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HELPING INDIVIDUAL INVESTORS DO WHAT THEY KNOW IS RIGHT: THE SAVE MORE FOR RETIREMENT ACT OF 2005

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INTRODUCTION

As the American worker's life grows increasingly harried, the average workday seems to lengthen every year, and the concept of having multiple careers over the course of one's lifetime becomes the rule rather than the exception, one shudders at the prospect of a "working retirement." Yet this phenomenon seems increasingly likely as savings rates decline, life expectancies rise, and deficits soar. As the oldest baby boomers near retirement age, much uncertainty exists regarding their collective outlook. The safety net consisting of a traditional employer pension plan and Social Security is slowly but definitively unraveling beneath the metaphorical feet of an aging country. Americans are increasingly forced to ensure their own retirement security through employer-sponsored defined contribution plans; statistics show that many workers are not up to the task.

This Note seeks to outline the nature of the crisis that accompanies the dramatic shift from employer sponsored defined benefit to defined contribution plans, and to advocate a particular avenue for reform. As will be seen, many Americans, perhaps even those with obvious means to do so, do not contribute adequately to their employer's defined contribution plans. This Note will draw heavily on behavioral economics research, which uses empirical data to call into question many of the cherished assumptions of the neoclassical economists regarding savings and consumption behavior. This Note adds to the currently existing literature on the subject through its discussion of newly proposed and much needed legislation – the Save More for Retirement Act of 2005 proposed in April, 2005 – that aims to increase employee contributions to their employers' defined contribution plans. Part I of this Note outlines a brief history of defined benefit and defined contribution plans, explores the mechanics of the latter, and emphasizes the significance of this dramatic change. Part II discusses low savings and participation rates among defined contribution plan participants, and highlights the importance of saving for retirement early in one's life, something too few Americans seem to be doing. Part III addresses the economic theory that has long made sweeping assumptions about consumer behavior, and additionally explores the behavioral research that seems to undermine many of these assumptions. Part III also addresses the rationale for government intervention from a theoretical perspective. Part IV explores the legislation that has been proposed that would potentially remedy the problematic situations discussed in earlier parts of the Note, discusses current ERISA provisions that would need to change if the legislation is adopted, and outlines why such change is desirable.

I. HISTORY AND MECHANICS OF DEFINED CONTRIBUTION PLANS

A. HISTORY

The first private pension, or defined benefit plan, in the United States was introduced in 1875 by American Express Company, a railroad freight forwarder.[1] Defined benefit plans guarantee a specified amount of money at retirement, which is typically determined by a formula consisting of years of service and average final salary.[2] Following the railroads, a number of the nation's larger employers implemented pensions during the first part of the twentieth century in an effort to promote a stable, career-oriented workforce.[3] Perhaps counter-intuitively, the Depression had a positive impact on defined benefit plans, as tax rates soared and employers found the tax benefits of the plans to be financially advantageous.[4] Defined benefit plans increased in popularity after World War II and reached their peak in the late 1970's, when approximately 62% of all active workers were covered exclusively by these plans.[5] Beginning in the late 1970's participation declined slowly and steadily, until 1997 when just 13% of workers had such plans as their sole retirement benefit.[6] Participation rates in defined benefit plans have remained fairly steady since then.[7] However,

1. Stephen P. McCourt, *Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis,* BENEFITS & COMPENSATION DIG., Feb. 2006, at 1, http://www.ifebp.org/PDF/webexclusive/06feb.pdf.

2. Amy B. Monahan, Addressing the Problem of Impatients, Impulsives and Other Imperfect Actors in 401(K) Plans, 23 VA. TAX REV. 471, 475 (2004).

3. McCourt, *supra* note 1, at 1.

4. *Id.*

5. Mary Williams Walsh, *More Companies Ending Promises for Retirement*, N.Y. TIMES, Jan. 9, 2006, at A1.

6. *Id.* at A14.

7. *Id.*

some of the last remaining American companies offering defined benefit programs have begun to "freeze" these benefits in an effort to stave off unanticipated costs, such as interest rate changes and longer life expectancies, which tend to make the plans more costly.[8] Mirroring the decline in defined benefit plans, the percentage of workers participating in defined contribution plans and having no defined benefit pension has increased from 16% of active workers in 1979 to 62% in 2004.[9] Recent data shows that 55 million Americans are covered by defined contribution plans, representing more than $2.2 trillion in assets.[10]

Why the fairly recent dramatic shift to defined contribution plans? Although a complete explanation of this change is beyond the scope of this Note, perhaps the most frequently cited explanation is an increasingly mobile workforce.[11] Traditional pension plans are not as portable as defined contribution plans, and workers who frequently change jobs will receive a small pension from each employer, each of which accounts for only the salary and years of service for that particular employer.[12] The popular "rollover" option that is available with 401(k) plans avoids this

8. *See id.* When pension plans are frozen, the company stops the growth of retirement benefits, which typically accumulate with each additional year of service. Employees are able to retain those benefits that they earned before the freeze, however. Pension freezes may be on the rise, however, because as recently as 2003 the majority of pensions that were frozen had fewer than 100 employees. Recent moves by IBM, which had the third-largest pension fund behind General Motors and General Electric, and other large companies suggests that such trends are moving from traditionally troubled industries such as steel and textiles, into more established industries and involving larger companies.

9. Walsh, *supra* note 5, at A14.

10. Vanguard, How America Saves 2005, A Report on Vanguard 2004 Defined Contribution Plan Data (2004), *available at* https://institutional2.vanguard.com/iip/pdf/CRR_HAS_2005.pdf [hereinafter Vanguard Report].

11. Monahan, *supra* note 2, at 476. *See also* Walsh, *supra* note 5, at A1 (arguing that even strong and economically stable companies such as Verizon, Lockheed Martin, and Motorola have frozen pensions in the face of "longer worker lifespans, looming regulatory and accounting changes, and... heightened global competition"). *But see* Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 75-77 (2002) (rejecting the worker mobility explanation for the shift to defined contribution plans and arguing that defined contribution plans are less costly to employers and are less burdensome with respect to regulatory requirements. The plans also attract more conscientious workers who desire an opportunity to save for their own retirement without employer interference).

12. Monahan, *supra* note 2, at 476-77.

problem.[13] Also, defined benefit plans tend to be more expensive than defined contribution plans for employers.[14]

B. MECHANICS OF DEFINED CONTRIBUTION PLANS

Given the prominence of 401(k) plans in the contemporary American retirement landscape, a brief overview of the mechanics of this type of plan is instructive. Though widespread, it is important to note that the 401(k) is only one type of defined contribution plan. The 401(k) is a "profit sharing or stock bonus plan that contains a cash-or-deferred arrangement," [15] the most common of which is a salary reduction agreement. In such an arrangement, eligible employees may choose to reduce their pay and have employers contribute the balance of their income to the 401(k), allowing the employee to currently exclude from taxable income the portion of salary that the employer contributes to the plan. The employer may or may not choose to "match" the employee's contributions up to a certain level. A common employer "match" is 50% of the employee's contribution up to 6% of the employee's salary.

Employer and employee contributions to traditional 401(k) plans are tax-deferred, meaning that taxes are not levied on the contributions or earnings until funds are withdrawn.[16] Because of the tax-favored nature of the investment, certain restrictions are placed on contribution and withdrawal. For example, in 2006 employees may not contribute more than $15,000.[17] Additionally, defined contribution plans are also subject to ERISA's nondiscrimination provisions that aim to ensure that highly compensated employees do not disproportionately benefit from the tax-

13. *Id.* at 477.

14. *See id.* at 477-78 (outlining the following causes of increased costs of defined benefit plans: (1) defined benefit plans are entirely employer funded (as opposed to funded either entirely by the employee or by some combination of employer and employee); (2) administrative costs associated with acquiring the expertise required to calculate fund requirements; (3) Pension Benefit Guarantee Corporation premiums required for defined benefit plans; (4) the cost to the employer of the assumption of investment risk for plan assets).

15. Alicia H. Munnell et al., *What Determines 401(K) Participation and Contributions?* 4 (Ctr. for Ret. Research at Boston College, Working Paper No. 2000-12, 2000), *available at* http://www.bc.edu/centers/crr/papers/wp_2000-12.pdf.

16. *Id.* at 5.

17. *Id.* Employees over a certain age may make "catch-up" contributions beyond the level specified above.

advantages.[18] Federal law also imposes a 10% penalty on funds that are withdrawn before the worker reaches age 59½.[19] Participants may have access to funds through borrowing for specified purposes, however.[20] A frequently cited advantage of the shift to defined contribution plans is that employees are able to invest their own money as they see fit – and perhaps ultimately enjoy a more prosperous retirement from a financial standpoint as a result.[21] This was especially true during "a once-in-a-lifetime bull market that encouraged [individual workers] to think they could get rich quick in stocks."[22] As will be seen later, however, there is also the possibility that neophyte investors may become unduly confident in their investment skills in this environment, and invest in a portfolio that is overly-aggressive. Additionally, other investors may be unduly conservative in their investments. The next section will explore some of the implications of the shift to defined contribution plans from the perspective of the individual investor.

C. SIGNIFICANCE OF THE SHIFT FROM DEFINED BENEFIT TO DEFINED CONTRIBUTION PLANS

The gradual shift from defined benefit to defined contribution plans has extraordinary consequences for the average American worker, and perhaps even society as a whole.[23] Perhaps the single most salient difference between defined benefit and defined contribution plans is that the former guarantees a specified retirement benefit to an individual, while the latter does not. Another difference that has great practical significance is the notion that employees are not required to actively make choices in defined benefit plans, while most defined contribution plans require employees to affirmatively make elections from a myriad of complex and often

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18. Munnell, *supra* note 15, at 5.

19. *Id.* at 5. Funds may be withdrawn without penalty for disability or death.

20. *Id.* at 4-5.

21. Kelly Smith & Lani Luciano, *America's Best Company Benefits*, MONEY, Oct. 1999, at 116.

22. Terry Savage, *Problems Affect 401(k)s, But They Can Be Solved*, CHI. SUN-TIMES, Jan. 17, 2002, at 51.

23. *See* McCourt, *supra* note 1, at 4 (suggesting that the absence of the pool of wealth made available by the existence of large defined benefit program may have a deleterious effect on the nation's economy. Without the $10 trillion in savings that defined benefit plans provide to the U.S. economy, "U.S. interest rates would be substantially higher, the cost of capital for all companies in the United States substantially higher, overall investment substantially lower and economic growth substantially diminished").

intimidating investment options.[24] In fact, employees are faced with a multifaceted decision with respect to retirement savings in defined-contribution plans: not only must they surmount the initial obstacle of deciding whether or not to participate, but they must also decide how much to contribute and how to invest their assets.[25]

The largest potential problem accompanying the shift from defined benefit to defined contribution programs is that millions of individuals who had relied on experienced professionals to manage their retirement assets for them immediately became their own fund managers, very often with little relevant experience.[26] One consequence of such a phenomenon is that market risk is shifted from employers to employees.[27] The Department of Labor expressed its concerns as follows: "there has been an increasing concern on the part of the Department, employers, and others that many participants may not have a sufficient understanding of investment principles and strategies to make their own informed investment decisions."[28] Even employees who faithfully contribute to their defined contribution plans on a regular basis can have significant difficulties in

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24. Stabile, *supra* note 11, at 76.

25. Munnell, *supra* note 15, at 3.

26. *The MetLife Study of Employee Benefits Trends* (Nov. 2003), *available at*, http://www.metlife.com/WPSAssets/18837556591075757623V1FD7547_Broch.pdf (finding that just 30% of respondents were confident in their own ability to make sound investment decisions for themselves and their family).

27. For an interesting discussion of this shift in risk allocation with respect to retirement planning, see Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 458-62 (2004). The author divides the risk into three types: investment risk, funding risk, and longevity risk. Investment risk – the risk that retirement assets will receive an insufficient rate of return – shifts from the employer to employee under defined benefit programs the employer is charged with providing a promised benefit, even in the event of investment returns that fall short of this level. Under defined contribution arrangements, the risk or reward of exceedingly poor or good returns, respectively, shifts to the employee because the employee's entitlement is the account balance. Zelensky defines "funding risk" as the possibility that insufficient funds to secure an adequate retirement will be placed into the retirement account at all. By definition under defined benefit programs, the responsibility is that of the employer to ensure that promised funds are adequately invested. Under many defined contribution plans, by contrast, because it is up to the employee to elect whether to have his/her current compensation reduced in exchange for later compensation in accordance with a defined contribution plan, the responsibility to ensure adequate funds in retirement is that of the employee rather than the employer. Finally, longevity risk – the chance that the employee will outlive retirement benefits – shifts to employees because under defined benefit programs, individuals received a stream of income until their death. In defined contribution plans, of course, funds last only as long as individual investors do not exhaust them.

28. 29 C.F.R. § 2509.96-1(2006).

retirement in the event of an economic downturn.[29] Despite the rhetoric disseminated by proponents of defined contribution plans that these arrangements allow individuals to prosper financially by taking charge of their own retirement security, studies show that investment returns in defined contribution plans may be inferior to those of defined benefit plans.[30] As will be discussed throughout this Note, a potentially more debilitating problem is illustrated by recent behavioral economics literature, which suggests that investor inertia and other unfortunate human foibles may lead to excessively low contribution rates and may ultimately undermine Americans' retirement security.

II. PARTICIPATION AND SAVINGS RATES: A CAUSE FOR CONCERN?

A. THE IMPORTANCE OF "STARTING EARLY": THE REMARKABLE EFFECTS OF COMPOUND INTEREST

The shift from defined benefit to defined contribution plans may be construed as a double-edged sword: while individuals will no longer be guaranteed a stable stream of income in retirement, the shift enables individuals to take charge of their own retirement savings and to perhaps enjoy a more prosperous retirement through wise investment.[31] Indeed, retirement benefits can increase quite dramatically, even exclusive of times of extraordinarily high rates of investment returns, provided that interest has a sufficient amount of time to compound. As the materials in the pages ahead will demonstrate, current savings rates present a cause for concern. The implications for younger savers are significant as well: although low savings rates among this group does not alone signal a problem with

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29. *See* Walsh, *supra* note 5, at A6. Syl Schieber, director of research for Watson Wyatt Worldwide, calculated the retirement benefits available to a hypothetical investor who began working at 25, and put 6% of his salary into a 401(k) account for the next 40 years. Upon retirement at 65, this individual would be able to buy an annuity that paid 134% of his pre-retirement income if he retired in 2000 (during an economic boom), but could buy an annuity that replaced just 57% of his pre-retirement income if he retired in 2003 (during an economic downturn). *Id.*

30. *See* McCourt, *supra* note 1, at 4 (reporting that the average defined benefit plan outperformed the average defined contribution plan by 0.8% per year between 1985 and 2001, an aggregate difference of 25% in total return over a 30-year span).

31. *But see id.* (reporting that most studies show that "the average investor in 401(k) plans produces investment results worse than the average return generated by defined benefit plans").

retirement liquidity, non-savers may be forgoing an opportunity to secure a financially stable retirement that they will not be able to regain. Some commentators might argue that many Americans would benefit from a greater amount of time for retirement assets to accumulate, as studies show that the average American is not a very savvy investor.[32]

Certainly the benefits of compound interest in saving for retirement and of "starting early" in one's life have been thoroughly documented. Nevertheless, a brief overview of two hypothetical investors, A and B, vividly illustrates the tremendous benefit of beginning to save for retirement early in one's life. The savings behavior of two separate investors with vastly different habits is illustrated below, over a 40 year period.[33] Investor A begins investing when he is 25 years old, in Year 0, and invests $5,000 per year every year until Year 20 – when he is 45 – and then does not invest any new money again, but does allow interest to accrue on his account until Year 40, when he is 65. Investor B begins saving in Year 20, at age 45, and invests $10,000 a year – twice the annual and total contribution of investor A – for 20 years (the same amount of time as investor A) until he reaches age 65 in Year 40. The results depicted below may surprise the reader.

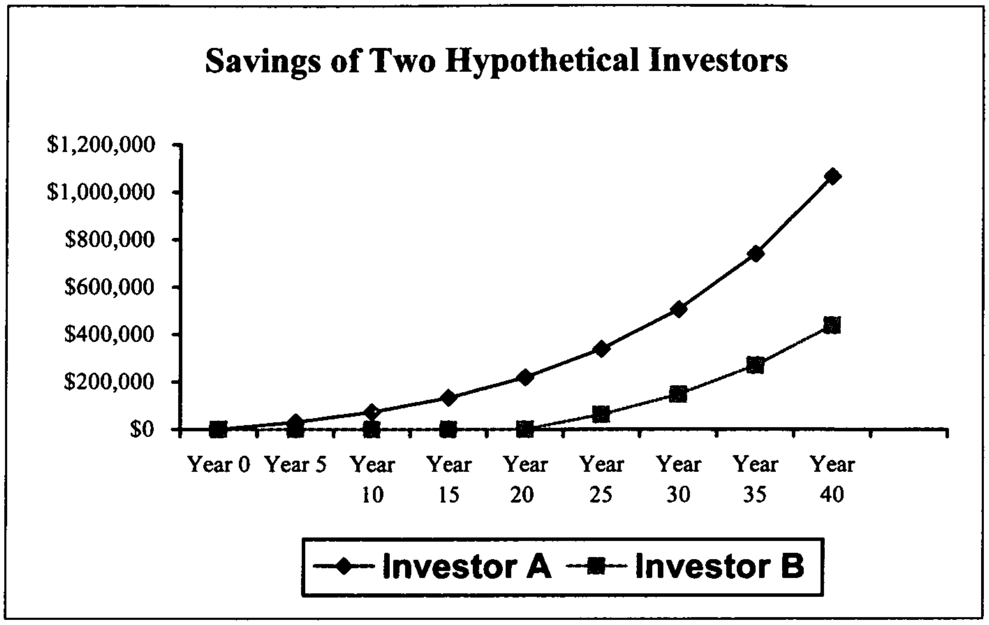
Table 1

Savings of Two Hypothetical Investors

	Investor A	Investor B
Year 0	$0	$0
Year 5	30,766	0
Year 10	73,918	0
Year 15	134,440	0
Year 20	219,326	0
Year 25	338,382	61,533
Year 30	505,365	147,836
Year 35	739,567	268,881
Year 40	1,068,048	438,652

32. *See id.* (reporting on a study that found that between 1984 and 2002, "the average equity mutual fund investor earned only 2.6% per year, on average, compared to a 12.2% annual return for the S&P 500 index. The average fixed income mutual fund investor earned only 4.2% annually, compared to a long-term government bond return of 11.7%").

33. Figures generated from the author's calculations. A 7% annual rate of return was assumed; interest was compounded annually.



The results are, of course, dramatic. Perhaps the first thing to note is that in Year 40, both investors have much more money than they actually contributed themselves. It is thus important not to invest too conservatively when one can be reasonably certain of adequate returns elsewhere. At the end of 40 years, Investor A has more than 10 times what he invested: $1,068,048 versus an actual investment total $100,000, all of which, it should be noted, reduced his taxable income in the year in which it was earned.[34] The similar is true of Investor B, although his gains are not as dramatic because the interest did not have the same opportunity to accrue.

A comparison between the final investments of the two individuals is instructive as well. Investor A finished with more than twice as much money as did Investor B at the end of 40 years ($1,068,048 versus $438,652), but invested only half as much ($100,000 versus $200,000). The main reason for this phenomenon is that in Year 20, when he was

34. It might be said that it costs person A less than $5,000 to invest that much annually in his tax-advantaged defined contribution plan. Assuming person A is in the 40% marginal tax bracket, the options are to invest a full $5,000 in the defined contribution plan or to take home an extra $3,000 because the $5,000, if not invested, would be taxed at ordinary income tax rates. Thus, in this case, the investor forgoes a current income stream of $3,000 for the opportunity to invest the non-taxed sum of $5,000.

finished investing, A already had a balance of nearly one-quarter-million dollars (at this point just 2.5 times what he actually invested), while B had not yet begun to invest. Between Years 20 and 40, A invests nothing but merely allows the interest to compound. The final item of note is that gains accelerate as time advances. For example between Years 0 and 5 person A invested $25,000 and had a balance of just $5,766 more than the amount he actually invested at the end of year 5. Between years 35 and 40, when he invested no new money, A had a positive cash flow of $328,481 (that is, he gained $328,481 in interest income alone).[35] This is, incidentally, almost double the gain that investor B enjoyed during this period (a total of $169,771), $50,000 of which was newly invested funds. Although this data could be analyzed countless different ways, the underlying point is that even investors who begin saving substantially in their 40s and 50s will find themselves with far less in retirement savings than those who save at lower rates but allow more time for these funds to accrue.

B. WHO PARTICIPATES IN 401(K) PLANS AND HOW MUCH DO THEY SAVE?

Given that the burden of saving for retirement is increasingly placed on the individual, one would hope that even liquidity-strained individuals save in at least small amounts early in life so they can capitalize on the advantages of compound interest as illustrated in the section above. Unfortunately, participation rates in defined contribution plans are low and declining, and many individuals are not saving at sufficient rates to secure a financially stable retirement. This section is meant to depart from the overly simplistic savings rates – often presented in the aggregate – that may cause the unwary to infer that savings behavior is fairly constant among different demographic groups. To the contrary, the data presented in this section[36] shows that despite the dramatic benefit of adequate retirement savings early in one's life, certain subgroups of individuals are chronic under-savers, and are particularly likely to experience a financially precarious retirement.

35. This phenomenon is a consequence of the fact that interest accrues on the existing balance – clearly this figure is much higher in later years than in earlier ones.

36. VANGUARD REPORT, *supra* note 10, at 5. Data is taken from a 2005 Vanguard publication surveying the defined contribution behavior of participants enrolled in these plans in 2004. The median Vanguard participant is a 44 year-old male who earns $54,000 per year and has an account balance of approximately $24,000 in retirement savings in his employer's defined contribution plan. *Id.*

Overall, approximately two-thirds of employees participated in their employer's defined contribution plan according to the Vanguard data.[37] The unfortunate corollary is that approximately one-third did not participate in their employer's defined contribution plan. Plan participation rates varied across different demographic factors. Income, for example, was one of the primary determinants of plan participation rates. Individuals with income over $100,000 were more than twice as likely as individuals making less than $30,000 to contribute to their defined contribution plan in 2004 (89% versus 39%).[38] Age is also an important factor in explaining participation rates. Workers less than 25 years of age were by far the least likely to participate in their employer's defined contribution plan in 2004 (29%), followed by workers over age 65 (53%).[39] Participation rates by age are depicted in Table 2 below.

Table 2

Participation Rates by Age

	2000	2002	2004
Under 25	31%	30%	29%
25-34	61	60	58
35-44	72	72	69
45-54	75	75	72
55-64	76	74	72
65+	61	58	53

Source: Vanguard, 2005

Job tenure, a variable highly correlated with age, influenced plan participation as well. While approximately one-third of employees with less than one year of employment participated, more than twice as many employees with more than ten years of experience did (36% versus 78%).[40] Particularly disturbing are participation rates among those with between two and three years tenure. While more than two-thirds of these individuals participated in their employer's defined contribution plan in 2000, slightly more than half did so by 2004 (68% versus 53%).[41] Some

37. *Id.* at 4.
38. *Id.* at 12.
39. *Id.*
40. *Id.*
41. *Id.*

studies also demonstrate that women face particularly dire retirement prospects if they do not arrange their financial affairs appropriately.[42]

When one examines average account balance by age, the picture becomes even more dismal. Perhaps the most troubling single statistic from Table 3 below is that individuals between the ages of 45 and 54 have an average account balance of only $38,193.[43] Even more striking is the realization that this median, by definition, suggests that half of all individuals surveyed actually have account balances that are *less than* or equal to this figure. Although many individuals who seemingly have pessimistic prospects for a well-funded retirement based on the above data in fact have additional sources of income, for many others that is not the case: "a defined contribution plan is the sole source of an employer-sponsored pension plan for many employees and the primary source for many others... for many employees, their 401(k) plan is their only meaningful source of employer-provided retirement income."[44]

Table 3

Account Balance by Age

	Median
Under 25	$1,536
25-34	8,683
35-44	22,194
45-54	38,193
55-64	51,937
65+	53,346

Source: Vanguard, 2005

Overall, the concern for the retirement prospects of the average American seems well-placed given even a cursory analysis of the above

42. *See generally* Cindy Hounsell & Pat Humphlett, The Female Factor: Why Women Face Greater Retirement Risk and What Can Be Done to Help Beyond Employer-Based Retirement Programs (2005), *available at* http://www.wiser.women.org/asr_femalefact_v3.pdf (suggesting that due to longer life expectancy than men, lower wages, and possibly more conservative investment strategies than men, that women face a greater risk than men of experiencing a decline in standard of living in retirement).

43. *See* WILLIAM GALE ET AL., THE AUTOMATIC 401(K): A SIMPLE WAY TO STRENGTHEN RETIREMENT SAVINGS 2 (2005), *available at* http://www.brookings.edu/views/papers/20050228_401k.pdf (finding that in 2001, half of all households headed by individuals between the ages of 55 and 59 had less than $10,000 in an employer sponsored program such as a 401(k) or other type of tax-preferred plan).

44. Stabile, *supra* note 11, at 74-75.

data. As noted in the section above, in 2004 fully one-third of respondents reported not participating in their employer's defined contribution program at all; non-participation rates were far higher among younger employees. Perhaps even more troubling is the trend toward lower rates of participation and lower savings rates that seems to be developing. As illustrated in Table 2, rates of participation declined by two to three percentage points between 2000 and 2004 in all age cohorts except the over 65 age group, where participation rates declined by eight percentage points during this time period.[45] This is, of course, particularly disturbing given the current climate in which the deficit is soaring and in which the President himself has stated that Social Security is in serious jeopardy. One possible redeeming factor within this data is that employers seem to be aware of the fact that their employees' retirement savings may be inadequate.[46] As will be addressed in the sections that follow, intervention on the part of employers and the government may be some of the only antidotes to the bleak retirement prospects facing millions of retirees in the years ahead.

III. THEORETICAL PARADIGMS

A. ECONOMIC THEORY AND THE SHIFT TO DEFINED CONTRIBUTION PLANS

It is useful to view the shift from defined benefit to defined contribution plans through the lens of traditional economic theory. Neoclassical economic theory suggests that individuals are rational actors who view all the choices before them and choose the option that will maximize their wealth.[47] The theory assumes that decision makers possess

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45. It should be noted, however, that further calculation would be necessary to determine statistical significance.

46. *See* 401khelpcenter.com, Survey Reveals New Employer Trends in Retirement, (2006), http://www.401khelpcenter.com/press_2006/pr_hewitt_011006.html (last visited Sept. 22, 2006) (reporting on the results of a 2006 employer survey of more than 200 large companies and finding that employer confidence in employees' ability to take account for their own retirement this year declined from 12% in 2005 to 6% in 2006, and that 23% of employers are very likely to add some form of automatic enrollment options to 401(k) plans this year; 13% are very likely to add contribution escalation features this year; and 20% plan to add automatic plan rebalancing this year).

47. *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1214-15 (2003). Camerer argues that though some disagreement exists among economists with respect to what precisely "full rationality" is, most economists generally agree with the following three

"unlimited sophistication,"[48] and are not, for example, intimidated by an overwhelming number of unfamiliar alternatives to an extent that would affect their decision. From this perspective, a scheme in which individuals have the widest array of choices from which to choose would likely be superior to one with little or no choice, as the theory assumes that individuals always make the optimal decision, given the alternatives available.[49] This conclusion assumes that an individual is more likely to find an optimal choice among a larger rather than smaller set of alternatives.

Contrary to the above theory, however, studies have shown that individuals are not, in fact, rational actors 100% of the time and have been known to make poor decisions, particularly with respect to retirement planning.[50] The field of behavioral economics impugns many of the assumptions of neoclassical economists presented above and seeks to define new, more realistic assumptions that are more reflective of human behavior.[51] Specifically, Choi et al. contend that employees often make the decision that "requires the least current effort... often... the 'path of least

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propositions: "First, people have well-defined preferences (or goals) and make decisions to maximize those preferences. Second, those preferences accurately reflect (to the best of the person's knowledge) the true costs and benefits of the available options. Third, in situations that involve uncertainty, people have well-formed beliefs about how uncertainty will resolve itself, and when new information becomes available, they update their beliefs using Bayes's law - the presumed ability to update probabilistic assessments in light of new information." *Id.*

48. Monahan, *supra* note 2, at 480.

49. *Id.* at 473. *See also* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1276-78 (1991) (questioning the neoclassical economic model of consumer choice and suggesting that individuals err systematically and that such inconsistency of consumer choice "offers a foundation for a methodical analysis of paternalistic savings policies... that will aid in the creation of more satisfactory retirement security programs").

50. *See* Monahan, *supra* note 2, at 481-83. The author uses Professor Weiss's conceptions of two types of "imperfect actors" who, when faced with saving for retirement in a defined contribution plan such as a 401(k) fail to save sufficiently, but for different reasons. "Impatients" are those who make poor decisions with respect to savings rates because they choose to save later rather than sooner. These actors procrastinate, "which produces a strong tendency toward inertia" and incorrectly "assume that whatever they will be doing later is not as important as what they are doing now." *Id.* "Impulsives," on the other hand, are keenly aware of the importance of saving sufficiently for retirement but suffer from "self-control problems" and "situationally inconsistent preferences," meaning that their preferences "vary according to the situation." *Id.*

51. Camerer, *supra* note 47, at 1215.

resistance.'"[52] The reality, the authors note, is that for many employees the easiest course of action is simply not to contribute to a retirement portfolio at all.[53] Thus, contrary to the models of neoclassical economists that would predict that individuals consistently maximize their utility and choose the best alternative, Choi et al. have shown that when they are presented with a broad range of investment options, individuals frequently fail to act and ultimately opt for the status quo by default. While the possibility exists that investors are in fact choosing the best alternative by doing nothing, this hypothesis is contradicted by available data.[54]

The consequences of the tendency for individuals to act irrationally are enormous. As noted above, such inertia often leads investors ultimately to choose the default contribution, a phenomenon which leads to significant employer influence on employee savings rates.[55] If employers elect non-participation as the default contribution, employees forgo the opportunity to save for retirement in a tax-favored way, an alternative that has been shown to be tremendously beneficial from a financial standpoint, and that, regrettably, cannot be fully regained. In many cases, employees forgo the

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52. James J. Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, 2001).

53. *Id. See also* Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1175-76 (2003). This phenomenon is lucidly described by the authors in a natural experiment in which they found the default rule to be "sticky." The authors compared the insurance regimes of New Jersey and Pennsylvania, the former of which adopted a default program with a relatively low insurance premium and no right to sue, while the latter adopted a default program with a higher premium and a full right to sue. Individuals had the option of opting out of their state's default regime, but in both cases the defaults tended to stick. Only approximately 20% of New Jersey drivers opted for the full right to sue, and 75% of Pennsylvania drivers opted for this right (their default). Since there is no reason to suggest that drivers of the two states should have systematically different preferences, the authors attributed the differential effects to the existence of different default provisions. *But see* Gregory Mitchell, *Libertarian Paternalism Is an Oxymoron*, 99 NW. U. L. REV. 1245, 1276 (2005) (rejecting Sunstein and Thaler's basic premise and arguing that the authors "neglect alternative approaches to dealing with irrational choice behavior that are more consistent with libertarian principles and that make choice-framing paternalism evitable, subjugate the liberty of irrational individuals to the central planner's paternalistic welfare judgments, and fail to deal with the redistributive consequences of libertarian paternalism").

54. Choi, *supra* note 52, at 7-8.

55. *Id.* at 4. *See also* Stabile, *supra* note 11, at 87-88 (suggesting that such control by employers runs counter to the philosophy underlying the current statutory regime in which employers are not held liable for investor losses. The theory underlying this principle is that the investment choices are those of the investor; this notion is undermined by data suggesting the context-dependent nature of investor decisions).

opportunity to receive "free money" from their employer if a "match" of employee investments is offered, as is typically the case. Skeptics may suggest that this result is desirable, given that employees actively made the choice to opt for non-participation. While this argument has some merit, research shows that many individuals actually do wish to save more than they currently do for retirement, but somehow have not taken the initiative to enroll in their employer's defined contribution plan to the extent they would prefer.[56]

The available data suggests that the decisions of even those who manage to open a retirement account are flawed in many respects. First, investor decisions are largely context-dependent, meaning that actors' ultimate choices are heavily influenced by the alternatives presented to them.[57] Additionally, Benartzi and Thaler have shown that individuals' asset allocations correspond roughly to the number of options available, suggesting that investment decisions may be too heavily influenced by the asset allocations presented.[58] Moreover, Stabile has found that investor decisions may be inferior to those of asset managers, due in large part to

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56. Choi et al. surveyed a random sample of employees at a large U.S. food company and compared responses regarding employees' ideal versus actual savings rates. Respondents consistently reported that they believed that they currently saved too little, but that they planned to increase 401(k) contributions in the future. The authors also found that of these individuals who plan to increase their savings rate soon, just 14% of this group actually increase their savings rate within four months. Additionally, of those who admitted to being at a point in their lives where they reported they "should be saving seriously already," 35% were "behind" in saving. Choi, *supra* note 52, at 6-8. *See also* David T. Laibson et. al., *Self-Control and Saving for Retirement*, *in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 91, 94 (William C. Brainard & George L. Perry eds., 1998) (reporting results of a survey finding that 76% of respondents believed that they should be saving more).

57. *See* Stabile, *supra* note 11, at 87. The evidence Stabile offers is from an EBRI study in which investors were offered one of three investment allocation options: a guaranteed investment contract (GIC) and employer stock, plans which contained only one of the above options, and plans which contained neither investment options. *See id.* The study found that "participants in plans offering neither option have the highest allocations to equity funds, that plans offering an employer stock fund but no GIC fund have substantially lower allocations to all other investment options, and that participants in plans with a GIC fund but no employer stock fund have lower allocations to bond, money market, and equity funds. The EBRI also found that where a plan requires that a company match be invested in employer securities, participants tend to direct a higher percentage of their self-directed funds into that option as well." *Id.*

58. For example, if a fund offers ten options, people tend to allocate 1/10 of savings to each available option. Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. REV. 79, 79 (2001).

the fact that many investors are financially illiterate.[59] Such investors predictably make poor decisions, including investing too conservatively, and attempting to "time the market," a strategy that most investment experts discourage.[60] Neophyte investors are also prone to excessive inactivity with respect to the management of their investment portfolio.[61] Stabile also found that individual investors tend to invest too heavily in company stock, noting that typically 30% to 40% of plan assets are invested in stock among companies that offer securities as part of the employer's 401(k) plan.[62] Given the poor decisions many investors have been shown to make with respect to saving for retirement, the next section will explore whether government intervention is justifiable from a theoretical perspective.

B. THE CASE FOR INTERVENTION: CAN "PATERNALISM" BE THEORETICALLY JUSTIFIED?

The foregoing sections have sought to outline a fundamental inconsistency that could prove deleterious to a great many Americans, as well as society as a whole: while the benefits of saving sufficiently for retirement have perhaps never been more dramatic, a surprisingly small fraction of the population seems to be exploiting the benefits available through tax-advantaged investment in defined contribution plans. This section sets forth some of the potential consequences that may result from this behavior, and ultimately attempts to justify government intervention in this important area.

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59. Stabile, *supra* note 11, at 88. *See also* Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 14 (2000) (noting that investors' lack of knowledge about financial management of retirement assets may jeopardize their ability to accumulate sufficient assets in retirement); Laura Lallos, *The 60 Minute 401(k)*, MONEY, Nov. 2000, at 85 (noting that almost half of survey respondents could not name even one investment option in their 401(k) plan).

60. Stabile, *supra* note 11, at 89-90.

61. *Id.* at 90.

62. *Id.* at 90-91. *See also* James J. Choi et al., *Employee Investment Decisions About Company Stock* 2 (Nat'l Bureau of Econ. Research, Working Paper 10228, 2004) (suggesting the following possible employer motivations for offering employees stock in 401(k) plans despite the obvious dangers of doing so: providing stock is relatively inexpensive, morale or incentive effects that result of employees having an ownership interest in the company, and that friendly employees may prove beneficial in a management or takeover dispute).

One of the more prominent theories that advocates government intervention is that of "libertarian paternalism," which has been articulated by Cass Sunstein and Richard Thaler. Contrary to the contentions of various critics, the authors argue that far from being an oxymoron, the theory allows for "private and public institutions to influence behavior while also respecting freedom of choice."[63] The underlying idea is that people's choices are often unclear and/or uninformed and are often influenced by, among other things, the way in which various choices are presented.[64] Libertarian paternalists "attempt to steer people's choices in welfare-promoting directions without eliminating freedom of choice."[65] The authors see the need for change because data from behavioral economics and cognitive psychology has shown that individuals may "make inferior decisions in terms of their own welfare – decisions that they would change if they had complete information, unlimited cognitive abilities, and no lack of self-control."[66]

Susan Stabile argues that some degree of paternalism is justified with respect to defined contribution plans for two reasons: (1) individuals often do not make good decisions because of certain biases affecting decisions; and (2) poor investor behavior may be harmful to third parties.[67] Stabile argues that the above evidence about the flaws in investor decisions suggests that they are "incapable of understanding their own best interests, or they are incapable of acting in their self-interest" and that government intervention becomes more justifiable as a result.[68] Whether or not

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63. Sunstein & Thaler, *supra* note 53, at 1159. *See also* Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. REV. 106, 133-34 (2002) (drawing on behavioral law and economics and arguing that switching default rules might have the effect of producing change in many different areas of labor and employment law).

64. Sunstein & Thaler, *supra* note 53, at 1159.

65. *Id.*

66. *Id.* at 1162. *See also* Shlomo Benartzi & Richard H. Thaler, *How Much Is Investor Autonomy Worth?*, 57 J. FIN. 1593, 1594-98 (2002). Employees shared their retirement portfolios with researchers performing a behavioral experiment. Researchers presented the investors with a statistical distribution of expected retirement income of three portfolios: their own, the average of fellow employees, and the median of fellow employees. Subjects rated the median portfolio more highly than their own and just 20% of investors rated their own portfolio more highly than the median. Sunstein and Thaler interpret this data to mean that "people do not gain much ... from choosing investment portfolios for themselves." Sunstein & Thaler, *supra* note 53, at 1169-70.

67. Susan J. Stabile, Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices, 11 CORNELL J. L. & PUB. POL'Y 361, 391 (2002).

68. *Id.*

individuals are "incapable" of understanding or acting in their own best interest, it is clear that they are not, in practice, acting in accordance with their own best interest, as demonstrated by the materials in the sections above. Voluminous evidence suggests that employees want to invest at greater rates in their employers' defined contribution plans but that a debilitating status-quo bias prevents them from doing so.[69] This situation, in tandem with the dire consequences that may ensue if the coming waves of retirees are not sufficiently funded for retirement, justifies aggressive government intervention.[70]

The second justification for legal intervention that Stabile advances relates to the social harm that could result if the current system remains unchanged. Stabile argues persuasively that employee decisions not to participate in 401(k) plans, to participate at low levels, or to participate and subsequently opt for a cash distribution, have negative externalities that will impact the rest of society.[71] Rather than retiring with insufficient assets, some employees may decide not to retire at all, or to retire later in

69. *See* Sunstein & Thaler, *supra* note 53, at 1175-76. *But see* Mitchell, *supra* note 53, at 1276.

70. Opponents of relatively aggressive models of intervention such as the Save More for Retirement Act of 2005 often suggest that other less intrusive methods of increasing savings rates in defined contribution plans exist. Proponents of this school of thought might argue that alternatives are desirable because they rely more on the demonstrated intent and explicit actions of the investor herself. Increased education is a popular alternative that has been shown to be inadequate. Choi et al. interpreted a study undertaken by Brigitte C. Madrian and Dennis F. Shea in which the authors examined the effect of a general education seminar that was conducted at one particular company. Madrian and Shea tracked seminar attendance and matched data on seminar attendance with subsequent statements about changes that seminar participants desired to make with respect to savings behavior, in addition to the actual changes that participants made regarding their retirement savings. During one particular six month period, of the fraction of attendees who currently did not participate in their employer's defined contribution plan but responded that they intended to start as a result of the seminar, only 14% actually joined their plan at the end of the six month period. Choi et al. note that some of these individuals would have likely joined their employer's 401(k) plan even in the absence of the seminar, as 7% of non-attending employees did. Of seminar attendees who had already been participating in their employer's 401(k) plan, "41 percent reported plans to make changes in the selection of their investment choices within the 401(k) plan, and 36 percent reported plans to change the fraction of their money allocated to the various 401(k) investment choices." The fraction of individuals who actually made those changes was substantially lower. This data strongly suggests that education alone is insufficient to deal with the serious issues presented by employee non-participation in employer defined contribution plans. Choi, *supra* note 52, at 30-31.

71. Stabile, *supra* note 67, at 391.

life than they otherwise would if they had adequate retirement savings.[72] A potential consequence is having a sizable portion of the workforce with decreased levels of motivation for work.[73] More workers of retirement age occupying employment positions would also decrease the number of employment opportunities available to both new employees and to employees that would otherwise be promoted to those positions.[74] Stabile notes that attempting to justify additional regulations on corporations is particularly easy, because "corporations... are creations of society" that enjoy favorable tax treatment, and "[i]f notions of corporate social responsibility imply that public corporations 'have an obligation to contribute to the betterment of society in a manner distinct from the maximization of corporate profit,' those same notions demand that corporations adopt a more responsible attitude toward promoting the retirement security of their own employees."[75]

The abysmal savings rates that seem virtually ubiquitous in an aging country in conjunction with the persuasive evidence presented by various behavioral economists that individuals wish to save more but simply fail to do so for irrational reasons justifies government intervention. The argument that significant social harm could ensue if current savings practices remain unchecked is additional fodder for reform advocates. The section below will discuss various reforms that could be implemented that would almost inevitably increase savings rates markedly.

IV. ALTERNATIVES

The foregoing sections have sought to justify government intervention in employer-sponsored defined contribution plans due to the imminent crisis in the American retirement security arena. The remaining portions of this Note outline the most promising alternatives, with emphasis on a particular piece of legislation that was introduced to the Senate in April, 2005: The Save More for Retirement Act of 2005.

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72. *Id.* at 395.
73. *Id.*
74. *Id.*
75. *Id.* at 396.

A. THALER AND BENARTZI'S SAVE MORE TOMORROW PLAN

The data presented above demonstrate that individuals often desire to save for retirement at greater rates, but do not do so for a variety of reasons. The behavioral experts Thaler and Benartzi have devised an ingenious way to get employees to overcome many of the obstacles that prevent them from saving adequately for retirement. Acknowledging the empirical fact that many individuals desire to save more but often lack willpower and sophisticated investment knowledge, the plan capitalizes on the notion that people are generally more willing to forgo a future benefit than a current benefit.[76] As such, the plan invites employees to commit to increased 401(k) contributions in advance of when the payroll deductions would actually be taken. As described by Thaler and Benartzi, the (SMarT) plan works as follows:

> First, employees are approached about increasing their contribution rates approximately three months before their scheduled pay increase. Second, once they join, their contribution to the plan is increased beginning with the first paycheck after a raise. Third, their contribution continues to increase on each scheduled raise until the contribution rate reaches a preset maximum. Fourth, the employee can opt out of the plan at any time.[77]

The authors found that those who joined the plan, on average, more than tripled their savings rates, from 3.5% to 11.6%, in 28 months.[78]

According to Thaler and Benartzi, the SMarT plan is successful in part because it was designed with an eye toward circumventing the traditional obstacles to saving for retirement.[79] One of the primary obstacles in saving

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76. Professor Thaler eloquently described this phenomenon as follows in a personal interview: "For example, given the option of going on a diet three months from now, many people will agree. But tonight at dinner, that dessert looks pretty good." Richard Thaler, *Save More Tomorrow: A Simple Plan to Increase Retirement Saving,* CAPITAL IDEAS, Sept. 2004, http://gsbwww.uchicago.edu/news/capideas/sept04/savemoretomorrow.html.

77. Id..

78. *Id.*.

79. *Id.* Traditional obstacles include, as discussed herein: (1) ascertaining how much to save; (2) addressing problems related to investor self-control; (3) addressing problems related to investor inertia; and (4) addressing investors' feelings of loss aversion. *Id.*

adequately for retirement is attempting to ascertain how much to save.[80] The life-cycle theory of consumption assumes that individuals decide what level of consumption they desire over a lifetime and borrow and save in accordance with that calculation.[81] Since incomes are relatively lower when workers are younger, more borrowing usually occurs then, with retirement savings occurring later in one's career. The SMarT plan helps individual investors approximate the appropriate level of savings.[82] Second, the plan addresses problems of self-control that can often impede one's ability to save for retirement.[83] Because individuals only contribute at higher rates when they receive pay increases, investors never see a decrease in their take-home pay, and often see increases when they receive pay raises, although less dramatic increases than would be the case if they did not opt for the SMarT program. Third, the authors capitalize on investor inertia - that is, the tendency for investors to fail to make changes in savings rates or investment allocations, even once they are actively investing in their employer's plan.[84] Since employees agree to gradual increases in their contribution rate in advance of when the deductions are actually taken, they do not actively increase contributions as time progresses. Finally, the authors' plan addresses an individual's feeling of loss aversion: the tendency to be more concerned with losses than with comparable gains.[85]

Thaler and Benartzi reject critics' arguments that automatic enrollment and the SMarT plan are a sort of "sneaky paternalism." The authors emphasize the inevitability of having some form of a default rule, and point out that these plans are not mandatory because individuals are able to opt out of the program if they desire. Introducing a default rule that many policymakers believe individuals themselves would make if they had complete information and did not lack self-control is meant to be helpful to individual investors and to society as a whole.

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80. Indeed, the authors note that ascertaining the appropriate amount to save can be a technical undertaking that even trained economists find challenging. *Id.*

81. *Id.*

82. Thaler, *supra* note 76.

83. *Id.*

84. Julie Agnew et al., *Portfolio Choice and Trading in a Large 401(k) Plan*, 93 AM. ECON. REV. 193, 200-201 (2003) (discussing the infrequent rate of portfolio adjustments for investors in defined contribution plans).

85. *See* Thaler, *supra* note 76.

B. THE SAVE MORE FOR RETIREMENT ACT OF 2005

Were it not for Senator Jeff Bingaman, the innovative scheme presented above could perhaps be dismissed as a whimsical notion proposed by two ivory-tower theorists who are devoid of any sense of the political palatability of such a dramatic proposal. All this changed in April, 2005 when Senator Bingaman, a Democrat from New Mexico, introduced the Save More for Retirement Act of 2005 (S. 875). This legislation would amend the Internal Revenue Code and ERISA in an effort to increase savings in defined contribution plans such as 401(k) plans using the same mechanisms as Thaler and Benartzi's plan.[86] Likely sensing the imminent crisis enshrouding America's retirement security landscape, in his comments on the Senate floor, Senator Bingaman emphasized the urgent need for Congress to "look at ways to expand retirement savings" and noted the historically low national savings rate.[87]

As in Thaler and Benartzi's plan, the first part of the new legislation seeks to change the default investment contribution to automatic enrollment. Additionally, in an effort to increase savings rates, the plan would "encourage plans to add a feature that increases employees' contributions annually until it reaches at least 10 percent of the employees' compensation."[88] The Save More for Retirement Act of 2005 includes a safe harbor provision to encourage employers to make changes to the plan. The plan would be treated as nondiscriminatory for ERISA non-discrimination testing purposes if the following safe harbor provisions are met: "the employer must provide either a non-elective match of 3 percent of the employee's compensation or an elective match of 50 percent of the first 7 percent of the employee's compensation."[89] Additionally, the employer must allow vesting in two years if the employee is enrolled in the plan before their first paycheck, or in one year if the employee is enrolled within the first quarter of starting work. The legislation instructs the Department of Labor to provide regulations that will provide guidance to employers in selecting default provisions beyond money market accounts and guaranteed investment contracts, although the specifics of those

86. B. Janell Greiner, *Save More for Retirement Act of 2005*, BENEFITS BLOG, Apr. 25, 2005, http://www.benefitscounsel.com/archives/001463.html.

87. *Id.*

88. *Id.*

89. *Id.* The criteria will also be deemed to have been met if the employer provides comparable benefits in another qualified account for the same employees.

regulations have not been articulated.[90] Importantly, the legislation seeks to amend ERISA § 404(c) rather than eliminate it, and retains employer exemptions from liability if participants exercise control over their accounts. The safe harbor provision of the legislation is set out below:

Table 4
Non-Discrimination Testing Safe Harbor
Employer Contributions Non-elective match of 3% of employee's compensation OR Elective match of 50% of the first 7% of employee compensation
Vesting 2 years if deferrals taken from first paycheck OR 1 year if employer enrolls employees within the first quarter of hire
Employee Contributions If employee does not opt out of participation AND does not opt out of the default feature, the plan must: Start employee's contribution at 3% of compensation AND Increase contribution 1% annually or whenever employee receives a raise AND Contribution rate must increase up until at least 10% of compensation
Employee Protection Employee can withdraw without penalty as of the latest of: $500 of contributions 2 paychecks OR 1 month
Pre-emption from State wage withholding laws ERISA preemption to extent that state wage withholding laws would prevent employers with automatic enrollment plans from sending employees' contributions to their retirement plan
Source: American Benefits Council, 2005[91]

The proposed legislation is desirable for a number of reasons. At the most fundamental level, it attempts to reconcile the following two competing notions: while individuals have a right to control their own retirement planning choices and invest their assets as they so desire,

90. *Id.* Specifically, the legislation calls for guidance on the appropriateness of designating default investments.

91. American Benefits Council, *Save More For Retirement Act of 2005,* http://www.americanbenefitscouncil.org/documents/s-875_bingaman_summ.pdf.

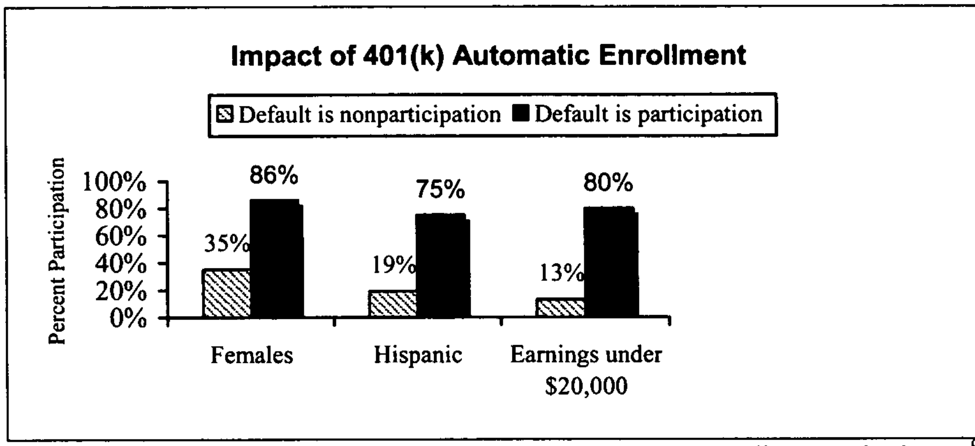
extensive research has shown that individuals "make inferior decisions in terms of their own welfare – decisions that they would change if they had complete information, unlimited cognitive abilities, and no lack of self-control."[92] By thoroughly informing individuals of the consequences of automatic enrollment, the plan ensures that individuals are free to make any choice regarding participation in their employer's defined contribution plan they desire, but simultaneously addresses the strong status quo bias that prevents many investors from investing in their employer's defined contribution plan. Further, the way in which the plan seeks to encourage investment is preferable to other alternatives that have been suggested by commentators. Specifically, the existence of the safe harbor provision provides an incentive for employers to implement the program, and attempts to ensure that employees at all income levels will have an opportunity to invest. Finally, as will be discussed below, the plan amends rather than eliminates ERISA section 404(c), and enables employers to continue to enjoy exemption from liability for investor losses. The former alternative is preferable to the latter because removing employer exemptions from liability provides a disincentive for employers to offer defined contribution plans – a step that would truly be disastrous to Americans' retirement security.

C. CHANGE THE DEFAULT: AUTOMATIC ENROLLMENT

Perhaps the foundation of Senator Bingaman's proposed legislation is automatic enrollment. Under this scenario, the default enrollment option regarding the employer's defined contribution plan is participation; employees must actively "opt out" of the default arrangement if they do not wish to contribute to the plan. Under most such arrangements, employees are specifically informed of the nature of automatic enrollment and are always able to "opt out" quite easily. The benefits of automatic enrollment are dramatic, particularly among certain subgroups of individuals who have historically participated in defined contribution plans at the lowest levels. Choi et al. has demonstrated that automatic enrollment significantly influences 401(k) participation.[93] In a study of three large firms, the authors use several years of administrative data to study the impact of automatic enrollment on participation rates in defined contribution plans, savings behavior, and asset accumulation. The researchers found that

92. Sunstein & Thaler, *supra* note 53, at 1162.
93. Choi, *supra* note 52, at 28.

although employees have the option of "opting out" of participation, few ultimately do. The authors found that automatic enrollment virtually eliminates those employees who do not contribute to their employer's defined contribution plans, and increases participation rates to approximately 90%.[94] The results are particularly striking for those subgroups with historically low participation rates, such as women and minorities.[95]



Largely because default choices are "sticky," as discussed above,[96] participation is dramatically affected by the employer's choice of default, particularly among the subgroups depicted in the chart above. Participation in 401(k) plans increased more than two-fold among women (from 35% to 86%) when automatic enrollment was introduced. Results were even more pronounced for Hispanics and those earning less than $20,000 per year.[97]

Despite the dramatic impact of automatic enrollment on participation rates in 401(k) plans, Choi et al. conclude that automatic enrollment "probably had a modest positive impact on *employee balances*, controlling for tenure."[98] The main reason for this outcome is that low default savings rates had offsetting effects on wealth accumulation in the Choi study. That is, even though more people enrolled in defined contribution plans when

94. *Id. See also* Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Saving Behavior*, Q.J. ECON. 1149, 1158-59 (2001) (finding participation rates for new workers increased from 49% to 86% after a switch to automatic enrollment).

95. Madrian & Shea, *supra* note 94.

96. Sustein & Thaler, *supra* note 53, at 1160.

97. Madrian & Shea, *supra* note 94.

98. Choi, *supra* note 52, at 28.

the default was participation, their balances did not increase dramatically because their contribution rates (e.g. percent of income) remained relatively low. The authors found that "initially, about 80% of participants accept both the default savings rate (2% or 3%...) and the default investment fund (a stable value or money market fund)... after three years, half of the plan participants subject to automatic enrollment continue to contribute at the default rate and invest their contributions exclusively in the default fund."[99] Thus these conservative investment outcomes led to relatively low levels of wealth accumulation.[100] In fact, research has shown that investors would have opted for higher savings rates if given the opportunity to do so.[101] Available data also suggests that most employees would not object to their employer adopting automatic enrollment.[102] The Save More Tomorrow plan, in contrast to plans incorporating only automatic enrollment such as those discussed above, uses automatic enrollment as a foundation, but improves on that arrangement by periodically increasing the amount of money set aside for retirement and offering age-appropriate investment allocations.

D. EFFECTS OF CHANGING ERISA SECTION 404(c)

ERISA was enacted in 1974 to regulate defined benefit programs.[103] The legislation mandates "disclosure and reporting requirements for retirement plan sponsors and sets standards of conduct for plan fiduciaries. ERISA also sets standards for vesting and accrued benefits, minimum funding requirements, and termination of retirement plans."[104] The underlying goal of ERISA is to "protect and strengthen the rights of employees, to enforce strict fiduciary standards, and to encourage the development of private retirement plans."[105]

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99. *Id.* at 2.

100. *Id.* at 28. Default savings rates of two to three percent of income and default investments in money market accounts undermine long-term wealth accumulation.

101. Madrian and Shea, *supra* note 94.

102. American Benefits Counsel, *Automatic Enrollment and Automatic Acceleration Features Encourage Worker Participation in Defined Contribution Plans*, http://www.americanbenefitscounsel.org/documents/abc_ae_ai_042105.pdf (reporting that two-thirds of non-participants in their employer's 401(k) plan would be either very likely or somewhat likely to remain in their employer's plan if they were automatically enrolled).

103. Keith R. Pyle, Note, *Compliance Under ERISA Section 404(c) with Increasing Investment Alternatives and Account Accessibility*, 32 IND. L. REV. 1467, 1468 (1999).

104. *Id.* at 1468-69.

105. *In re* Unisys Sav. Plan Litig., 74 F.3d 420, 434 (3d Cir. 1996).

Nevertheless, certain ERISA provisions remain some of the most significant impediments to implementing the reforms outlined above. Section 404(c) of ERISA states the consequences that result from a participant's exercise of control of his defined contribution account. That section provides that if a pension plan provides individual accounts and allows the investor to "exercise control" over the assets in the account, "such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and . . . no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's, or beneficiary's exercise of control."[106] Thus if the investor is deemed to have "exercised control" as set forth in the regulations, the employer is able to avoid liability for any losses that may occur in employer sponsored defined contribution plans. Of course, employers wish to ensure that employees "exercise control" so that employers are exempt from liability in accordance with § 404(c).[107] Because employees cannot be deemed to have "exercised control" when passively accepting the default provision of automatic enrollment, employers are understandably reluctant to adopt plans with such features.[108] The Save More for Retirement Act addresses this issue by amending § 404(c) so that an investor is deemed to have "exercised control" - even if she is invested in the default alternative - if the default investment plan is allocated in accordance with regulations to be promulgated by the Department of Labor.

Some commentators have questioned the theoretical foundation of the concept of "control" in a world in which individuals have been shown to make irrational investment decisions.[109] Susan Stabile, for example, questions the extent to which even individuals who make an affirmative choice to participate in their employer's 401(k) plan can actually be said to have "exercised control" over their account as defined by ERISA.[110] Stabile argues that section 404(c) should be eliminated since it "lacks a

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106. 29 U.S.C. § 1104(c)(1) (2000).

107. *See* Stabile, *supra* note 67, at 375-76 ("[I]n automatic enrollment plans, there is no section 404(c) relief unless a participant makes an affirmative election to change from the default contribution and investment options selected by the employer").

108. *See* 29 C.F.R. § 2550 (2005) ("decisions have affirmatively been made by participants and beneficiaries who have exercised independent control... Unless an affirmative instruction is given, there can be no relief under ERISA section 404(c)"). Of course, employers are able to control their exposure by using money market and stable value funds as well as guaranteed investment contracts as the default investments.

109. *See, e.g.*, Stabile, *supra* note 67, at 376.

110. *Id.* at 376.

firm theoretical basis because control by participants is illusory."[111] The crux of the argument is that individuals who are deemed to have "exercised control" in their 401(k) plans have often not, in fact, exercised meaningful control because of the "influence exerted by employers and other fiduciaries."[112] Because employers may influence employees to invest in company stock and service providers may "steer participants into funds paying the largest fees," the argument goes, the extent to which investors actually exercise control is diminished.[113] While there can be little question that individuals' decisions regarding retirement savings can sometimes be faulted, ERISA § 404(c) serves a useful purpose, and as a liability shield, offers employers an incentive to offer these voluntary investment programs for employees. As will be discussed in the section below, the potential costs of eliminating the provision would likely outweigh the benefits.

1. Potential Consequences of the Imposition of Liability under § 404(c)

An increased risk of employer liability could potentially have disastrous effects on Americans' retirement security. An advocate for the elimination of § 404(c) herself, Stabile notes the possible employer responses to potentially creating liability on the part of employers for employee losses.[114] First, employers might decide to end participant-direction of defined contribution plans and opt to make the decisions for employees themselves. Stabile argues that management by professional asset managers is actually a positive outcome, because many individual investors have indicated a desire for professionals to manage their investments.[115] A second possible response is for employers to provide more extensive education to employees, and to monitor investor decisions.[116] Finally, employers may decide to eliminate 401(k) plans entirely in response to increased potential for liability.[117] Although Stabile emphasizes that pension plan sponsorship is voluntary, she notes the unlikelihood of this dramatic alternative, as "[c]orporations competing for

111. *Id.* at 397.
112. *Id.* at 383, 386.
113. *Id.* at 385.
114. *Id.* at 398-400.
115. Stabile, *supra* note 67, at 398-99.
116. *Id.* at 399.
117. *Id.* at 400.

talented and skilled employees have no choice but to offer pension plans in order to compete with competitors offering such plans."[118]

Senator Bingaman's proposed legislation is preferable to eliminating § 404(c) for a variety of reasons. Given the behavioral evidence presented above, it is clear that the objectives heretofore accomplished by non-discrimination provisions will be accomplished with the non-discrimination testing safe-harbor: data suggest that it is quite likely that the proposed legislation will succeed in increasing participation rates dramatically.[119] Additionally, the changes to § 404(c) deal with the problems related to actual control that Stabile raises, without the potentially harsh consequences that could accompany elimination of § 404(c) protection. While it is clear that employers would still exercise some influence on investors' choices, the ultimate choice would still be that of the investor, as he would be made aware of the automatic nature of the defined contribution plan and be required to consent to this arrangement. Moreover, in contrast to the situation that now exists, control would be explicit, and presumably employees would be more aware than they currently are of potential employer influence, on both an implicit and explicit basis. As a result, it is likely that employees would act more affirmatively to alter choices they find unfavorable, rather than continue to be subtly, and perhaps deceitfully, influenced by employer actions.

Furthermore, even proponents of elimination of § 404(c) acknowledge the possibility that employers would discontinue their defined contribution plans for employees. In light of the data set forth at the outset, this could clearly have a deleterious effect on Americans' retirement security. In ultimately reaching the conclusion that discontinuation would likely not occur, Stabile suggests that for competitive reasons firms would not be able to take this step, as it would effectively preclude them from attracting the most talented job applicants.[120] Such reasoning ignores the fact that large firms could potentially act in concert with one another to discontinue the practice of offering defined contribution plans, and that other less well-known organizations might well follow suit. Given the pronounced lack of investment-savvy on the part of many Americans, it is indeed possible that some organizations that do not offer a defined contribution plan might attempt to lure the unwary with above-market salaries, essentially offering

118. *Id.*

119. Richard H. Thaler & Shlomo Benartzi, Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, 112 J. POL. ECON. S164 (2004).

120. Stabile, *supra* note 67, at 400.

new employees the option to consume somewhat more in the form of inflated salaries now, while choosing to forgo a much larger benefit in the form of a mature defined contribution benefit later. The unfortunate truth is that many investors may not know of the benefit of even small contributions to retirement savings early in one's life.

E. THE PENSION PROTECTION ACT OF 2006

On August 17th, 2006, President Bush signed the Pension Protection Act of 2006 into law. Although the legislation was perhaps more newsworthy for its impact on defined benefit plans, the law had significant implications for the world of defined contribution plans as well.

The 2006 Act paves the way for employees to automatically enroll employees in defined contribution plans, and amends ERISA "to provide a safe harbor for plan fiduciaries investing participant assets in certain types of default investment alternatives in the absence of participant investment direction."[121] Specifically the legislation extends § 404(c) protection to plans using automatic enrollment features, subject to various regulations prescribed by the Department of Labor.[122]

The automatic enrollment provisions of the Pension Protection Act constitute an effective starting point for addressing the upcoming crisis regarding Americans' retirement security. As the Choi study demonstrates, however, automatic enrollment alone is not a complete solution. To more fully address savings inadequacy, employers must make every effort to periodically accelerate employees' contributions to the extent consistent with ERISA.

CONCLUSION

The precarious future of Social Security in conjunction with the increased role of the defined contribution plans in the average American's retirement portfolio suggests that reform is needed. Many Americans have not been devoting adequate care to retirement planning, and have not been taking full advantage of the potential benefits available to them through a tax-advantaged defined contribution plan. But new research has identified

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121. U.S. DEPT. OF LABOR, PROPOSED REGULATION RELATING TO DEFAULT INVESTMENT ALTERNATIVES UNDER PARTICIPANT DIRECTED INDIVIDUAL ACCOUNT PLANS, *available at* (last visited Jan. 19, 2007).

122. For a detailed examination of the effect of the Act on § 404(c) of ERISA and of the details of the Department of Labor regulations, see *id.*

one of the main causes of this disturbing trend, and the Save More for Retirement Act of 2005 offers a sound solution. By changing the law to reflect the actual savings and consumption patterns of individual investors as demonstrated by behavioral research, individual retirees will enjoy a more prosperous retirement, and society will not be forced to bear the costs of a nation of chronic under-savers. Furthermore, it is essential that employers not face disincentives to offering defined contribution plans to their employees, as the consequences of such an occurrence in terms of Americans' retirement security would be disastrous. As such, ERISA § 404(c) should be amended rather than eliminated, as proposed in Senator Bingaman's legislation. The strength of the Save More for Retirement Act of 2005 is that it facilitates what research has shown are the decisions employees would make if they were not limited by the cognitive constraints that often influence the behavior of many investors.