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HIGHLIGHT:
Offering too many options with your company's 401(k) plan can cause some liability problems

BODY:

To protect themselves from 401(k) liabilities, employers have increased the number of investment options available to their employees. While doing so allowed them to empower employees in planning for their retirements, the high number of options also increased their burdens to educate their employees since workers may become confused. There is also an added risk of investment style overlap. Consequently, exposing them to more risks. Recent studies indicate that the average number of investment options have become stable at 9, with most employers viewing options in excess of 15 as too much choice. One of the few companies that offer a huge number of options is General Motors, who has 71 investment choice. Although the employees contribute to most investment options, it was noted that the bulk of their investments are on two options that have been available ever since. GM, on the other hand, defends its practice by citing that giving their employees with more options allow them to enhance returns with the same or lower level of risks.

401(k) managers may be increasing their liability risk by offering too many investment options.

By Margaret Price

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Souped-up plans empower employees in their retirement planning, but they also multiply the worker-education burdens of the employer.

Corporate treasurers who fret that they aren't giving employees enough choice in the company 401(k) benefits package won't be comforted by General Motors's recently remodeled plan.

The $154 billion Detroit-based automaker upgraded its $15.5 billion 401(k) plan for salaried workers last January to give participants no fewer than 71 investment choices, ranging from the very mundane bond and balanced fund selections to much sexier real estate, international bond and over-the-counter stock investment options. Employees can even bet on General Motors's own investment know-how by picking among the company's new, homegrown Promark funds run by its pension investment arm, General Motors Investment Management Corp. (Gmimco). "We're excited about the program," says Gmimco managing

director Michael Klehm. So, apparently, are General Motors's workers. Participation is up to 89% from an already healthy 86% before the revamping.

General Motors does not hold the record on investment options. One large company that asked not to be identified offers more than 150 such options through the use of a mutual fund window. This device gives users access to a host of fund choices offered by one or more mutual fund families. In addition, self-directed brokerage accounts give plan participants-sometimes with employer-imposed limitations~the ability to buy and sell any number of individual securities or mutual funds offered by the broker. United Technologies, the $25.7 billion defense contractor based in Hartford, Conn., offers its employees a mutual fund window, while $12.4 billion US West of Denver has both a mutual fund window and self-directed brokerage options in its 401(k).

Pro Choice

Ever since the U.S. Department of Labor indicated in October 1992 that adequate choice was one way for companies to sidestep 401(k) liability burdens, the number of investment options in these defined-contribution plans has crept steadily higher. So has the debate over how much choice is too much choice.

If these souped-up plans empower employees in their retirement planning, they also multiply the disclosure and worker-education burdens of the employer~and potentially increase the risk of liability should any of these investments tank. That's enough to prompt most companies to act conservatively on the issue. There's already evidence that the movement toward more 401(k) choice is topping out~and at numbers well below those at General Motors.

According to a March survey by consulting firm Barra RogersCasey in Darien, Conn., 498 corporate respondents averaged 9.7 options in their 401(k) plans. That's a slight jump from 8.5 in 1998 and 7.9 in 1997. But companies don't appear willing to move the number of choices much higher. Fully 80% of respondents in the same survey said 15 investment options were too many, while 33% believed 10 or more is excessive, says Adele Heller, a Barra RogersCasey managing director. "You can cover the investment risk-return spectrum with eight to 10 investment options," Heller says.

But General Motors's Klehm sees good reason for having more options. "Over the long term, a well-diversified portfolio should provide investors with the opportunity to enhance returns with the same or lower level of risk than would a much more concentrated portfolio," he says, explaining the advantages of General Motors's new program. The plan's 71 options, up from an earlier 56, are grouped into three tiers, or "pathways," based on employees' level of investment expertise. In fact, Gmimco hopes to replicate the new structure with its 401(k) plan for hourly employees. This issue is likely to be on the table at upcoming contract negotiations with the various unions involved. (Gmimco is also considering marketing its new Promark funds outside the company.)

In February 1997, $13.4 billion Eastman Kodak in Rochester, N.Y., lifted to 36 from six the number of options in its more than $5 billion 401(k) plan and grouped those options into three categories aimed at participants with varying levels of investment ability. Participation in the plan has climbed to 78% from 72% just prior to the revisions.

Still, too many choices can be confusing to workers. There's the increased possibility that fund investment styles will overlap. In addition, companies need to be sure they're maintaining their exemption from liability from poorly performing 401(k) plans.

The final regulations of 404(c) of the Employee Retirement Income Security Act (Erisa) lets employers off the hook for poorly performing plans if they meet criteria such as having at least three materially different investment options, allowing investment changes at least quarterly and providing adequate information about the plan's investment choices.

So far, adhering to these criteria has been a snap for most companies. But 401(k) programs that make use of multichoice mutual fund windows or self-directed brokerage accounts complicate the compliance picture. For instance, if employees spend too much time trading through self-directed brokerage accounts and make poor investment choices, will employers somehow be liable?

What's also unclear is just how much education companies must provide on potentially hundreds or more individual investment choices to maintain 404(c) protection. Not even the U.S. Department of Labor

has shed much light on the matter (see box).

Barra's Heller, meanwhile, points to the sheer complexity of distributing and explaining perspectuses on 35 to 75 different funds in a mutual fund window. "It can get very confusing," she says. "It's also a challenge for the recordkeeper to list all 75 mutual funds of a mutual fund window on the same 401(k) plan statement that goes to plan participants."

With the self-directed brokerage option, moreover, employees pay special fees. According to Heller, brokerage firms usually charge a flat $75 to $300 a year for such options, in addition to commissions on securities trading. Employees need to know and understand what all the associated costs are.

Employee Needs Are Modest

Ironically, employee demand for a huge range of investment choices seems slight. At General Motors, salaried workers have contributed money to all 71 of their 401(k) investment options. But the two most popular ones are those that have been available to them since before 1995, when the plan offered only seven choices. A stable value fund has drawn 28% of the plan's total assets, followed by the General Motors common stock fund, with 21%.

In New York, $3.7 billion publisher McGraw-Hill is now reviewing the investment options in its $1.1 billion combined profit-sharing and 401(k) plan. But having doubled those to 10 three years ago, the company is reluctant to go any higher especially since the five options added three years ago have attracted only 7% of total plan assets.

McGraw Hill Senior Vice President and Treasurer Frank Penglase notes, "You have to ask yourself, 'Am I really adding value by introducing a lot of overlapping options to a 401(k) plan?'"

Unanswered Liability Questions

Just because you've structured the company's 401(k) plan to comply with Employee Retirement Income Security Act (Erisa) guidelines doesn't mean you are automatically exempted from liability if the plan's performance turns sour. Section 404(c) of Erisa indicates that employers can generally rest easier on liability issues if their plans offer a broad range of investment options, permit movement within those options at least quarterly and provide adequate disclosure on those investment choices.

"But that's not to say employers have no liability at all," says Alan Lebowitz, deputy assistant secretary for program operations at the U.S. Department of Labor's Pension and Welfare Benefits administration. Potentially, he notes, employers could lose 404(c) protection if their 401(k) plan investment options seem imprudent. Maintaining a package of choices that regularly rank at the bottom of performance rankings could put companies at risk, he says. So could providing inadequate information on options, including the fees attached to them.

Program monitoring is an essential due-diligence ingredient. Employers must periodically evaluate their 401(k) program to "see how well it's doing and to decide whether to make changes," says Lebowitz.

All of this said, the legal picture gets murky when it comes to the latest 401(k) plan schemes~self-directed brokerage and mutual fund window accounts. "A lot of legal issues here are unresolved because there hasn't been much in the way of litigation," says Lebowitz. "We won't have answers until the market dives and people assert various legal theories of liability."

Meanwhile, a recently filed lawsuit underscores the importance of prudent selection of the funds~and the need to cross all legal t's before transferring assets from one plan to another. Nine employees at Signet Banking recently filed suit against Signet acquirer First Union, claiming that the bank illegally moved $100 million of the $250 million Signet 401(k) plan to underperforming mutual funds managed by First Union. The workers argue that the move cost them some $150 million in lost investment returns, even as it boosted fee income for First Union.

"The decision to raid the Signet Plan was never approved by the First Union board of directors in the first place," says Eli Gottesdiener, a partner at Sprenger & Lang, the Washington, D.C., law firm representing the employees. That, he says, created an illegal transfer of assets. In addition, Gottesdiener states, First Union "unilaterally changed Signet employees' investment options, liquidated nonproprietary funds and shunted the money to First Union's own family of funds."

Observers believe the case could have implications for other employers using their own internally managed funds in a 401(k) plan. Even with 404(c), "you have some residual responsibilities as a plan sponsor," says Mike Gordon, a Washington, D.C., attorney specializing in employee benefits. "And those increase significantly if you insist employees invest in your own stock or your own proprietary funds."

-M.P.

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