



EBRI Special Report

Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members

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EBRI expresses its appreciation to members of ISCEBS, without whose cooperation and quick response this survey would not have been possible.

*The January 28th version contained typesetting errors for the □ data labels in Figures 2 - 4

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Introduction

The incidence of employer stock in 401(k) plans has been analyzed extensively as part of the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for the past five years. The most recent information¹ applies to year-end 2000 account balances and shows that:

- The aggregate percentage of 401(k) assets that are in company stock is equal to 19 percent and has stayed constant over the last five years.
- Where company stock is offered as either an employer match and/or an employee investment option, 32 percent of plan assets are in company stock if the plan sponsor does not offer a GIC (guaranteed investment contract, a stable-value investment) and 28 percent if it does.
- Where employer matching contributions are provided in the form of company stock, 33 percent of employee-directed deferrals are in company stock. But where company stock is not the match (but is available as an investment), just 22 percent of employee deferrals are in company stock.

Although the topic of company stock investment in 401(k) plans has recently been the focus of considerable interest, the concept of preferred status for employee ownership has been part of the U.S. tax code for more than 80 years.² When the Employee Retirement Income Security Act (ERISA) was passed in 1974, it required that fiduciaries diversify plan investments for defined benefit plans and some types of defined contribution plans. However, there is an exception for "eligible individual account plans" that invest in "qualifying employer securities."³ An Employee Stock Ownership Plan (ESOP) normally qualifies for this exception, as do profit-sharing plans.⁴

Profit-sharing plans with cash or deferred arrangements (more commonly referred to as 401(k) plans) grew from virtually no plans in 1983⁵ to a point where by 1997 (the most recent year for which government data are currently available) they accounted for 37 percent of qualified private retirement plans, 48 percent of active employees, and 65 percent of new contributions.⁶

The concept of legislating diversification for qualified retirement plan investments in company stock was first applied to ESOPs via a provision enacted as part of the Tax Reform Act of 1986.⁷ Employees who are at least age 55 and who have completed at least 10 years of participation must be given the opportunity to diversify their investments by transferring from the employer stock fund to one or more of three other investment funds.⁸ The right to diversify need be granted only for a 90-day window period following the close of the plan year in which the employee first becomes eligible to diversify and following the close of each of the next five plan years. This right is limited to shares acquired after 1986⁹ and is further limited to 25 percent of such shares until the last window period, when up to 50 percent of such shares may be eligible for diversification.

The Taxpayer Relief Act of 1997 applied a limit on mandatory investment of 401(k) contributions in employer stock. This was a more modest version of a proposal by Sen.

Barbara Boxer (D-CA) to impose a separate limitation of 10 percent of plan assets on the mandatory investment of 401(k) contributions in qualifying employer stock and real property.¹⁰

The Economic Growth and Tax Relief Reconciliation Act of 2001 expanded the dividend deduction for ESOPs to include dividends paid on qualifying employer securities held by an ESOP that, at the election of participants or beneficiaries, are: 1) payable directly in cash; 2) paid to the plan and distributed in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan; or 3) paid to the plan and reinvested in qualifying employer securities.¹¹ A 401(k) plan with a company stock fund that regularly pays dividends may consider designating a portion of the plan that includes the company stock fund to be an ESOP in order to take advantage of this deduction.¹²

At Enron, 57.73 percent of 401(k) plan assets were invested in company stock, which fell in value by 98.8 percent during 2001.¹³ The decrease in share price and eventual bankruptcy filing of Enron resulted in huge financial losses for many of its 401(k) participants. This has prompted several lawsuits as well as congressional and agency investigations into the relative benefits and limitations of the current practice. In addition, the practice of imposing “blackout” periods when the 401(k) sponsor changes administrators has recently been called into question in light of the Enron situation.¹⁴

Presumably, any recommendations to modify current pension law would attempt to strike a balance between protecting employees and not deterring employers from offering employer matches to 401(k) plans. Some have argued that if Congress were to regulate 401(k) plans too heavily, plan sponsors might choose to decrease employer contributions or not offer them at all. Previous research¹⁵ has shown that the availability and level of a company match is a primary impetus for at least some employees to make contributions to their 401(k) account. Others have argued that individuals should have the right to invest their money as they see fit.

This survey was conducted in an attempt to provide a context to the current debate on company stock in a timely fashion, and it is not a statistically representative survey of the 401(k) industry; rather, this survey is a nonrandom polling of benefits professionals who are knowledgeable about the subject matter and able to respond to the survey quickly.

Survey Background Information

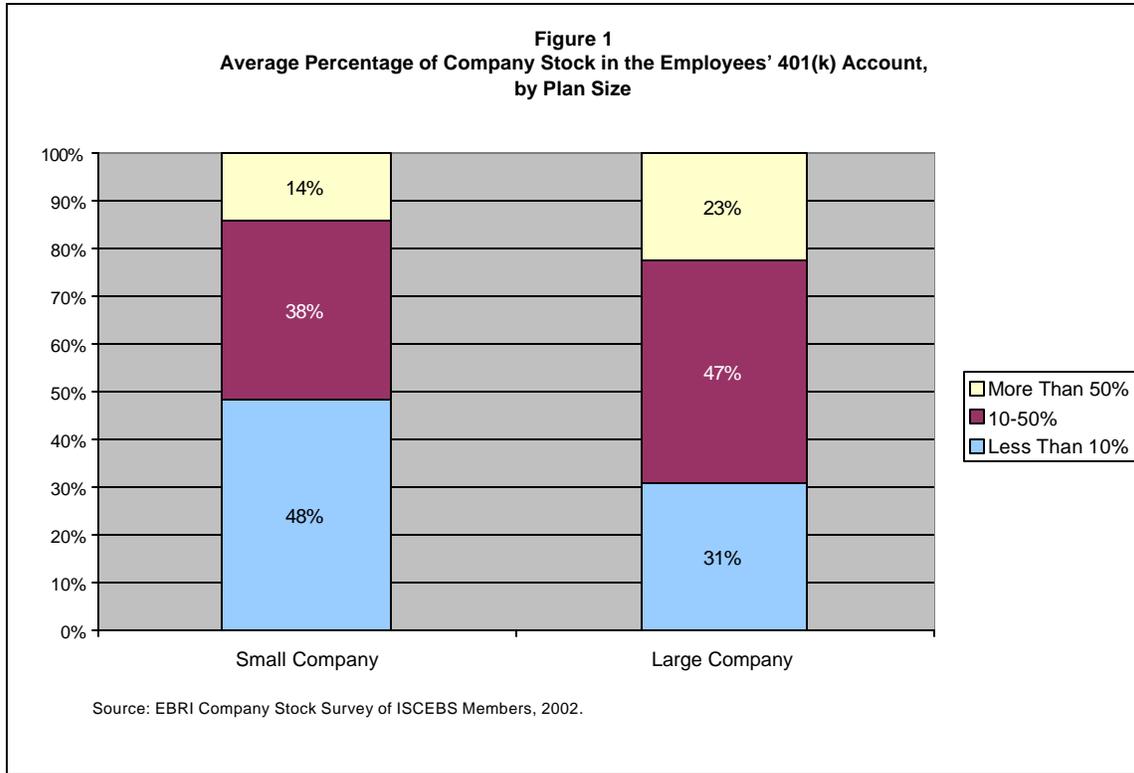
On Jan. 15, 2002, a fax-back survey was sent to 3,346 members of the International Society of Certified Employee Benefit Specialists (ISCEBS). Respondents were asked to respond by Jan. 23 and to answer the questions for the largest (in terms of participants) client they worked for (if they were a consultant or service provider for 401(k) plans); otherwise, they were asked to answer for the firm that they were employed by. The survey instrument was divided into six parts: Part I asked for personal information relating to respondents' type of benefits expertise, age, and number of years in the benefits industry. Part II asked for information on the client/employer—including industry, number of employees, and whether it offered a defined benefit plan and/or a 401(k) plan. For those that did offer a 401(k) plan, additional information was collected with respect to company stock investment options, whether employer contributions are

required to be invested in company stock, average percentage of company stock in the employees' accounts, restrictions on selling the company stock, and blackout periods. Part III examined the employees' perceptions of the Enron situation. Part IV examined the respondents' views on the appropriate limits for investment in company stock and the role of the government. Part V requested information on the respondents' perceptions on public policy issues related to company stock in 401(k) plans, and Part VI asked the respondents to speculate on likely reactions to various legal/legislative developments.

Although all results were tabulated, for purposes of this report, I have screened out all respondents for whom their client/employer did not sponsor a 401(k) plan. This provided 375 usable responses, once surveys with missing information were excluded.

Company Stock: Availability and Percentage of Average Asset Allocation

- 48 percent of the respondents to this survey reported a company stock investment option in their client/employer's 401(k) plan.
- Large plans (defined as those with 5,000 or more employees) are much more likely to have a company stock option in the 401(k) plan: the large plans had this option 73 percent of the time vs. 32 percent for small plans (defined as those with less than 5,000 employees).
- Among those plans that have a company stock option, the average percentage of company stock in the employees' 401(k) account breaks down as follows: Less than 10% (39 percent); 10–50% (42 percent); more than 50% (18 percent).
- Large plans have a higher average percentage of company stock in the employees' 401(k) account (see Figure 1).



Employer Contributions: Investment in Company Stock and Restrictions on Sale

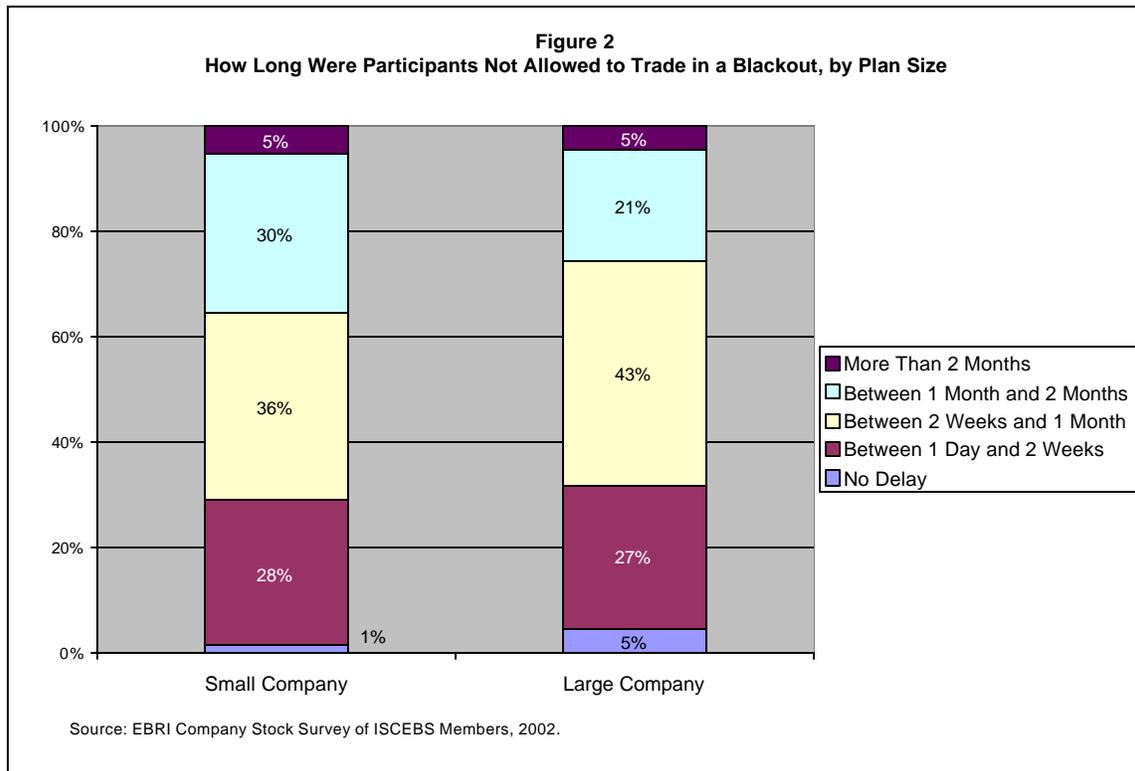
- 43 percent of those having a company stock investment option in the 401(k) plan reported that employer contributions were required to be invested in company stock.
- Among those plans that have a company stock option, large plans are more likely to require employer contributions to be invested in company stock: 49 percent of large plans vs. 38 percent of small plans.
- Of the 401(k) plans where employer contributions were required to be invested in company stock:
 - 13 percent reported no restrictions existed for selling the company stock.
 - 27 percent reported that they were restricted throughout a participant's investment in the plan.
 - 60 percent reported that they were restricted until a specified age and/or service requirement is met.

Limitations on Company Stock That May Be Held by an Employee

- 14 percent of those having a company stock investment option in the 401(k) plan reported that they limited the amount or percentage of company stock that employees may hold in their 401(k) plan.

Blackouts

- 74 percent of the respondents’ plans have undergone a blackout.
- Of those that have undergone a blackout, the distribution of the blackout period follows:
 - No delay/overnight/over weekend, 3 percent.
 - Between one day and two weeks, 27 percent.
 - Between two weeks and one month, 39 percent.
 - Between one month and two months, 26 percent.
 - More than two months, 5 percent.
- Blackout periods appear to be somewhat shorter for large plans than for small plans (see Figure 2).



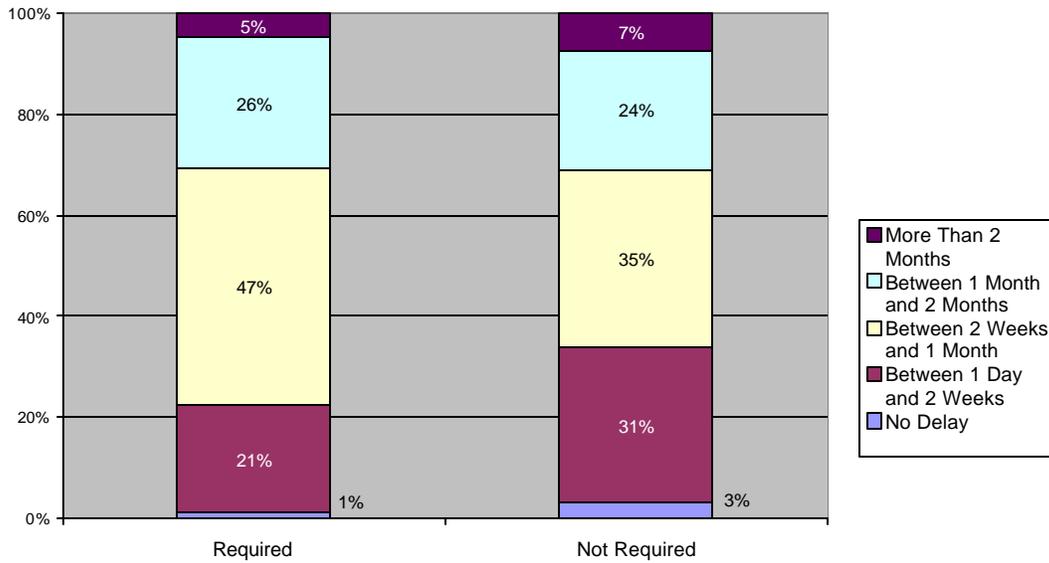
- The duration of the blackout period appears to be invariant (unaffected) to whether or not there is a company stock option (see Figure 3); however, the duration does appear to be slightly longer when employer contributions are required to be invested in company stock (see Figure 4).

Figure 3
How Long Were Participants Not Allowed to Trade in a Blackout,
by Existence of Company Stock



Source: EBRI Company Stock Survey of ISCEBS Members, 2002.

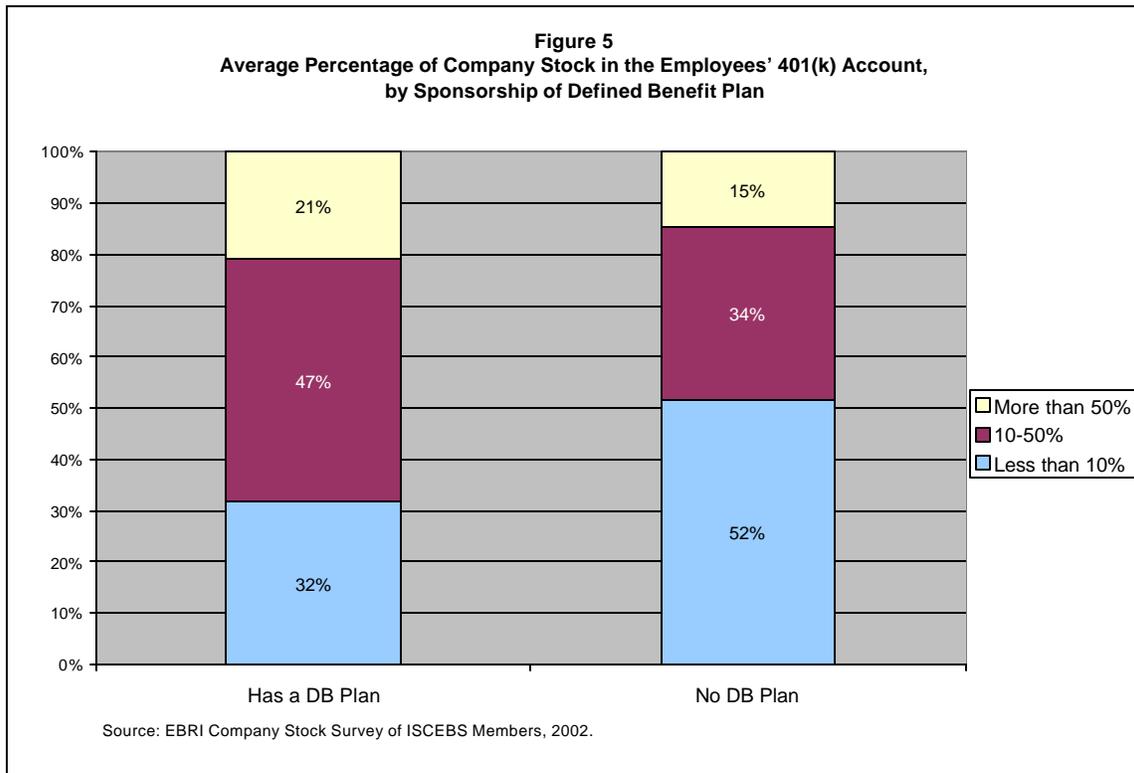
Figure 4
How Long Were Participants Not Allowed to Trade in a Blackout,
by Whether Employer Contributions Are Required to Be Invested in Company Stock



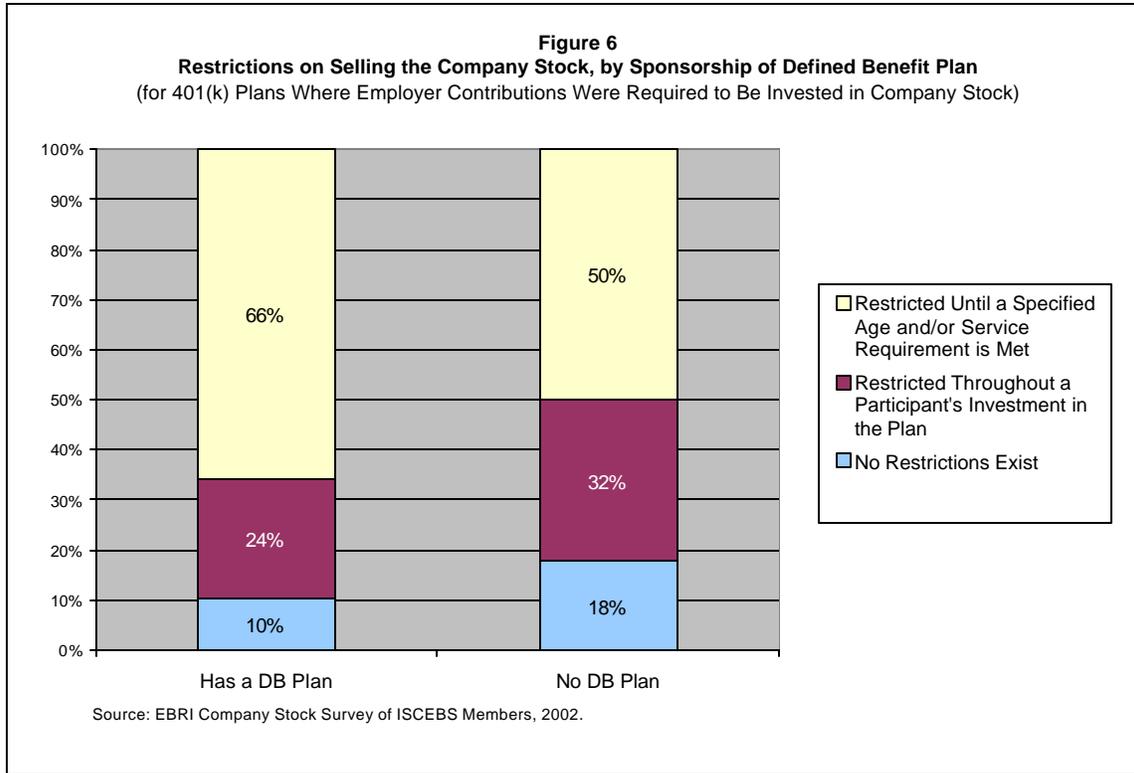
Source: EBRI Company Stock Survey of ISCEBS Members, 2002.

Impact of Defined Benefit Sponsorship

- It is more likely for there to be a company stock investment option in the 401(k) plan if there is also a defined benefit plan: 60 percent of those with a defined benefit plan vs. 35 percent of those without.
- Employer contributions are more likely to be required to be invested in company stock if there is also a defined benefit plan: 50 percent of those with a defined benefit plan vs. 33 percent of those without.
- There is a heavier concentration of company stock (among those that have it) if there is also a defined benefit plan (see Figure 5).



- It is more likely for restrictions to exist on selling the company stock if there is also a defined benefit plan (see Figure 6).



Enron

- 74 percent of the respondents thought that most of the employees at the employer/client were familiar with the Enron 401(k) situation.
- Respondents who did believe that most of the employees at the employer/client were familiar with the Enron 401(k) situation thought that the employees' typical reaction was as follows:
 - 43 percent thought that the employees did not think that the Enron situation applies to them.
 - 27 percent thought that the employees questioned why employers are allowed to mandate that company matches must be invested in company stock.
 - 22 percent thought that it caused the employees to review their asset allocation.
 - 6 percent thought that it caused the employees to question why employers are allowed to offer a company stock option.
 - 2 percent thought that the employees did not care.

Respondents' Perceptions on Appropriate Limits and the Role of Government

- When asked what they thought was the maximum percentage of company stock any employee SHOULD hold in his or her 401(k) portfolio, the distribution of responses was:¹⁶

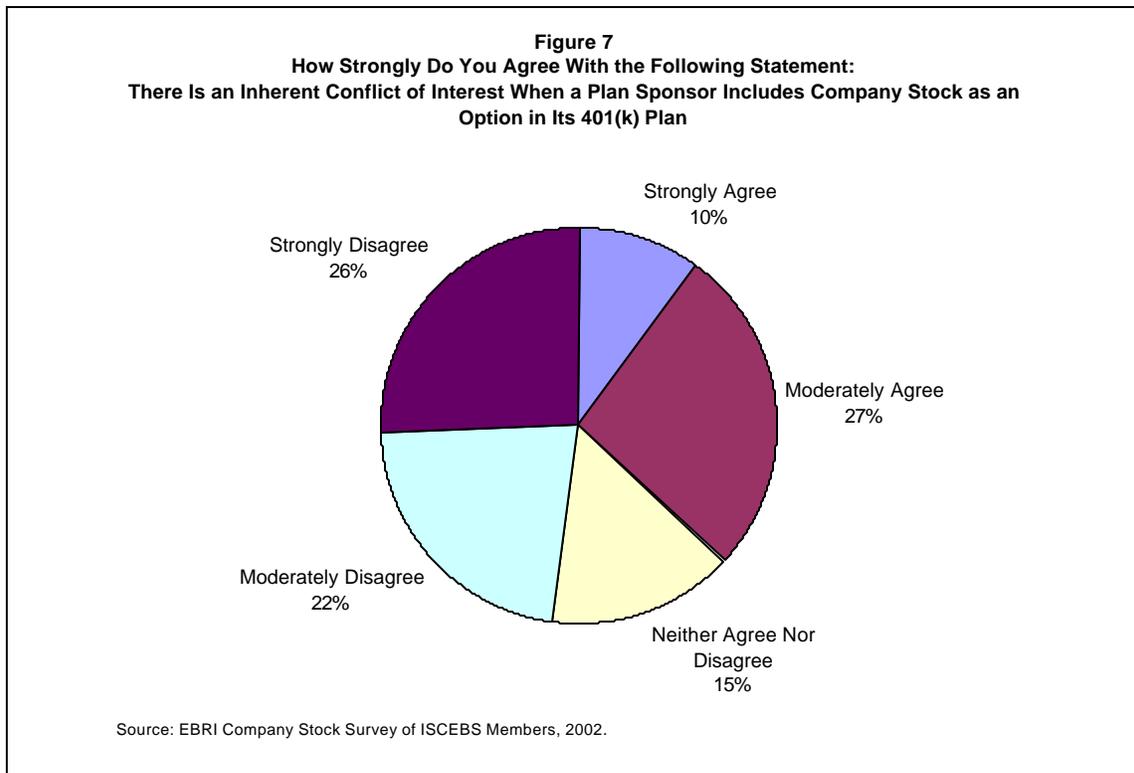
- 4 percent of the respondents thought it should be zero.
- 39 percent replied with no more than 10 percent.
- 38 percent replied with no more than 20 percent.
- 9 percent replied with no more than 50 percent.
- 9 percent did not know.
- When respondents whose client/employer did not require employer contributions to be invested in company stock were asked if they thought the government should limit the plan sponsor's ability to mandate that matching contributions to a 401(k) plan be invested in company stock, 66 percent of the respondents said yes, 29 percent said no, and 5 percent did not know. However, when respondents whose client/employer did require employer contributions to be invested in company stock were asked if they thought the government should limit the plan sponsor's ability to mandate that matching contributions to a 401(k) plan be invested in company stock, 38 percent of the respondents said yes, 61 percent said no, and 2 percent did not know.
- When asked if they thought the government should limit the employees' ability to invest their own (participant-directed) contributions to a 401(k) plan in company stock, 32 percent said yes, 63 percent said no and 5 percent did not know.¹⁷
- Of those who thought the government should place a limit on the percentage of the employee's 401(k) balance in company stock, the distribution of responses was analyzed as a function of whether the client/employer required employer contributions to be invested in company stock.
 - For those respondents where this was *not* the case:
 - 9 percent thought it should be zero.
 - 32 percent thought it should be no more than 10 percent.
 - 35 percent thought it should be no more than 20 percent.
 - 14 percent thought it should be no more than 50 percent.
 - 4 percent thought it should depend on the employer match.
 - 7 percent responded with "other."
 - 12 percent did not know.
 - For those respondents where this *was* the case:
 - 8 percent thought it should be zero.
 - 35 percent thought it should be no more than 10 percent.
 - 23 percent thought it should be no more than 20 percent.
 - 8 percent thought it should be no more than 50 percent.
 - 13 percent thought it should depend on the employer match.
 - 13 percent responded with "other."
 - 8 percent did not know.

Respondents' Perceptions on Blackouts

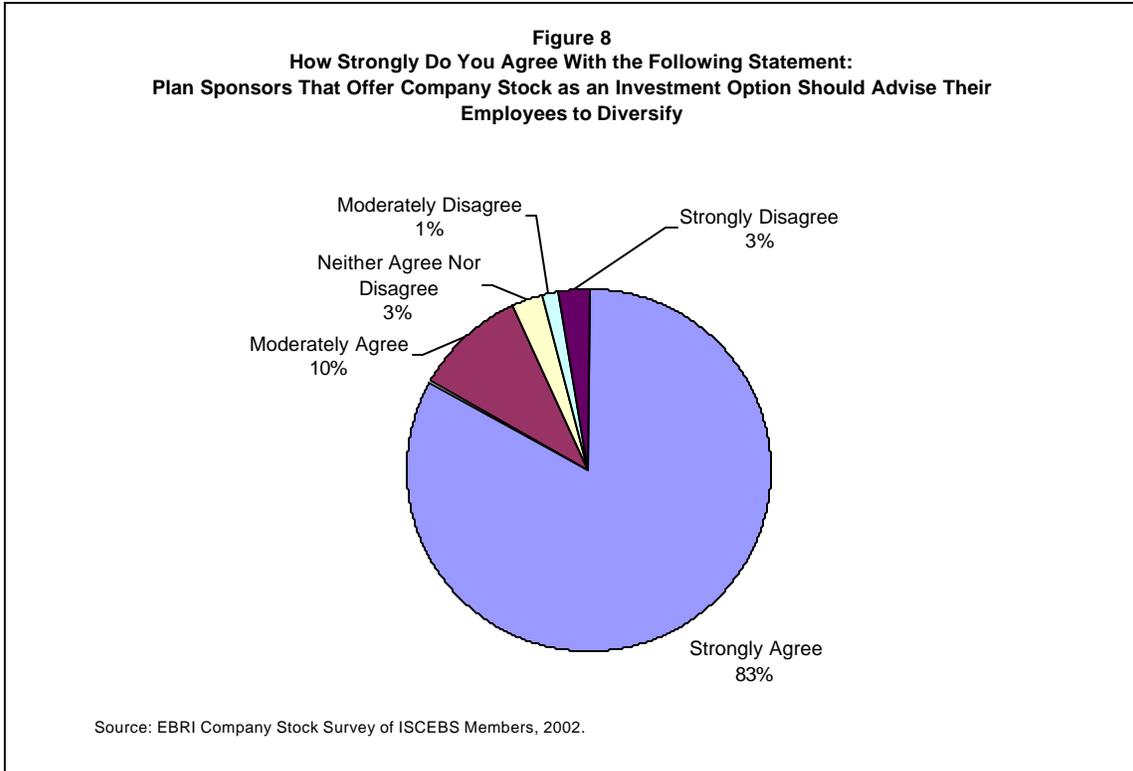
- When asked if they thought it was fair to impose a blackout period on participants in cases when there was *no* company stock:
 - 10 percent said yes.
 - 9 percent said no.
 - 79 percent thought it was a necessary by-product of the conversion.
 - 2 percent had no opinion.
- When asked the same question but when there *was* company stock:
 - 7 percent said yes.
 - 16 percent said no.
 - 72 percent thought it was a necessary by-product of the conversion.
 - 1 percent had no opinion.

Respondents' Perceptions on Public Policy Issues Related to Company Stock in 401(k) Plans

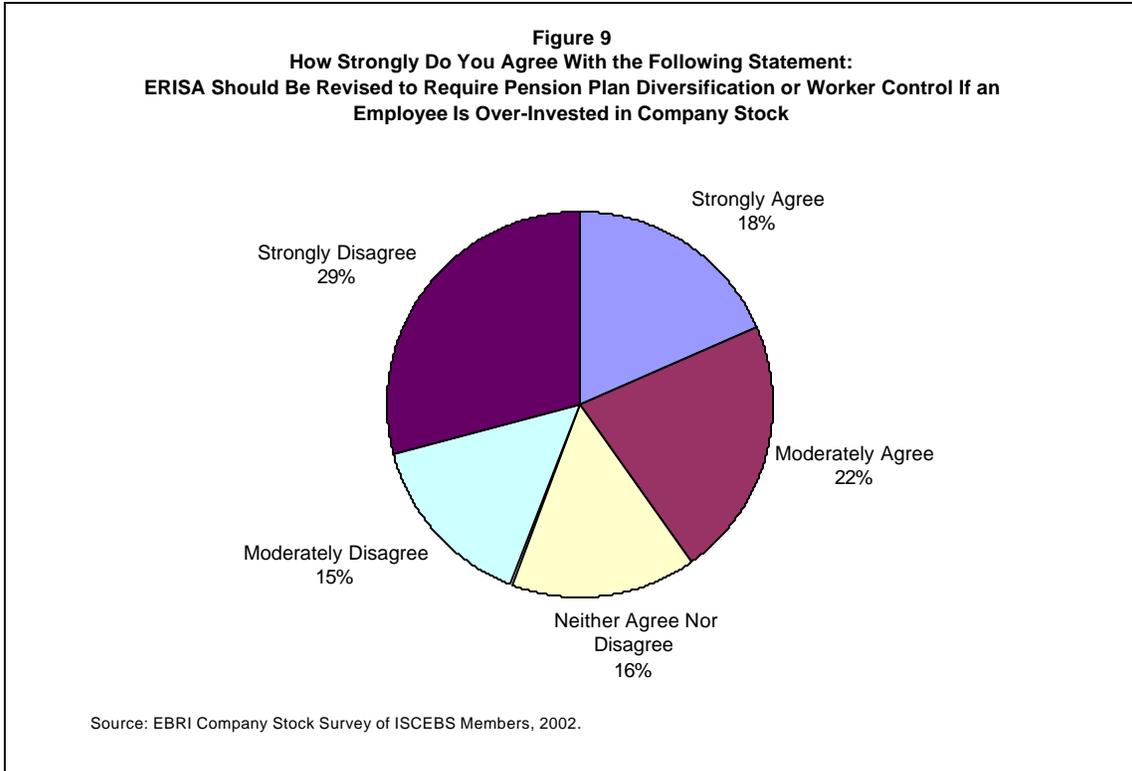
- Respondents were fairly evenly split on whether they thought there was an inherent conflict of interest when a plan sponsor includes company stock as an option in their 401(k) plan (see Figure 7).



- The vast majority of respondents (83 percent) strongly agreed that plan sponsors that offer company stock as an investment option should advise their employees to diversify (see Figure 8).

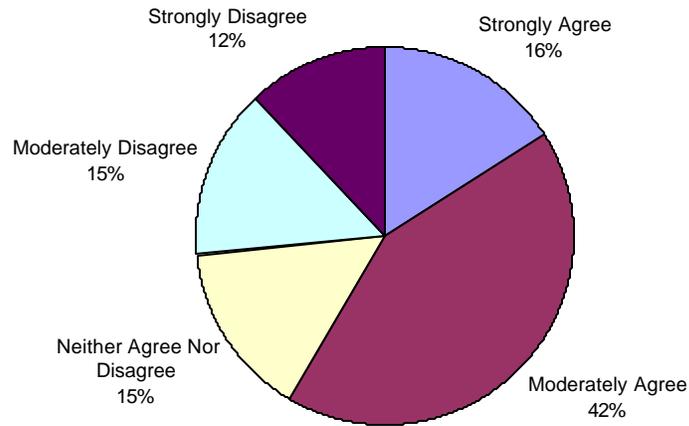


- Respondents were fairly evenly split on whether they thought ERISA should be revised to require pension plan diversification or participant direction if an employee is over-invested in company stock (see Figure 9).



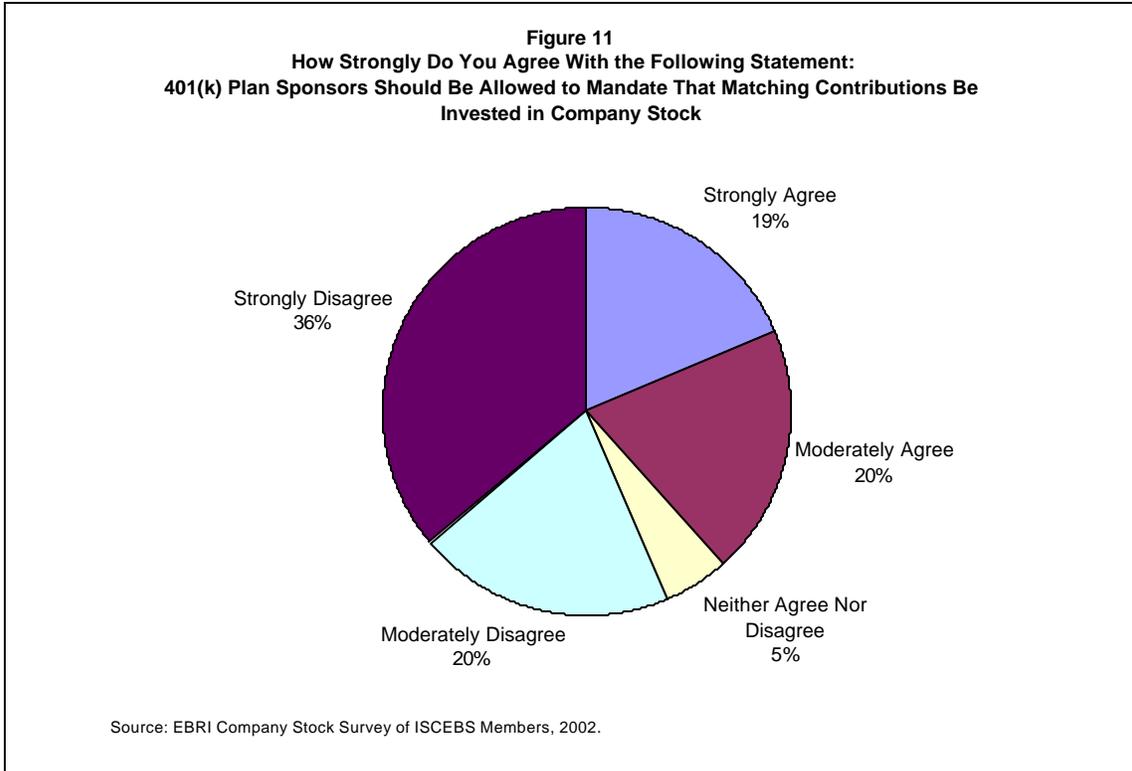
- The majority of respondents (58 percent) agreed that problems resulting from employees investing their own contributions in company stock would be mitigated if employers were allowed to provide independent financial advice to their employees. Only 27 percent of the respondents disagreed with this statement (15 percent were neutral, see Figure 10).

Figure 10
Problems Resulting From Employees Investing Their Own Contributions Into Company Stock Would Be Mitigated If Employers Were Allowed to Provide Independent Financial Advice to Their Employees

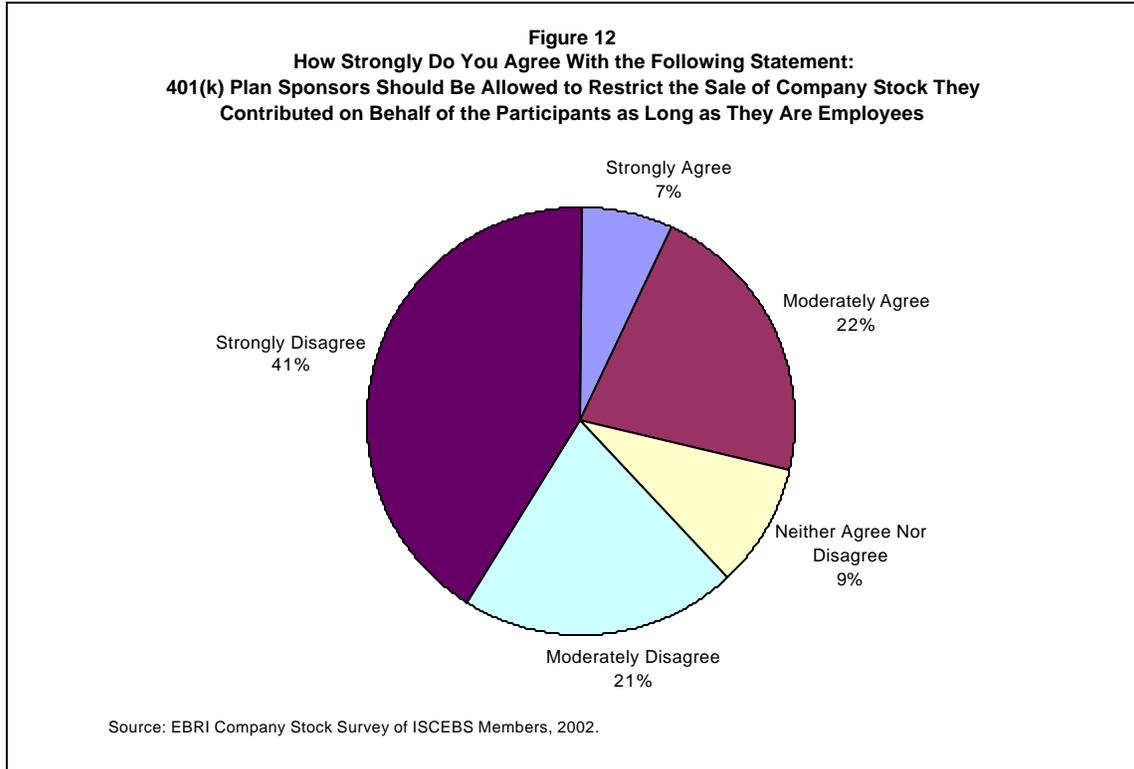


Source: EBRI Company Stock Survey of ISCEBS Members, 2002.

- The majority of respondents (56 percent) did not agree that 401(k) plan sponsors should be allowed to mandate that matching contributions be invested in company stock, while 39 percent agreed and 5 percent were neutral (see Figure 11).

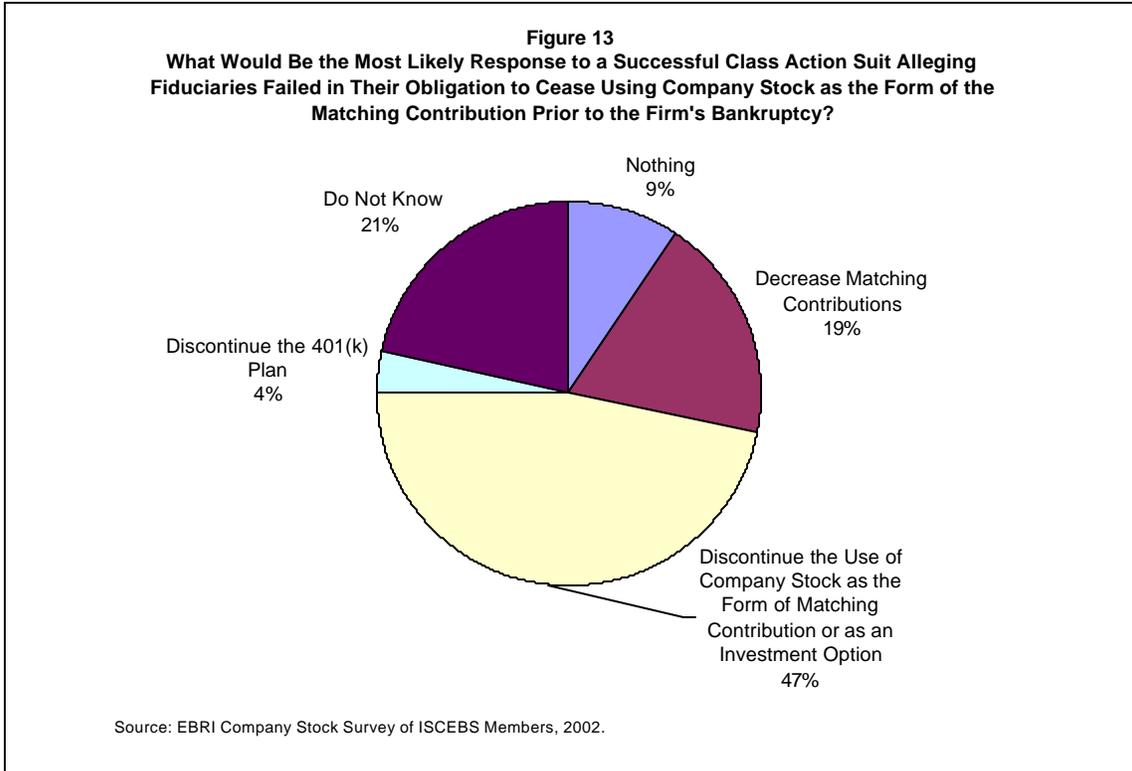


- More than 3 in 5 respondents (62 percent) did not agree that 401(k) plan sponsors should be allowed to restrict the sale of company stock they contributed on behalf of the participants as long as they are employees. 29 percent of the respondents agreed and 9 percent were neutral (see Figure 12).

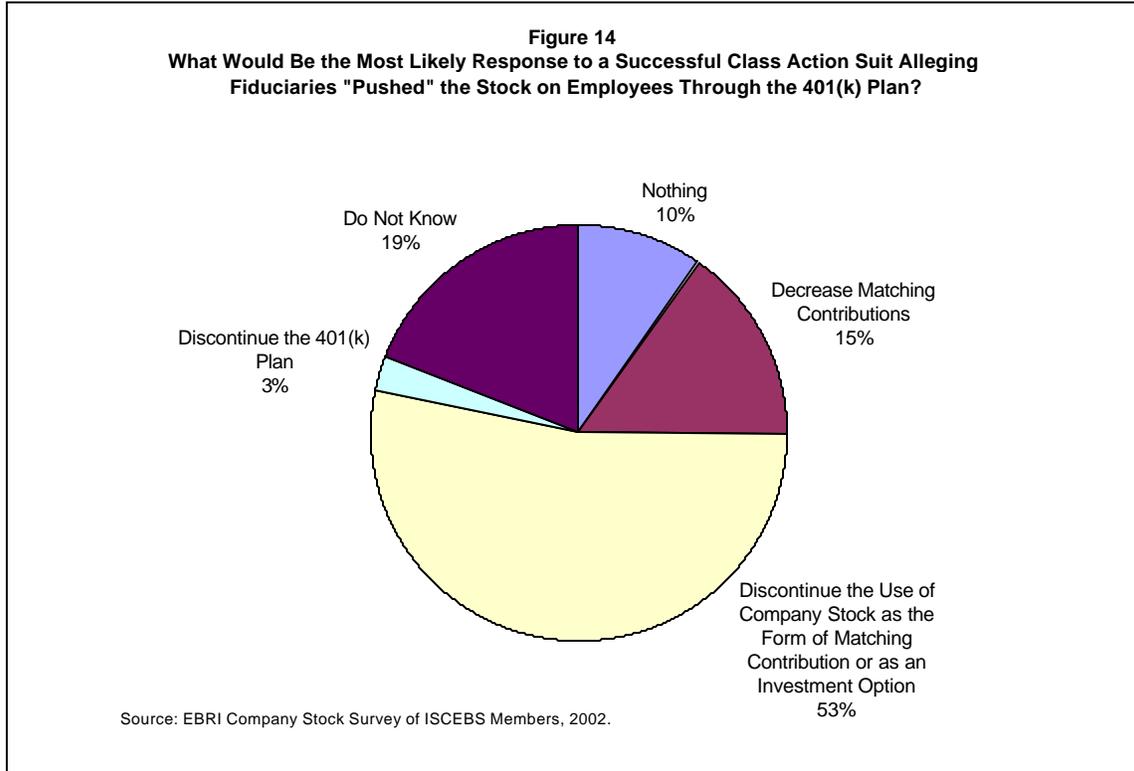


Respondents' Perception of the Impact of Various Legal/Legislative Developments

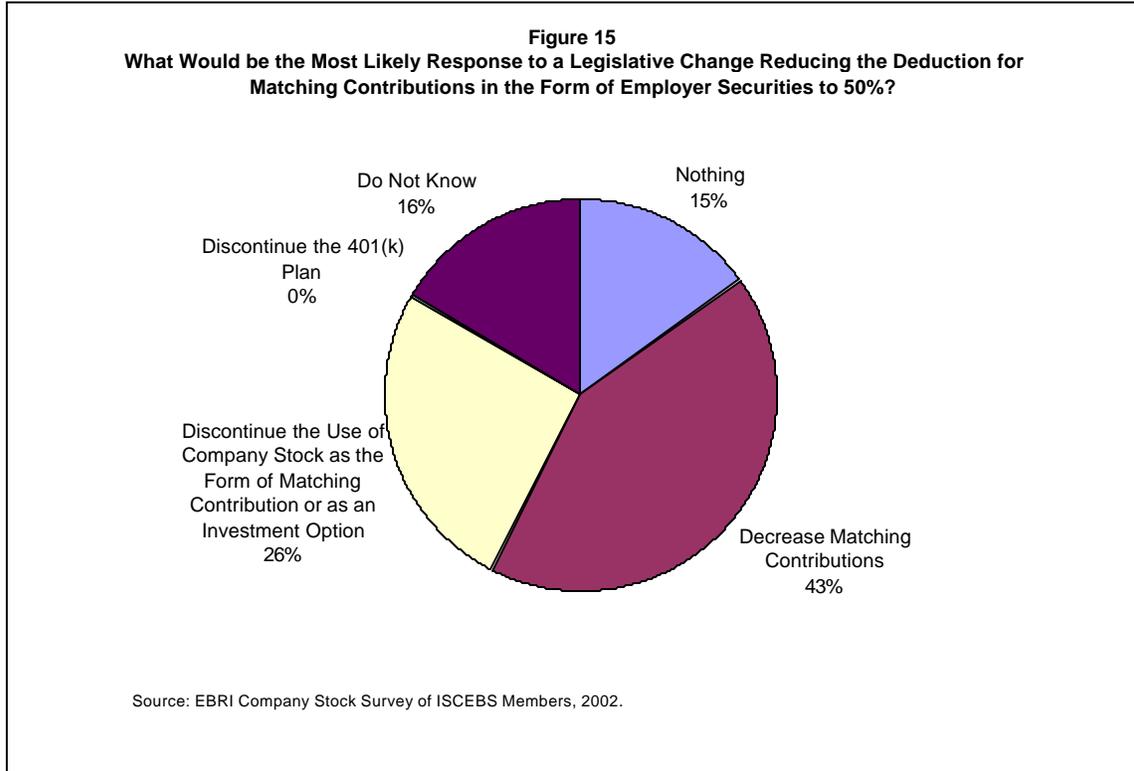
- Nearly one-half (47 percent) of respondents thought the most likely reaction to a successful class action suit alleging fiduciaries failed in their obligation to cease using company stock as the form of the matching contribution prior to the firm's bankruptcy would be to discontinue the use of company stock as the form of matching contribution or as an investment option (see Figure 13).



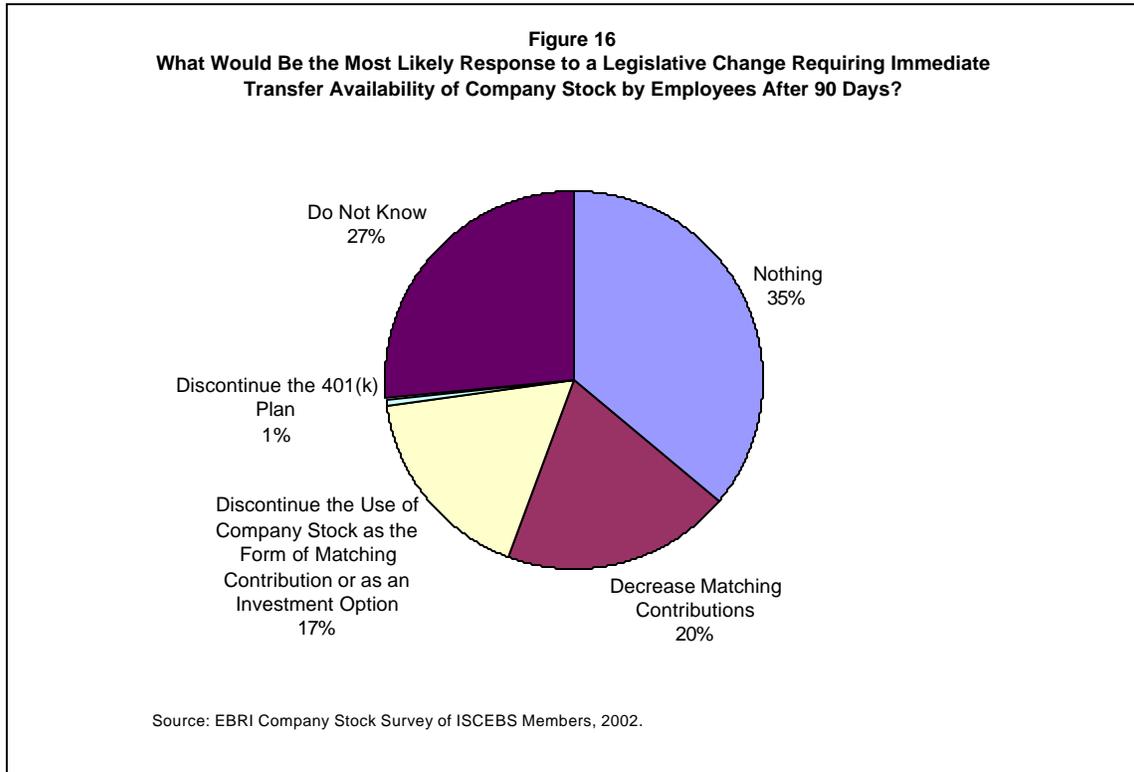
- More than one-half (52 percent) of the respondents thought that the most likely reaction to a successful class action suit alleging fiduciaries "pushed" the company stock on employees through the 401(k) plan would be to discontinue the use of company stock as the form of matching contribution or as an investment option (see Figure 14).



- Nearly 7 in 10 respondents (69 percent) thought that the most likely reaction to a legislative change reducing the deduction for matching contributions in the form of employer securities to 50 percent would be to either discontinue the use of company stock as the form of matching contribution or as an investment option, or to decrease the matching contributions (see Figure 15).

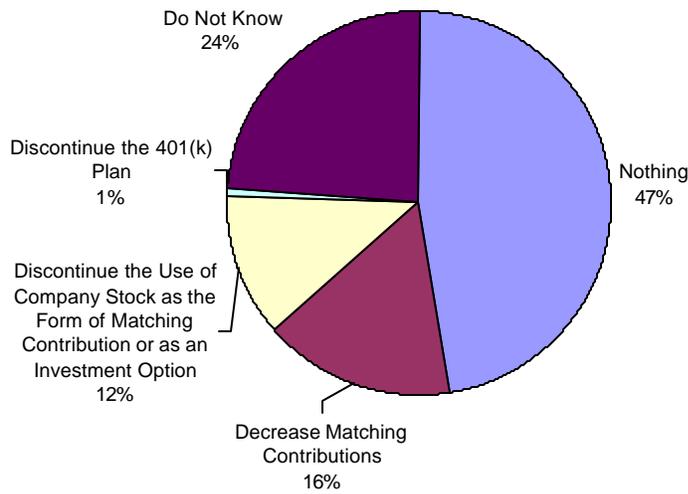


- Approximately one-third of the respondents (37 percent) thought that the most likely reaction to a legislative change requiring immediate transfer availability for company stock for employees after 90 days would be to either discontinue the use of company stock as the form of matching contribution or as an investment option, or to decrease the matching contributions. However, another 35 percent thought that there would be no reaction (see Figure 16).



- Nearly one-half (47 percent) of respondents thought there would be no reaction to a legislative change limiting to 20 percent the investment an employee can have in any one stock in his or her individual account plans. Another 28 percent thought that this would cause plan sponsors to either discontinue the use of company stock as the form of matching contribution or as an investment option, or decrease the matching contributions (see Figure 17).

Figure 17
What Would Be the Most Likely Response to a Legislative Change Limiting to 20% the Investment Employees Can Have in Any One Stock in Their Individual Account Plans?



Source: EBRI Company Stock Survey of ISCEBS Members, 2002.

Endnotes

¹ Sarah Holden and Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," *EBRI Issue Brief*, November 2001.

² The first stock bonus plans were granted tax-exempt status under the Revenue Act of 1921. See Robert W. Smiley, Jr. and Gregory K. Brown, "Employee Stock Ownership Plans (ESOPs)," *Handbook of Employee Benefits*. 5th Ed. Jerry S. Rosenbloom, ed, Homewood, Illinois: Dow Jones-Irwin, 2001.

³ ERISA Sec. 407(b)(1)

⁴ This is of importance because an ESOP is to be "primarily invested" in qualifying employer securities. See "Employee Stock Ownership Plans (Part II)," *Journal of Pension Planning and Compliance*; Winter 2000; John L Utz; pages 1-34.

⁵ Although cash or deferred arrangements have existed since the 1950's, the Revenue Act of 1978 enacted permanent provisions governing them by adding Section 401(k) to the Internal revenue Code. While this was effective for plan years beginning after 1979, the proposed regulations were not released until November 1981. See Jack VanDerhei and Kelly Olsen, "Section 401(k) Plans (Cash or Deferred Arrangements) and Thrift Plans," *Handbook of Employee Benefits*. 5th Ed. Jerry S. Rosenbloom, ed, Homewood, Illinois: Dow Jones-Irwin, 2001.

⁶ United States Department of Labor, Pension and Welfare Benefits Administration. "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10*, Winter 2001, Washington, DC. For a review of the academic literature analyzing these trends see William Gale, Leslie Papke and Jack VanDerhei, "Understanding the Shift Toward Defined Contribution Plans," in *A Framework For Evaluating Pension Reform* (Brookings Institution/TIAA-CREF/Stanford University), forthcoming. (www.brook.edu/es/erisa/99papers/erisa2.pdf)

⁷ It should be noted that less than 5 percent of all ESOPs are in public companies. For an explanation of the challenges that stricter diversification rules may present to private company ESOPs, see Corey Rosen, "Should ESOPs Be Subject to Stricter Diversification Rules?" (www.nceo.org/library/boxer_corzine_bill.html)

⁸ Alternatively, amounts subject to the right of diversification may be distributed from the plan. See Everett T. Allen, Jr., Joseph J. Melone, Jerry S. Rosenbloom and Jack L. VanDerhei, *Pension Planning: Pensions, Profit Sharing, and Other Deferred Compensation Plans* (8th ed), Homewood, Illinois: Richard D. Irwin, Inc., 1997.

⁹ As a result, the impact of this change was de minimis during the significant market decline in the fall of 1997. See Jack VanDerhei, "The Impact of the October 1987 Stock Market Decline on Pension Plans," written testimony for U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, July 1988.

¹⁰ The final version exempts from the 10 percent limits:

- De minimis (i.e., as much as 1 percent of pay) mandatory investment provisions.
- Plan designs under which the Sec. 401(k) deferrals (regardless of amount) are part of an ESOP.
- A plan in which the total assets of all defined contribution plans of the employer are not more than 10 percent of the total defined benefit and defined contribution plan assets of the employer.

The limit applies prospectively with respect to acquisitions of employer stock. The investment of matching or other employer contributions continues to be exempt from any limits. See Louis T. Mazaway, "1997 tax law changes affecting retirement plans," *Journal of Pension Planning and Compliance*; Winter 1998: 72-86. For more detail on the original proposal, see Ann L Combs, "Taking Stock of the Boxer Bill," *Financial Executive*; Jan/Feb 1997:18-20.

¹¹ Hewitt, *Special Report to Clients*, July 2001, "Impact of EGTRRA on Employer Plans." (<http://was.hewitt.com/hewitt/resource/wsr/2001/egtrra.pdf>)

¹² Watson Wyatt Worldwide, "Retirement Plan Provisions: What, When and How Much?" (Washington, DC: Watson Wyatt Worldwide, 2001).

¹³ "Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans," *IOMA's DC Plan Investing*, Dec. 11, 2001, p. 1.

¹⁴ Currently, there is no statutory or regulatory limit on the length of time during which participants can be blocked from reallocating assets or conducting other transactions in a 401(k) plan. See Patrick J. Purcell, "The Enron Bankruptcy and Employer Stock in Retirement Plans," *CRS Report for Congress*, Jan. 22, 2002, p. 5.

¹⁵ Jack VanDerhei and Craig Copeland, "A behavioral model for predicting employee contributions to 401(k) plans." *North American Actuarial Journal* (First Quarter, 2001).

¹⁶ This distribution was invariant with respect to whether the client/employer required employer contributions to be invested in company stock.

¹⁷ This distribution was invariant with respect to whether the client/employer required employer contributions to be invested in company stock.