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DEFINED CONTRIBUTION PLANS AFTER TRA '86

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Recorder: THOMAS HUGH DODD

- o Tax reform -- Taxation of distributions and discrimination testing
- o Market crash -- Valuing plan transactions in a volatile market environment; unit versus cash accounting
- o Asset mix -- proposed Department of Labor regulation 404(c); fund selection, evaluation and communication

MR. THOMAS HUGH DODD: The topic we will cover in this session is Defined Contribution Plans After the Tax Reform Act of 1986 (TRA '86). As originally conceived in late 1987, this session was going to cover specific topics relating to the TRA '86. However, several events have occurred since then that have caused us to change the content of this session.

First, the stock market crashed in October 1987. Second, the Department of Labor (DOL) has issued two regulations: one regulation dealing with participant-directed individual accounts and another regulation dealing with participant loans.

And, finally, state-of-the-art accounting systems have been gaining increasing popularity. These accounting systems provide for daily transactions by plan participants via an 800 telephone number. These are becoming increasing popular and are the source of some friendly controversy among plan professionals.

We are going to examine these events and other related defined contribution plan issues from three perspectives: (1) the perspective of the investment community; (2) the perspective of the plan administrator; and (3) the perspective of the retirement plan consultant.

Our first panelist is Mr. Jeffrey C. Paster who will speak from the viewpoint of the investment community. Mr. Paster is National Corporate Market Manager for Fidelity Investments Institutional Services Company. In this role, he is

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responsible for nationwide marketing of Fidelity's investment management and participant record keeping services for defined contribution plans, as well as investment management services for defined benefit plans.

Our second panelist is Ms. Cyndee K. Kahn who will speak from the viewpoint of the plan administrator. Ms. Kahn is Manager, Benefit Finance, at Ameritech. She is responsible for managing trustee relationships of the company's pension and savings plans, as well as controlling cash flows of the master trust.

Finally, our third panelist is Ms. Barbara I. Gladman who will speak from the viewpoint of the retirement plan consultant. Ms. Gladman is an Associate at Mercer-Meidinger-Hansen where she manages the defined contribution plan consulting unit in Mercer-Meidinger-Hansen's Chicago office.

MR. JEFFREY C. PASTER: I will discuss developing the menu of investment options for participant-directed plans, especially in light of two of the events to which Tom has referred. The first one is the DOL issuance of proposed regulations under ERISA Section 404(c) dealing with how plan sponsors and other fiduciaries can reduce some of their fiduciary liability with respect to participants' exercising control over their investments. The second event is the stock market crash, which heightened awareness of the increased volatility of our financial markets for plan sponsor and plan participant alike.

First of all, let me give an overview of what I'm going to talk about. I'll begin with a discussion of the categories of investment options from which you have to select. Then I'll give you a brief overview as to the DOL proposed regulations under ERISA. Then I'll discuss how many investment options you should offer. What is the right number of investments? All that with the discussion of the frequency of exchange among investment options -- monthly, quarterly, or daily. Then I'll talk about the current state of the art with the daily valuation system and daily telephone exchange.

The first category of investment options is what I refer to as stable principal options. I define these as options which virtually have no risk of principal for participants. Included are GICs, Money Market Funds, CDs, and CD pools.

The second option, a diversified equity option can be broken into two separate categories or subcategories. The first is a conservative equity style, and the mutual fund industry refers to these options as gross and income funds. Included here would be blue chip funds and funds that have some type of a yield discipline as to how they manage their equity investments. In the second subcategory are more aggressive equity styles, or what we refer to as growth funds. These are not your go-go funds, superaggressive funds, but funds which have a primary goal of capital appreciation. In their security selection, they don't consider, or don't consider to a very high degree, the amount of dividend income that a security produces.

The third option is balanced funds, in which you use asset allocation to determine how much stocks, bonds, or cash makes up the investment mix. Fourth is income or bond funds.

The last category I refer to as specialty funds. Specialty funds involve a narrower investment focus and/or by definition greater risk. An example would be a small capitalization equity fund or any other style which focuses on any one sector of the market. Additionally, international funds, real estate, precious metal (such as gold funds) would be considered. In this last subcategory are employer securities, which are the most common specialty option of all.

A recent Gallup study surveyed the 300 largest defined contribution plans and determined what were the investments being offered by those firms. At the top were diversified equity funds at 80%, followed by GICs and company stock, bond funds, balanced funds, and money market funds.

Now, a couple of trends become apparent as you go beyond the 300 top plans into a broader universe. There you find, number one, the usage of company stock diminished, either because you are getting into some privately held companies or companies which have less liquidity in their company stock. Another trend that you see is that the money market fund usage increases as you get into the smaller plan arena.

Before I get into a deeper discussion of the DOL proposed regulations, there are a couple of points that are very important to keep in mind. The first is that these are proposed regulations. Nothing says they have to pass, although it appears as though some form of them will appear in the future. (But it only took them 13 years to come up with the final regulations originally issued in 1974 with the passage of ERISA.) The second point is that compliance is not required in any event. They are voluntary. If a plan sponsor wants to reduce some of its fiduciary exposure and liability, then that plan sponsor can choose to comply. But if the plan sponsor doesn't, there is no adverse effect on the plan.

First of all, what is the basic objective of these proposed regulations? What they do is outline the requirements for reduction of fiduciary liability in participant-directed plans.

The first thing that the regulations say is that a participant, even though he is exercising control over his investment, is not considered a fiduciary. It just made that clear.

Secondly, relief of liability for fiduciaries with respect to a participant's exercise of control over assets is the game plan -- that's the goal. A plan sponsor cannot be held liable for how a participant chooses to allocate his investments, assuming that the plan sponsor meets the requirements of this section.

The third part of it, which is an important part as well, is that the relief of liability is not extended for transactions involving company stock. Again, these are proposed regulations. These are not final, but this is the direction that they are heading.

There are two different sections and two different types of plans or sets of investments that are covered. Let me first talk about the requirements for plans which allow investments in individual securities. You may think of them as self-directed brokerage accounts.

First of all, the participant has to be able to exercise control over his assets. He's got to be able to move the money in a timely manner.

Secondly, there has to be a broad range of investments from which to choose, and this falls into at least three categories; in simple terms, bonds, stocks, and money market instruments. And the participants have to be able to diversify in two ways: one, within each of the three categories -- stocks, bonds, and money market instruments -- and two, in total. What that means is that if you've got smaller account balances or a newer plan, it may be necessary to have a pooled fund as an alternative in order for someone to have a diversified pool. If someone only has $100 in an account, it's pretty difficult to come up with a diversified stock portfolio. Therefore, it may necessitate pooled funds for that purpose.

Lastly, a fail-safe option has to be offered. A fail-safe option is defined as a federally insured bank interest-bearing account or a pooled fund which invests in government securities, call it a government money market fund, or something of similar nature. What's interesting about the fail-safe definition is not what's included, but what's not included. What they didn't include in the original writing of the proposed regulations is GICs. There's obviously a very hot debate going on now regarding the inclusion or exclusion of GICs as a fail-safe option, given their prevalence among the plans.

There are a couple of issues that have come up in the discussion dealing with GICs. The first is the creditworthiness of the insurance company issuing the GICs. Should a GIC issued by Baldwin United be considered a fail-safe option? That's Question No. 1. Question No. 2: Do you cover just GICs or would it apply to other types of insured contracts: immediate participation guarantees (IPGs), etc? And those are some of the questions that are being wrestled with before the final regulations are issued.

Let me talk now about the more common case, that is, those plans which offer pooled funds. Pooled funds would include mutual funds, commingled pools, and individually managed accounts by designated manager.

In order to qualify under the proposed regulation, it must include at least four separate investment objectives: a fixed income fund, growth fund, a balanced fund, and a money market fund. And they, too, must include a fail-safe option. The fail-safe option could be the money market fund if it were a government money market fund. But those are the sets of investment objectives that would have to be included for the participants to choose from if you wanted to qualify for the relief.

Now the question becomes "How many options should you offer? What's the right number?" If you wanted to comply with the DOL proposed regulations, that would require a minimum of either four or five. Five if your fail-safe option does not meet your money market fund definition as well, or if it could be one and the same fund. However, on the other side, it's very difficult to communicate more than five or six investment options. The lines of distinction between options become blurred and you confuse participants. And you lose a lot of value to your plan that way.

There are administrative costs to be considered -- both internally and externally. There are system constraints. How many funds can record keeping and payroll systems accommodate? In general (and this is a big general because there isn't a set of answers that makes sense for all plans) four to six options should be appropriate: stable principal option, diversified equity option, an income fund, and a balanced fund. Add to that company stocks and that still gives you room for another specialized discipline.

What is the right frequency with which your participants can exchange among their funds? In the preamble of the proposed regulations of the DOL it's indicated that, generally, quarterly should be sufficient with diversified pooled funds. However, they also caveat that more frequent exchange may be required for more volatile securities.

Another factor to consider is participant satisfaction. Is quarterly exchange, which is generally the norm, frequent enough given the recent volatility of the stock and bond markets? Most plan participants could not react to the stock market crash of October 19, 1987, until January, 1988. Most plans are quarterly, and most occur on calendar quarters. Therefore, the soonest calendar quarter following October 19 is January 1, and participants couldn't react until January 1, and is that frequent enough? That is a question that you have to at least ask yourself when you're coming up with the rules under which your plan would operate.

There are also system constraints. Can your system and does your system do quarterly, monthly, or daily valuations? That's going to affect how frequently you can exchange.

Another consideration is the investments that you have in your plan. Can they be valued, and how frequently are they valued? Many investments cannot be valued on a daily, weekly, or monthly basis, depending on the liquidity and the nature of the investment. Another factor is the restrictions these investments would have on accepting or withdrawing the monies.

Administrative costs come into play. What does it cost for you to go more frequently, as the case may be? Right now, based on the trends that have happened over the last couple of years, the state of the art is a daily exchange/daily valuation system. It may not be right for all plans; it is certainly not suitable for all types of investment classes. But it is the current state of the art, and I'd like to explore it with you.

The basic concept of daily telephone exchange is that participants direct transactions among a family of mutual funds on any business day by telephone. The key here is that it's on any day. If he or she were smart enough, a participant could have called on October 16 (the Friday before Black Monday) and said "I want to transfer all my money out of the equity fund into the money market fund." But it's key that it's on any day, and the intent is not to have a trading account in which people are extremely active in the way they manage their money.

The concept is to really provide flexibility to participants so they can react to the changing markets and their own changing financial situations. For example, let's say that Aunt Tilly died and left $1 million. That may allow that participant to be able to take a little more risk with this portfolio, the portfolio in the defined contribution plan, than maybe he had before because now he's got a huge nest egg somewhere else.

Conversely, and more importantly, what if a catastrophic medical event occured in the family where now they could no longer subject themselves to the risk level they were at before. And suppose this happened in early October -- not necessarily 1987 with the market crash, but any October -- or any time. Is it fair for them to have to go through a two- or three-month waiting period before they can reallocate their assets and have to expose themselves, given the financial market's volatility, to maybe a 15% or 20% exposure in a given quarter? It's not unheard of that that will occur again, that type of volatility. And daily telephone exchange gives them a lot more flexibility.

The participants can do a number of things. Number one is that they can work to reallocate their existing assets. So if their assets now are 100% in the equity fund, they can go 50% in the equity fund and 50% in a money market fund or some other vehicle.

They can also redirect their future contributions, which would be picked up with the next payroll contribution, so they can move those two factors independently. And, of course, very important to all of this is that participants are provided with immediate confirmations of their transactions, so that in the event they have done something they did not intend to do, it can be corrected immediately (as opposed to having to wait for a quarterly statement to be issued).

Let me talk briefly of the concept of daily valuation systems themselves and some of their advantages. First of all, it allows participants to call directly and have daily account knowledge. Participants can call any day and find out where they stand in their investments. They don't have to do a transaction to find out the net value of their portfolio.

Benefit requests can be processed on any day. What that does is allow faster turnaround of withdrawals. The money remains invested until the withdrawals are processed, too, rather than having to work off a specified valuation date which might be monthly or quarterly.

Daily valuation systems also allow for flexible processing of contributions to accommodate various payroll cycles. If your payroll comes on the 17th of the month, that can be taken, accepted, and invested without having to wait until month-end or quarter-end.

The last thing, and this became important with the market crash, is that you have fairer allocation of investment experience versus a pooled fund accounting. Let's go back to September 30, 1987. In most cases, the money was moved some time after October 19, 1987, but based on a September 30 valuation. That meant one of two things had to happen: First, the remaining participants in those funds (assuming equity funds because they are the ones that suffered) had to suffer disproportionate losses to make up for the losses that those people who had withdrawals based on September 30 valuations didn't suffer. And the other thing that happened, and happened with some frequency, is that plan sponsors had to make up the differences and contribute money into the plans. This would not be a problem with a daily valuation with which you can take money out on any day based on that valuation date.

For argument's sake, let's assume that (1) you want to comply with the proposed regulations as they were written in September, 1987, and (2) you want to integrate daily telephone exchange into your plan. How do you do it? I'll present two examples, the first one being a simple example and the second being more complex.

In the first scenario, there are quarterly exchanges between a money market fund, a diversified equity fund, and a balanced fund. The question now is how you integrate the types of things you want to be able to do.

Well, in this case, it's rather simple. Make your money market fund a government securities money market fund to qualify as a fail-safe option, keep the diversified equity fund, a balanced fund and a bond fund. So what you have here is a family of mutual funds. You have daily telephone exchanges among the funds, and you have compliance with proposed regulations because you have the four investment categories covered as well as the government securities fail-safe option.

Scenario 2 is a little bit more complex. And it's more complex because it has investments that are not conducive to exchanging on a daily basis. GICs, for example, are not conducive because you can't get withdrawals from carriers (and I'm sure carriers don't want to be involved with daily processing of withdrawals from their contracts) on a daily basis. Company stock isn't conducive because (1) you have to deal with five-day settlement on the stock, and (2) plan sponsors probably don't want that frequent a transaction capability on their own company stock, be it for insider trading reasons or because of general objectives of their fund.

When you've got a GIC fund, company stock fund, and a balanced fund, how do you now integrate the types of things you want to do? The first thing you do is keep the GIC fund, keep the company stock fund, and expand the balanced fund into a family of four mutual funds, the same ones we had in example 1 -- government money market fund, diversified equity fund, a balanced fund and a bond fund. You allow for quarterly transfers on that upper level, between the GIC, company stock and the family of funds. When you move down into the family of funds, into the second tier, you allow daily telephone exchange among the family of mutual funds.

Now, obviously, with the GIC there, you now have introduced competing vehicles to the GIC in the form of, generally, the bond fund and the money market fund. So what you do is allow no direct exchanges between the GIC and competing vehicles. And what you have to do is track a three-month or six-month equity wash to make sure you don't have any type of arbitrage going on, and that's easily trackable from a systems point of view.

The second thing you could do is target the GIC toward your savers (those people who are going to be in a fixed vehicle whether the market is going dramatically up or dramatically down), and gear your money market fund as the parking place for those investors who would use it when they don't want to be invested in some of the other more volatile types of funds.

You could also "build a wall" between your GICs and all other investments. You may get a higher rate, and you may simplify some of the communication issues; or you could also introduce a little "gate" (if I can carry that analogy further) in the wall that allows maybe a once-a-year transfer from the GIC to the other funds, and vice versa.

You have also accomplished compliance with the proposed regulations because you do have the funds on the bottom tier. We know they complied because they complied in example 1. The only thing you don't get relief for, based on the way the regulations are now written, is for any transactions involving the company stock pool.

In summary, there are no pat answers to developing the menu of investments. Each plan sponsor or consultant must make his or her own decisions. I hope

I've helped, though, at least in raising some of the questions that should be asked.

For example, what categories of investment options do you offer? Do you comply with DOL proposed regulations? There's no requirement that you have to. That's a choice. How frequently do you allow your participants to exchange among options?

And once you answer those first three questions, then how do you communicate the changes? Do you hire a single provider of services or multiple providers to achieve the objectives you want?

MS. CYNDEE K. KAHN: In case you don't know who or what Ameritech is, that's one of the companies formed out of the divestiture of AT&T. We're located in Chicago, and we're the midwest regional holding company for the Bell Telephone Companies of Illinois, Indiana, Wisconsin, Ohio and Michigan. Just to give you an idea of the size of the company, we have 77,000 employees, 43,000 retirees, and as of December 31, 1987, we had $18 billion in assets, $9.5 billion in revenues. Our pension plan is the ninth largest private pension plan in the United States with $10 billion. That was as of December 31, 1987; it's a little bit better than that now.

Basically I'm going to give you a short history of our savings plans, where they are today; and then I'm going to discuss the proposed 404(c) regulations and how we feel they may impact our plans.

Our savings plans were a result of divestiture. The AT&T plans consisted of two plans: a management plan and a nonmanagement plan. They were broken up into eight pieces. Both of them together had a million participants, $6.5 billion in assets. Bankers Trust was the record keeper and trustee.

The two plans had the following investments. There was a diversified equity portfolio that was managed by three separate investment managers. Seventy-five percent of it was actively managed; the remaining 25% was passive. There was a guaranteed investment fund comprised of GIC contracts with major insurance carriers. It was called a guaranteed investment contract because the return really was guaranteed. What AT&T did is take out umbrella contracts which were used to make up any shortfall in the guaranteed rate of return. Next there was a government obligations portfolio that was comprised strictly of securities of the United States government. Then there was the AT&T stock fund. All four of these funds were split up into eight pieces and distributed to the seven regional companies in AT&T. The AT&T stock fund was split into the stocks of all of the regional companies of AT&T. After divestiture it was called the Diversified Telephone Portfolio, and that became a wasting trust.

When we took the plans, we made some changes to the investment options. We made the diversified equity portfolio a mostly passively managed Standard and Poor's (S&P) fund so that 75% of the fund became passively managed, rather than actively, and the remaining 25% was actively managed.

We got rid of the government obligations portfolio because we felt that was in direct conflict with the fixed income fund. We made AT&T's guaranteed interest fund a fixed income fund. Rather than guaranteeing a rate of return, we gave participants a pretty conservative range, which we have always met. Then, of course, we added an Ameritech stock fund.

That was all done in 1985. Also in 1985 we converted the management savings plan to a 401(k) plan. A few months later we added a loan feature, and then we started searching for a new record keeper and trustee. We felt very strongly in starting, basically, as a brand new company that we wanted things to be the best way they could be for us. And we wanted to find a trustee and record keeper who would view Ameritech as an important client and give us the best service we could get.

So we started a search for trustee and record keeper candidates. We needed someone who could fill both of those functions. We looked at major financial institutions across the United States. We started with 15 candidates, and then narrowed those candidates to five finalists. We set down a rating process. The most important thing to us was to find a candidate who had a very state-of-the-art, sophisticated, flexible record keeping system. The plans we inherited from AT&T were some of the most complex plans you'd ever find, and we needed to find a system that was going to be able to custom design itself for our needs.

We ended up selecting the Northern Trust in Chicago as our record keeper and trustee, mostly because at the time Northern was building a custom-designed, flexible, sophisticated record keeping system. It worked out very well for us because, as it happened, Northern's operations offices were right across the street from Ameritech, and that really does help to keep things going.

We started our conversion process in May, 1985. We converted one plan effective January 1, 1987, and we're just finishing up the conversion of the second plan. But we ran into a lot of delays, mostly due to system delays. The Northern Trust system just wasn't ready, but that worked to our advantage because we were given the opportunity to get in on the building of the system, making sure the system was right for us.

In addition to delays as a result of system problems, we were just about ready to convert the first plan when tax reform happened. So we had to go back and redesign some of our plan features, withdrawals and vesting, and then redesign the system. But we made it, and we did convert.

The savings plans at Ameritech have a high degree of exposure. These plans have been in existence a long time, one of them for 20 years, the other for 10. So participants have very significant six-figure balances. Whenever anything goes wrong, we hear about it. In the management plan we have almost 100% participation. Currently the assets of the plan are $1.3 billion combined. The salaried plan has 23,000 participants, 95% participation; nonsalaried has 35,000 participants, 78% participation.

I will give you a bit more information about our funds. Our fixed income fund has 53% of our people participating in it. With both the plans, we are looking at 27 contracts with eight separate carriers. The equity fund currently has about 12% participation. As I mentioned, we have narrowed down from three investment managers to two. It's mostly an S&P-type fund. And then we have the Ameritech stock fund with 35% participation. Ameritech really promotes employee ownership in the company, so that fund has been very popular with our employees.

Basically, that's the way the Ameritech savings plans look today. What I want to talk about next is the proposed 404(c) regulations by the DOL. I think Jeff pretty much described in detail everything pertinent about those regulations. What I want to do is talk about how they would affect the plans of a sponsor.

Ameritech's position is basically represented by that of the Association of Private Pension and Welfare Plans (APPWP). APPWP is a lobbying group in Washington, D.C. They're a very strong lobbying group, and they represent the viewpoints of most major U.S. corporations. What APPWP has said, which we very definitely agree with, is that these proposed regulations basically ignore the existing arrangements of current defined contribution plans. What these regulations do is make current plans obsolete. If 95% of current defined contributions plans were forced to comply today, they would no longer be able to be covered under the ERISA 404(c) protection.

The DOL felt that there would be a minimum economic impact to employer-sponsored defined contribution plans, and that's absolutely not true. As I'll get to, we see very significant economic impact on our plans. What we recommend, which is in line with the APPWP's recommendation, is that the safe-type investment definition be expanded to include GIC funds and short-term investment funds (STIF). We also recommend that the DOL consider that we use two separate investment options to meet the balanced requirement. If we could use a fixed income fund and an equity fund, we feel that would enable us to meet that requirement.

The type of fund the DOL never even touched is the company stock fund. And based on a study by Bankers Trust Company, 82% of large defined contribution plans have an employee stock fund. We feel the DOL really needs to take a look at that, and include that kind of fund among the requirements.

As I mentioned, complying with these regulations is going to have a significant cost impact on Ameritech. The way it looks now, we only have two funds that would comply with the requirements. Our fixed income fund would probably go along with the preservation of capital and generation of income requirement. And the diversified equity fund would probably be all right for the capital appreciation. But that still leaves us with at least two other investment options we would need to offer participants.

What it would mean to us in order to be able to add at least two more investment options is, first of all, taking a significant amount of time to research, talk to people, and determine what types of investments would be appropriate to our plans. Second, it's going to mean making significant modifications to our internal payroll systems (we have about 15 of those) as well as our participant record keeping system. In addition to that, it's going to mean revising every report that comes out of both of those systems. It's going to mean launching a massive employee communications effort to tell people about the new investment options and, basically, to get them to re-enroll in the plans. In addition to that, our administrative costs have to increase with our record keeper, and new trust accounts are going to have to be opened with the plan trustee.

We're really not in favor of the new proposed regulations.

Another requirement that would go along with these proposed regulations is a reasonable exercise of control. What the DOL is saying is, depending on the types of investments being offered in your plan, participants need to have a reasonable amount of control in changing their investment options. For example, if you had a fund where securities were quite volatile, reasonable control may mean giving participants the opportunity to change investment elections on a daily basis. The APPWP agrees with us (or we agree with them) that this would be an imprudent thing to do. In light of the long-term plan objectives of our defined contribution plans and those of most plan sponsors, this would really be an unreasonable thing to add to the plans. It makes the plans sound more like brokerage accounts than long-term investment vehicles. We feel very strongly that a participant should not be encouraged to play short-term swings in the market with his or her long-term retirement savings.

Nevertheless, we have looked at the issue of whether a plan such as ours should be more responsive to participants and be able to function more like a mutual fund. We've had some participants complain that, "If I decide to transfer funds, from the time I submit my form to you, it's going to take between 30 and 45 days. Why can't I just call and have that happen right away? Why do I have to wait?"

The first thing is that participants would have instant phone access to their account balances. The second is that they would be able to transfer their fund balances immediately -- call and say "I want to move my balances today," and it's going to happen. In addition to that, there would be daily valuations on participant accounts. That's something we can't do. It would also provide participants with a family of investment options, all different types of mutual funds to select from.

So we considered that description of what a mutual fund would be and compared that to the objective -- what are we trying to accomplish with our defined contribution plans? The first thing we are trying to do is give participants long-term retirement savings so that when they retire they've got a good-sized nest egg. The investments we've established in those defined contribution plans have a long-term plan horizon. They are not built for playing the market. These are investments you get into, you stick with them, and you're going to make money in the long term.

In addition, through these defined contribution plans participants are able to tax defer a portion of their income into a savings plan. Looking at a mutual fund in its purest sense where, in reality, you are setting up individual accounts with the mutual fund company, participants would not have that facility of deferring their contributions through payroll deduction.

Another major plan objective for us is to be able to deliver the plan at the least possible cost. And to be able to provide participants with a daily valuation of their accounts would probably double the cost of administering the plan.

What is the cost of modifying the plan? First of all, we couldn't have our current investments. Participants are pretty happy with them, especially the fixed income fund. They know they are going to get a fixed rate of return. They're not going to lose money. It's a safe investment.

As I mentioned, there are going to be higher administrative costs. At this point, Ameritech pays for all the administrative costs related to the plan. If we provided for daily valuations of accounts, we are not sure we could continue to do that. We'd probably have to pass on some of that cost to participants. They'd lose in terms of performance.

In addition to that, we considered the fact that if participants were able to call the mutual fund at any time and make changes in their accounts, wouldn't there be some kind of loss of control by the company? And aren't we responsible for making sure these plans are always qualified plans? To us, that was a real detriment.

The last thing we looked at was would participating in a mutual fund and having that flexibility have benefitted our participants on October 19, 1987? We didn't think so. From our understanding, people who were participating in mutual funds weren't even able to reach the mutual fund companies on October 19; the phone lines were so jammed they couldn't get through. But besides that, the participants in our plans made no effort to change balances. In monitoring the activity of transferring funds from October through January, there was no change in the volume of transfers.

Basically, we decided that the long-term retirement savings aspect of our savings plans would be compromised by changing our plans to become more like mutual funds.

Just to give you a postscript about the 404(c) regulations and the plan sponsor's viewpoint, two people from our office attended a conference recently where there were about 200 plan sponsors, and the subject of 404(c) proposed regulations came up. It was typical for the companies to say that they've decided if the regulations come into existence the way they are proposed, they will not even try to comply. Their exposure is not worth the expense of what they were going to have to do to their plans in order to comply.

It appears as though the only people who are really in favor of these proposed regulations are the mutual fund companies. They are the only ones who really have something to gain by it.

And just to give you a bit more information on where we are on those proposed regulations, the DOL heard some testimony in February and basically came out of it feeling pretty embarrassed. They claimed they had no idea that 95% of plan sponsors could not at this point comply with the requirements. So what they've decided to do is make some dramatic changes to the proposed regulations, and they are hoping to come out with something by the end of the year.

MS. BARBARA I. GLADMAN: Now that Cyndee and Jeff have addressed defined contribution plans from their perspective, I thought it would be helpful to step back and address what we are seeing in the majority of our client situations. As tax reform and other recent happenings have tinkered with some of the simplicity which made defined contributions attractive in the first place, let's just review the basic objectives and the factors which contributed to their popularity originally.

Every plan should start with a clear set of objectives. Changes for compliance purposes should prompt a review of those original objectives. Most plans clearly focus on providing employees with long-term retirement income, a focus which can be lost when responding to pressures for investment alternatives and plan loans.

When we do studies, we increasingly count on employee balances in defined contribution plans to evaluate the adequacy of retirement income provided. Capital accumulation in support of goals other than retirement is often the reason younger employees join the plan, and we can't deny this goal is key as well. We need to help plan sponsors balance these first two objectives in their own mind, and then fairly share those goals with their employees through communication and supporting plan design.

Employee stock ownership is a primary objective for many plans. Such profit sharing plans or stock bonus plans usually have a proud history and a tradition which has led to few changes over the years. Recent events would support review of these plans as well, and certainly payroll stock ownership plans (PAYSOPS) need to be dealt with.

Income deferral for highly compensated employees was early on the reason for many 401(k) plans. Now with these deferrals being capped and with increasing problems in meeting the deferral tests, we would suggest careful examination about whether or not this objective, in fact, is a good reason for having a plan exist.

Finally, the plan design objective, which will become increasingly important as plan balances grow in the future, is just how much investment risk can participants tolerate. I've worked with plans where employees were involved in the design phase of the plan. In these cases, much to the surprise of the financial executives who hired us, employees gravitated toward investment options that they understood and felt were defensible to fellow employees. I've seen indexed equity funds chosen above managed funds with better performance for that reason.

Clearly, employee risk tolerance varies, but in one project the employee committee voted to eliminate the investment options and return investment responsibility to the plan sponsor and professional manager. Not too surprisingly, employees seem to be more conservative the larger the role the defined contribution plan plays in their retirement future. GICs remain very popular for that reason.

Communication objectives need to be established and reviewed regularly. While employee appreciation and participation remain pretty constant, plan sponsors face an increasing burden to provide retirement, investment, and tax communication. Further, as employee savings play a larger role in retirement income, plan sponsors need to set realistic objectives and strategies to help employees plan for their retirement.

One large client of ours recently shared with me the story of a plan participant who was retiring with a defined contribution balance of $150,000. The plan sponsor had, out of curiosity, reconstructed what that employee would have had had they made the "right" investment decisions over their career. This particular benefit manager felt some responsibility for the fact that the employee balance was $150,000, and not $450,000, which they could have had had they made the "right" investments.

I think, increasingly, plan sponsors change responsibility to their employees and are going to be feeling nervous about the fact they've not provided perhaps enough information to have employees take the best advantage of the opportunities available.

Plan administration objectives are seldom established in advance, but evolve over the life of a plan. Establishing those objectives, especially in light of the first two categories here, makes perfect sense right now. There are any number of strategies to address the objectives once basic decisions have been made. Service, timing and accuracy are critical and very visible issues with employees. There is often a reason to evaluate the cost of an administrative feature and its respective value.

Frequent valuations make sense; but then again there may be other ways of addressing those same issues that are more cost-effective. External sources for administration support are prevalent, but often internal capabilities are under-used and poorly documented. We frequently do client studies and find that companies have huge investments in personnel and payroll systems and are unaware of their own data capabilities.

Checks and balances remain an interesting issue, and there is a wide diversity of opinion here. Some plan sponsors like a one-stop shopping approach, where others clearly seek out the best trustee, investment manager, and record keeper under the assumption that, in addition to auditing each other, the replacement of one party is easier than replacing the entire system when things go wrong. In all cases, employee perception of administrative decisions is critical and should be a factor in any choices made.

I'd like to review quickly what's ahead, based to a large extent on what has recently passed. Clearly, the popularity of defined contribution plans will continue, despite tax reform and the market crash. I'll briefly discuss the proposed regulations on plan investment and plan loans, while skimming the recent administrative pronouncements on excess deferrals and contributions.

Many of the tax reform issues were dealt with in 1987 as far as defined contribution plans are concerned. Clearly, we will be living with the problems associated with contribution limits, taxation and plan loans for years to come. I'll look at each of these separately and briefly review the defined contribution plan issues effective in 1989.

Limits to highly compensated employee contributions come from a variety of sources: the 401(k) test, 401(m), 401(k) limits, the compensation definition and the new inclusion of after-tax contributions in the 415 limit. This results in a pronounced pressure for nonhighly compensated employee participation at a time when there are any number of factors which make this participation unlikely.

Many plans were originally designed to acquire some pretax contributions before an employee could make after-tax contributions. Since TRA '86, only matching contributions are a permitted incentive. The 401(k) plan eligibility has been broadened and hardship withdrawals tightened. Lower tax rates make deferrals less attractive and, as loans become popular, I fully expect that the feature that originally encouraged plan participation will start to have an impact on the ability of lower-paid employees to participate in the plan at all. Finally, coverage tests could further complicate the differences in participation rates between the highly compensated employees and nonhighly compensated employees.

What, then, are the issues that need to be measured against your objectives? The role of nonqualified supplements will grow in light of decreased deferral opportunities. Other design changes surrounding vesting and the restructuring of employer matches in favor of nonhighly compensated employees can be expected.

The administrative complexities resulting from TRA '86 have been enormous. The 401(k) and 401(m) tests have caused problems for most every plan sponsor, resulting in messy mid-year adjustments and, for many, a return of excess contributions, with all the commensurate complications. Even monitoring the $7,000 (or now $7,313) limit seems to be difficult for employers.

Communication objectives will need to focus on different opportunities to expand participation to newly eligible as well as nonparticipating employees and, again, a clear message needs to be sent about the employee role in retirement savings, long term.

Early on in tax reform dealings, the taxation of withdrawals and distributions became a real area of confusion for most employers and employees. Temporary regulations shed some light on the 15% excise tax on excess distributions. Notice 88-33 provides further guidance than Notice 87-77, but the distribution of excess deferrals and contributions remains an area of uncertainty. The latest in the series of administrative pronouncements provides for alternate methods of allocating income on the excess, but creates considerable confusion with very limited timetables available.

While 1987 is behind us, what will happen in 1988 and beyond is still unclear.

Identification of highly compensated employees turned out to be no simple task, regardless of the use. Separate contract account requirements surrounding the taxation of interest on after-tax contributions have taken considerable administrative effort. In total, the data and system requirements in defined contribution plan administration will continue to be considerable. And since withdrawals have become less attractive, many plan sponsors have added loan provisions with the accompanying administrative complications.

While many plan sponsors had previously refrained from providing tax advice, that trend has changed and been complicated by the TRA '86 grandfather provision. Plan sponsors now stress in advance the tax consequences of withdrawals, for example.

Retirement plan loans were hit hard with TRA '86, but those changes now pale in comparison when we review the proposed regulations relating to plan loans issued this year. Briefly, the proposed regulations imply that a participant's vested benefit or account balance may not provide adequate security for a plan loan. In fact, 401(k) account balances appear to be restricted from use as a security.

The regulation defines reasonable rate of interest, but calls into question some common practices for establishing loan terms, such as fixing the rate of interest for the term of the loan. The regulation provides for a retroactive effective date to January 1, 1975, which clearly complicates compliance. The regulation requires that loans are not made available to highly compensated employees in an amount greater than to other employees without specific guidance as to what sort of minimums would be tolerated. Finally, the regulation requires that the loan provisions be set forth in a written document, which seems the least innocuous of all the provisions.

Loans present any number of issues within a plan, many of which are up in the air with the proposed regulations. Employers to date have reasonably shied away from acting as lending institutions. This may no longer be possible. As administrative requirements grow, handling record keeping requirements, establishing default procedures, completing truth-in-lending paperwork and making record keeping accounting decisions already cause sponsors concern when adding a loan provision, to say nothing of the communication issues.

The year 1989 brings continuing challenges in a number of tax reform areas, including participation and coverage testing, integration, and vesting. Additionally, 1989 signifies the application of a number of qualified plan provisions to the world of tax-sheltered annuities, which so far has been relatively simple -- unless you're talking about the exclusion allowance, which isn't simple at all.

Leaving tax reform for just a minute, the October market crash left a huge and lasting effect on defined contribution plans, as we've discussed. It left us asking a very important question: "Does volatility reduce the effectiveness of the defined contribution plan as a retirement vehicle?"

Valuing transactions without disadvantaging the wrong participants can be difficult, given typical trust accounting. While the acute problems of insufficient trust assets and unsecured loans have been dealt with for the moment, volatility has prompted an examination of basic long-term plan objectives.

Clearly, shifting investment responsibility to plan participants is comfortable in an environment of steady market appreciation, but less so if, as most experts believe, the market corrections will continue. In addition to proposed 404(c) regulations, the market crash caused plan sponsors to focus on the types of investment alternatives offered. And, in a rare opportunity, employers with defined benefit plans took a bit of a bow, reminding participants that their benefits were unaffected by the market crash.

Once again, administrative issues surfaced. The trend toward more frequent valuations was reinforced. Many prior valuation date transactions were limited. Plan sponsors are requiring more notice for transactions in an effort to transfer estimated funds to more closely reflect market conditions at the valuation. Stock and unit accounting continue to grow in popularity. Plan sponsors increasingly feel that employees with equity investments would rather see plan balances reported in numbers of units rather than cash value, which implies gains and losses which are not recognized for continuing participants.

Communications efforts now center on helping employees understand the investment funds offered, keeping in mind concepts of dollar cost averaging and emphasizing a long-term perspective.

I won't spend much time on proposed DOL Regulation 404(c), except to say that our testimony at the hearings in Washington in February, 1988, asked the DOL to reconsider their position. We have found our clients to be reacting like Ameritech. For the most part, compliance would be difficult, expensive, and, in many cases, would require far more effort than the protection from fiduciary liability justifies.

We do, however, see plan sponsors examining the types of funds they offer to participants. The manager selection process is under scrutiny, and plans with a larger portion of their funds in employer stocks are now wondering whether or not 404(c) is a continuation of the trend established by the employee stock ownership plan (ESOP) and the diversification provisions of TRA '86. Both employer stock and GICs, which are very popular investment funds, are silent in proposed regulations.

The increased record keeping complexity and expense are obvious. While there are certainly large plans which value accounts monthly, the preponderance of plans are valued quarterly or even annually. Asset transfer provisions have generally been restricted to discourage employees from market timing in qualified plans. Regulation 404(c) calls this practice into question.

Finally, the communication issues of 404(c) are obvious and would require a substantial investment of time to present really useful information to participants with widely varying levels of investment sophistication.

In closing, with all of the issues facing defined contribution plans, sponsors are understandably seeking to review objectives and reinforce the reasons for establishing the plans in the first place. To briefly review those reasons, employees understand and value defined contribution plans highly. Every employee survey bears this out. We have sold employees on the tax advantages of income deferral and tax-sheltered growth. Individual account statements remain the best communication vehicle for continued participation. Investment choices that are well chosen, well communicated and appropriate for the population can and do prompt a positive response from employees. Defined contribution plan balances are portable, providing a feeling of continuity to a mobile work force. Finally, the sales pitch plan sponsors have given 401(k) plans has reinforced their popularity with employees. Communication pays.

In short, plan sponsors value the plans because of their popularity with employees. And while contributions are often dependent on employee participation, considerable employer discretion remains. The value of what I call contribution leverage cannot be overlooked. While it's true that a dollar spent in defined contribution plans very often does not provide the same amount of retirement income as a dollar contributed to a traditional defined benefit plan, there is a real value to encouraging employees to participate in saving toward their long-term security.

Many organizations value highly the employee stock ownership, and ESOPs provide yet further financing advantages to employers. In a world of growing concern with work force productivity, an emphasis on employee profit sharing is a historic concept worth reviving. A couple of years ago, I would have added a bullet here alluding to the administrative ease of a defined contribution plan. Except for the fact that it would be nice to end with a laugh, I think you'll agree with me that that bullet point should be dropped.

MR. DODD: Do we have any questions for our panel? I've got a couple of questions that I'll lead off with. Barb, you mentioned briefly unit accounting versus cash accounting, and I know there is less than total agreement on which method to use. Maybe we can just go down the panel here quickly and get individual opinions. Jeff?

MR. PASTER: The whole question of how you report to employees what their balances look like is difficult, as employees always struggle with trying to read their statements and understand them. And you are again dealing with different employees with different levels of sophistication. What we have found is that (partially because of the nature of our investments) to report all the transactions in both shares and dollars is very helpful because what they understand in reality is cash. But if they want to track their account in between statements, if they know they have 800 shares of Fidelity Magellan Fund, they can then track that in the paper based on the number of shares they own and the price that it closes at each day. This gives them some type of interim values other than just the quarterly statements they have. We've found that both are very helpful.

MS. GLADMAN: I think I pretty much stated my position in my presentation. I think we see a trend toward unit accounting. As one of our communications consultants likes to talk about it, people would rather see they have the same number of milk bottles, even though now they're half full, whereas before they were entirely full. I think the perception of the fact that you haven't lost anything, but that the value of what you own is less now than it was, or can be more, is more important. So I think we see a trend toward unit accounting. I think this is especially reinforced by the fact that many of the plans with investment choices also have shares of mutual funds that are the main investment vehicle, so it reinforces the nature of the vehicles they are including.

MS. KAHN: Our participants seem to prefer cash accounting. Prior to converting the plans over to the Northern Trust, all the funds in our plans were accounted for in units. And our participants never really understood what that meant. If we had had the types of funds, for example, that Fidelity has where you can watch the progress in the paper, maybe that would have helped them understand what the values of their accounts were. But they never seemed to understand. Now we've moved over to cash accounting and share accounting, also for the company stock fund, and people understand. They understand what their accounts are valued at, they know how many shares they have, and they seem to be pleased with it.

MR. DODD: I want to share an experience with the group and get some comments. The day after the market crash, there was a called meeting of all employees. Employees were given the option of redistributing their choices in the 401(k) plan during a special 20-day window. Normally, they had quarterly allocations, but they were doing a special 20-day window on October 20. Your opinions on this -- was this a good move or a bad move?

MS. KAHN: Based on what our participants did, which was pretty much nothing, I'm not sure it's a positive move. I think the more information or opportunities you give to people, they feel like, "Maybe I should change. They're giving us the opportunity, maybe the company is telling us we really should make a change." I don't know that it necessarily works for the participant's benefit.

MS. GLADMAN: I agree. When Tom came running down to my office with the story, I was surprised, to say the least. I think that reinforces exactly the opposite message that you'd like employees to understand. A loss isn't a loss until it's recognized, and why recognize the loss if you are in it for the long haul? I think it's really important that employees remember that volatility is part of the risk characteristic of certain types of funds, but that you don't necessarily need to react to those swings in the market in a way in which you are actually impacting your retirement savings long term. So I think I would agree with Cyndee that that was probably inappropriate and exactly the wrong reaction.

An interesting point, although I don't have the actual numbers, we did a survey of professional managers and evaluated what their responses were to the market crash. We found for the most part the professional managers stayed put; very few actually got out of the market. The people who were engaging in any activity at all were actually buying. So it was interesting that the experts were doing that; you probably don't want to give your employees the opportunity to make a bad decision.

MR. PASTER: I think there are two parts of what took place that are important. One of them I think is good, and the other I don't think is good. First is to have a meeting after such a tumultuous event. This is good. Explaining what happened so people understood what effect it may have had on their own plan investments is very good. However, I agree with the other two panelists that to give them a short window of 20 days to "make a decision or forever hold your peace," focuses them and almost forces them to do something that maybe goes against their longer-term plans. I guess that's one of the reasons why I'm a believer in the ability to exchange on any day, and then you don't have that pressure of having to react. You've got the flexibility to say, "If something happens I can always do something tomorrow." In fact, to a large degree that can encourage a lot less activity than with quarterly valuations.

MR. MICHAEL E. STROTHER: Jeff, I think, talked about certain situations under which an employer might be obligated to make good, to restore, participant account balances. Did I hear that correctly?

MR. PASTER: To my knowledge, there's no obligation for them to make the plan or the participants whole for the activities. Some of them may have felt that obligation, either morally or in a legal sense. But I know of no absolute obligation that they would have to make that plan whole for the delay in the transfer.

MR. STROTHER: I'd be curious as to whether anyone else could comment. When you do have a big drop like that, you could conceivably get 80% of the people withdrawing their funds and leaving the plan in a negative position. Would the employer have any obligation there?

MS. GLADMAN: I agree with Jeff entirely. I think we saw some plan sponsors feeling as if they ought to do that, and many made a decision based on when the election was made -- if there were September 30 balances, for example, that were being withdrawn. If people made an election before the crash, they honored those. If people made an election after the crash, they didn't. I think there was a lot of judgment calling that went on, and a lot depended on how severely the particular assets in the fund were hurt. But I also know of some clients who kicked in additional funds to cover what they thought were unusual losses in the funds with a very nervous look toward the future about what happens the next time. So I think the people who did it were few and far between, and very nervous and perhaps quiet about the fact they did it.

MR. STROTHER: Can you tell me, generally, in a situation like that, what are the restrictions on the contributions that the employer can make concerning the taxability of those contributions or the limitation on the amounts of the contributions that the employer can make?

MS. GLADMAN: Assuming a profit sharing plan, it was simply a discretionary contribution, and I think that's the way it was certainly addressed in the two situations that I know about. And in both cases it wasn't so significant; it was primarily a restoration of people making withdrawals or retiring based on distribution as of September 30.

MR. ROBERT S. CARNACHAN*: Just to follow up on that, there was an interesting story in the paper about Allied Signal. Allied Signal seemed to be going through a change; I think they were combining companies. Anyway, they were evidently allowing their people to trade, notifying them of an ability to trade on a certain date. People did put their trades in, and they weren't executed by the time of the crash. People were obviously very unhappy about that, so the company decided they should be put back where they were. But they took it out of the accounts of the others. In other words, they revalued the whole thing, and these people got made whole. There was a controversy about that, and then Allied made up the difference saying, "We're going to take care of all you people." But this brings back the question of how fast do you have to operate upon trades?

MS. GLADMAN: I think "have to" or "can" are two different things. I think it depends on what you're trading. And I think it's not at all unusual for plan sponsors to save transactions, if you will, for the entire quarter if they value quarterly. That happens all the time. One of the things I think we saw as a result of the market crash, and it was an interesting provision that we found in some of our plan documents that had been there for years and never had occasion to be called into play, was the fact that if the fund value decreased or increased by more than 15% that the sponsor could call for an interim valuation immediately and base transactions on that most recent valuation rather than waiting for the next December 31, which was the first one after the market crash, for most of our plans. So, I think you're finding clients reacting to that by giving themselves some flexibility in dealing with transactions more closely and making those transactions as close to the date as one can.

MR. CARNACHAN: Just as a follow-up, I think that, to a large degree, it's an employee communication issue, so that employees understand when transactions happen. Transactions happen some time in the future, and you can't track them. If employees know what the rules are, then they may or may not be happy about it, but they can't really complain. But to a large degree, I think a lot of employees are not aware of the rules as to how the activity takes place; and, therefore, when you have a large swing in the market, either positive or negative, employees get surprised. And when they get surprised, employee benefit people get calls.

MR. DODD: Barb, I've got a question regarding plan loans. That is, in the face of the regulations, which appear to be very difficult to comply with from an administrative and a communications aspect, you implied that plan loans are gaining increased popularity because of the new withdrawal restrictions. How do you resolve that apparent dilemma with a client?

MS. GLADMAN: I've put everyone who is thinking about a loan provision on hold, especially if it's a 401(k) plan where there's some question about whether or not the account balance is adequate security. I think it makes it difficult to administer. I really question whether plan loans which had, before the proposed regulations gained in popularity will be viable [401(k) account balances were just getting to the point where people had enough to borrow]. TRA '86 changes the

* Mr. Carnachan, not a member of the Society, is President of Pension Actuarial Services, Inc. in Sonoma, California.

taxation of withdrawals to make them less attractive. Even without the deductibility of interest, I think people still saw plan loans as a good way to use the money while they were still working, repay it, and have it there when they retired. I think, in their current form, the proposed regulations will kill the attractiveness of plan loans, and I think anyone considering putting in a loan provision probably ought to sit tight until there is more clarification on that issue.

MR. DODD: Is the DOL aware? What sort of feedback do they have, and what are they doing? Do we know?

MS. GLADMAN: I've never seen more reaction from employers on any proposed regulation in my life. The phone was simply ringing off the hook, and we sent copies of our testimony and reaction to many clients who wanted to use that as a basis for reacting on their own. The 401(k) plans are just so popular, and we've made them popular by communicating them; employees are going to react really strongly to this sort of change. There has been an awful lot of noise made, and I'm sure that there will be some changes. What those will be, I don't know. But I think the whole security issue is going to have to be addressed.

MR. DODD: Cyndee, did Ameritech ever consider participant loans?

MS. KAHN: We have participant loans.

MR. DODD: How are you handling that in light of the proposed regulations?

MS. KAHN: We are continuing as usual until we know what's going to happen.

MR. DODD: Have you found administration of participant loans difficult, or do you have an apparatus set up?

MS. KAHN: Administering the loans is difficult for everybody, not only the administrator but also the record keeper. People learned as they went along. There were many errors made everywhere, both by local benefit offices and by the record keeper. But right now everything seems to be running smoothly. It's a complicated feature, but of great benefit to employees.

MR. CARNACHAN: Cyndee, I'd like to ask you a question on that. What's your feeling about building into the loan agreement a provision that failure to pay the loan authorizes the employer to withhold sufficient funds from wages to pay back the trust?

MS. KAHN: That is the way it works. Unless an employee leaves, then the whole thing becomes taxable -- the outstanding balance becomes totally taxable.

MS. GLADMAN: I think defaults are a really big issue. They could be considered a premature distribution. There are a lot of questions. I think much of it depends on the accounting decisions you make and how you account for those loans. If the loan is an asset of the individual, as opposed to an asset of the trust, I think you can do some different things with the default procedures. If the default is only affecting that individual participant's balance, it's a whole different issue than when the default is impacting the entire trust.