Individual Pension Savings – A Labor or an Investment Issue?[+]

by

Dana Muir*

I. Introduction

Over the past twenty-five years there has been a paradigm shift in both the United States (US) and the United Kingdom (UK) in work-based retirement programs. Those programs have morphed from providing lifetime monthly pension checks to making available tax-favored savings and investment-style accounts to interested employees.[1] In spite of the dramatic changes in the form of those programs and in the amount of risk borne by employees, the allocation of institutional authority over work-based retirement programs in the US has not changed. In contrast, the UK, which has experienced a similar shift in work-based retirement programs, has reallocated institutional authority for those programs.

This paper examines the allocation of regulatory authority in each the US and the UK. The primary focus here is on the considerations in apportioning regulatory oversight between the relevant labor regulator and the national regulator of financial services or investment-related disclosures. These considerations are particularly timely given the potential for broad-based reform in the US of the federal oversight of financial and insurance institutions, which may occur in response to the near collapse of Bear Stearns and the upheavals associated with the mortgage-backed securities markets. It is possible that US reform would consolidate at least some of the regulatory functions currently shared among an array of state and federal agencies.[2] The UK has already followed a path to consolidation. In 1997 the UK established a single regulator system for all banking and financial services regulation under the newly constituted Financial Services Authority (FSA).[3]

The regulatory issues are complex because of the numerous variables among what this paper will refer to generically as individualized pension accounts (IPAs). Although the focus here is work-based IPAs, technically IPAs may be made available through a workplace or may be independent of employment. IPAs may be alternatives to another type of pension arrangement based in the workplace, to at least a portion of a government-provided pension or they may be an additive scheme. IPAs may be based in trust or in contract. And, the financial markets continuously adapt the investment products that underlie the potential success of IPAs.

Part II begins with a brief overview of the paradigm shift in work-based retirement programs in the US and UK. It concludes with a description of the fundamentally different ways in which the US and the UK allocate regulatory authority over IPAs. Part III considers major legal challenges that have arisen in the US and the UK regarding IPAs. Part IV turns to two problems that regulators in the US and the UK have confronted in recent years with respect to IPAs. The first issue involves the problem of establishing suitable default investments. The second issue relates to appropriate levels of account fees. Finally, Part V unpacks the considerations in choosing between a labor regulator and a financial services regulator by considering the risks inherent in IPAs and the types of entity to be regulated. The analysis is informed by the earlier examination of the types of issues that must be addressed by any IPA regulator.

II. Transition in Programs and Regulation – UK and US

A. From Monthly Checks to Savings Accounts

For most of the twentieth century one of the many traditions shared between the US and the UK was a type of employment-based retirement plan known as a defined benefit (DB) plan. DB plans typically promise monthly pension checks for the life of the recipient. The amount of the benefit is based on a formula often related to salary and years of work with the employer funding the DB plan. The employer is obligated to fund the plan sufficiently to provide the promised benefits.[4]

The financial commitments inherent in employer funding and increasing regulatory burdens caused many employers in the US and UK to terminate or freeze their DB plans.[5] In the US, participation in DB plans fell to approximately 18.5 per cent of workers in 2003 from 22.9 per cent in 1995. Much of the drop in DB coverage occurred earlier than in the UK; one has to go back to 1980 to find a 35 per cent coverage rate in the US.[6] In the UK, between 2000 and 2006 the number of open private sector occupational DB plans with only one section dropped from 18,350 to 3,470.

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*Arthur F. Thurnau Professor & Professor of Business Law, Stephen M. Ross School of Business, University of Michigan, Ann Arbor, MI.

During the same period, membership in those plans fell from 4.1 million to 1.6 million employees.[7]

The decrease in the numbers and coverage of DB plans did not spell the end of employment-related pension arrangements though. While employer sponsorship of DB plans decreased, work-based IPAs in the US and the UK have increased in numbers of plans, covered employees and in the value of assets held in the accounts. Before discussing the relevant statistics, it is necessary to define what types of accounts and benefits for purposes of this paper, are encompassed within this paper's definition of IPAs. To begin by exclusion, state funded benefits, such as those provided under the US Social Security program and the UK National Insurance program, are not covered in this paper. Nor does the paper explicitly address the various US proposals to establish individual accounts as part of the Social Security program.[8] Finally, the paper excludes from consideration all pension arrangements for public sector employees.

In order to qualify as an IPA, the particular type of account being addressed must be formally recognized by legislation as a savings vehicle intended to provide retirement support. In addition, individual accounts must exist, at least on a notational basis. Table 1 shows the types of IPAs available in the UK and US and the extent of their relationship to the workplace. Each of the arrangements receives favorable tax treatment. None of them are government funded unless that funding is in lieu of a governmental account. Individuals may bear all of the account fees and investment risks or those costs and risks may be shared with the employer or government in some way.

In the US, 401(k) plans, named after the Internal Revenue Code section that authorizes the plans, constitute the primary type of work-based IPA. Sponsorship of 401(k) plans has grown from essentially zero in 1981[9] to the point those plans now have more participants and assets than any other type of IPA in the US. At year-end 2006, approximately 50 million US workers participated in 401(k) plans with assets totaling an estimated $2.7 trillion or about 66 per cent of all work-based IPA assets.[10] In the UK, approximately ninety-seven per cent of the open private sector occupational IPA plans were founded after 1979. In recent years, though, the number of those plans has fallen from a peak of 46,730 in 2004 to 33,770 in 2006. Membership, however, has remained at about 1 million.[11]

Beginning in 1998 the UK expanded the population eligible to open a type of IPA designated as personal pensions. At the same time, workers received the right to opt out of a portion of the public pension system (the portion then known as SERP) or out of their current or former employer-sponsored occupational pension scheme.[12] When it announced expanded access to personal pensions, the UK estimated that about half a million workers would establish a personal pension in lieu of SERP or an occupational pension scheme. The actual take-up rate was dramatically higher. By 1994-95, approximately 5.6 million people had established personal pensions.[13]

A new type of IPA, popularly known as a stakeholder pension, was made available in 2001. Those accounts were intended to operate at low cost while meeting a set of minimum requirements intended to protect account holders. Most employers that do not offer any other type of pension plan that meets minimum standards must select a stakeholder scheme and make it available to employees. As of 2004 approximately one million individuals had contributed to a stakeholder plan, about the same number as are members of open private sector occupational IPA plans. But, 82 per cent of the schemes designated by employers had not garnered any members as of 2004.[14]

Although not the focus of this paper, the US and UK both make provision for individualized pension accounts initiated outside the workplace. In the UK individuals can establish personal pensions as well as versions that qualify as stakeholder pensions. In the US, Individual Retirement Account (IRA) assets have risen from $1.1 trillion in 1994 to $4.2 trillion in 2006.[15]

To complicate matters further, these categories of IPAs are more complex than they may seem on the surface and are perfectly compartmentalized. For example, about one-half of the assets held in IRAs originated in work-based plans.[16] And, IPA offerings change frequently as governments modify regulations and financial firms create new products. Major changes are expected in the UK with the introduction of a new personal accounts scheme, which is planned for 2012.[17]

Figure 1. Individual Pension Account Arrangements			
	Employer-based Schemes		**Personal Plans**
	Trust-based IPA	**Contract-based IPA**	**Contract-based**
US	• 401(K) • Profit-sharing, ESOP	• Simplified Employee Plan, SIMPLE	IRA
UK	- Occupational Money Purchase	• Group Personal Pension • Stakeholder Pension	• Individual Personal Pension • Stakeholder Pension

B. Division of Institutional Authority – US and UK

Once government-provided pensions are excluded, the primary participants in establishing, operating, or benefiting from individual pensions are employers, individuals and the entities that provide financial products or services related to IPAs. Considering the actors to be regulated, then, natural choices for regulators of IPAs would be the agencies responsible for oversight of financial institutions and those that focus on workplace relationships. To the extent that IPAs receive favorable tax treatment or other governmental funding, the government's taxing authority also has an interest in ensuring the governmental expenditure achieves its objectives and is not subject to misuse.

The institutional oversight regimes that have developed in the US and UK to regulate IPAs are quite complex. Both countries have established entities that provide a safety net in limited circumstances for underfunded DB plans. In the UK, three different ombudsman services and The Pensions Advisory Service share responsibility for assisting individuals with pension-related questions, disputes and compensatory rights. The US leaves dispute resolution to the plan in the first instance with appeals heard primarily in the federal court system. In addition to the authority assigned to these and other regulatory entities, in each the UK and the US two institutional entities have emerged as the central entities with responsibility for oversight of pension-related matters. The foundational nature of the primary institutional entities, however, differs between the two countries. And, the two countries relied on distinct conceptual approaches to determine the allocation of authority.

In the US most of the regulatory authority over DC plans is split between the Internal Revenue Service (IRS) and the Employee Benefits Security Administration (EBSA), which is an agency within the Department of Labor (DOL). In part this division of authority may exist because US pension policy has long reflected the tension between balancing tax and other incentives for employer sponsorship of pension plans with provisions that protect employees from malfeasance and unfairness. The interests of each agency led to battles between the two agencies and the supporters of each in Congress during the debates prior to the passage of the Employee Retirement Income Security Act of 1974 (ERISA).[18] When the statute finally was passed, many of its provisions were written into both the labor and the tax sections of the US Code.[19] In order to resolve the regulatory overlap, the agencies agreed to cede each other authority over specific types of regulation. The IRS received responsibility for funding, eligibility to participate in plans, and ensuring entitlement to plan funds. The DOL received authority over fiduciary issues, proper disclosure, and claims procedures. The anomalous approach to duplicative legislative provisions continues as does the division of responsibility.[20]

In the UK the agencies with primary regulatory responsibility for pensions are the Financial Services Authority (FSA) and The Pensions Regulator (TPR). The FSA and TPR have entered into a detailed memorandum of understanding that allocates authority between the two entities. At the conceptual level, the memorandum divides authority on the basis of the entities subject to oversight. In general TPR has responsibility for oversight of and providing advice to employers and to trustees of work-based pension plans. TPR is a public body accountable to the Department for Work and Pensions (DWP). Although DPW, not TPR, develops pension policy and law in the UK, TPR is widely-recognized as a regulatory

body. In contrast, the FSA regulates the financial and insurance firms (FIFs) that advise on the marketing, sale and provision of personal pensions and annuities. The FSA also has responsibility for improving investor knowledge and understanding of financial products and markets.[21]

At a high level of generality, both the US and the UK have empowered an entity accountable to the country's primary regulator of workplace issues to act vis-à-vis workplace pensions including IPAs. The more detailed contextual examination that follows, however, reveals significant differences between the scope of authority of those workplace regulators. In addition the regulator with which the workplace regulator shares responsibility differs significantly between the countries. In the UK the other regulator is the FSA, which generally has responsibility for financial market integrity and oversight of financial market firms. In the US the other regulator is the IRS, which at an institutional level is charged with collecting federal taxes and enforcing federal tax law. Finally, the conceptual basis for the division of authority differs between the two countries. The US divides authority according to the substantive nature of the regulation. The UK divides authority according to the entity to be regulated.

III. Issues Resulting From the Use of IPAs

The US and the UK both have sufficient experience with IPAs to enable identification of specific types of issues that pose challenges for the institutional oversight of those types of accounts. This part develops analyses of a wide-spread problem with IPAs from each country and draws some parallels between the two situations. The first analysis, from the UK, addresses the misselling scandal from the period 1988-1994. The second, from the US, analyzes the more recent legal issues that have resulted from account losses due to individual account investments in employer stock.

A. Misselling in the UK

In 1988 individuals in the UK were first permitted to choose personal pensions in lieu of SERPs (a portion of the government-provided retirement benefit) or occupational pensions.[22] It did not take long for reports to surface of noncompliance with regulatory standards in the sale of personal pensions in lieu of a pension schemes offered by employers. In 1992 the Securities and Investments Board (SIB) reviewed a sample of the records associated with personal pension sales and found that only nine per cent substantially complied with regulatory rules.[23] As a result of its concern, the SIB commissioned a study of industry practices. That study found "'widespread regulatory compliance failure'" [24]

The concern with misselling focused on the sale of personal pensions by insurance companies and recommendations by independent financial advisors to employees who, as a result, in some way opted out of a pension scheme offered by their employer. The investigations found that existing records were insufficient to demonstrate compliance with best advice and know your customer rules. It also appeared that numerous employees who had bought a personal pension would have clearly and unambiguously been better off in the offered employment-based pension scheme. Two factors tended to cause employment-based pension schemes to be more lucrative for most individuals who had that option. First, employers typically contribute to them but not to personal pensions. Second, the benefits formula of the employment-based pension plans typically were more generous than the investment growth that could be expected in a personal pension.[25]

Professors Julia Black and Richard Nobles attribute the misselling to failures on the part of both the responsible regulators and the FIFs involved in misselling. Concentrating here on the potentially problematic actions of the regulators, one allegation by FIFs was that the regulators retrospectively changed the standards for suitability and know your customer requirements. Nobles and Black effectively explain that although additional guidance was eventually given by the regulators, that guidance constituted a more thorough explanation rather than a change in standards.[26]

Professors Black and Nobles chastise the regulators for failing, until the 1992 SIB audit, to focus their regulatory efforts on personal pensions as a product line. The regulators allegedly suffered from a lack of expertise with personal pensions, which constituted a new line of products. Instead of watching for patterns of problematic activity in personal pensions, the regulators established review processes that tended to focus at the firm level. According to Professors Black and Nobles, the regulators emphasized reviews of the activities of internal firm controls. As a result, the regulators missed the problems that existed across FIFs in the personal pension product line. Both the government inquiry and Nobles and Black believe that the incentives for aggressive sales created by the commission salary structures for salespeople were at the heart of the industry-wide misselling.[27]

Finally, the FSA concluded from its inquiry that division of authority among multiple regulators created coordination problems among the regulators.[28] During the misselling period, responsibility was divided among three regulators. Lautro, which regulated insurance companies, and Fimbra, which regulated financial advisors, both were self-regulatory organizations. The primary governmental regulator was SIB, which regulated the banks and the equivalents of US credit unions.[29]

Ultimately regulators required FIFs that had sold personal pensions and independent financial advisors who provided advise to purchasers to undertake a two-part review process intended to identify misselling that occurred between

April 1988 and June 1994. The priority phase covered older purchasers who were at or near retirement. Phase two extended to younger purchasers, who typically were younger than 50. As of June 2002, FSA estimated that the pensions industry would pay out £11.8 billion (approximately $3.36 billion at the current exchange ratio) after reviewing the records of 1.7 million customers.[30]

B. Use of Employer Stock in DC Plans in the US

In the US, issues relating to the investment of DB and IPA pension assets in the stock of the plan's sponsoring employer pre-date the enactment of ERISA in 1974. The issues were largely dormant though, other than in the context of potential corporate takeovers and Employee Stock Ownership Plans, until two events resulted in large losses in employee 401(k) accounts across a number of companies. The first event was the dramatic drop in the US stock markets after the bursting of the tech bubble in early 2000. The second event was the the collapse of Enron Corporation in 2001, which was followed by a surge in governance and accounting scandals at other US companies.

Estimates of the amount lost by employees who participated in the Enron 401(k) plan range from $1 to $2 billion. WorldCom employees allegedly lost more than $1 billion.[31] Nor were these types of losses limited to the companies that appeared at the top of news stories about corporate malfeasance around the turn of this century. An accurate count of the number of companies that faced claims by employees associated with use of their stock in DC plans is not available; however, between 2003 and early 2005 US courts issued opinions involving at least 31 different employers. Legal commentators in the US appear to be unanimous in their view that the claims are widespread and of substantial importance.[32]

In the employer stock cases, employees alleged wrongdoing against an array of individuals and institutions including the companies sponsoring the plans, individual plan fiduciaries, company directors and directed trustees. The legal claims brought under ERISA can generally be divided into three categories, all based in fiduciary obligation. One typical allegation was that plan fiduciaries continued to permit the use of employer stock in the plan even after they knew or should have known that stock had become an imprudent investment. Second, plan fiduciaries allegedly made material omissions or misstatements in their direct or indirect communications with employees about the employer stock. Third, plaintiffs claimed that high level plan fiduciaries failed to properly appoint or monitor those lower level fiduciaries that had responsibility for decisions regarding communications or plan use of employer stock.[33]

The responses varied by claim as well as by the type of defendant. Some number of cases involved disputed factual situations but the early court decisions on summary judgment motions addressed the underlying viability of the alleged legal claims. One important category of responses pointed out that the ERISA claims typically overlapped with more general shareholder claims brought under US federal securities laws. In other instances, defendants claimed that the duties plaintiffs alleged that ERISA imposed upon them were inconsistent with the federal securities laws.[34]

Unlike the UK situation with misselling, the employer stock controversy remains largely unresolved. Some cases have settled.[35] Others have been dismissed for various reasons, including the unavailability of relief.[36] The Fifth Circuit recently granted summary judgment in favor of an employer based upon limitations on the employer's fiduciary duties and ERISA's reflection of policy goals favoring investment in employer stock.[37] Most cases, however, continue to remain active in the court system.

For this paper, the important subset of employer stock arguments are those centered on the allegedly conflicting obligations imposed by ERISA and the federal securities laws. The possible conflicts arise in two circumstances. One question is whether ERISA's general fiduciary provisions require more frequent or more extensive disclosure to employees holding stock in 401(k) plans than the Securities and Exchange Commission (SEC) has established based upon federal securities laws for general public shareholders. The scope of required disclosure is related to the second problem. If employees holding stock in 401(k) plans are entitled to superior disclosure as compared to general public shareholders then compliance with the 401(k) would violate the federal securities law prohibition on insider trading.

The US courts have not been uniform in their decisions on these arguments. One court granted summary judgment to the defendants, suggesting that if the employer would have disclosed otherwise non-public information about the company to employees holding employer stock in their 401(k) accounts then the employer would have violated securities laws. The court refused to interpret ERISA as requiring pension plan sponsors to violate the federal securities laws .[38] The majority of courts, however, have accepted the position advocated by EBSA that the ERISA and federal securities law obligations can be rationalized. According to that view, companies must make public disclosures at the earliest time and to the highest standard of disclosure required by either ERISA or the securities laws.[39]

Professor Jeffrey Gordon has questioned whether employees should have the right to invest in an undiversified manner in company stock in their 401(k) plan accounts. He argues that the risk profile of such holdings may be incompatible with the tax incentives provided to those accounts.[40] Other commentators have called for a complete ban on employer stock in US IPAs.[41] The US Congress has considered capping employee account holdings of employer stock but to date has refused to do so. Instead it enacted legislation in 2006 that requires plans to grant 401(k) account holders certain

rights to diversify out of employer stock. The scope of those rights depend on whether the employer stock was purchased through employer or employee contributions.[42]

C. Comparing the Misselling and Employer Stock Issues

The technical differences between the IPAs in the two situations are significant. First, in the UK the individuals had the ability to choose among tax-favored pension products while the individuals in the US 401(k) plans had limited choices. In the UK misselling scandal, the nature of the personal pension products enabled firms to sell directly to individuals who had the right to choose a personal pension scheme or to remain or become part of a workplace scheme. In the US an employee's choice at the plan level was whether to participate in a 401(k) plan or to opt entirely out of tax-favored pension plans other than the social security scheme. Nor were individuals in the US the subject of direct selling by a firm providing pension products. The UK personal pension products were typically based in contracts between the employee and the FIF. In the US, 401(k)s are trust-based and employers had substantial roles in establishing the trusts.

Second, the US scandal resulted from specific decisions on contribution or asset allocation whereas in the UK once an individual made a decision in favor of a specific scheme there typically was no further need for the individual to designate investment vehicles. In a number of instances in the US, the investment option, company stock, was alleged to be inappropriate for any pension account. In contrast, whether an employee was mis-sold a personal pension scheme in the UK depended on a variety of individualized circumstances including whether the particular employee had access to alternative pension schemes and the rate of employer contributions.

In spite of the differences between them, this history of issues with IPAs in the US and Uk provide important insights for the division of regulatory authority with respect to IPAs. In each instance employees were delegated choices that would be determinative of the ultimate value of their IPAs. Whether those choices are at the scheme level or the investment vehicle level, the misselling and employer stock scandals highlight the risk of delegating to employees the decisions that determine investment returns. The result of poor decision making can cause serious deterioration in the accumulation of wealth in IPAs.

Another insight results from the window provided on the reaction of the US and UK to the widespread problems with IPAs. Both of the currently existing UK institutions with primary responsibility for IPAs, TPR and FSA, were formed after the misselling scandal. The establishment of the FSA as a 'super-regulator' included the merger of ten different agencies. Such a fundamental change in regulatory authority cannot be ascribed to a single scandal or set of problems. But commentators have noted that the misselling of personal pensions was a consideration in the formation of the FSA. The US reaction to the employer-stock scandal was more muted. In 2006, broad ranging pension legislation established the diversification rights discussed above.[43] There has not been any change however in agency structure or in the allocation of authority over IPAs.

Finally, the IPA problems prompt the question of what type of regulatory institution is best suited to anticipate, avoid and respond to risks associated with participant decisions that have direct relevance for wealth accumulation in IPAs. In this context, the difference between the UK and US approaches become particularly stark. The UK's division of authority is based on the type of entity to be regulated. As a result, the FSA has responsibility for overseeing the FIFs that are responsible for marketing, selling and paying out individual pensions. It also has responsibility to improve individual understanding of individual pension products through education and disclosure. TPR concentrates primarily on problems and potential problems at the employer level.

In comparison, in the US EBSA has regulatory and enforcement authority over IPA fiduciaries only to the extent those accounts are covered under ERISA. This allocation of authority based on the type of investment account results in some curious line drawing. If an advisor provides investment advice to either a private sector employer as plan sponsor or to an individual employee regarding 401(k) assets, the investment advisor must meet ERISA's fiduciary standards. If the IPA is not sponsored by a private sector employer then the provision of investment advice to either a sponsoring employer or to an employee is regulated at the federal level by the SEC.

IV. Two Current Issues with IPAs

Two issues related to IPAs recently have received attention from regulators in the US and the UK. The first problem is with the selection of default investments. The second question relates to the effect and appropriateness of account fees.

A. Default Investments

There are a variety of routes through which individuals with IPAs may have their account assets allocated to a default investment. For example, in the US, a 401(k) plan may adopt an automatic enrollment provision. New employees are then enrolled automatically in the 401(k) plan unless they affirmatively opt out of the plan. Research and experience

indicates that such automatic enrollment features help overcome employee inertia and thereby increase the take-up rate for 401(k) plans.[44] Plans with automatic enrollment, though, need to determine a default investment for the contributions of those employees who are enrolled under the automatic feature. Similarly where an employee enrolls in a 401(k) plan or transfers funds from another plan but does not select among available investment options, the plan must default contributions to an investment vehicle. An example of the use of default investments in the UK occurs in employer-selected stakeholder schemes. In order to meet the minimum requirements of a stakeholder scheme, the employer must designate a default investment vehicle.[45]

A 2006 survey of 401(k) plans in the US found that forty-five per cent of the plans provided for a stable-value fund or money-market fund as the default.[46] The goal of selecting stable-value or money-market funds as of default funds tends to be the preservation of capital as opposed to investment growth. Such conservative default investments have been heavily criticized particularly for younger investors.[47]

Although issues associated with default investments had been observable in 401(k) plans since they became popular plans, the US did not issue guidance on default fund selection until October 2007. The guidance, in the form of regulations issued by EBSA, establishes a safe harbor protecting an employer from liability if the employer selects a default fund that possesses the characteristics of what EBSA terms a Qualified Default Investment Alternative (QDIA). An employer may, however, at its own risk designate as a default fund a fund that is not a QDIA. With the exception of investments that pre-date the regulation and investments during the first 120 days of an employee's participation in a 401(k) plan, a QDIA must consist of a mix of investments that take into account either the characteristics of the individual account holder or of a group of employees.

In the UK, a recent study of the stakeholder pension plan schemes registered with TPR as of December 2006 found that the default funds offered in those schemes are less uniform than one might expect. The study reviewed default funds selected by FIFs that registered stakeholder schemes. When an employer chooses a particular stakeholder scheme that employer has the option of designating a different default fund. Industry experience, however, indicates that most employers accept the default option suggested by the financial firm that packaged the stakeholder plan.[48]

Among the registered schemes the default funds were almost evenly split between actively and passively managed funds. A few default funds are styled as UK equity funds but the majority were evenly divided between global equity funds and balanced funds. It is difficult to rationalize these significant differences in the types of funds chosen by FIFs as default funds. A FIF marketing a given stakeholder scheme typically markets that scheme to a wide variety of employers with various employee demographics. Perhaps the FIFs do not agree on the appropriate type of default fund for the average individual who opens a stakeholder pension account. Or the FIFs may not be in agreement over the typical earnings, other investment holdings, risk tolerances and other characteristics of the average individual account holder.[49] In any event the requirement that stakeholder schemes must designated a default fund will be less than optimally implemented to the extent that the default funds are inappropriate for purchasers of stakeholder schemes.

In addition to its requirement that stakeholder schemes establish a default fund, in 2005 the UK began to require that every stakeholder default fund utilize a life-cycle profile. By ensuring that years remaining to retirement age is a consideration in the structure of a default portfolio, the requirement addresses some of the concern over the variance in default funds. Implementation of the life-cycle requirement is not totally uniform across stakeholder schemes but the vast majority of the schemes begin increasing the per centage of bonds and cash held in a portfolio between 5 and 10 years prior to retirement.[50]

B. Account Fees

Along with the rates of contributions and return on investment, investment and account fees fundamentally impact the accumulation of assets in IPAs. In the world of traditional economic theory and perfect markets, one would expect rational plan participants and fiduciaries to consider fees when choosing investment products and account services.[51] Behavioral economics, however, has offered a number of possible explanations for how and why traditional economic theory breaks down in situations involving IPA decision making.[52]

The UK anticipated the issue of account fees when it established stakeholder pensions. When first offered in 2001 stakeholder scheme charges were capped at 1.0 per cent per year. Effective in 2005 the cap was increased to 1.5 per cent a year for the first 10 years of a customer account. Thereafter the account fee cap drops back to 1.0 per cent.[53]

To date the US has failed to adopt legislation or regulation directly addressing 401(k) account fees. This author was a member of the 2004 EBSA Advisory Council working group that studied the disclosure of account fees in 401(k) accounts. The working group published a report, which included both factual findings regarding failings in current fee disclosures and recommendations intended to enhance fee disclosure. After evaluating a variety of problems with current methods of disclosing, or failing to disclose, fees in 401(k) plans, one commentator observed that "[t]he disclosure of fees paid by 401(k) participants currently is closer to what behavioral economics would prescribe for hiding information than it is to clear, informative disclosure."[54]

In 2006 plan sponsors were forced to pay attention to the fees question after a number of lawsuits were filed alleging that 401(k) plan fee structures violate ERISA's general fiduciary requirements. Some of the suits claim that plan fiduciaries violated their ERISA obligations by failing to understand or capture for the plan fees paid by one plan service provider (such as a mutual fund) to another service provider (such as a record keeper).[55] Suits also have presented claims that plan fiduciaries failed to appropriately consider the fees charged by plan investment alternatives and, thus, did not make prudent selections of available investment options.[56] Subsequent to the filing of the fees cases, EBSA and the Congress have shown an increased interest in the issues surrounding plan account fees. Legislation has been proposed in Congress. However, in late 2007 the Assistant Secretary of EBSA requested in congressional testimony that Congress delegate to EBSA the oversight of fees and the disclosure of fees.

In the UK a recent study of fees charged by stakeholder plan default funds implies that the legal caps have had a significant impact on account fees. Expectations based on general fee data would lead to the expectation that the approximately fifty per cent of default funds which utilize a passive investment style would have lower fees than the default funds that consist of actively managed funds. The actual modal investment fee however is 1.0 per cent across both active and passive default funds. Effectively it appears that the fee cap has been established as a floor for stakeholder scheme fees. The mean charge of passive default funds is 20 basis points lower than the mean for active default funds, which is somewhat more in accordance with expectations. And admittedly a number of other factors may impact the fees charged, including the level of services provided by the scheme and the size of the employee population at a particular workplace.[57]

V. Choice of Regulator

The country-specific issues and discussion of issues pertaining to the selection of default funds and account fees show that the US and the UK have faced similar problems with IPAs. This is true even though the type of IPAs that underlie these comparisons are quite different in each country. Rather than being specific to a particular type of IPA scheme, the challenges encountered in the US and the UK have arisen from some of the basic characteristics of IPAs. As compared to traditional workplace DB plans, IPAs decrease the role of employers as mediators. At the same time the relationships between FIFs and the individuals who hold IPAs become stronger. Employees not only take on additional risks, they typically must make decisions which impact those risks.

One result of these characteristics of IPAs is that the proper distribution of regulatory oversight becomes a challenge for countries that established their pension regulatory systems to oversee DB plans. IPAs pose different regulatory challenges. In addition countries that have little experience with supplementary pension schemes can expect to see similar issues arise as they implement IPAs.

The US and UK have taken different approaches, at a fundamental level, to the regulation of IPAs. The UK completely reformed its system in recent years whereas the US has not made any significant changes in either the structure of the relevant regulatory entities or in the division of authority among them. The difference is particularly stark in relation to the investment and fee issues, which are discussed above and have been problems in each country. In most part the UK has allocated authority for those issues to the FSA, a relatively new entity charged with regulating FIFs in the UK The US has left authority for those issues with EBSA, the workplace-related agency which is generally responsible for the oversight of fiduciary issues, proper disclosure, and claims procedures. This section examines the problems faced by and the decisions made by the US and the UK to compare the implications of choosing a financial services regulator as compared to a workplace regulator as the entity charged with primary oversight of the investment and fees issues associated with IPAs. It does so by unpacking considerations in the allocation of that regulatory authority according to the conceptual approaches used by the US and the UK; by type of risk posed and by type of entity to be regulated.

A. Financial Services Regulator - A Risk Perspective

Professors Nobles and Black argue that one factor in the misselling scandal was the inability of regulators to understand the dynamic market for personal pensions.[58] They did not evaluate the risks created by the structure of sales commissions and other factors in the marketing of personal pensions. Nor did they focus attention on personal pensions as posing a particular set of risks to investors.[59]

Their criticism encompasses the Securities and Investment Board (SIB), which was a predecessor of the FSA. Therefore, it could be understood to imply that a financial services regulator such as the FSA cannot be expected to bring relevant expertise to the regulation of IPAs. Actually though their argument resonates with the benefits that could be expected to result from the choice of an experienced financial services regulator. Professors Nobles and Black explain that the SIB was a newly formed agency at the time personal pensions were introduced. Its inexperience with the private pension products and industry prevented the SIB from successfully overseeing and identifying problems with new products in an industry undergoing a complete restructuring.[60]

The implication of Professors Nobles' and Black's analysis is that the misselling problem illustrates the value a regulator with experience in financial services can bring to the oversight of IPAs. In contrast to the situation of the SIB at

the time of the misselling, an established regulator with authority over a wide variety of financial products and FIFs, such as the FSA, should develop a broad perspective on risks posed to investors. That broad perspective and experience should have relevance to the investment and fee issues which occur across investment products and accounts regardless of their status as IPAs. In sum, a financial services regulator should have substantive expertise with the risks posed to IPAs by investment and fee issues.

The risk of insolvency or nonpayment represents a different concern common across all types of pension plans as well as across all types of investment products. In traditional DB plans the first insurer against the risk that a benefit will not be paid is the employer that sponsors the plan. Both the US and UK have established institutional guarantors that provide a second tier insurance against plan insolvency. In IPAs though the risk of insolvency is with the FIFs. There is no reason to believe that the evaluation of financial reserves and other mechanisms to offset insolvency risk is substantially different in the context of IPAs than it is with respect to other long term investment and insurance products. Thus the expertise developed by the financial services regulator with respect to those products should be applicable to addressing insolvency risk in IPAs.

B. Financial Services Regulator - An Entity Perspective

Although it has famously been said that "A foolish consistency is the hobgoblin of little minds . . .,"[61] consistency does contribute value in the context of regulation. If regulatory authority over IPAs is allocated according to the entity to be regulated, that decision has implications for consistency of regulation. Some financial services and products cross all types of individually held investment accounts, regardless of whether the account is tax-favored or funded through payroll deductions. FIFs do not typically limit the sale of their financial products to IPAs, let alone to a particular type of IPA. Consider the example of a mutual fund, which can be purchased in a traditional investment account that does not receive any tax-favored treatment. That same mutual fund might be utilized in a personal pension, in a stakeholder pension and in an occupational DC plan.

In fact, The highly individualized nature of IPAs raises the question of whether they constitute pension plans at all in the same sense as supplementary DB plans and government social security-style programs do. After all, IPAs may permit account holders to allocate their assets among an array of investment vehicles. Account holders may be allowed to take loans against their account balances. An employee who stops working for the employer associated with a particular scheme might receive an immediate distribution of all or part of the account assets held in the scheme. In short, they may bear more resemblance to traditional investment accounts - albeit with a tax-favored status – than to devices intended for the accumulation of pension wealth. This is especially true since IPAs have become increasingly de-linked with employment.

If a financial services regulator has primary oversight of the mutual fund regardless of the formal structure of the account in which the fund is being held then the mutual fund has one touch point with a regulator. A contrasting approach might allocate responsibility for IPAs, or a segment of IPAs, to a workplace regulator instead of to a financial services regulator. The mutual fund then will face not just two sets of regulators but also the possibility that the two regulatory entities have different basic goals. For example the financial services regulator may place a high priority on maintaining market efficiency. A workplace regulator may be more paternalistic or believe that holders of IPAs require a particular type of protection not needed by the general investing population.

Consistency in disclosure regimes may be another benefit from assigning oversight of IPAs to a single financial services regulator. Consider again the example of account fees. It is difficult to conceive of a regulatory regime where there would not be a financial services regulator charged with oversight of fees and fee-related disclosures in non-tax favored investment accounts. The existence of such authority does not presume the nature or extent of direct regulation. It only presumes that a financial services regulator will have responsibility for determining the need for such regulation. The starting point in considering fee-related disclosures in such a context should cross the boundaries of all investment products.

It is possible that policymakers would decide that individuals with IPAAs need different disclosures than those provided to individuals with standard investment accounts. If so, the deep understanding a financial services regulator should have of the nature and complexity of fees as well as its experience with investor education should be valuable in determining the extent to which the disclosures should differ. Having the disclosure oversight assigned to a single financial services regulator should avoid the need for inter-agency coordination. It also provides for one agency touch-point for FIFs subject to the disclosure requirements.

Another consistency-related benefit that may result from regulation of IPAs by a financial services regulator is consistency and integration of investment advice across an individual's IPA and non-IPA investment accounts. In the US investment advisors are subject to EBSA regulation for advice given in 401(k) accounts and to regulation by the SEC for advice provided on non-employment based investment accounts. As a result of the harsher ERISA regulatory standards, it is a frequent practice for investment advisors to provide advice across the entire spectrum of an individual's financial planning needs with the sole exclusion of 401(k) accounts and any other ERISA-covered IPAs.

The problem in the US remains, though perhaps to a lesser extent, even after statutory changes in 2006, which were intended to expand 401(k) participants' access to investment advice.[62] Rather than eliminate differences in the standards governing advice or allocating authority to a single regulator, the changes authorized advice to 401(k) plan account holders if the advisors meet specific standards. Of particular importance under the legislation is the structure of advisory fees and disclosure of conflicts of interest. The US division of authority between EBSA and the SEC and the resulting differing standards governing the provision of investment advice results in a lack of integrated advice all of an individual's investment accounts. As such it serves as an example of the lack of consistency that can result from the involvement of multiple agencies and legislative approaches.

C. Workplace Regulator - A Risk Perspective

From a risk perspective certain of the risks associated with IPAs are related to the workplace. For example, in both UK stakeholder plans and US 401(k) plans the employer must withhold contributions from an employee's paycheck and transmit the funds to a FIF. The resulting risk is that an employer may fail to transmit the withheld funds, at least on a timely basis, to the FIF.

A workplace regulator would be expected to have expertise that would be relevant to the risk associated with contribution withholding and transmittal. For example, in the US the DOL has authority over the implementation of wage and hour standards. And EBSA oversees the withholding and transmittal of employee contributions to the cost of health care coverage. The issues that arise under these areas would seem to have relevance for the oversight of 401(k) contributions.

Workplace oversight may not, however, be unified under a single regulator. In the UK, HM Revenue and Customs is charged with enforcement of the national minimum wage. In the US oversight of the timely payment of wages and over the withholding of some charges such as garnishments by creditors occurs at the state level rather than by the DOL. The lack of a single workplace regulator decreases the expected expertise that such a regulator would bring to bear on oversight of IPA contributions.

A second question on risk is whether certain types of risks are unique to pension accounts. Professor Stabile has argued that pension accounts require a different type of regulation than typical investment accounts.[63] Pension accounts are intended, and tax-favored, for the single goal of providing income after retirement. The investments selected for an account, the account fees, and account statements and other disclosures all should support the goal of retirement income. In the US. these concerns are evidenced in ERISA's fiduciary standards, which are more rigorous than those imposed under securities law.

Similarly, as discussed above, Professors Nobles and Black argue that one factor in the misselling scandal in the UK was the failure of the relevant regulators, all of which had responsibility for aspects of investments and financial services firms, to focus on the unique issues associated with personal pensions.[64] A country that considers its IPAs to be highly differentiated from other investment alternatives may determine that the expertise of a general financial services regulator is of limited value in the oversight of IPAs. In that context a workplace-related agency with experience in overseeing compensation and relationships between employees and employers may be best equipped to provide appropriate oversight over such accounts.

D. Workplace Regulator - An Entity Perspectve

The preferred approach to achieving consistency in the regulation of IPAs may depend upon the type of consistency a particular country values. As discussed above a financial services regulator may be best positioned to achieve consistent oversight across account fees, financial products, services and disclosure. Those issues arise with respect to all investment products, not just IPAs.

IPAs that are based in the workplace though may benefit from consistency across workplace dimensions. Employers are less involved in the offering, administration and funding of IPAs than they were in occupational DB schemes. But some countries, such as the UK and US, have traditions of pension programs being embedded in the workplace. In that context the employer's IPAA-related actions are a dimension of the employer-employee relationship. An employer communication about its compensation and benefits programs might logically categorize its IPA activities as a part of those programs. Similarly, employees, because of both historic experience and the wage-related nature of workplace IPAs may view them as part of the compensation and benefits package.

These employer and employee expectations point to values associated with consistence of regulation across matters such as payroll withholding and communications about withholding and workplace benefits. Employers may prefer to deal with a single regulator for all of their workplace responsibilities. Such a preference, and the increased costs associated with multiple regulators, takes on particular importance in countries where workplace pensions are voluntary. Even in the case of a country such as the UK, where employers must offer at least a minimum stakeholder pension scheme,

the complexity and costs of dealing with multiple regulators could discourage employers from sponsoring more generous IPA plans or from contributing to stakeholder plans.

Employees also may prefer to interact with a single regulator for all compensation-related matters. For example, employees with concerns that their IPA contributions are not being properly forwarded to the scheme provider may have concerns with other employer pay practices as well. Conferring authority over all workplace issues on one regulator simplifies the complaint mechanisms for employees. It also permits that single regulator to investigate across all workplace-related issues.

In countries, such as the US and UK, where employers have an established history of providing workplace-based pension schemes, employers utilized the schemes as workplace management tools. In industries where workforce stability was important, DB plans were constructed to increase employee retention. When workforce reductions were required, those same DB plans could provide early retirement programs to ease the impact of the reduction in force.

IPAs provide fewer workplace management tools because they are transferrable among employers and the benefits are not back loaded in the way DB benefits typically are. However employers still may view IPAs as beneficial in their relationships with employees. For example a generous employer contribution to an IPA may be attractive in a competitive job market. The nature of IPA as workplace management tools may favor the designation of a workplace regulator that can coordinate regulation across all of an employer's compensation-related activities.

VI. Conclusion

The nature of work-based retirement programs in the US has changed significantly over the past few decades. The result has been a major shift in responsibility from employers to employees particularly for decisions relating to investment selection and contribution levels. Neither the basic structure of retirement plan regulation nor the allocation of authority among regulatory agencies in the US has changed in response to the shift in plan paradigm. In contrast, the UK has experienced a similar shift in plan paradigm but it has restructured the relevant law and the division of authority among regulators. While important to the US and UK, the decisions on allocation of regulatory authority are not limited to those countries. Interest in IPAs is increasing around the world as countries confront the cost of their social security-style government plans and employers with DB plans seek alternative pension arrangements.

Analysis of the differences between how the US and UK allocate regulatory authority for IPAs provides a number of insights for division of regulatory authority for IPAs. The misselling and employer stock problems illustrate the risks for capital accumulation when decision making is delegated to individuals. The continuing concern in both the US and UK regarding the selection of default investments and account fees shows the persistence of complex issues even years after the authorization of IPAs.

Broadly viewed, the ultimate allocation of regulatory authority by any country will be embedded within the values of the particular country. The paths taken by the UK and the US illustrate two approaches to the division of authority among regulators. This paper considered the allocation of regulatory authority for investment and fee issues associated with IPAs. It compared as alternatives a financial services regulator and a workplace regulator along the dimensions of risk and entity to be regulated.

A country's decision on allocation of regulatory authority may vary depending on the value placed on considerations such as consistency, the types of consistency that are most valued and regulatory expertise. Within those general considerations, specific concerns may favor a particular choice. If a country's goal is to minimize costs and increase the efficiency of regulation of financial services and products, it may place a high value on the consistency expected from a financial services regulator. A country that, as an example, wants to provide employees with a single point of regulatory contact for investigation and resolution of workplace or compensation-related matters may decide to allocate oversight of those aspects of IPAs to a workplace regulator.

Footnotes

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[1] *See infra* text accompanying notes 5-7.

[2] *See* U.S. Dept. of the Treasury, *Treasury Releases Blueprint for Stronger Regulatory Structure*, March 31, 2008, *available at* http://www.ustreas.gov/press/releases/archives/200803.html (advocating a model of three regulators).

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[7] U.K. Office for National Statistics, OCCUPATIONAL PENSION SCHEMES ANNUAL REPORT 8, 16 (2007) (*hereinafter* "UK ANNUAL REPORT").
[8] *See* Barbara Waine, *Ownership and Security: Individualised Pensions and Pension Policy in the United Kingdom and the United States*, 10 J. COMP. & CHANGE 321-337 (2006) (discussing US proposals for individual accounts).
[9] Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice*, 23 BERKELEY J. EMP. &LAB. L. 1, 6 (2002).
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[12] Elizabeth D. Tedrow, *Social Security Privatization in Other Countries – What Lessons Can Be Learned for the United States?*, 14 ELDER L.J. 14, 35-59 (2006).
[13] Julia Black & Richard Nobles, *Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure*, 61 MODERN L. REV. 789, 797 (1998).
[14] Waine, *supra* note 8, at 324, 328-29.
[15]Paul Brady & Sarah Holden, *The U.S. Retirement Market, 2006*, 16 ICI RESEARCH FUNDAMENTALS 1, 4 (2007).
[16] *Id.* at 6.
[17] Barbara Waine, *Individualising Pension Provision in the UK, in* PERSONAL CHOICE IN THE PROVISION OF RETIREMENT INCOME: MEETING THE NEEDS OF OLDER PEOPLE (Gerry Hughes & James Stewart eds., forthcoming 2008)
[18] 29 U.S.C. §§ 1001-1461 (2006).
[19] JAMES WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY, (2004).
[20] STANLEY, *supra* note 4, at 39.
[21] *See* Ian Greenstreet, *Stakeholder Pensions – The Compliance Regime,* 8 PENSIONS 152 (2003).
[22] *See supra* text accompanying note 12.
[23] Richard Nobles & Julia Black, *The Privatization Process: Pensions Mis-selling – The Lessons for Regulating Privatised Social Security*, 64 BROOKLYN LAW REVIEW 933, 939 (1998). The SIB was one of a number of entities later combined to form the FSA.
[24] Milner & Syrett, *supra* note 3, at 142.
[25] Select Committee on Treasury, House of Commons, Ninth Report: The Mis-selling of Personal Pensions 1-2 (1998).
[26] Nobles & Black, *supra* note 23, at 947-951.
[27] *Id.* at 947-951; Select Committee on Treasury, *supra* note 25, at 3.
[28] Select Committee on Treasury, *supra* note 25, at 3.
[29] Nobles & Black, *supra* note 23, at 936-37.
[30] Financial Services Authority, *11.8 billion compensation for pensions and FSAVC reviews*, June 27, 2002.
[31] Dana Muir & Cindy Schipani, *New Standards of Director Loyalty and Care in the Post-Enron Era: Are Some Shareholders More Equal Than Others?,* 8 N.Y.U. J. Legis. & Pub. Pol'y 279, 314.
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[35] *See, e.g.*, Rankin v. Rots, No. 02-CV-71045, 2006 U.S. Dist. LEXIS 45706 (E.D. Mich. June 28, 2006).
[36] *In re* McKesson HBOC Inc. ERISA Litig., 391 F. Supp. 2d 812 (N.D. Cal. 2005).
[37] Kirschbaum v. Reliant Energy, Inc., No. 06-20157, 2008 U.S. App. LEXIS 9124, at *12, *21-34 (5th Cir. Apr. 25, 2008).
[38] *In re* McKesson HBOC Inc. ERISA Litigation, No. C00-20030 RMW, 2002 U.S. Dist. LEXIS 19473, at *24 (N.D. Cal. Sept. 30, 2002) (stating that "fiduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties."); see *also Kirschbaum*, 2008 U.S. App. LEXIS 9124, at *33-34 (referring to the potential of a securities law violation as a factor weighing against fiduciary liability).
[39] *See, e.g.*, Rankin v. Rots, 278 F. Supp. 2d 853, 873 (E.D. Mich. 2003), *settled*, No. 02-CV-71045, 2006 U.S. Dist. LEXIS 45706 (E.D. Mich. June 28, 2006); *In re* WorldCom Litig., 263 F. Supp. 2d 745, 766-67 (S.D.N.Y. 2003); Enron Corp. Sec., Derivative & ERISA Litig., 284 F. Supp. 2d 511, 563-67 (S.D. Tex. 2003).
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[43] Pension Protection Act of 2006, Pub. L. No. 109-289, 120 Stat. 780 (2006).
[44] *See* Matthew Venhorst, *Helping Individual Investors Do What They Know is Right: The Save More for Retirement Act of 2005,* 13 CONN. INS. L.J. 113 (2006) (discussing the proposed "SMART" plan).
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[46] Watson Wyatt, *Watson Wyatt's Survey on Default Investments and the DOL's Proposed Regulations*, INSIDER, table 5 (2006).
[47] *Id.*
[48] Alistair Byrne, *et. al, Default Funds in U.K. Defined-Contribution Plans,* 63 FIN. ANAL. J. 40, 42 (2007).
[49] *Id.* at 42-43.
[50] *Id.* at 42-45.
[51] *See* John A. Turner, *A Behavioral Economics Perspective on 401(k) Fee Disclosure,* 2008 Newsletter of ABA Employee Benefits Committee, *available at* http://www.abanet.org/labor/ebcomm/newsletter/08/spring/ebc-spring-08.shtml. Evidence does indicate that mutual fund investors tend to invest in stock mutual funds with lower than average expense ratios. 2008 Investment Company Fact Book, 60-61, *available at* http://www.ici.org/statts/res/2008_factbook.pdf.
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[54] *Turner, supra* note 51.
[55] *See, e.g.,* Spano v. The Boeing Co., 2007 U.S. Dist. LEXIS 28774, at *2-3 (S.D. Ill. Apr. 17, 2007).
[56] *Id.*
[57] Byrne et al., *supra* note 48, at 48.
[58] *See supra* text accompanying note .
[59]Nobles & Black, *supra* note 23, at 948-49.
[60] *Id.*
[61] THE COMPLETE ESSAYS AND OTHER WRITINGS OF RALPH WALDO EMERSON (A. Brooks, ed. 1940).
[62] *See supra* text accompanying note 43.
[63] *See* Dana M. Muir, *The U.S. Culture of Employee Ownership and 401(k) Plans,* 14 ELDER L.J. 1, 17 (2006).
[64] Nobles & Black, *supra* note , at 948-49).