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Employer Stock in the 401(k) Plan: Handle With Care

Offering employer stock in a 401(k) plan comes with its own set of issues, but many plan sponsors continue to do so at their own risk.

By Lori Lucas

When a company runs into financial trouble, it inevitably seems that employer stock-drop lawsuits swiftly follow. One case in point: In early January, a Fortune 100 employer settled a nearly $40 million class-action lawsuit over its employer stock investments.

The suit alleged that the employer put its own interests ahead of that of plan participants by offering employer stock as an investment option, matching employee contributions in employer stock and failing to diversify the stock fund when it was clear that it wasn't a prudent investment.

It is commonly held that the reasons for offering employer stock are to align employee interests with the company, to keep large allocations of company stock in "friendly hands" or because employer stock is the only affordable way to offer a company matching contribution.

However, a recent focus group of large-plan sponsors revealed a different reality. The prevailing reason given for offering employer stock was simply that it was a legacy fund. In other words, the actual role of employer stock in the plan was unknown.

Even so, eliminating an unwanted employer stock fund can be a tremendous challenge. There is the inevitable communication issue: How does the plan sponsor eliminate employer stock without inadvertently implying that something is wrong with the company?

There are also employee relations challenges—frankly, employees often like being able to invest in the employer stock fund. They may believe it is less risky than other diversified funds that they are less familiar with, or they may hold that they possess special "insider knowledge."

Then there are timing challenges: If the employer stock fund is removed when the employer stock price is rising, employees may perceive that they are being deprived of upside potential; if the employer stock fund is removed when the employer stock price is falling, employees may believe that they are being forced to lock in their losses.

In light of all this, many plan sponsors do still offer employer stock in their defined-contribution plans regardless of the potential lawsuits and the nebulous role of employer stock.

According to the Callan DC Index, 43 percent of large plan sponsors offer employer stock as an available investment option. When available, 19 percent of the typical plan's assets reside in employer stock. This average isn't terribly alarming if you consider that the threshold cited by the Department of Labor in its required diversification notice is 20 percent.

However, it's notable that the typical professionally managed portfolio tends to limit individual security holdings to 5 percent to 10 percent of assets. Further, it's important to consider that even plans with low average employer stock holdings often have participants with the majority or even all of their balances in the employer stock fund. Often these are older participants who are close to retirement and in no position to assume high levels of company specific risk.

The tools plan sponsors have to discourage over-concentration in employer stock are few. According to a recent Callan DC survey, nearly one in three plan sponsors anticipated that they will increase their communication regarding employer stock in 2008. One in 10 will offer more tools to improve diversification out of employer stock. Four percent will cap contributions to employer stock.

All of these solutions are far from ideal. Simple communication advocating diversification rarely results in action. Even if participants pay attention to the communication, they are likely to resist for behavioral reasons such as inertia or fear of regret—that is, that they sold low. Diversification tools such as online investment advice typically experience low utilization rates (10 percent is common).

Finally, the recently proposed

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Department of Labor regulation mandating employer stock diversification actually makes it more difficult to administer caps on the amount of employer stock held by participants.

The proposed regulation generally states that participants must not be prevented from transfers with respect to employer stock. So if a participant has 50 percent in employer stock, but the plan has a 20 percent cap on the amount of employer stock that can be held, that participant must still be allowed to transfer the full 50 percent in and out of employer stock regardless of the cap. Only participants with 20 percent or less in employer stock prior to the cap could be restricted in this case. If finalized in its current form, the employer stock diversification regulation is likely to create administrative and communication challenges when it comes to employer stock caps.

To help avoid lawsuits, some plan sponsors have outsourced the oversight of employer stock to a third party, such as a trustee, or eliminated insiders from their investment committee. The former solution can be expensive and its efficacy is relatively untested. The latter, of course, may mean that some of the most qualified people are being removed from plan oversight.

Clearly there are no easy answers to the employer stock dilemma. Some approaches that have met with success include:

- Leveraging the plan's target-date funds. The key to successful communication in 401(k) plans is that it is actionable—and target-date funds can serve that need when it comes to employer stock diversification. Plan sponsors who have accompanied diversification communication with a response card that allows participants to check a box indicating they wish to transfer employer stock balances to a diversified alternative such as a target-date fund report greatly improved response rates.
- Implementing automatic rebalancing. High allocations to employer stock may result simply from a failure to rebalance. In a recent white paper, David Laibson of Harvard University proposed that plan participants should be defaulted into an automatic rebalancing solution that prevents them from being too concentrated in employer stock. Participants could always opt out of the program if they choose to.
- **Offering managed accounts.** While participant utilization of managed accounts generally tends to be modest, some research has shown that when participants do turn over discretionary management of their 401(k) account to a managed account provider, the result tends to be dramatically reduced employer stock allocations.
- **Biting the bullet.** Eliminating the employer stock fund may not be an easy decision, but in some cases it could be the best one. Some plan sponsors do so by first freezing contributions into the fund, and then proceeding on a fairly lengthy communication campaign that announces the ultimate removal of the employer stock fund. In this way, participants have ample time to shift their balances, and the removal of the employer stock fund can be positioned as a strategic change to the plan.

At a minimum, plan sponsors are wise to assess the role of employer stock in their 401(k) plan. What goal is it meant to achieve? Can the goal be better achieved through other means, such as restricted stock offerings? And most important, is offering employer stock in the 401(k) plan worth the potential risk to plan participants—and to plan sponsors?

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