Spring 2002

The Collapse of the Enron Corporation and its Effects on 401(k) Retirement Plans

Brian Terhune Shore

University of Tennessee - Knoxville

Follow this and additional works at: https://trace.tennessee.edu/utk_chanhonoproj

Recommended Citation
https://trace.tennessee.edu/utk_chanhonoproj/599

This is brought to you for free and open access by the University of Tennessee Honors Program at Trace: Tennessee Research and Creative Exchange. It has been accepted for inclusion in University of Tennessee Honors Thesis Projects by an authorized administrator of Trace: Tennessee Research and Creative Exchange. For more information, please contact trace@utk.edu.
UNIVERSITY HONORS PROGRAM

SENIOR PROJECT - APPROVAL

Name: Brian Shore

College: Business
Department: Finance

Faculty Mentor: Dr. Harold Black

PROJECT TITLE: "The Collapse of the Enron Corporation and its Effects on 401(k) Retirement Plans"

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

Signed: ____________________________, Faculty Mentor

Date: 5/1/02

Comments (Optional):
The Collapse of the Enron Corporation and its Effect on 401(k) Retirement Plans

Brian Shore
Dr. Harold Black, Faculty Advisor
Senior Honors Project
The University of Tennessee
Spring, 2002
# Table of Contents

Introduction ........................................................................................... 1

The 401(k) – The Basics ............................................................................ 2  
  o Benefits  
  o 401(k) Design  
  o Typical Investments in a 401(k)

The Legal Structure of 401(k)s ...................................................................... 7

The Enron Saga ....................................................................................... 9  
  o Enron’s Beginnings  
  o The Good Times  
  o The Downfall  
  o The Effects of Enron’s Collapse  
  o Enron’s 401(k)

Fixing 401(k)s – Current Proposals and Opinions .............................................. 14  
  o Do Nothing  
  o Ted Benna, creator of 401(k) Plans  
  o President Bush  
  o Congressional Proposals  
  o The Protecting America’s Pension Act of 2002  
  o The Pension Security Act of 2002

My Recommendations .............................................................................. 20  
  o Limiting the Amount of Company Stock  
  o Employee Education and Advice  
  o Minimum Number of Investment Options  
  o Required Holding Period for Company Stock Matches  
  o Blackout Periods

Conclusion ........................................................................................... 26

References ........................................................................................... 28

Appendices ........................................................................................... 29
In an effort to provide for employees who have given service to their employer, most companies in the US have developed retirement plans for their workers. Previously found primarily in the defined-benefit pension structure, many plans now feature the defined-contribution setup of 401(k)s. The 401(k) form of retirement plan has grown tremendously in popularity since its inception in 1981, but the 401(k) has recently come under fire since the collapse of the Enron Corporation.

Enron. The name which previously signaled the potential for tremendous returns for many investors now strikes fear and anger in their hearts. The company’s downfall was unexpected, catching many investors off guard. The repercussions of Enron’s collapse have been felt throughout the business world, and changes are likely to follow. From the way companies operate to the accountants’ audits to the world of investments, few businesses are immune to Enron’s effects.

The media has devoted attention to many aspects of the company’s downfall, including the Congressional testimonies of Enron executives and the numerous clients leaving Enron’s auditor, Arthur Anderson. One story not overlooked, but also not as publicized, is the effect of Enron’s bankruptcy on the numerous shareholders, particularly Enron employees holding the company’s stock in their retirement portfolios.

The intent of this study is to analyze the structure of 401(k)s in the United States and determine how the plan might be improved. Since the fall of Enron, many have rethought how 401(k) plans are designed. Should an employee’s retirement benefits be at the mercy
of the stock market? How can the US Government provide additional protection for 401(k) holders, if at all? Should they interfere in the workings of the stock market? These and other questions will be analyzed and answered in the coming pages.

To fully develop the extent of the issues regarding 401(k)s, it is important to initially detail the development of the 401(k) and its legal regulations. Following this, an analysis of Enron's downfall will be provided to better understand the current situation. As many have witnessed the demise of Enron and its effect on the 401(k) plan, legislators and news analysts have provided their opinions as to what should be done to correct the retirement plan, some of which will be detailed. Finally, an acceptable solution to the problems, the ultimate goal of this study will be provided.

**The 401(k) – The Basics**

Retirement plans have been in place for over two centuries now, with companies rewarding employees for their years of work service. Traditionally, these plans have been in the form of pensions, where a company provides a predetermined amount upon retirement based on the number of years the employee is with the company. The worker can calculate his or her retirement benefits accurately based on the expected term of service with the company. Recently, however, the 401(k) plan has revolutionized retirement saving with different attributes for investors.

The 401(k) form of retirement plan began humbly in 1981 with little celebration. In fact, the plan was the idea of a retirement consultant who discovered the opportunity while
reading the Internal Revenue Code in 1980. Ted Benna found a change in Section 401(k) of the Code developed under the Revenue Act of 1978 that interested him. Designed primarily for banks, Section 401(k) provided for employees to take out money from their paychecks before taxes and invest it. When they retired, the employees could remove the money from this account, at which point it would be taxed. Benna decided to apply the format to non-bank companies, and set up the first 401(k) plan in 1981.

Unlike the defined-benefit plans, such as a pension, the 401(k) is a defined-contribution format, meaning that the employee does not receive a guaranteed amount upon retirement. Instead, the employee contributes a percentage of his salary to the 401(k) account. The worker will then receive a varying amount at retirement based on the performance of the investments in the portfolio. The 401(k) form of retirement plan has grown considerably in terms of participants, eligible employees participating, and the number of companies offering plans, as seen in Appendices 1, 2, and 3.

**Benefits of the 401(k)**

The 401(k) form of retirement savings presents many advantages for the employee. First of all, the employee's contributions, as well as any earnings on that money, are tax-deferred until the employee retires and removes the money from the account, when his tax bracket is likely lower. The 401(k) deductions are taken prior to income taxes, meaning the employee does not incur an income tax on that money. Because the employee contributions are not taxed, the worker has more money in the account, and therefore more
interest earned. Also, the interest earned in the 401(k) portfolio is compounded, meaning the employee earns interest on interest.

Other advantages of 401(k)s exist. One key benefit is that the plan encourages the employee to save. The employee states the amount he wants deducted for the 401(k), and the company extracts this amount before the employee receives the paycheck. This prevents the employee, who intends to save, from spending the money before depositing it in a savings account. Secondly, the employee gains access to the stock and bond markets and receives professional management of his portfolio. After the money is deducted and the employee specifies how he wants his contributions invested, his work is complete. Although monitoring the performance of the investments is important, professional managers care for the rest. In today's job environment, where employees transfer jobs more frequently than in the past, the 401(k) is a quality investment, for the worker can take his contributions and earnings in the account to the next job or roll it into an IRA.

Perhaps the most convincing benefit for employees is the prospect that their employer will match a portion of their contributions. The company will match in either cash or stock, depending on the set up of the plan. This potential advantage means the employee will receive financial benefits for simply participating.

401(k) Design

Because it was not an intentional product of the federal government, the 401(k) was left to much interpretation before it became widely recognized. As with pensions and other
established retirement plans, most design of a company’s 401(k) plan was left to the
discretion of that company. Many aspects of the plans are still developed by the employer
offering the plan, resulting in distinctly different formats throughout the US as well as the
world.

An important part of designing a company’s 401(k) involves its choice of a 401(k)
administrator. The administrator, typically an investment or mutual fund company,
provides the investment choices for the plan. Joe Thompson, administrator for Morgan
Keegan & Co. investment firm in Memphis, described the administrator’s importance by
stating that the administrator “must help develop a plan to meet the needs of that specific
company’s employees and continue to manage the plan with those needs in mind” ⁴.

One key decision for the company’s plan designers is whether to offer a match to
employee contributions. While some companies do not match at all, many offer a form of
match to encourage employee participation. Furthermore, those who do decide to match
must determine whether to match with cash or stock. They must also set the calculations
for how much to match. For instance, a company might decide to match $0.50 for each
dollar that the employee contributes up to 5% of the salary. In 1999, 84% of the companies
with 401(k) plans offered a match, with most matches falling between $0.50 and $0.99 for
every dollar contributed ⁵.

The company also determines the eligibility requirements of the plan. Many employers
require their employees to work for a period of time before they receive the opportunity to
participate in the 401(k). For some companies, workers must be 21 years old to participate. On average, 36.5% of companies allow employees to join immediately, and 90% of companies allow employees to join within one year of service (Appendix 4) 6.

Along with time requirements for participation in the plan, many companies install vesting periods as well. A vesting period is the amount of time an employee must work for the company before they receive full value of any company match. The employee always owns the full value of the contributions from their salary, but employers can require years of service to receive the matches. Two types of vesting schedules exist 7:

- Graded Vesting – a percentage of the employer match becomes available each year until 100% is available.
- Cliff Vesting – the entire amount of company matches become available at one point.

Other issues are resolved at the plan’s outset by the 401(k) designers. One of these includes the contribution limits for the employees. While US regulations establish a maximum yearly contribution to a 401(k), the company has the discretion to set a lower limit for its employees. Currently, as seen in Appendix 5, the average 401(k) account is less than $10,000. Employers will also determine the amount of advice which employees receive, if any at all. The employer will determine the employee’s investment options as well.
**Typical Investments in a 401(k)**

Unlike the defined-benefit plans, 401(k)s offer the employee a variety of investments, depending on company preferences. Most companies allow their employees to choose from a variety of stock and bond mutual funds, the averages are shown in Appendix 6. Some plans will offer the employee funds which vary in risk, such as high-risk technology stock funds or low-risk total market funds. Most companies provide at least three investment alternatives to the employees to suit various needs. In 1999, the average amount of investment options for 401(k) holders was 10; in 2000, that number jumped to 13 (Appendix 7)\(^8\).

Another common investment alternative is the employer’s own “company stock”, shares in the ownership of the employee’s company. Aside from the company stock matches, companies offer employees the chance to purchase their stock with the employee’s contributions. As shown in Appendix 8, 65% of employees say they invest a portion of their personal contributions in company stock\(^9\). Ownership in the company is often seen as a way to motivate workers, encouraging workers that their duties directly affect their income.

**The Legal Structure of 401(k)s**

Though the structure for 401(k) retirement plan was developed by government outsiders, the basis for the plan was adapted from an amendment to the Internal Revenue Code, which can be found in Appendix 9. Because there were no specific regulations in this piece, the US government had little to do with the initial policies of the 401(k).
Consequently, many of the key structure decisions were left to the individual companies who were providing the plan. The government quickly realized, however, that because 401(k) contributions are tax-deferred, the government was losing money. Congress decided that regulations should be in place to prevent substantial losses in tax revenues.

To combat the loss of incoming taxes, the government installed its most important regulation, a limit on contributions to an individual’s 401(k) plan. Initially, with the Tax Reform Act of 1986, the government prevented employees from contributing more than $7,000 in tax-deferred funds. In 2002, the limit for tax-deferred contributions will increase to $11,000. The government also regulates the total annual amount which can be submitted to a 401(k). This includes before and after tax contributions as well as employer matches. For 2002, this total cannot exceed the lesser of $40,000 or 100% of the employee’s annual salary.

To help protect the employees, the federal government also instilled early withdrawal penalties for 401(k)s. The government realizes that these accounts are intended for retirement, and they aim to discourage employees from taking their savings out before they retire. To accomplish this, government regulations require that an employee must be 59 ½ years old before they can withdraw these funds. If an employee takes the money out before that age, they will incur a 10% penalty charge on the amount removed. Additionally, they are charged the income taxes on this amount. Some hardship situations are excepted, but in general, the employee must wait until retirement for these funds.
Companies also face regulations to ensure that workers of all income levels are utilizing their 401(k) plan. To accomplish this, government policy states that the total amount contributed by highly compensated employees (HCEs) must not greatly outweigh the contributions of all other employees. Employees who earn over $85,000 annually are subject to HCE designation and often receive fewer 401(k) benefits than other employees. If the company violates this non-discrimination test, they risk losing their tax-exempt status on these accounts.

Traditionally, the US Government has refrained from greatly regulating how individual plans are constructed. As with pension plans, much of the decision-making is left to companies who know their employees best. The recent crash of The Enron Corporation, however, has prompted many to question the legal policies surrounding 401(k) plans and encouraged some to propose reform.

**The Enron Saga**

*Enron's Beginnings*

Enron began humbly in 1985, when Ken Lay merged his company, Houston Natural Gas with InterNorth of Omaha, Nebraska. Lay used proceeds from junk bonds to set the merger in motion and formed Enron with the combination. Founded as a natural gas pipeline company, a development in the energy market would set the company on a new course of business.
In the mid 1980’s, the energy markets became increasingly deregulated, allowing private companies much more control of how energy was sold in the US. As the markets became deregulated, the prices of fuel and other forms of energy became much more volatile. Previously, government regulations handcuffed those in the energy business from greatly influencing prices. Now, however, much more volatility occurred, and with volatility comes uncertainty and risk. Executives at Enron had an idea to take advantage of this uncertainty.

The Good Times

Shifting from the business of delivering energy, Enron began business as a broker in “energy futures”, a practice common in agricultural products. For instance, a cotton grower would negotiate a price with a buyer with a future contract when he plants his crop, locking in a price and providing more stability for both parties. Enron felt this could be used for energy as well, since prices were fluctuating more greatly since the deregulation of energy. For this, Enron was called one of the most innovative companies in the nation.

As the company moved into the 1990’s, it ventured into other businesses as well. It began marketing electricity in the US in 1994 and in Europe in 1995. In 1999, the company launched EnronOnline, a website to sell commodities. It also began to buy and sell access to high speed, high bandwidth internet space. The company was well on its way to becoming a major success story in US business.
As Enron progressed into new markets and became a leader in the energy market, its revenues grew as well. In the 1990's, Enron's profits grew tremendously as the company expanded into different markets. The company saw its stock price rise tremendously, reaching a high of $90 in 2000. Investors flocked to the stock and it became a company with much promise for years to come.

**The Downfall**

Unfortunately, Enron would not reach the potential so many had predicted. In the second half of 2001, Enron was hit with allegations of wrongdoing and quickly lost favor in the business world. Enron had high expectations for every market which it entered, but the company required large amounts of capital to undertake these projects. The company began to take on large amounts of debt, but these loans went largely unnoticed to the investing public. Enron set up “separate” companies to take on this debt, masking it from their financial statements and inflating the company’s revenues and net income.

Adding to the controversy was Arthur Anderson’s involvement as Enron’s independent auditor. Anderson was also Enron’s consultant, creating a conflict of interests. If Arthur Anderson had detected Enron’s cover-ups, it would have been hesitant to release the findings because they would probably lose their consulting contract. Instead, Anderson overlooked any accounting misrepresentations on Enron’s part and is charged with shredding important documents regarding the fraud. Investment banks and brokerage
houses such as Merrill Lynch and First Union (which is now Wachovia) have also been implicated for contributing to the cover-up due to their questionable relationships.

Since the allegations of accounting fraud have been released, Enron’s stock price entered a free fall, falling from over $80 on February 5, 2001 to $0.26 on November 30, 2001. The stock was even suspended from trading on the New York Stock Exchange on January 15, 2002. The falling price cost investors billions, and no investor type was immune. The downfall hurt institutional investors such as mutual funds, average investors, and, especially, the company’s employees, many of whom held Enron stock in the retirement portfolios.

The government did not overlook the downfall of Enron and its effects as a consequence of the market. Since the stories began to break, Congressional committees and independent counsels have been constructed to investigate Enron’s wrongdoings. These groups have called former Enron executives as well as Arthur Anderson employees and others in for testimonies as to what exactly happened.

On December 12, 2001, Enron filed for Chapter 11 bankruptcy. Once the perfect example of how a unique and useful idea could propel a company to prominence, Enron has since become the “Most Wanted” poster child for business fraud. Once the seventh largest company in the United States, Enron has become the prime example of something wrong with business today. The company, and its downfall, has already made wide impacts
throughout the world of business, and this trend will only continue and broaden in scope as more information is known.

**The Effects of Enron’s Collapse**

The downfall of Enron has had many important impacts throughout the world economy and structure of business. First of all, investors now expect auditors to exude impartiality, and the auditors’ work will now endure much more scrutiny. The consulting arms of large accounting firms have come under fire for possible conflicts of interest, and many investors are hoping for companies to use an accountant and consultant from different firms. For Arthur Anderson, the implications have been devastating, as the company has seen several major clients, such as FedEx and International Paper, find new auditors.

Also, companies like Enron with large amounts of debt and many intangible assets are being examined for any accounting improprieties. Many of these companies are high-tech companies such as Global Crossing and Tyco, who feature similar financial statements to Enron’s. Even long-established companies such as GE have been hurt. For GE, the wide range of its businesses and its large amount of intangible assets has raised flags for investors. Since the Enron downfall, many companies are issuing more detailed financial statements to alleviate any liability.

Coupled with the terrorist attacks on September 11, 2001, Enron’s crash has created a stock market full of hesitant investors afraid of the next major move in the market.
Investors have become more hesitant, holding their money as opposed to spending it in the market.

The effects of Enron’s downfall have not only been felt outside the company. In the process of the company’s bankruptcy, thousands of employees have lost their jobs. These employees range from administrative assistants to front line workers to top executives, and everyone in between.

Another major impact on the employees is the losses they have sustained in their retirement accounts, which is a focus of this study. Enron had set up a 401(k) program for its employees, in which 11,000 participated. In this plan, many employees had large amounts of their money invested in Enron’s stock, as well as the matches of stock that the company made. They watched happily as the stock climbed to its peak, but as the company began to fall, so did the stock price. Accordingly, the value of employees’ retirement accounts bottomed as well, as roughly $1 billion in retirement savings was lost.

**Fixing 401(k)s – Current Proposals and Opinions**

Before Enron’s collapse, there was little interest in reforming retirement plans to better protect participants. The market was booming and investors were profiting. The House of Representatives was in the midst of examining the current laws, but it was not prominent on the public radar. As previously noted, however, the effects of Enron have touched virtually all areas of business, including 401(k) and other retirement plans, prompting many to call for 401(k) reform.
From the President and Congress to media writers to Ted Benna (creator of the 401(k)), everyone seems to have an opinion as to what should be done to better protect 401(k) participants. Through the stock market boom of the late 1990's, many saw 401(k) plans as the perfect retirement vehicle, offering higher returns through the market. Unfortunately, the risk element with the stock market is greater, and Enron employees suffered. Now, some are proposing that changes be made to prevent this from happening again.

**Do Nothing**

Inherent in the stock market is a greater potential return than treasury bills or bonds. With that potential, however, comes more risk. This relationship is widely known, especially by stock market investors. Consequently, some observers feel that no changes should be made to 401(k) plans. In Enron’s case, the 401(k) participants were not complaining when the company’s stock ran up to around $90. It is only when they lost money that many felt the structure of the plan should be reformed.

**Ted Benna, creator of 401(k) Plans**

Ted Benna, whose retirement ideas resulted in the first 401(k) plan, has witnessed many changes in the plans since their origination. As the Enron bankruptcy caused many to consider changing the plans, Benna came up with some recommendations of his own. First of all, Benna feels that if an employer’s stock contributions are limited, the company will simply refuse to contribute. Therefore, he says, employees should be prohibited from investing their own contributions in company stock. Though probably unpopular, it would
reduce overall employee holdings in company stock without altering company stock matching.

Benna also states that though popular, the restrictions on selling company stock matches should not be repealed. Aside from the probability that this will reduce employer matches, Benna also feels that employees should not alter their retirement funds like they might an investment account. This helps prevent some uneducated employees from affecting the performance of their 401(k)s. Benna commented, "We require auto passengers to wear seatbelts because many won't wear them voluntarily. We should also protect employees from financial disaster" 20.

**President Bush**

After witnessing the collapse of Enron and its effect on 401(k) plans, President Bush was careful in reacting to the situation. In his State of the Union address on January 29, 2002, Bush commented on the need to examine retirement plans for possible reform. He stated, "A good job should lead to security in retirement. I ask Congress to enact new safeguards for 401(k) and pension plans. Employees who have worked hard and saved all their lives should not have to risk losing everything if their company fails". Bush authorized the creation of a Task Force on Retirement Security to better analyze the situation 21.

In his radio address on February 2, 2002, Bush announced some specific recommendations for improving retirement plans, 401(k) plans specifically. The President emphasized diversification, a common risk-aversion principle, by allowing workers to sell their
company stock matches at an earlier point. Also, through better investment advice, the employee should diversify as well. Bush stated the way to improve this education is to reduce the liabilities involved. He also recommended shorter vesting periods for company matches. Finally, he commented that companies need to have a single standard for all workers — executives and other employees. By this, he means that if employees are restricted from selling their shares, employees should be as well.

**Congressional Proposals**

With the diverse collection of personalities and backgrounds, it is not surprising that a wide range of 401(k) reform ideas have come from Congress since Enron's bankruptcy. As previously mentioned, Congress has traditionally done little in terms of tinkering with the details of 401(k) plans. As weaknesses have surfaced in the plan's structure, however, Congress has attempted to reform the plan to protect American workers.

One of the earliest proposals for reform was submitted in December of 2001, when Senators Barbara Boxer (D-CA) and Jon Corzine (D-NJ) submitted the Boxer-Corzine Pension Protection and Diversification Act. One key piece in this bill limits the amount of one stock which an employee can own in a 401(k) portfolio to 20%. This would guarantee employee diversification, in turn reducing employee risk. Corzine commented on the bill by saying, "The key question to ask of any proposal is: would this reform have protected the retirement savings of Enron employees? No legislation can be considered true reform unless the answer is 'yes'". 22
Other Congressmen have presented their opinions on how to reform 401(k) and other retirement plans in various bills. These suggestions include a maximum percent limit on company stock (like the Corzine-Boxer bill), required quarterly statements to 401(k) policyholders, investment advice and education available to workers, warning of and limiting blackout periods, and limiting the required holding period on company matches. Many of these principles have been incorporated into two proposed acts, one from the Senate and one from the House of Representatives. The ultimate results of this work will produce the most comprehensive pension reform since the Employee Retirement Income Security Act (ERISA) in 1974, where vesting requirements were established among other changes.

**The Protecting America’s Pension Act of 2002**

On March 21, 2002, the Senate Committee for Health, Education, Labor, and Pensions released The Protecting America’s Pension Act of 2002 (S. 1992). This bill, sponsored by the committee’s Democrats and was introduced by Ted Kennedy, passed the committee with a vote of 11-10.

Several important points are contained within. To discourage employees from holding large amounts of one stock, this act provides workers the right to sell company matched stock after 3 years of service. Also, employers are required to provide 401(k) holders with quarterly statements that explain how their investments have performed. The statements will also specially notify employees if their concentration in one stock comprises 20% of their portfolio. This is an attempt to encourage more diversification in 401(k) accounts.
The most unique clause in this legislation, the "Either/Or" scenario, allows companies to offer company stock as a match or an investment option for employee contributions, but not both.

**The Pension Security Act of 2002**

Like The Protecting America's Pension Act of the Senate, the House of Representatives has also produced a piece of legislation to improve the structure of 401(k)s. The Pension Security Act of 2002, sponsored by John Boehner (R-OH) was passed by the House on April 12, 2002. The PSA incorporates many of President Bush's proposals. Like the Senate Act, The Pension Security Act requires statements to be sent to employees quarterly detailing the individual's investment performance. These statements will also offer investment advice, such as the risks of placing a large portion of the 401(k) funds in one stock.

The blackout period is a key component in the Pension Security Act. Firstly, the act specifies that insiders are restricted from selling stock during periods that the employees cannot sell stock from their 401(k) portfolio. Also, the blackout period, typically ranging from four to six weeks, will be kept as short as possible, protecting each party's interests. A major provision of this act clarifies the legal liability during a blackout period. If enacted, this plan would make a company's plan trustees liable for their employees' investment performance during blackouts. To reduce risk, most plan administrators will
therefore utilize low-risk money market funds during this time. Nevertheless, it is an important part of the proposal. 

**My Recommendations**

Based on the research presented, I have developed a set of recommendations which I feel will best protect and improve the 401(k) structure as laid out in the Internal Revenue Code and other US laws. 

It is important to consider the purposes of 401(k) plans when developing a set of recommendations. 401(k) plans were initially designed to give employees a different type of retirement saving, allowing them to invest in the stock market to hopefully provide greater returns than traditional defined-benefit plans. With the potential for greater returns, however, comes increased risk, a natural trade-off when examining market features. The defined-contribution 401(k) plan was also designed to provide employees with more flexibility when deciding how much of their salary to contribute to retirement. As with other retirement plans, the structure of the plan is designed to encourage the worker to hold the contributions until retirement, unlike other investment accounts where buying and selling is common. 

Aside from the purposes of 401(k) plans, another factor to consider is what draws employees to participate in 401(k) plans. Ultimately for employers, who receive tax breaks for 401(k) contributions, the goal is to increase employee participation as completely as possible. For employees, there are several key drawing factors. One is the tax-deferred
status, allowing workers to contribute to their earnings pre-tax and not incur income taxes until the money is removed from the account. With current legislation, there are no material changes to the tax status of the plans. A major drawing factor which will be greatly affected by current legislative proposals is the matching contribution which many companies offer. To employees, these matches are viewed as free money. In analyzing the current proposals, an important consideration is how will companies react and will they continue to match?

**Limiting the Amount of Company Stock**

In an effort to reduce the risk involved with allocating a large percentage of an employee’s portfolio to the company’s stock, several proposals include percentage limits on the amount of one security in an account. In the case of Enron, many employees held company stock. This was due to employer matches in stock as well as encouragement from executives to buy the stock with an employee’s own contribution. As the stock price fell, these employees lost billions. While good in theory, this practice will produce hazardous results in the future.

Companies like to match their employees’ contributions with their own stock for several reasons previously mentioned. If the government regulates the amount of this company’s stock in a portfolio, many companies will likely discontinue their matching policies or reduce the amount matched. This could have negative effects on the employees who chose to participate based on this important factor. Like several current proposals, I feel that the
best way to decrease the risk in an employee’s portfolio is through educating these workers about their investments.

Employee Education and Advice

The issue of providing advice about investing for employees with 401(k) plans is a common recommendation in the current debate over 401(k) plans. Currently, companies are allowed to provide only limited advice to their employees, which in reality means that the employers push investing in their own stock. Not only does this create a conflict in interests, but it also greatly increases the number of portfolios that are not well diversified.

Providing advice brings with it liability issues for the employer or advisor, as lawsuits over losses are inevitable. For instance, had advisors been able to provide comprehensive recommendations, many would have possibly recommended Enron stock to all companies’ employees, causing tremendous losses. As many employers use investment companies to administer their 401(k), these brokers would be logical choices for advisors because of their knowledge. A serious concern, however, arises over the brokers’ impartiality. In the business environment today, many conflicts of interest are being exposed and creating controversy. An investment company might be inclined to recommend the companies with which they have banking relationships.

Because of these questionable sources of advice, it is best to educate, not advise the employees. Through education about investing principles such as diversification or information about what investments would suit retirement accounts better, the employees
are better equipped to make less risky decisions. By teaching as opposed to advising, the employers and brokers are not as likely to push products that would create conflicts of interest. Companies should work with their 401(k) administrator to create help education literature about investing in 401(k)s and possibly hold information sessions for those participating in the plan. If employees would like advice on specific investments, they should be given a list of investment companies that can give impartial insight.

**Minimum Number of Investment Options**

One major factor in determining the ability to diversify is the number and type of investment options given to employees. It is important for employees to have investments that are suitable for retirement accounts, as well as enough options for diversification. Employers have recognized the importance of diversification and are offering more investment options.

Nevertheless, some are calling for a minimum floor on the number of investments that a company can provide, with three being the most common figure. To encourage diversification, this idea is practical in theory. Most companies offer more than three investment options, however, so they would not be affected by these proposals. Furthermore, true diversification requires more than three investments. If this point is included in a final 401(k) reform act, the number of required options should be increased to at least five to ten.
**Required Holding Period for Company Stock Matches**

Another issue debated in 401(k) reform discussions is the holding time required for employees before they can sell shares that their employers have contributed as matches. Currently, employers can mandate that their employees hold the stock they receive as matches for decades, even until retirement. In the case of Enron, the company required its employees to hold their matches until age 55. When the company’s stock price began to fall, the employees who wanted to sell were unable to and were forced to watch the value of their shares plummet.

After seeing Enron’s employees handcuffed while the stock price fell, Congress is close to changing the requirements on how long employers can require employees to hold stock. Many employers who match in stock, however, oppose this principle as they do not like frequent secondary sales of their stock. In turn, lowering the holding limit of company stock to three years could lead companies to reduce the amount they match.

While it is important to protect employees in the case of a bottoming stock price, it is also important to protect the 401(k) contribution matches companies offer. Therefore, reducing the maximum holding period for stock matches is a viable recommendation, but not as far as is being proposed. A five to ten year maximum would appease companies which are considering ending matches and would also encourage employees to hold the funds in their retirement accounts.
**Blackout Periods**

As previously mentioned, a major contention point in the Enron 401(k) losses, and subsequent congressional proposals, is the blackout period while a company changes 401(k) providers. Currently, during this period, employees are prevented from making any transactions in their portfolio. This means that the workers have little control over what happens during this time. In the case of Enron, while the company switched providers, its stock price fell dramatically. Not only were employees restricted from selling the shares that the company had donated as matches, but they could not even sell the Enron shares which they purchased with their own contributions. At the same time, executives were aware of the oncoming blackout period and could still conduct transactions during the time.

There are several issues surrounding blackout periods which are being debated and decided on in the current reform of 401(k) plans. These issues include the notice given to employees before the onset of a blackout period, the ability of insiders to trade during this time, and the responsibility of managing the investments during this time while the workers cannot.

The blackout period can be a positive for employees if the switch in providers improves the 401(k) plan. Nevertheless, for the sake of their investments, employees should be given notice of an impending blackout period. A 30-day warning would be adequate time for employees to evaluate their investments and make the changes where they see fit. One
Concern with this will be the urge for some employees to panic whenever a blackout period is announced. Through education, however, this potential problem will be solved.

Another issue involved in blackout periods is the ability of executives to sell stock while their employees are unable to. Though not currently illegal, it is not right for insiders to profit while their workers cannot. Regulations should be enacted, as is likely to happen, that will prevent insiders from making transactions while employees are locked out. Aside from simply being fair, this will calm employees' fears as blackout periods approach.

A final issue surrounding blackout periods is the liability surrounding what happens to an employee's 401(k) while the portfolio is locked. Some recent proposals have suggested that a company's trustees should be responsible for employees' investment performance during the blackout period. While controversial and likely to create liability issues, this is a positive recommendation. Most executives will simply place their employees' accounts in low-risk investments such as money market funds. By acting in the workers' best interests and avoiding risk while the account is locked, employers will be doing a service for employees and will face little liability risk.

**Conclusion**

The Enron debacle has spurred changes throughout the business world, as a collapse of this magnitude with as many fraudulent tactics has never occurred before. The most prominently discussed proposals include changes in financial statement reporting as well
as altering the relationship between auditors and consultants. In terms of 401(k)s, however, the downfall of Enron will likely produce tremendous new regulations.

Since Enron’s bankruptcy in December of 2001, Congress has been quick to produce numerous solutions to the perceived problems. The speed with which they have acted is promising, but some are worried about if enough planning and study has gone into the situation. R. Glenn Hubbard, chairman of President Bush’s Council of Economic Advisers, stated in the Wall Street Journal, “There is room for improvement, but by moving too quickly and emotionally, we risk overcompensating and curtailing a trend that has been both a boon for workers and a driving force in our economic prosperity.”

The 401(k) holders at Enron suffered on multiple fronts, as they not only lost retirement savings but their job as well. It is a tragic set of circumstances which should be prevented in the future. Their situation is unique, however, in that the company’s fraud led to its downfall. Enron employees should, therefore, pursue legal avenues to correct the problem and collect the savings which executives cost them, and Congress should be careful with the choices before it.

As it wrestles with current legislative reform proposals, Congress should consider the millions of employees who have profited from their 401(k) as well as those at Enron who lost. A hasty decision which causes companies to end their matching policy would create more negative effects than their positive intentions.
References

3 Fidelity Investments. “Eight Reasons why 401(k)s are a Smart Idea”. http://www.401k.com
4 Personal Interview with Joe Thompson, April 12, 2002.
7 Nicholson 233-234
10 Nicholson 2-3
13 Nicholson 27-30
14 Nicholson 113-115
16 Lay 21-22
APPENDICES
Number of 401(k) Participants per year (in millions)

Source: SPARK - 2000 Marketplace Update

Appendix 1
401(k) Participation Rates
(% of eligible employees)

Source: SPARK - 2000 Marketplace Update

Appendix 2
Growth in Number of 401(k) Plans, 1984-2000

Source: SPARK - 2000 Marketplace Update

Appendix 3
401(k) Plan Eligibility – Work Service


Appendix 4
Size of 401(k) Balance

Source: SPARK - 2000 Marketplace Update

Appendix 5
401(k) Investment Option Popularity (by Mutual Fund or Company Stock)

<table>
<thead>
<tr>
<th>Employer Stock</th>
<th>Large Cap Stock</th>
<th>Stable Value</th>
<th>Stock Index</th>
<th>Balanced</th>
<th>Small Cap Stock</th>
<th>Money Market</th>
<th>Bonds</th>
<th>Global Stock</th>
<th>Emerging Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>19%</td>
<td>16%</td>
<td>11%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Hewitt Associates 2001 Survey, as reported in "Diversification Becomes the Vogue" The Wall Street Journal, 2/15/02

Appendix 6
Average Number of Investment Options in 401(k) Plans

1993: 5
1995: 6
1997: 7
1999: 10
2000: 13

Source: SPARK - 2000 Marketplace Update

Appendix 7
Percent of Employees with Personal Contributions in Company Stock, 2000

- Yes: 65%
- No: 32%
- Don't Know: 3%

Source: SPARK - 2000 Marketplace Update

Appendix 8
Section 401(k) of the Internal Revenue Code

401(k) Cash or deferred arrangements

(1) General rule
A profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

(2) Qualified cash or deferred arrangement
A qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of subsection (a) -

(A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash;

(B) under which amounts held by the trust which are attributable to employer contributions made pursuant to the employee's election -

(C) which provides that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable, and

(D) which does not require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to subparagraph (B)(i) thereof).