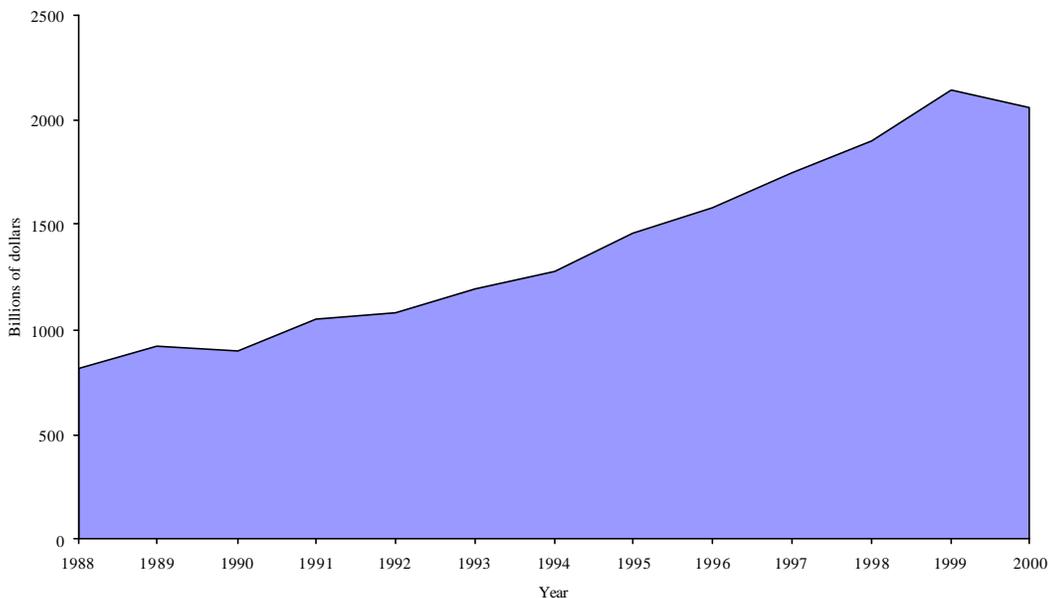
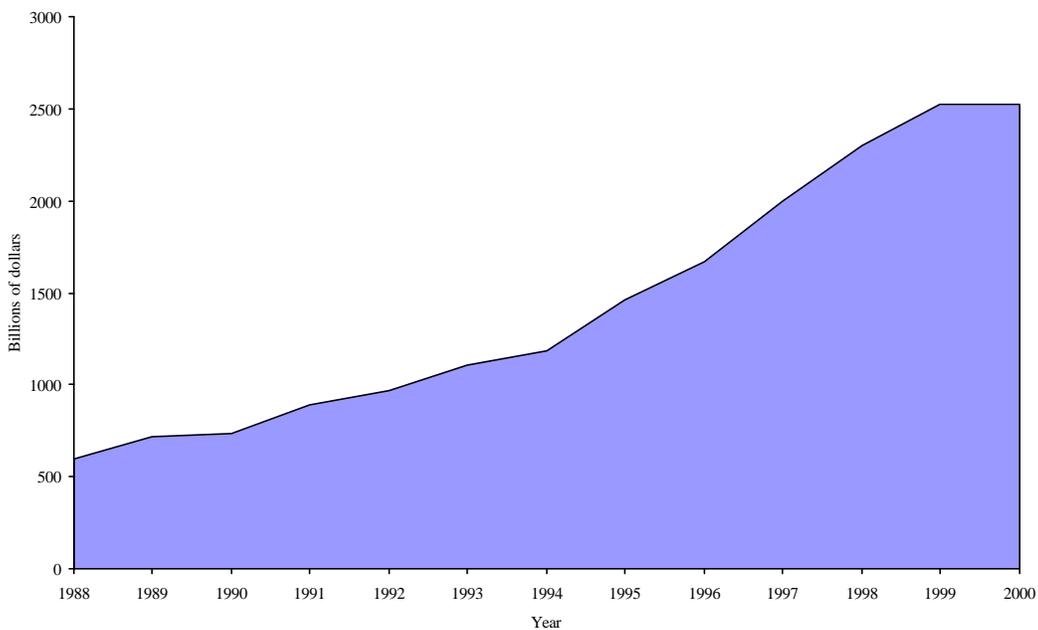


Figure 8

**Market Value of Assets Held in Defined Contribution Plans,
1988-2000**

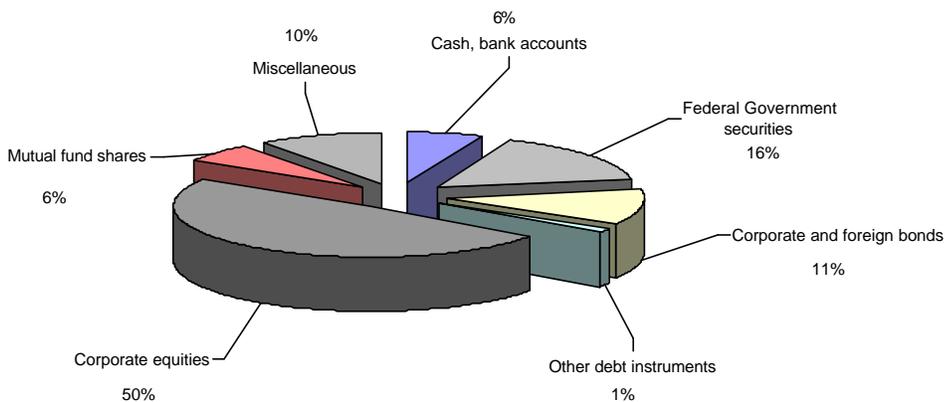


Source: Board of Governors, Federal Reserve, Flow of Funds.

Figure 9 and Figure 10, below, present estimates of the Federal Reserve Board of Governors of the distribution of defined benefit plan and defined contribution plan assets among different types of investments as of December 31, 2000.

Figure 9

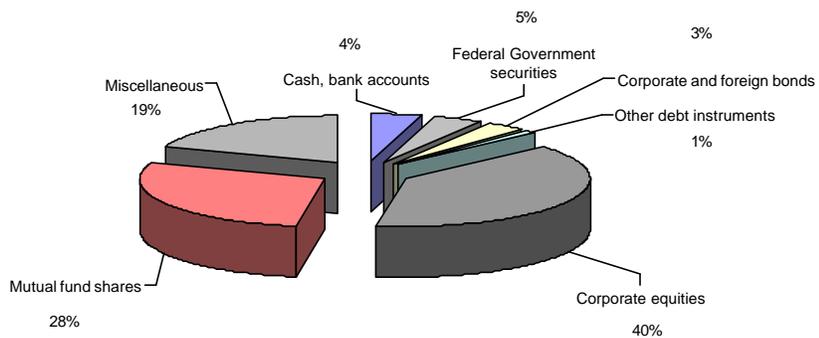
Distribution of Assets in Defined Benefit Plans, December 31, 2000



Source: Board of Governors, Federal Reserve System, *Flow of Funds*, December 7, 2001.

Figure 10

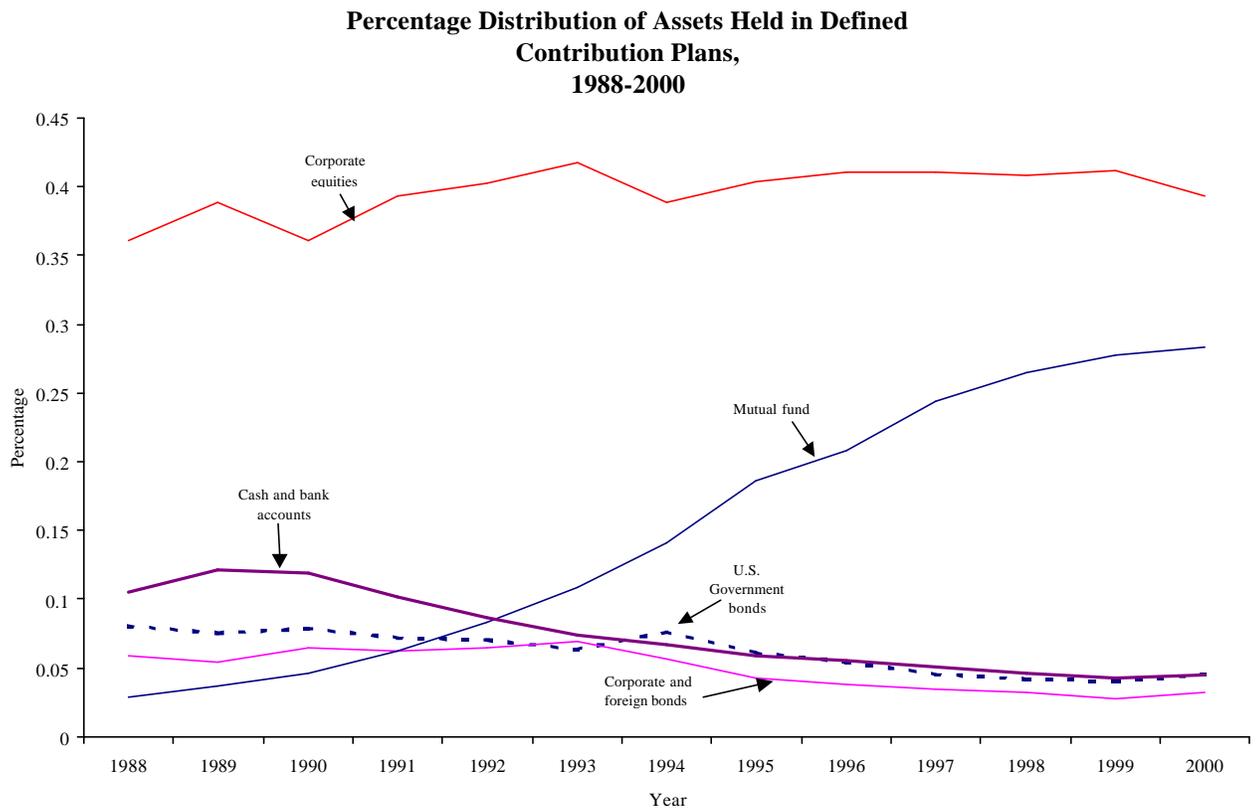
Distribution of Assets in Defined Contribution Plans, December 31, 2000



Source: Board of Governors, Federal Reserve System, *Flow of Funds*, December 7, 2001.

Over time, mutual fund holdings have become more important as a component of defined contribution plan assets. In 1988, mutual fund shares constituted only 2.8 percent of defined contribution plan assets. The increased importance of mutual fund shares in defined contribution plan holdings has come largely at the expense of relative declines in holdings of cash and bank accounts (including money market mutual funds), holdings of United States Government bonds, and holdings of corporate and foreign bonds. The share of corporate equities directly held in defined contribution plans has remained roughly constant from 1988 through 2000. Figure 11, below, plots these trends.

Figure 11



Source: Board of Governors, Federal Reserve, Flow of Funds.