# The Behavioral Economic Case for Paternalistic Workplace Retirement Plans

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*Dependence on 401(k) retirement accounts continues to cause a massive retirement crisis in the United States by leaving most workers unprepared for retirement. The voluntary, inaccessible, employer-centered, expensive, and consumer-driven natures of these plans have combined to make retirement a type of corporate-inspired elder abuse in America.*

*Behavioral economics considers the utility of permitting individual choice in decision-making settings. Many, however, have been misled to believe that greater choice is always better. Yet, according to one prominent commentator, this consumer-driven paradigm will lead to 48% of current workers between the ages of fifty and sixty-four being poor when they reach retirement. Behavioral economic workplace research, instead, strongly suggests that a better approach would be to use "choice architecture" to nudge workers into well-diversified, low-fee default retirement accounts set up by government-regulated private retirement funds.*

*Such a successful paternalistic workplace retirement model already exists. The Australian Superannuation Guarantee is a mandatory, universal, private, and comparatively inexpensive workplace retirement scheme. It also aligns the interests of retirement fund managers with fund participants. Most Australian employees do not exercise choice with regard to how their retirement contributions are invested. Employer contributions default into an individual's MySuper retirement account operated by the country's best money managers, who invest worker funds in a diversified manner, while charging very low investment fees.*

*As part of my Stewart Lecture remarks, I outline here a vision for the transformation of the American 401(k) retirement system into an efficient and*

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*sustainable superannuation model based on behavioral economic insights from the Australian workplace retirement system.*

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## INTRODUCTION

The American retirement security system hangs treacherously on a precipice. With a low personal saving rate[1] and an average Social Security income replacement rate of only between 40%–45%,[2] the future vitality of the American workplace

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1. The personal saving rate in the United States in October 2015 was 4.8%. *Personal Saving Rate*, FED. RES. BANK ST. LOUIS (Oct. 30, 2015, 7:46 AM), http://research.stlouisfed.org/fred2/series/PSAVERT [perma.cc/2CLQ-HU7R].

2. *See How Do Benefits Compare to Earnings?*, NAT'L ACAD. SOC. INS., http://www.nasi.org/learn/socialsecurity/benefits-compare-earnings [perma.cc/2EJK-B53U] ("For example, a 65-year-old who retired in 2015 with a lifetime of 'medium' earnings (about $46,290 in 2014) would receive about $18,320 a year, which would replace about 40 percent of past earnings."). Some estimates of how much income Social Security replaces in retirement are much lower. *See* Kenneth Glenn Dau-Schmidt, *Promises to Keep: Ensuring the Payment of Americans' Pension Benefits in the Wake of the Great Recession*, 52 WASHBURN L. J. 393, 396 (2013) ("In 2012, the OASDI [old age, survivor and disability insurance] program paid an average monthly benefit of $2,051 to a retired worker and spouse, which on average replaced approximately 17% of the retiree's pre-retirement income.").

retirement system has become even more crucial.[3] The traditional definition of retirement security is that an individual will receive, for the balance of his or her retirement, income equal to approximately 70% of her income while employed.[4] Yet, over 48% of current American workers between the ages of fifty and sixty-four will be poor when they reach retirement.[5]

All in all, too many Americans are saving too little for retirement.[6] This is especially problematic because "[s]ome 76 million Americans born between the years 1946 and 1964—Baby Boomers—are retiring. That translates to about ten thousand Boomers retiring daily."[7] The Employee Benefit Research Institute (EBRI) has stated that "[t]he aggregate national retirement deficit number is currently

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3. *See* Frans Pennings & Paul M. Secunda, *Towards the Development of Governance Principles for the Administration of Social Protection Benefits: Comparative Lessons from Dutch and American Experiences*, 16 MARQ. BENEFITS & SOC. WELFARE L. REV. 313, 321 ("[A] large segment of the American populace receives employer-provided retirement and welfare benefits either under collective bargaining agreements or, more likely, through the unilateral and voluntary actions of employers (spurred on by vast tax subsidies for sponsoring such benefit plans).").

4. U.S. DEP'T OF LABOR, TOP 10 WAYS TO PREPARE FOR RETIREMENT 3 (2013), *available at* http://www.dol.gov/ebsa/pdf/top10ways.pdf [perma.cc/VGA6-PPXN]; *cf.* Teresa Ghilarducci, Op.-Ed., *Our Ridiculous Approach to Retirement*, N.Y. TIMES, July 21, 2012, www.nytimes.com/2012/07/22/opinion/sunday/our-ridiculous-approach-to-retirement.html [perma.cc/2XXF-8WLW] ("To maintain living standards into old age we need roughly 20 times our annual income in financial wealth. If you earn $100,000 at retirement, you need about $2 million beyond what you will receive from Social Security.").

5. Teresa Ghilarducci, *Retirement Security Worse on ERISA's 40th Anniversary*, 6 DREXEL L. REV. 453, 453 (2014) (discussing how about 48% of workers between the ages of fifty and sixty-four will be poor when they reach retirement); *see also* Shlomo Benartzi & Richard H. Thaler, *Behavioral Economics and the Retirement Savings Crisis*, 339 SCI. 1152 (2013) (discussing increased percentage of workers at risk of not having adequate funds in retirement); Eduardo Porter, *Americans Aren't Saving Enough for Retirement, but One Change Could Help*, N.Y. TIMES, Mar. 3, 2015, http://www.nytimes.com/2015/03/04/business/americans-arent-saving-enough-for-retirement-but-one-change-could-help.html [perma.cc/TU88-LSNP] ("On average, a typical working family in the anteroom of retirement — headed by somebody 55 to 64 years old — has only about $104,000 in retirement savings, according to the Federal Reserve's Survey of Consumer Finances."); Jack VanDerhei, *Retirement Savings Shortfalls: Evidence from EBRI's Retirement Security Projection Model*, EMP. BENEFIT RES. INST. ISSUE BRIEF, Feb. 2015, at 1, 1, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_410_Feb15_RSShrtfls.pdf [perma.cc/FVS7-QEMZ].

6. *See* Paul M. Secunda & Brendan S. Maher, *Pension De-Risking*, 93 WASH. U. L. REV. (forthcoming 2016) (manuscript at 1 n.1) (on file with the Indiana Law Journal) (citing Hazel Bradford, *Study: Retirement Crisis Real and Getting Worse,* PENSIONS & INVESTMENTS (Jan. 26, 2015, 2:34 PM), http://www.pionline.com/article/20150126/ONLINE/150129904/study-retirement-crisis-real-and-getting-worse [perma.cc/T3HK-36X7] ("The most convincing estimates project that more than 50% of households will fall short, and even the most optimistic studies predict that nearly one-quarter of retirees will . . . .")).

7. DIANE OAKLEY & KELLY KENNEALLY, NAT'L INST. ON RETIREMENT SEC., RETIREMENT SECURITY 2015: ROADMAP FOR POLICY MAKERS 1 (2015), *available at* http://www.nirsonline.org/storage/nirs/documents/2015%20Opinion%20Research/final_opinion_research_2015.pdf [perma.cc/5D3Q-5Z97].

estimated to be $4.13 trillion for all U.S. households where the head of the household is between 25 and 64."[8]

The current American retirement predicament derives primarily from the fact that employers have transitioned away from pension or "defined benefit" (DB) plans that promised workers a monthly pension to retirement accounts or "defined contribution" (DC) plans that offer workers retirement savings accounts.[9] This "defined contribution paradigm"[10] has led to workers being completely shut out from the workplace retirement system,[11] failing to participate in workplace retirement schemes even if offered by their employers,[12] investing their money unwisely because of their lack of financial savvy,[13] or spending down their retirement savings in a way that will not make their money last through retirement.

The DC approach to workplace retirement does not appropriately prioritize beneficiary welfare in a fashion consistent with the protective and remedial purposes of the Employee Retirement Income Security Act of 1974 (ERISA).[14] This is because

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8. VanDerhei, *supra* note 5, at 1. "The Retirement Savings Shortfalls [RSS] show that for those on the verge of retirement (Early Baby Boomers), the deficits vary from $19,304 (per individual) for married households, increasing to $33,778 for single males and $62,734 for single females." *Id.* The RSS represents "the size of the deficits that households are simulated to generate in retirement." *Id. See also* OAKLEY & KENNEALLY, *supra* note 7, at 7 ("The Boston College Center for Retirement Research National Retirement Risk Index indicates that as of 2013, more than half of U.S. households lack sufficient retirement income to maintain their standard of living even if they work longer than the average retirement age of 65.").

9. Secunda & Maher, *supra* note 6 (manuscript at 1) (citing Samuel Estreicher & Laurence Gold, *The Shift from Defined Benefit to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (2007)). *See also* Dau-Schmidt, *supra* note 2, at 394 ("American employers have been terminating the traditional defined benefit pension plans of the post-World War II era, in favor of the more portable defined contribution plans that leave investment and annuity decisions and risk with individual workers.").

10. *See generally* EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA (2007).

11. An estimated 46% of American workers have no access to a 401(k) or similar retirement account. *See* Dau-Schmidt, *supra* note 2, at 397 ("Since 2000, the percent of full-time American private-sector workers covered by some form of pension plan has decreased from 59.8% to 53.7%.").

12. *See* Richard Eisenberg, *Is This the Solution to America's Retirement Crisis?*, NEXT AVENUE (July 26, 2012), http://www.nextavenue.org/blog/solution-americas-retirement-crisis [perma.cc/D49W-BYSP] ("[R]oughly a fifth of people eligible for a 401(k) don't sign up.").

13. The Department of Labor has expressed concern over individuals' ability to understand investment principles in order to make well-informed decisions in the context of DC plans. Matthew Venhorst, *Helping Individual Investors Do What They Know Is Right: The Save More for Retirement Act of 2005*, 13 CONN. INS. L.J. 113, 119 (2006) (citing 29 C.F.R. § 2509.96-1 (2006)).

14. 29 U.S.C. §§ 1001–1461 (2012). Section 2 of ERISA states as its purpose:

> to protect . . . the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.

one of the central structural aspects of ERISA is flawed when it comes to workplace retirement plans. ERISA makes adoption of all ERISA plans by employers *completely voluntary*.[15] Because of the voluntary nature of these plans, many employees, especially in small and midsize firms, do not have access to such retirement plans.[16]

Those that do have access and sign up are mostly incapable of investing or matching their salary contributions according to basic principles of modern portfolio theory.[17] Or more problematically, employees are permitted various forms of preretirement distribution, which leads to a significant amount of leakage from these accounts before retirement even begins.[18] Moreover, many times 401(k) participants do not understand the high fees associated with certain types of actively managed mutual fund investments and squander a large amount of potential retirement savings based on their ignorance of these matters.[19] Finally, because of the legal repercussions of being labeled a fiduciary under ERISA,[20] many employers, or their delegated third-party administrators, fail to provide the necessary investment education that their employees need to make appropriate decisions concerning their 401(k) accounts.[21] Instead, many plan participants receive conflicting advice from

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*Id.* § 1001(b).

15. *See* Lockheed Corp. v. Spink, 517 U.S. 882, 887 (1996) ("Nothing in ERISA requires employers to establish employee benefits plans. Nor does ERISA mandate what kind of benefits employers must provide if they choose to have such a plan."). *See also* Dana M. Muir, *From* YUPPIES *to* GUPPIES*: Unfunded Mandates and Benefit Plan Regulation*, 34 GA. L. REV. 195, 209–11 (1999) (discussing the history of voluntary plan sponsorship in the U.S.).

16. *See* Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2012*, EMP. BENEFIT RES. INST. ISSUE BRIEF, Nov. 2013, at 1, 10, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-13.No392.Particip.pdf [perma.cc/3H33-RWAT] ("For wage and salary workers ages 21–64 who worked for employers with fewer than 10 employees, 13.5 percent participated in a plan, compared with 54.8 percent of those working for employers with 1,000 or more employees.").

17. *See* Ghilarducci, *supra* note 4 ("Basing a system on people's voluntarily saving for 40 years and evaluating the relevant information for sound investment choices is like asking the family pet to dance on two legs."). *See also* Dau-Schmidt, *supra* note 2, at 395 ("By any objective measure, workers seem very myopic in their decisions as to how much to save for retirement, valuing current consumption and the crush of current needs over saving for retirement.").

18. Alexandra Moen, *Putting a Stop to Retirement Plan Leakage*, RETIREMENT TOWN HALL (Mar. 3, 2015), http://www.retirementtownhall.com/?p=6914#sthash.5GmTLq2a.XyVCbBza.dpbs [perma.cc/8HDR-U76R] ("Leakage refers to the erosion of assets in retirement accounts—approximately 1.5% of retirement plan assets 'leak' out every year. This can potentially lead to a reduction in total retirement assets of 20% to 25% over an employee's working years.").

19. *See* Porter, *supra* note 5 ("Actively managed mutual funds, in which many workers invest their retirement savings, are enormously costly.").

20. *See, e.g.*, Varity Corp. v. Howe, 516 U.S. 489, 506 (1996) ("ERISA requires a 'fiduciary' to 'discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries.'" (citing ERISA § 404(a) (codified at 29 U.S.C. § 1104(a) (2012))).

21. *See* 29 C.F.R. § 2509.96-1 (2014). ("[M]any employers have not offered programs or offered only limited programs due to uncertainty regarding the extent to which the provision

investment advisors and brokers. Such conflicted advice led the U.S. Department of Labor (DOL) to propose rules on April 20, 2015, to expand the definition of "fiduciary" so that such advisors act in their employees' best interests.[22]

Behavioral economics explains that preserving choice for individuals at all costs is not always in the best interest of those making the choices.[23] Indeed, it is employees making improper choices regarding their 401(k) plans that has helped fuel the current retirement crisis. The concept of choice architecture, already used successfully with automatic enrollments in 401(k) plans,[24] can be applied to allow workers who do not want to actively manage their retirement accounts to still be successful when it comes to retirement security.[25] Through this approach, workers will be "nudged" into saving for retirement without having to think about it, and yet can opt out of the default if they wish to take a more active role in investing for their retirement future.[26]

Such a system already exists in Australia, and most agree that "Australians are in better shape for retirement than Americans."[27] Under the Australia Superannuation Guarantee (SG), employers must contribute 9.5% of employee compensation to a

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of investment-related information may be considered the rendering of 'investment advice' under section 3(21)(A)(ii) of ERISA, resulting in fiduciary responsibility and potential liability in connection with participant-directed investments.").

22. *See* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509–10).

23. *See infra* Part II.

24. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 902, 120 Stat. 780, 1033–39. The Pension Protection Act "assisted the movement toward autoenrollment by allowing employers to utilize an autoenrollment provision in their 401(k) plans in order to avoid certain nondiscrimination requirements otherwise mandated by the IRS." Steven D. Cohen, Note, *Autoenrollment and Annuitization*: *Enabling 401(k) "DB-ation"*, 5 N.Y.U. J.L. & BUS. 281, 300 (2009) (citing I.R.C. § 401(k)(13) (2006)). The Department of Labor later "promulgated regulations that provide the types of investment funds into which plan contributions can be automatically invested," which are called qualified default investment alternatives (QDIAs). *Id.* (citing 29 C.F.R. § 2550.404c-5 (2008)).

25. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 131–33 (2009) (describing how nudging works with retirement plan participant choices through choice architecture).

26. *See* Richard Eisenberg, *To Solve the U.S. Retirement Crisis, Look to Australia*, NEXT AVENUE (July 26, 2013), http://www.nextavenue.org/blog/solve-us-retirement-crisis-look-australia [perma.cc/4ZFL-EW4F] ("[A]ccording to Putnam Investments, employees who are automatically enrolled in workplace plans are on track to replace 91 percent of their pre-retirement income in retirement and those in auto-escalation plans are headed to 95 percent replacement rates.").

27. *Id.* ("Australia's highly rated system [is] (tied with the Netherlands for the second best in the world, behind Denmark, according to the Melbourne Mercer Global Pension Index)."). *See also* Julie Agnew, *Australia's Retirement System: Strengths, Weaknesses, and Reforms*, CENTER FOR RETIREMENT RES. AT BOS. C. BRIEFS, Apr. 2013, at 1, 1, *available at* http://crr.bc.edu/wp-content/uploads/2013/04/IB_13-5-508.pdf [perma.cc/5738-QXKC] ("Australia's retirement income system is regarded by some as among the best in the world. It has achieved high individual saving rates and broad coverage at reasonably low cost to the government.").

"superannuation fund" of the employee's choice.[28] If the employee takes no action with regard to this retirement contribution, as is the case currently with approximately 80% of Australian employees according to some estimates,[29] they are invested in a "MySuper" account, which is a default SG account appropriately diversified based on where they are in their career.[30] My belief is that this paternalistic workplace system has been incredibly successful[31] because it (1) is mandatory, (2) is universal, (3) is independent of employers, (4) is inexpensive, and (5) aligns pension fund manager interests with those of participants.[32]

This Article is one of the first in the legal literature comprehensively describing how SG accounts could revolutionize American workplace 401(k) plans. In Part I, I offer a succinct explanation of the current American 401(k) crisis. In Part II, I provide an accessible discussion of basic behavioral economic principles to explain why giving unfettered choice to employees when it comes to retirement plans will lead to retirement insecurity. Instead, I argue it is better for the pocketbooks of all Americans to provide a paternalistic retirement framework today rather than to have to pay later through taxes for social welfare programs for the elderly who find themselves increasingly destitute in retirement.

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28. *See Super from My Employer*, AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Individuals/Super/Growing-your-super/Super-from-my-employer/ [perma.cc/P76X-U5CX] ("If you're eligible for super guarantee contributions, at least every three months your employer must pay into your super account a minimum of 9.5% of your ordinary time earnings, up to the 'maximum contribution base' . . . .").

29. *See* Adam Butt, Scott Donald, Douglas Foster, Susan Thorp & Geoff Warren, *MySuper: A Stage in an Evolutionary Process* 7 (Ctr. for Int'l Fin. Regulation, Working Paper No. 048, 2014), *available at* http://ssrn.com/abstract=2537198 [perma.cc/HNQ8-AYRX] ("For Australia, Cooper (2010) suggests about 80% of members are invested in the default fund nominated under their employment contract; a percentage that is not dissimilar to that reported for other countries."); Eisenberg, *supra* note 26 ("Employees can contribute to The Super on their own, but just 20 percent choose to do so, according to Julie Agnew, author of the Center for Retirement Research at Boston College article 'Australia's Retirement System: Strengths, Weaknesses, and Reforms.'"(linking to Agnew, *supra* note 27)). This 80% default has not been empirically proven and its providence remains a mystery.

30. *See* Butt et al., *supra* note 29, at 33.

31. *See* Press Release, Bronte Tarn-Weir & Deborah Ralston, Austl. Ctr. for Fin. Studies, Australia's Retirement Income System #2 on Global Stage but Delayed SG Could Make for Shaky Ground 1 (Oct. 13, 2014), *available at* http://www.globalpensionindex.com/wp-content/uploads/141013_Media-Release_MMGPI_Australia_FINAL.pdf [perma.cc/C35A-3XBY] ("Increasing superannuation guarantee (SG) payments have been a major influencer in Australia's retirement savings system being ranked second best in the world, beating Netherlands for the first time in five years and falling just short of Denmark, according to the 2014 Melbourne Mercer Global Pension Index (MMGPI).").

32. Porter, *supra* note 5 ("[With regard to misalignment of interests,] a critical driver of unpreparedness [is the fact that] Wall Street is bleeding savers dry. . . . John C. Bogle, founder and former chief executive of Vanguard, . . . suggests a different policy prescription: shoring up Americans' retirement requires, first of all, aligning the interests of investment advisers and their clients."). *See* John C. Bogle, *The Arithmetic of "All-In" Investment Expenses*, FIN. ANALYST J., Jan.–Feb. 2014, at 13, 13 ("Compared with costly actively managed funds, over time, low-cost index funds create extra wealth of 65% for retirement plan investors.").

In Part III, I explain that such a paternalistic workplace pension exists in the form of the Australian SG, which has been remarkably successful during its existence because of five principal traits, which I discuss in detail below. Finally, in Part IV, jumping off from the uncontroversial proposition that retirement plan regulation should promote retirement security, I offer a roadmap for workplace retirement reform in the United States: it is time to eliminate the voluntary 401(k) plans system in favor of a financial and tax approach that favors the development of independent SG funds to which employers must contribute. Although employees and employers must participate in the SG system, employees will have the choice to do nothing and be invested in a low-cost, highly diversified SG account or to more actively pick among SG funds and, then, among investment options provided by the selected SG fund.

These funds would be regulated by the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS), not the DOL, and would provide sophisticated retirement savings strategies for all workers. Because of economies of scale and competitive market forces, such services would be provided at low costs.[33] Finally, because such SG fund managers would continue to have fiduciary duties to the participants of such plans to act in their sole interest, there would be a direct alignment of interests between fund managers and plan participants without employer plan sponsors gumming up the work with conflicted third-party financial advisors.

## I. THE AMERICAN 401(K) RETIREMENT CRISIS

When I talk to individuals in my community, they are generally surprised when I tell them that our 401(k) retirement system is causing a retirement crisis of epic proportions in the United States. This reaction is probably related to one of two facts: (1) many people do not give much thought to the health of their 401(k) plans and do not do some of the basic calculations to determine whether they are currently saving enough money in retirement to live comfortably, and (2) they do not realize that over half of the people in the United States have no access to such plans or choose not to participate in such plans.[34] In this Part, I set out to explain the history of workplace pensions and retirement plans in the United States and how we arrived at this current mess. I also explain why reform of our 401(k) system demands immediate attention: because retirement unpreparedness is likely to accelerate with the remaining baby boomers retiring.

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33. *See* Dau-Schmidt, *supra* note 2, at 399–400 ("With respect to minimizing investment management costs, there are undoubtedly economies of scale to be achieved by employing professional firm managers to invest the plan assets for multiple participants on a group basis.").

34. *See* Laura Shin, *The Retirement Crisis: Why 68% of Americans Aren't Saving in an Employer-Sponsored Plan*, FORBES (Apr. 9, 2015, 8:00 AM), http://www.forbes.com/sites/laurashin/2015/04/09/the-retirement-crisis-why-68-of-americans-arent-saving-in-an-employer-sponsored-plan/ [perma.cc/Y4K7-FRQ8] ("A staggering 68% of working-age people . . . did not participate in an employer-sponsored plan.").

### *A. ERISA & Retirement Plan Basics*

ERISA, with narrow exceptions, governs retirement promises made incident to employment.[35] ERISA requires such pension promises to be effectuated under a "plan" that is created by the sponsoring employer.[36] Those plans come in two varieties: the DB plan and the DC plan.

A DB plan is one in which the retirement promise is defined in terms of what the employee can expect to receive upon retirement, that is, a fixed, periodic payment based on the employee's years of service and average salary.[37] As I have stated with Professor Maher in an earlier article, "[a] DB entitlement is functionally an annuity earned through service and paid for by foregone wages."[38] A DB benefit is what most people think of when they hear the word "pension." ERISA heavily regulates DB arrangements.[39]

A DC plan, in contrast, is one in which the retirement entitlement is defined in terms of what the employee (and sometimes the employer) contributes to a retirement savings account, plus any investment return on those contributions.[40] A DC plan is a limited savings account. Currently, "[r]ecord-keeping assets [in all DC plans responding to the survey] . . . jumped 9.9% to $5.56 trillion, up from $5.06 trillion for the year ended Sept. 30, 2013. The number of participants . . . rose to 90.56 million, up 5.8% from 85.57 million."[41]

The classic and most frequent example of a DC plan is the 401(k) plan.[42] The 401(k) plan did not even exist until the late 1970s when it was developed, not as a retirement vehicle, but as a savings account in which wealthier Americans could

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35. *See* Brendan S. Maher & Peter K. Stris, *ERISA & Uncertainty*, 88 WASH. U. L. REV. 433, 445–46 (2010).

36. 29 U.S.C. § 1002(1)–(3) (2012).

37. Maher & Stris, *supra* note 35, at 446.

38. Secunda & Maher, *supra* note 6 (manuscript at 5).

39. *See* Maher & Stris, *supra* note 35, at 451–56 (discussing ERISA regulation of defined benefit plans).

40. *Id.* at 448.

41. Robert Steyer, *DC Record Keepers' Assets Jump 9.9% to New High Point at $5.56 Trillion*, PENSIONS & INVESTMENTS (Mar. 9, 2015), http://www.pionline.com/article/20150309/PRINT/303099996/dc-record-keepers-assets-jump-99-to-new-high-point-at-556-trillion [perma.cc/5EKS-CSVY] (numbers based on survey taken by Pensions & Investments of the largest DC record keepers). "Reduced competition among record keepers could make it tougher for plans to negotiate better prices and services . . . . Other drawbacks could be reduced flexibility for investment options and services as record keepers standardize their offerings, or concerns by participants that a change in record keepers represents a takeaway of services and options." *Id.* Needless to say, the DC market in the United States continues to expand at a substantial pace.

42. In 2011, there were 638,390 defined contribution plans in the United States; 513,000 of them, or 80%, were 401(k) plans. EMP. BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2011 FORM 5500 ANNUAL REPORTS 2 (2014), *available at* http://www.dol.gov/ebsa/pdf/2011pensionplanbulletin.pdf [perma.cc/66D4-RUQA].

place their money tax-free.[43] Although ERISA regulates DC arrangements to some degree, it does so far less strictly than it does DB plans.[44]

This seismic shift from DB plans to DC plans in the American workplace has been largely responsible for the lack of retirement preparation for many Americans.[45] This is because the risks of retirement (for example, longevity risk, interest rate risk, inflation risk, investment return risk, etc.) are placed squarely on the shoulders of those who are least able to negotiate such complex risk: financially illiterate American workers. Nevertheless, most employers are in favor of DC arrangements because there is usually less expense and administrative hassle associated with them. Surveyed employees tend to favor DC plans like the 401(k)[46] because they are available even to short-term employees, they are portable from job to job, they allow the employees to see their retirement monies grow, and they give employees choices in how to invest their retirement savings.[47]

In a previous piece, Professor Maher and I set forth a formula for how DC plans must operate to provide appropriate retirement savings to individuals and explained why they generally fail to provide adequate retirement income:

> For DC plans to "work" from a societal perspective, participants must habitually *save* at the appropriate rate, they must earn an appropriate *investment return* on those savings, and they must *consume* that balance, post-employment, at an appropriate rate. Put more concretely, for a DC participant to have assets sufficient to fund retirement income equal to some W% of this career wage, that worker must (1) annually save X% of this compensation, (2) earn Y% in investment appreciation on those

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43. *See* Bradley P. Rothman, *401(k) Plans in the Wake of the Enron Debacle*, 54 FLA. L. REV. 921, 930–31 (2002) (explaining how Congress intended for 401(k) plans to be used for "supplemental retirement savings," but has since been relied on by employees "as a primary source of retirement income.").

44. *See* Maher & Stris, *supra* note 35, at 456 (maintaining that ERISA regulates DC plans and subjects them to some of the rules that govern DB plans, but that DC "plans were a relatively minor part of the pension landscape" when ERISA was enacted in 1974).

45. *See* Porter, *supra* note 5 ("As companies gradually did away with the defined-benefit pensions that once provided working families with their main supplement to Social Security, workers found they had to shoulder the responsibility and risk of saving and investing for retirement largely on their own."). Prior to this shift, the DB plan was the primary means by which employers provided pension benefits to employees and employers took on the pension risks. Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 74 (2002).

46. 26 U.S.C. § 401(k) (2012). Section 403(b) plans exist for public educational institutions and other tax-exempt institutions. *Id.* § 403(b). Section 457 plans exist for local and state government employees and tax-exempt organizations. *Id.* § 457. Section 403(b) and § 457 plans are not necessarily ERISA plans because governmental plans are exempt under ERISA section 4(b), and are not further discussed in this paper. *See* 29 U.S.C. § 1003(b) (2012).

47. Today's workers tend to favor the 401(k) plan because they "place[] less emphasis on retirement plans that reward long-term service and, instead, favor[] plans that provide more immediate, tangible retirement benefits, [and] those that offer benefit front-loading, accessibility, and portability." Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMP. L. REV. 809, 821 (2007) (citation omitted).

> savings, and (3) draw down those savings at Z% a year in retirement. Many workers have proved unable to do those things.[48]

In other words, (1) DC participants do not save enough of their current income, (2) they do not optimally invest their savings, and (3) they spend their DC savings too quickly.[49] For many workers, then, the stark reality is that 401(k)-type plans have not been a good bargain for retirement security.[50]

### *B. Voluntary Nature and Lack of Access to 401(k) Plans*

Scholars disagree over why DC plans have not led to the promised retirement benefits.[51] One of the easiest culprits to identify is the voluntary nature of ERISA plans. Because employee benefit plans can be expensive to establish, administer, and manage, not every employer believes offering such plans make sense after undertaking a cost-benefit analysis. In the 401(k)-plan context, this means that almost half of U.S. employees do not even have access to such plans.[52] Even if they desired to participate, because the employer does not offer one, they are left out in the retirement cold.

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48. Secunda & Maher, *supra* note 6 (manuscript at 21–22) (citing Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 329–31 (2007), for the proposition that many Americans are financially illiterate and have psychological biases that may adversely affect the numerous and complex decisions they have to make in the context of defined contribution plans).

49. For example, it is estimated that participants in DC plans, such as 401(k)s, who expect to maintain their standard of living will need to save approximately 17% of the income they earn from age twenty-five to sixty-six. *See* Ghilarducci, *supra* note 5, at 454. Yet participants in 401(k) plans are only contributing approximately 7.5 to 8% of their income. Amy B. Monahan, *Employers as Risks*, 89 CHI.-KENT L. REV. 751, 757 (2014).

50. *See* Hazel Bradford, *Study: Retirement Crisis Real and Getting Worse,* PENSIONS & INVESTMENTS (Jan. 26, 2015, 2:34 PM), http://www.pionline.com/article/20150126/ONLINE/150129904/study-retirement-crisis-real-and-getting-worse [perma.cc/RN3J-PZH8] ("Roughly 31% of Americans have no retirement savings and no access to defined benefit plans, according to Federal Reserve data, including 19% of people ages 55 to 64.").

51. *Compare id.* (discussing how many people do not have access to private-sector retirement plans, and those plans that people do have access to are not that beneficial), *with* McClendon, *supra* note 47, at 828 (discussing how defined contribution plans do not provide for a set benefit at retirement and do not guarantee plan participants "significant benefit accruals"), *and* Stabile, *supra* note 45, at 88–89 (discussing how many plan participants lack the financial knowledge and literacy needed to make important investment decisions that are required by defined contribution plans).

52. Joelle Saad-Lessler, Teresa Ghilarducci & Kate Bahn, SCHWARTZ CTR. FOR ECON. POLICY ANALYSIS, ARE U.S. WORKERS READY FOR RETIREMENT? TRENDS IN PLAN SPONSORSHIP, PARTICIPATION AND PREPAREDNESS 1 (2015), *available at* http://www.economicpolicyresearch.org/images/docs/research/retirement_security/Are_US_Workers_Ready_for_Retirement.pdf [perma.cc/CHC4-PV7N] ("[A]lmost half of Americans who were working in 2011 were not offered a retirement account at work."). As far as what percentage of the U.S. population works, Saad-Lessler et al. suggests "71 percent of the population was working in 2011 and 53 percent of those workers were offerd [sic] a retirement plan at work." *Id.* at 8.

There is another cohort of workers who have access to 401(k) plans through their employers but decide, for whatever reason, not to participate.[53] This phenomenon appears more common with small- and medium-size employers that not only do not automatically enroll their employees in 401(k) plans, but also tend not to offer the plans.[54]

### *C. Employer-Sponsored 401(k) Plans Not Properly Utilized by Employees with Access*

According to one recent, prominent study, "more than two thirds (68 percent) of the working-age population did not participate in an employer-sponsored retirement plan because they were not sponsored, did not participate or were not working."[55] Of the remaining 32% of employees who have access to and participate in a 401(k) plan to some degree, the biggest problem is either that they do not contribute enough toward retirement or they do not understand how to invest in a financially savvy way by diversifying their retirement account holdings in low-cost funds.

With regard to the first problem, employees do not know how much of their salary they should defer into their 401(k) retirement account.[56] Many employees will pick a random number, an arbitrary formula, or the default number selected by the employer as a starting place.[57] For instance, many employees will defer 3% of their salary into a 401(k) plan and stay at that level throughout their working career.[58] This amount of money, even with an equal employer match up to 6% of salary,[59] is not even close to the amount that employees need to save to have sufficient retirement income. Indeed, many retirement plan experts suggest that average employees need to save as much as 17% of their salary per pay period.[60]

The problem is also that many employees do not adjust their retirement plan contribution once they have more money to save in the future.[61] Part of the problem is inertia, in the sense that once they enroll in their 401(k) plan, they do not consider

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53. *See id.* ("Of the 53 percent of workers whose employers offered a retirement plan in 2011, 85 percent participated in the plan.").

54. *See* April Yanyuan Wu & Matthew S. Rutledge, *Lower-Income Individuals Without Pensions: Who Misses Out and Why?* 15 (Ctr. for Retirement Research at Bos. C., Working Paper No. 2014-2, 2014), *available at* http://crr.bc.edu/wp-content/uploads/2014/03/wp_2014-2.pdf [perma.cc/2PQQ-AAMX] ("[W]orking at a small or medium-sized firm and having low risk aversion are associated with low offer rates for both [DB and DC] plans.").

55. Saad-Lessler et al., *supra* note 52, at 8 ("[O]nly 32 percent (.71* .53* .85) of U.S. workers participated in an employer-sponsored retirement plan in 2011.").

56. *See* Venhorst, *supra* note 13, at 118 (discussing the possibility that "neophyte investors may become unduly confident in their investment skills in this [401(k)] environment, and invest in a portfolio that is overly-aggressive.").

57. *See* COLLEEN E. MEDILL, INTRODUCTION TO EMPLOYMENT BENEFITS LAW: POLICY AND PRACTICE 489–90 (3d ed. 2011).

58. *See id.* at 489.

59. Venhorst, *supra* note 13, at 117 ("A common employer 'match' is 50% of the employee's contribution up to 6% of the employee's salary.").

60. Ghilarducci, *supra* note 5, at 454.

61. *See* MEDILL, *supra* note 57, at 489.

it again.[62] The other problem is our culture's obsession with immediate gratification. Why save for retirement today when you can buy a boat, go on a nice vacation, or buy some expensive jewelry for a loved one?[63] As will be discussed below, a number of solutions to some of these problems exist already.

### *D. Misalignment Between Fiduciaries and Participants Perpetuates Financial Illiteracy and Makes 401(k) Plans Expensive*

DC plans have largely failed because they transferred to unsophisticated and unprepared individuals the responsibility for making saving, investment, and longevity decisions.[64] An oft-cited study found that only 34% of Americans are able to answer three simple questions about interest rates and diversification.[65] Even when financially literate, an individual may still have a difficult time making wise investment choices due to the high information costs that are often associated with retirement financial planning.[66] To help cope with these high information costs, individuals often end up using "mental shortcuts" or "heuristics" to help make the decision-making process easier.[67] However, this results in poor decisions, such as heavily investing in company stock (for example, Enron),[68] overly investing in more conservative investments, or proportionately allocating investments among all investment choices.[69] These mental shortcuts are detrimental to an individual's retirement financial planning and fail to achieve the goals of "modern portfolio theory, which seeks to maximize investment earnings over time while minimizing the risk of disproportionate investment losses."[70]

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62. *See* Venhorst, *supra* note 13, at 120 ("[I]nvestor inertia and other unfortunate human foibles may lead to excessively low contribution rates and may ultimately undermine Americans' retirement security.").

63. *See* David Pratt, *Retirement in a Defined Contribution Era: Making the Money Last*, 41 J. MARSHALL L. REV. 1091, 1110 (2008) ("The Employee Benefit Research Institute . . . estimated that pre-retirement withdrawals and loans reduced the median replacement rate for the typical 401(k) plan participant in the lowest quartile from 70% to 50%." (citing Sara Holden & Jack VanDerhei, *Can 401(k) Accumulations Generate Significant Income for Future Retirees?*, EMP. BENEFIT RES. INST. ISSUE BRIEF, Nov. 2002, at 1, 16, *available at* http://www.ebri.org/pdf/briefspdf/1102ib.pdf [perma.cc/BJT4-FMR3])).

64. *See* MEDILL, *supra* note 57, at 491 ("Relying solely on private sector employers voluntarily to provide investment education to the working population appears to be producing an information gap that primarily affects young and low-income workers . . . .").

65. Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement Wellbeing* 7, 26 (Nat'l Bureau of Econ. Research, Working Paper No. 17078, 2011), *available at* http://www.nber.org/papers/w17078.pdf [perma.cc/3HQB-84XF].

66. MEDILL, *supra* note 57, at 489. One of the problems associated with high information costs is "choice overload," which occurs when individuals face an excessive number of choices when making plan investment decisions. *Id.*

67. *Id.*

68. *See* Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 480 (2001); *see also* MEDILL, *supra* note 57, at 481.

69. *See* MEDILL, *supra* note 57, at 490.

70. *Id*.

As discussed above, workplace pensions have shifted dramatically from DB-dominated to DC-dominated (and then mostly 401(k) DC plans).[71] Private sector worker participation in DB plans dropped from 62% in 1975 to 7% in 2009.[72] Conversely, worker participation in DC plans rose from 16% in 1975 to 67% in 2009.[73] Not coincidentally, during that same time period, retirement security has eroded. For example, the percentage of workers who were "at risk of having inadequate funds to maintain their lifestyle through retirement" increased from 31% in 1983 to 53% in 2010.[74] Indeed, a wealth of data shows how DC plans have failed to deliver retirement security.[75]

But not all the responsibility with 401(k) plans is left to participating employees. Under ERISA section 404(c), although plan administrators do not have fiduciary responsibility for the investment decisions of participants, they do retain the fiduciary duty to act in the best interests of the plan by selecting a prudent group of investment options.[76] Not only do 401(k) fiduciaries have the duty to select prudent investment options, but they also have the ongoing duty to monitor the appropriateness of these options, given the needs of participants.[77] All of this means that the plan sponsor may retain some residual responsibility for providing a sensible menu of investment options for monies contained within the plan.[78]

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71. *See supra* Part I.A.

72. EMP. BENEFITS RESEARCH INST., EBRI DATABOOK ON EMPLOYEE BENEFITS 4 (2011), *available at* http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2001.pdf [perma.cc/TX2V-64Q6]. Other statistics show that in 1975, DB plans accounted for one-third of all pension plans in the nation. Samuel Estreicher & Laurence Gold, *The Shift From Defined Benefit to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (2007). By 1998, DB plans accounted for only one-twelfth of all pension plans. *Id.* at 331–32. In 2011, that number dropped further to about one-sixteenth. MEDILL, *supra* note 57, at 131.

73. EMP. BENEFITS RESEARCH INST., *supra* note 72, at 4.

74. Benartzi & Thaler, *supra* note 5, at 1152.

75. According to a 2014 Employee Benefit Research Institute (EBRI) retirement confidence survey, about a quarter of Americans are not at all confident in their retirement savings, and an additional 37% are only somewhat confident. JACK VANDERHEI & NEVIN ADAMS, EMP. BENEFIT RESEARCH INST., EBRI'S 2014 RETIREMENT CONFIDENCE SURVEY: CONFIDENCE REBOUNDS—FOR THOSE WITH RETIREMENT PLANS 1 (2014), *available at* http://www.ebri.org/pdf/surveys/rcs/2014/PR1066.RCS.18Mar14.pdf [perma.cc/PZL2-2E5R]. Worker retirement saving remains low, according to the survey, and not many Americans are taking even basic steps toward preparing for retirement. *Id.* While many American workers realize that they need to bolster their retirement savings, many have not even tried to estimate the savings that they will need in order to live comfortably during retirement, and only about one in five workers has obtained financial advice to assist in retirement planning. *Id.* at 2. However, of those workers who have sought out and obtained financial advice, only 27% of those workers admitted to following the advice of the financial planner, while the rest have only followed some or most of the advice. *Id.*

76. 29 U.S.C. § 1104(c) (2012); 29 C.F.R. § 2550.404c-1 (2014); Final Regulations Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. 46906, 46924 n.27 (Oct. 13, 1992).

77. *See* Tibble v. Edison Int'l, No. 13–550, slip op. at 6–7 (U.S. May 18, 2015) ("A plaintiff may allege that a fiduciary breached the duty of prudence by failing to properly monitor investments and remove imprudent ones.").

78. The degree of residual fiduciary responsibility is unsettled. The Department of Labor has taken the position that fiduciaries remain liable for the selection of investment options in

So how do employer plan sponsors determine which investments are prudent and in the best interest of their employees' 401(k) plan? First, most employers, because they lack the core competencies to engage in sophisticated investment analysis, delegate their fiduciary duties to investment firms or other third-party administrators.[79] It has long been recognized that many ERISA fiduciaries are conflicted, in practice, because they are employed, controlled, or beholden to the plan sponsor.[80] Empirical evidence establishes that these companies, which sometimes provide compensated investment advisors for employees, do not always act in the best interests of plan participants.[81] One way that conflicted investment advisors harm the long-term prospects of a participant's 401(k) retirement plan is by having them invest in high-fee mutual funds. Eduard Porter, of the *New York Times*, recently gave an apt example of this phenomenon:

> [T]here is the expense ratio—about 1.12 percent of assets for the average large capitalization blend fund. Then there are transaction costs and distribution costs. Active funds also pay a penalty for keeping a share of

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a participant-directed DC plan. *See* 29 C.F.R. § 2550.404c-1; Final Regulations Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46924 n.27.

79. Indeed, there are many different ways to delegate fiduciary responsibilities, including under ERISA definitions in sections 3(16), 3(21)(A), and 3(37). *See* 29 U.S.C. § 1002(16), (21)(A), (37) (2012). Under section 3(16), the "employer is, in some circumstances, the default plan administrator." Varity Corp. v. Howe, 516 U.S. 489, 498 (1996). Section 3(21)(A) "limit[s] the scope of fiduciary activity to discretionary acts of plan 'management' and 'administration.'" *Id.* at 502; *see* ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, OUTSOURCING EMPLOYEE BENEFIT PLAN SERVICES 12–13 (2014), *available at* http://www.dol.gov/ebsa/pdf/2014ACreport3.pdf [perma.cc/8DFG-F4U4]; *see also* Sendhil Mullainathan, Markus Noeth & Antoinette Schoar, *The Market for Financial Advice: An Audit Survey* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 17929, 2012), *available at* http://www.nber.org/papers/w17929.pdf [perma.cc/LAN4-92XG] ("In a survey of retail investors, Hung et. al. (2008) found that 73% of all individuals surveyed consult a financial adviser before purchasing shares or mutual funds.").

80. *See* Metro. Life Ins. Co. v. Glenn, 554 U.S. 105, 120 (2008) (Roberts, C.J., concurring) (discussing conflict of interest as a common feature of ERISA plans); Beverly Cohen, *Divided Loyalties: How the* Metlife v. Glenn *Standard Discounts ERISA Fiduciaries' Conflicts of Interest*, 2009 UTAH L. REV. 955, 974 ("[V]irtually all ERISA plan benefit claims are decided by fiduciaries that are conflicted to some extent (including employers, third-party administrators, and insurance companies providing the coverage) . . . .").

81. *See* Mullainathan et al., *supra* note 79 ("We document that advisers fail to de-bias their clients and often reinforce biases that are in their interests. Advisers encourage returns-chasing behavior and push for actively managed funds that have higher fees, even if the client starts with a well-diversified, low-fee portfolio.") (quote appears within the abstract on an unnumbered page). In other words, investment advisers appear mostly to recommend investment strategies that fit their own financial interests, while advising against low-cost options like low-fee index funds. *See* Porter, *supra* note 5; *accord* Susan E. K. Christoffersen, Richard Evans & David K. Musto, *What Do Consumers' Funds Flow Maximize? Evidence from Their Brokers' Incentives*, 68 J. FIN. 201, 204 (2013) ("To summarize our main results, brokers' incentives play a significant role in both flows and performance. New investment increases with the load paid to the broker.").

> their assets in low-yielding cash. Altogether, costs add up to 2.27 percent per year, Mr. Bogle [of Vanguard] estimates.
>
> By contrast, a passive index fund, like Vanguard's Total Stock Market Index Fund, costs merely 0.06 percent a year in all.[82]

Over a period of forty years, this disparity in fees paid has an enormous impact on the final amount the typical participant has saved for retirement.[83] So not only are conflicted investment advisors selected by the employer plan sponsor misleading 401(k) participants regarding their investments, but such investments turn out to be relatively expensive, given the fees and costs associated with such funds.

The problems do not end there. Although one solution to financial illiteracy and the resulting expense associated with using investment advisors or brokers is to provide investment education to plan participants, this rarely happens. The lack of investment education is because employers and their delegates do not want to assume fiduciary status unnecessarily. Whereas providing investment advice for compensation amounts to a fiduciary undertaking, providing investment education does not.[84] However, historically, the line between investment advice and investment education has been hard for courts and regulators to draw consistently.[85] Thus, plan participants receive a less than optimal amount of unbiased investment education.[86]

Another issue that arises under most 401(k) plans is that many plans permit both authorized and unauthorized "pre-retirement leakage."[87] Preretirement leakage occurs when an individual takes money out of the plan for qualified or unqualified reasons before reaching the minimum retirement age of fifty-nine and a half years.[88] In the unauthorized context, plan participants can take a distribution from their retirement account if they pay a 10% excise tax to the IRS and as long as their

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82. Porter, *supra* note 5.

83. *Cf.* Lusardi & Mitchell, *supra* note 65 (hypothesizing that a lack of financial literacy is responsible for retirement saving shortfalls). High fees also reduce retirement savings.

84. *See supra* note 21 and accompanying text.

85. *See* Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice*, 23 BERKELEY J. EMP. & LAB. L. 1, 19 (2002) ("On the one hand, in order to avoid the Scylla, an employee benefit plan must provide a reasonable amount of investment information to plan investors. This will qualify the plan as a 404(c) plan and protect the employer from fiduciary liability. On the other hand, steering far enough away safely to avoid the Scylla risks a disastrous encounter with the Charybdis. If the plan provides too much information on investments, the sponsoring employee will be deemed an investment adviser and will have fiduciary liability for the investment advice.").

86. *See id.* at 20 ("[U]nder the current legal regime, rarely will an employer intentionally offer investment advice to plan investors.").

87. *See* Pratt, *supra* note 63, at 1108–09 ("Many [retirement lump sum] distributions are spent, wholly or partly, rather than being kept in a retirement plan: the younger the recipient, and the smaller the amount distributed, the more likely it is that at least part of the distribution will be spent rather than saved for retirement.").

88. *See id.* at 1110 ("[Internal Revenue] Code section 72(t) imposes a penalty tax on most distributions made before age fifty-nine and a half. The tax is equal to 10% of the amount includible in income, so does not apply to the portion of any distribution that is not currently taxable, for instance because it is transferred to another plan.").

employer withholds 20% of the amount for tax withholding.[89] This is very expensive money, as a participant prior to age fifty-nine and a half only gets seventy cents on the dollar.[90]

In the authorized context, like under a qualified plan loan provision, there is no tax penalty,[91] but employees suffer anyway by either permanently or temporarily diminishing the amount of money that can benefit from investment returns. The expense of premature withdrawals is even worse when one considers the time value of money. Money withdrawn may be, of course, invested, but that money is no longer able to grow tax-free.

In short, 401(k) plans, even where employees have access and participate, lead to a misalignment between plan participants' interests and their investment advisors' or brokers' interest.[92] Moreover, the lack of investment education and prevalence of preretirement leakage make it difficult for individuals to invest their 401(k) money wisely or to resist the temptation to withdraw it before retirement. To respond to these emerging issues, the U.S. Department of Labor's Employee Benefit Security Administration (EBSA) has recently put forward an expanded definition of "fiduciary" in the retirement advice context under ERISA to seek to protect participants from these types of self-interested advisor behaviors.[93] Similarly, in the Dodd-Frank Act, Congress directed the SEC to require brokers to act in a fiduciary manner (that is, in their clients' best interest).[94] In all, the vulnerability of 401(k) plan participants is an ongoing and troubling issue in the American retirement planning context that must be comprehensively addressed as soon as possible to avoid an even larger retirement crisis.

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89. *Id.* Pratt maintains that these penalties on early withdrawals are "clearly not sufficient to deter premature withdrawals, and spending, of retirement savings." *Id.* He prefers, and I agree, that "[d]istributions before retirement age [should] be strictly limited, subject perhaps to narrow exceptions for cases of financial hardship." *Id.* For the requirement that an employer withholds twenty percent of the amount for tax purposes, see Treas. Reg. § 1.402(c)-2, Q&A (1)(b)(3) (2014).

90. *See* Pratt, *supra* note 63 at 1110 (10% excise tax); Treas. Reg. § 1.402(c)-2, Q&A (1)(b)(3) (2014) (20% withheld by the employer); *see also* I.R.C. § 3405(c)(1) (2012) (setting out 20% employer withholding requirement for early distributions from retirement plans).

91. Plan loans from DC plans must conform to different requirements under the Tax Code and ERISA. *See* MEDILL, *supra* note 57, at 204. A plan loan will only be subject to income taxation if it does not meet the requirements of Code Section 72(p)(1). *Id.* at 204–05.

92. *See* Hazel Bradford, *Labor Secretary Defends Conflict-of-Interest Proposal*, PENSIONS & INVESTMENTS (June 17, 2015, 2:18 PM), http://www.pionline.com/article/20150617/ONLINE/150619867/labor-secretary-defends-conflict-of-interest-proposal [perma.cc/65T9-WQN6] ("The [conflict of interest] rule is needed, [Labor Sectary Perez] said, because "the [retirement investment advice] system is misaligned."); *see also* Porter, *supra* note 5 ("If there is an industry rived with conflicts of interest, it is the financial conglomerates that advise Americans on investing these savings.").

93. *See supra* note 22 and accompanying text.

94. In 2010, Rule 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the SEC to establish a fiduciary duty for brokers and dealers, a standard of conduct that includes acting "in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." 15 U.S.C. § 80b-11(g)(1) (2012).

## II. BEHAVIORAL ECONOMICS AND 401(K) PLANS

Now that we understand from whence the American retirement crisis derives, it is helpful to consider a theoretical backdrop to more closely understand the behavior of the various actors in this calamity. Behavioral economics provides not only a coherent explanation of why the current American 401(k) system does not work, but it also importantly points to the type of DC plan system that would work going forward.

No serious doubt exists that human beings—even highly-educated human beings—are naturally inclined to, and systematically do, behave suboptimally.[95] I use the term "suboptimally" in the same way Professor Maher and I recently did in another paper: "given some plausible assumptions about what most people prefer, individuals make choices that fail to maximize those preferences."[96] Behavioral economics, including some of my own work on cultural cognition and cognitive illiberalism in the labor and employment law and ERISA law context,[97] has identified and categorized the many ways in which individuals' choices are afflicted with "cognitive biases" that result in poor decision making.[98]

This Part sets out the fallacy of absolute choice in the retirement planning context, the importance of behavioral economic insights to understand why absolute choice does not work in this setting, and the use of behavioral economic conceptual tools, like choice architecture, to more properly structure future retirement policy in the United States.

### *A. The Fallacy of Absolute Choice*

People generally overestimate their ability to invest wisely and overly discount their future needs.[99] These individuals are prone to spend too much today and save

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95. "It has been estimated that, even with Social Security, most people need to save about 9–11% of income in order to achieve post-retirement income equal to 66–75% of their pre-retirement income." Dau-Schmidt, *supra* note 2, at 395. Yet, "[i]n the United States, the average contribution in a defined contribution pension plan is only around 5%." *Id.*

96. Secunda & Maher, *supra* note 6 (manuscript at 23).

97. *See* Paul M. Secunda, *Cultural Cognition Insights into Judicial Decisionmaking in Employee Benefits Cases*, 3 AM. U. LAB. & EMP. L.F. 1 (2013); Paul M. Secunda, *Cognitive Illiberalism and Institutional Debiasing Strategies*, 49 SAN DIEGO L. REV. 373 (2012); Paul M. Secunda, *Cultural Cognition at Work*, 38 FLA. ST. U. L. REV. 107 (2010).

98. *See generally* DANIEL KAHNEMAN, THINKING, FAST AND SLOW (2011) (discussing and cataloguing cognitive biases); Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1034 (2012) (discussing how behavioral economists have documented cognitive biases that "demonstrate systematically irrational choice behavior by individuals and firms").

99. Mullainathan et al., *supra* note 79, at 1 ("A large and still growing body of research demonstrates that individual investors often make poor financial decisions if left to their own devices. Drawing on evidence from psychology and behavioral economics, these studies suggest that investor beliefs and decision processes are prone to biases that often result in financial decisions at odds with basic portfolio theory."); *see also* Kelli A. Alces & Brian D. Galle, *The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation*, 38 J. CORP. L. 53, 75 (2012) ("There is extensive evidence . . .

too little for retirement.[100] Additionally, the normal weaknesses surrounding the ability to delay gratification are exacerbated when older individuals may have diminished capacities and may no longer be able to determine on their own what is in their best interest.[101] There is also a tendency to procrastinate by putting off saving for retirement or making difficult choices regarding retirement planning.[102] Yet, our current 401(k) system places most of the investment risk on employees, who spend too much, have diminished capacities, and/or procrastinate when it comes to retirement saving.

Allowing individuals to make their own decisions in the context of their 401(k) plans appears to be based on the preference for independence over paternalism.[103] This "liberty argument" rests on the notion that individuals are capable of determining what is in their best interests and making rational decisions to meet those ends.[104] However, as just stated, human beings are naturally inclined to behave suboptimally.[105]

These issues are especially profound in the 401(k) context, where individuals are required to make many more plan decisions compared to their DB plan counterparts.[106] As discussed previously, in a 401(k) plan, individuals need to determine whether to participate in the plan, how much to contribute, how to invest plan contributions, and whether, as a terminated vested employee,[107] to take a cash distribution or rollover plan savings to another employee benefit plan or IRA in the

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that humans tend to excessively weigh costs and benefits in the present and very near future at the expense of those that are more distant.").

100. *See* Alces & Galle, *supra* note 99, at 75–76 ("[T]he time and mental effort of choosing a retirement plan looms much larger than the budget crunch one will face at retirement from choosing the wrong plan.").

101. *See* ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, PRIVATE SECTOR PENSION DE-RISKING AND PARTICIPANT PROTECTIONS 21 (2013), *available at* http://www.dol.gov/ebsa/pdf/2013ACreport2.pdf [perma.cc/UQ2J-L8MP] (reporting that some observers have said that allowing seniors to withdraw lump sum distributions amounts to "corporate elder abuse"). Professor Norman Stein of Drexel Law School "testified that, everyone besides those who are terminally ill, or almost everyone else who selects a lump sum, will be forfeiting a substantial portion of their retirement savings." *Id.*

102. Stabile, *supra* note 45, at 80.

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

104. *Id.*

105. *See* Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism*," 151 U. PA. L. REV. 1211, 1217 (2003).

106. *See* Stabile, *supra* note 45, at 78.

107. *See Glossary*, PENSION BENEFIT GUARANTY CORP., http://www.pbgc.gov/about/pg /header/glossary.html#27 [perma.cc/E4MZ-GHVE] ("[A terminated vested employee is] [g]enerally, a former employee who worked long enough to earn 'Vested Benefits' in a pension plan, but who left the company sponsoring the plan without receiving a retirement benefit immediately. Such a participant can receive benefit payments from the plan once he or she reaches the plan's 'Normal Retirement Age' or, if the plan allows, the plan's 'Early Retirement Age.'").

event employment ends before retirement age (which, of course, happens frequently in our mobile society).[108] Each of the above mentioned cognitive biases, as well as a lack of financial literacy, affects individuals' decision making with regard to each of these vital choices, especially for older individuals and women.[109]

Consequently, absolute choice and discretion for employees with regard to participation, investment decisions, and contribution amounts is not the answer.[110] The lack of retirement readiness in 2015 America illustrates the extent to which poor decision making by individuals, and those whom they rely upon, leads to not enough people saving at all through workplace retirement plans. So what can behavioral economics tell us about how better to structure the American workplace retirement model?

### *B. Behavioral Economic Insights into Retirement Savings*

Until very recently, the default option in most employer-sponsored retirement plans was nonparticipation, where employees had to "opt in" to the retirement savings plan.[111] Under this system, once the employer makes the decision to adopt a voluntary 401(k) retirement plan, the burden shifts to the employee to decide whether to participate and contribute a sufficient portion of his or her salary to last through that person's retirement.[112] The employer may give additional incentive by agreeing to match such employee contributions at some level.[113]

As the statistics referred to above indicate, not all employees have access to such retirement savings plans,[114] and the ones that do sometimes do not participate in such plans.[115] While many factors lead to a decision not to participate in a workplace retirement plan, several cognitive biases also play a role in the decision. Inertia, or a preference for the status quo, is one way bias operates to prevent people from participating in workplace retirement plans.[116] Procrastination and the complexity of decisions involved with workplace retirement savings plans may also prevent some people from opting in to such plans.[117] Of course, financial illiteracy might cause

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108. Stabile, *supra* note 45, at 75.

109. *See* Annamaria Lusardi, George Washington Univ. Sch. of Bus., Testimony for the ERISA Advisory Council To Address What Useful Information Do Participants Need To Make an Informed Decision in a Risk Transfer Transaction, and How Would You Suggest Getting This Information to Participants? 2 (May 20, 2015), *available at* http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk2.pdf [perma.cc/8XRA-EY2F].

110. *See* Jeffrey R. Brown, Arie Kapteyn, Erzo F.P. Luttmer & Olivia S. Mitchell, *Cognitive Constraints on Valuing Annuities* 25–26 (Nat'l Bureau of Econ. Research, Working Paper No. 19168, 2015), *available at* http://www.nber.org/papers/w19168.pdf [perma.cc/ASF8-BCLG].

111. Camerer et al., *supra* note 105, at 1227.

112. Stabile, *supra* note 45, at 78. When an individual chooses to contribute a portion of his or her salary to the plan, rather than being paid in current wages, this is a form of "deferred compensation." *Id.*

113. *See* Venhorst, *supra* note 13, at 117.

114. *See supra* Part I.B.

115. *See supra* Part I.B.

116. Stabile, *supra* note 45, at 80.

117. *Id.*

well-meaning employees to invest the money inappropriately. For instance, a frequent example of this tendency is described in Benartzi and Thaler's work, which "argued that employees follow a naïve diversification strategy of mechanically spreading their money equally across the funds they are offered (what they call 1/n rule), generating quite perverse outcomes since the equity mix depends on the investment menu."[118]

Because of these tendencies to invest money in an inappropriate fashion, the DOL's EBSA set forth regulatory safe-harbor regulations under ERISA Section 404(c) to both protect plan fiduciaries against breach of fiduciary claims based on how they set up their 401(k) plans and to help employees be more likely able to educate themselves and invest wisely.[119] The two requirements to meet the Section 404(c) safe harbor are that a fund prospectus for each mutual fund offered by the employer be provided to employees and that the employer have at least three diversified mutual funds, including a stock fund, bond fund, and money market fund.[120] In other words, these regulations seek to idiot-proof the 401(k) system against employee lack of sophistication in these matters.

Not surprisingly, these attempts at incentivizing good financial behavior on the part of employees have been less than successful. Anyone who has read a mutual fund prospectus knows that they are not the easiest reading for the uninitiated.[121] Moreover, even though the three minimum mutual funds that safe-harbor plans require *could* provide a decent, diversified portfolio for those who solely invest in them, they do not deal with the issue of why individuals do not participate in the first place, nor do they help employees who have more than three choices of funds in which to decide to invest. Indeed, the average 401(k) plan has no less than twenty-five choices,[122] and one prominent court has held that you can just offer the entire range of mutual funds on the market and not be liable for a fiduciary breach for not giving any guidance to employees.[123]

Congress sought to deal with these types of problems in the Pension Protection Act of 2006 (PPA).[124] Among the many provisions of that 800-page plus law was

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118. Mullainathan et al., *supra* note 79, at 1 n.1 (citing Schlomo Bernatzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, 91 AM. ECON. REV. 79 (2001)).

119. 29 C.F.R. § 2550.404c-1 (2014).

120. *Id.*

121. *See Why Is the Prospectus Hard To Understand*, A TO Z INVESTMENTS, http://www.atozinvestments.com/read-fund-prospectus.html [perma.cc/2NFE-G7PE] ("When you read the prospectus, you will see lots of gibberish.").

122. Kelley Holland, *How Many 401(k) Investment Choices Are Too Many?*, CNBC (Dec. 11, 2014, 12:02 PM), http://www.cnbc.com/id/102257669 [perma.cc/LRX4-59R5] ("The average 401(k) plan now offers 25 investment choices, according to newly released research by the Investment Company Institute and BrightScope. Some financial experts think that is a few too many.").

123. *See* Hecker v. Deere & Co., 556 F.3d 575, 586 (7th Cir. 2009) ("[T]he Plans here directly offered 26 investment options, including 23 retail mutual funds, and offered through BrokerageLink 2,500 non-Fidelity funds. We see nothing in the statute that requires plan fiduciaries to include any particular mix of investment vehicles in their plan.").

124. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in scattered sections of 29 U.S.C.).

one dealing with "automatic enrollment."[125] Under an automatic enrollment plan feature, now permitted by the PPA, employees can be made to opt out of a 401(k) plan, instead of having to opt in.[126] Overcoming the force of inertia, these opt out plans immediately led to much higher participation rates where plans were offered. Whereas 50% of employees had participated in the opt in method, now 85% or more participate under the opt out method.[127] These results can only be explained by realizing how most employees deal with workplace pensions; which is, they don't deal with them at all. Even if they are automatically enrolled, employees tend to stick with plan default options and contribution levels.[128] If they are automatically in, they remain in; if they are automatically out, they remain out. Summary plan descriptions (SPDs) meant to inform employees in laymen language about their workplace retirement benefits apparently go largely unread.[129] Ask yourself, when was the last time you read one of these SPDs or related documents?

Automatic enrollment helps deal with the participation issue, but the PPA also set up so-called qualified default investment alternatives (QDIAs).[130] Using a QDIA, the employer will put a fixed level (say 3%) of the employee's salary into a group of mutual fund investments that are appropriately diversified based on risk and return characteristics.[131] This opt out approach has recently been adopted under the federal

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125. *See* Kathryn L. Moore, *An Overview of the U.S. Retirement Income Security System and the Principles and Values It Reflects*, 33 COMP. LAB. L. & POL'Y J. 5, 21 (2011).

126. Empirical evidence has shown that automatic enrollment helps to increase the rate of participation in employer-sponsored 401(k) plans. *See* WORLDATWORK & AM. BENEFITS INST., TRENDS IN 401(K) PLANS AND RETIREMENT REWARDS 5 (2013), *available at* http://www.americanbenefitscouncil.org/documents2013/abc-waw-surveytrendsin401kplans-2013.pdf [perma.cc/9WPJ-W38J] (discussing a study that demonstrated the disparity in participation between plans with automatic enrollment features and those without). 37% of companies in the study that had automatic enrollment features in their retirement plans reported participation rates in the 80% to 89% range, compared to only 21% of companies without automatic enrollment features. *Id.* A similar model demonstrated that the use of automatic enrollment features in 401(k) plans increased the participation of eligible workers from 66% to 92%. Dana M. Muir, *Choice Architecture and the Locus of Fiduciary Obligation in Defined Contribution Plans*, 99 IOWA L. REV. 1, 13 (2013).

127. *See* MEDILL, *supra* note 57, at 179 (describing automatic enrollment plans).

128. *See* THALER & SUNSTEIN, *supra* note 25, at 85–89. *But see* Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155 (2013) (finding that automatic enrollment defaults put in place by the law do not always stick, and the people who opt out may be those who would benefit the most from the default).

129. SPDs are required under ERISA Section 102. 29 U.S.C. § 1022 (2012); *see also* 29 C.F.R. § 2520.102-3 (2014) (describing contents of SPD). Nonetheless, anecdotal evidence suggest that few workers actually take the time to read the SPD, let alone actually understand them. *Your Summary Plan Description (SPD) is a Treasure Trove of Information*, 401KHELPCENTER.COM, http://www.401khelpcenter.com/401k_education/401k_spd.html#.VlCysHarTIV [perma.cc/9MTM-H5QZ] ("'For most employees, the summary plan description looks pretty unappetizing. The employers say 'look at this' and the employees throw it away,' said David Wray, president of the Plan Sponsor Council of America, a trade group representing 401k plan sponsors.").

130. 29 C.F.R. § 2550.404c–5 (2014).

131. *See* U.S. DEP'T OF LABOR, REGULATION RELATING TO QUALIFIED DEFAULT INVESTMENT ALTERNATIVES IN PARTICIPANT-DIRECTED INDIVIDUAL ACCOUNT PLANS 1–2 (2008), *available at* http://www.dol.gov/ebsa/pdf/fsQDIA.pdf [perma.cc/ZA7Z-5LF8].

Affordable Care Act (ACA)[132] for healthcare plans sponsored by large employers.[133] Although not yet instituted as of 2015, the idea is that employees of large employers (more than 200 employees) who do not pick an employer health care plan will automatically be defaulted into the employer's base-level plan.[134] So this provision of the ACA also uses insights from behavioral economics to increase access to affordable healthcare coverage,[135] much like automatic enrollment features for 401(k) plans are designed to increase participation in workplace retirement savings plans.

Yet there are still problems with this opt out, behavioral economic approach. First off, employees still retain the ability to opt out and not contribute anything to their plans.[136] Moreover, how should the plan administrator go about picking the appropriate default investments?[137] There used to be some consensus among financial advisors that so-called target-date funds (TDFs) (also called life cycle funds) could provide adequate retirement security based on the year the employee thought he or she would retire.[138] So, the Lifecycle 2040 Fund with the longer investment horizon would be more willing to take on investment risk, as opposed to a Lifecycle 2020 fund. However, one of the complicated variables to figure out is what should be the "glide path" as the employee works throughout her career toward

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132. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

133. The Fair Labor Standards Act (FLSA) was recently amended by the Affordable Care Act to include an automatic enrollment feature for healthcare plans for certain large employers. *See* EMP. BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, TECHNICAL RELEASE NO. 2012-01, FREQUENTLY-ASKED-QUESTIONS FROM EMPLOYERS REGARDING AUTOMATIC ENROLLMENT, EMPLOYER SHARED RESPONSIBILITY, AND WAITING PERIODS 1–2 (2012), *available at* http://www.dol.gov/ebsa/pdf/tr12-01.pdf [perma.cc/GFN2-7SCX].

134. *See* 29 U.S.C. § 218a (2012); *see also* MEDILL, *supra* note 57, at 348 (citing the opt out provision but also that if the employer offers more than one plan, a default plan may be chosen for the auto-enrollment).

135. EMPLOYEE BENEFITS SECURITY ADMINISTRATION, *supra* note 133, at 1.

136. Muir, *supra* note 126, at 12–13.

137. Further, plan participants who are automatically enrolled in 401(k) plans still have to make vital plan decisions, such as the amount they choose to contribute to the plan. *Id.* at 13. As a result, the problem of inertia has not magically disappeared and still exists in 401(k) plans with automatic enrollment features. *See* Stabile, *supra* note 45, at 81; *see also* VANGUARD INSTITUTIONAL INVESTOR GRP., HOW AMERICA SAVES 2013: A REPORT ON VANGUARD 2012 DEFINED CONTRIBUTION PLAN DATA 18 (2013), *available at* https://pressroom.vanguard.com/content/nonindexed/2013.06.03_How_America_Saves_2013.pdf [perma.cc/329G-Q9RN] ("Many individuals deal with a difficult choice by deferring it to another day. Eligible nonparticipants, unsure of what to do, decide to postpone their decision. While many employees know they are not saving enough and express an interest in saving more, they simply never get around to joining the plan or, if they do join, to increasing their contribution rates over time.").

138. The Callan Survey indicates that, "TDFs continue to trump other options as the most prevalent choice of default investment fund for participant-directed monies" at 74.6%. CALLAN INVS. INST., 2015 DEFINED CONTRIBUTION TRENDS 2 (2015), *available at* https://www.callan.com/research/files/996.pdf [perma.cc/PYZ3-9KAW].

retirement?[139] In other words, how does the mutual fund manager decide how to allocate assets around investments as the employee gets older? As it turns out, there is much disagreement on this issue, and that type of active fund management is not inexpensive.[140]

The other problem with the current automatic enrollment system is that employees get stuck contributing the same percentage of their money throughout their career, even though the initial, relatively low percentage is not anywhere near what employees need to save on a yearly basis to be ready for retirement.[141] This has led some plan administrators to adopt auto-escalation provisions so that employees that are defaulted into the QDIAs are also automatically contributing more of their paycheck to retirement as years go by.[142] Unfortunately, these auto-escalation provisions are not required, and they are still comparatively rare to find in 401(k) plans, especially in smaller plans.[143]

So while the auto-enrollment and auto-escalation features of current 401(k) plans are starting to take advantage of behavioral economics to increase participation, appropriate investing behavior, and contributions, a more thorough behavioral economic approach is still possible and, as I'll argue below, more desirable. One recent study indicates that "[m]ore plan sponsors are offering automatic features in their plans, although robust implementation is not the norm."[144] Other findings in this study include: "Automatic enrollment usage increased for the fourth year in a row to reach 61.7% of plans"; "[o]nly one-third of plans offer both automatic enrollment and automatic contribution escalation"; "[d]efaults for automatic enrollment range from 1% to 10%, with an average of 4.3%"; and "[p]lans with opt-out automatic

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139. *See* Michael A. Pollock, *One Target, but Many Ways To Hit It*, WALL ST. J. (July 10, 2012, 5:07 PM), http://www.wsj.com/articles/SB10001424052702304199804577476882853714926 [perma.cc/3SDR-H3L3] ("Some managers have been altering key features of funds, such as how much the equities allocation drops by the target date. (That gradual reduction in stock exposure until and beyond the target date is termed the 'glide path' that a fund follows.)").

140. *Id.* ("All target-date funds tilt heavily toward stocks in their early years and gradually reduce equities exposure over time. But there is considerable disagreement over exactly how that should work.").

141. Many plan participants who are automatically enrolled in their workplace 401(k) plan tend to stick with default contribution rates, which may be lower than average. Stabile, *supra* note 45, at 81–82.

142. *See* Jack L. VanDerhei, *The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income*, EMP. BENEFITS RES. INST. NOTES, Sept. 2007, at 2, 2–3, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_09a-20071.pdf [perma.cc/DRQ7-JPDQ].

143. *See* LORI LUCAS, JOSHUA DIETCH, SUZANNE VAN STAVEREN, CATHERINE PETERSON, BRIDGET BEARDEN & CATHERINE COLLINSON, DEFINED CONTRIBUTION INSTITUTIONAL INV. ASS'N., DCIIA PLAN SPONSOR SURVEY 2014: FOCUS ON AUTOMATIC PLAN FEATURES 5 (2015), *available at* https://www.transamericacenter.org/docs/default-source/resources/tcrs2015_wp_dciia_plan_sponsor_survey.pdf [perma.cc/KSV6-EUUL] ("The impact is notable across plan size, where the largest plans (over $1 billion) reported a 53% [auto-escalation] adoption rate, versus the smallest plans (under $5 million), which reported that only 11% of plans has done so.").

144. CALLAN INVESTMENTS INSTITUTE, *supra* note 138, at 3 (reporting results based on survey of 144 plan sponsors, primarily large and mega 401(k) plans).

contribution escalation most frequently have an annual increase rate of 1% with a cap of 6%."[145] In short, although increasing in usage, automatic enrollment and escalation are still not used in the majority of plans in the United States.

*C. Using Choice Architecture To Boost Retirement Security*

One way of encouraging better choices by plan participants is through use of a behavioral economic concept called choice architecture. "Choice architecture" is a term that was coined by Richard Thaler and Cass Sunstein in their book, *Nudge*.[146] Choice architecture is defined as structuring the choices that people need to make in a way that allows them to make the choice that is best for them.[147] In *Nudge*, Thaler and Sunstein describe the cognitive errors that humans make when making life choices and recommend that governments take these errors into account when developing policies so that they can "nudge" people to make the right choices.[148] They describe this policy-making approach as "libertarian paternalism," whereby choice architecture is used to overcome cognitive biases, while freedom of choice by the individual is maximally preserved.[149]

Choice architecture can be readily used in the 401(k) plan setting to help drive participation in workplace retirement savings plans and increase the contribution levels of those who participate.[150] As Professor Muir has aptly observed, by incorporating automatic enrollment features and by strategically setting contribution levels, employers can help "nudge" employees into making the right decisions regarding retirement financial planning.[151] Choice architecture can also be used to help combat the problems associated with employees selecting inappropriate investment options for their 401(k) plan assets.[152] Employer-chosen default investment vehicles might help to combat the problems associated with an investment menu that has either too many or not enough investment options.[153] It might also help to have a default auto-escalation model in the plan.

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145. *Id.*

146. *See* THALER & SUNSTEIN, *supra* note 25, at 74–102; *see also* Muir, *supra* note 126, at 8 ("A choice architect 'has the responsibility for organizing the context in which people make decisions.'") (quoting THALER & SUNSTEIN, *supra* note 25, at 3).

147. Pierre Schlag, *Nudge, Choice Architecture, and Libertarian Paternalism*, 108 MICH. L. REV. 913, 915 (2010) (reviewing RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008)).

148. *Id.* This "nudge" comes in the form of framing choices in a way that "minimize[s] the negative impact of . . . cognitive biases." Anuj C. Desai, *Libertarian Paternalism, Externalities, and the "Spirit of Liberty": How Thaler and Sunstein Are Nudging Us Toward an "Overlapping Consensus*," 36 LAW & SOC. INQUIRY 263, 265 (2011).

149. Desai, *supra* note 148, at 265.

150. *See* Muir, *supra* note 126, at 12–13.

151. *See id.*

152. *Id.* at 16 (describing how choice architecture can be used to help "counteract the negative effects of employer decisions on plan investment menus and how those menus are presented.").

153. *See id.* at 18. Employees might even choose not to participate in a retirement savings plan if the number of investment options is too great. *Id.* Choice architecture can be used to combat the problem by "nudging" employees into participation if default investment vehicles

While some aspects of choice architecture already exist in the United States in the form of automatic enrollment features, default contribution levels, and QDIAs, these features are far from universal. Indeed, there is currently no one system in the United States that operates entirely on the principles of choice architecture. Such a system should have the exact opposite characteristics of those that beleaguer our 401(k) system.

The characteristics of America's current 401(k) system include: (1) voluntary employer plans; (2) lack of employee access; (3) lack of financial education provided by employers because of fiduciary liability concerns; (4) high costs associated with actively managed plans; and (5) financial advice provided by conflicted advisors with their own agendas.

In other words, choice architecture should be used in the workplace pension context to promote the opposite, more optimal plan characteristics: (1) compulsion for employers to minimally participate in workplace retirement plan system; (2) universal access for all employees; (3) plans independent from employer administration and control; (4) relatively inexpensive costs; and (5) alignment between the interests of investment advisors and retirement plan participants.

Australia, to a large extent, has such a choice architecture system in place with many of these characteristics. Known as the Superannuation Guarantee (SG), it is thus to an examination of the SG system that I now turn.

## III. The Australian Superannuation Guarantee As Exemplar

Although what lies ahead is an examination of a workplace retirement system that appears to attain retirement security for its citizens much better than our current 401(k) system, it is important to start with a cautionary note: there is no one perfect workplace retirement system in the world.[154] That being said, there are certainly some that are better than others.

In this Part, the first subpart discusses the genesis of the Australian SG. The second subpart then explores how the SG developed. Finally, the third subpart discusses how recent SG reforms reflect behavioral economic insights.

### *A. Initial Development of Superannuation Guarantee*

As an initial matter, the concept of "superannuation" is not new to Australia, as for over a century, it had been a type of savings plan mostly for highly paid white-collar workers in large corporations.[155] All the way back to the 1980s, Australia had similar retirement plans to what the United States had at that time,

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exist. *See id.*

154. Tarn-Weir & Ralston, *supra* note 31, at 2 ("The MMGPI [Melbourne Mercer Global Pension Index] found again there is no perfect system that can be applied universally around the world, but there are many common features that can be shared for better outcomes for individuals.").

155. *See 20 Years of Superannuation Guarantee*, AUSTL. TAX'N OFF., https://www.ato.gov.au/Media-centre/Commissioners-online-updates/20-years-of-super-guarantee/ [perma.cc/K3FQ-ZNYT] (describing the evolution of key milestones in the SG system).

which were mostly traditional DB plans.[156] Much like the United States today under the 401(k) system, however, pension plans covered less than half the Australian workforce.[157] As a result, for most of its existence, superannuation only covered a slim subset of Australians. By 1983, the system still covered only about 40% of Australian workers.[158] There were few DC plan options at this time, and the whole superannuation system was marked by light regulation.[159]

The Australian labor movement initiated the modern-day SG. More specifically, in 1985, the Australian government and the Council of Trade Unions agreed to productivity award superannuation—a system that provided for part of the award system's wage increase to come in the form of a 3% superannuation contribution to be paid by employers into a fund.[160] However, while the award system improved retirement coverage for Australian workers, it was not universal, and the contributions to the retirement funds were still inadequate.[161] The government eventually introduced the SG on July 1, 1992.[162] With limited exceptions, this scheme required employers to provide a minimum level of superannuation support to their employees each year.[163] The major exceptions to this requirement were that employers did not have to pay contributions for (1) employees earning less than AUD$450 per month, (2) part-time employees younger than age eighteen, and (3) employees aged sixty-five and older.[164] As the retirement contributions were put aside, employees were not able to withdraw them until they reached the age of fifty-five.[165] Initially, employers were required to contribute only 3% each year, and over a ten-year period, this contribution rate

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156. *Id.*

157. Eisenberg, *supra* note 26 (quoting David Knox, senior partner for Mercer and author of the firm's annual global retirement report).

158. *20 Years of Superannuation Guarantee*, *supra* note 155.

159. Hazel Bateman, *Recent Superannuation Reforms: Choice and Flexibility in Retirement*, 16 AUSTL. ACCT. REV. 2, 3 (2006) ("In the mid-1980s, less than 50% of the workforce was covered by superannuation . . . , the . . . industry was only lightly regulated, . . . retirement benefit systems were mainly of the defined-benefit variety, [and] defined-contribution schemes rarely offered any choice of investment strategy . . . .").

160. *20 Years of Superannuation Guarantee*, *supra* note 155. While this allowed about two-thirds of the private sector to come into the system, low contribution rates were not doing much to improve retirement incomes for most participants. *Id.*

161. SIMON KELLY, CPA AUSTL., TWENTY YEARS OF THE SUPERANNUATION GUARANTEE: THE VERDICT 1, 8 (2013), *available at* http://www.melbourneinstitute.com/downloads/hilda/Bibliography/Other_Publications/2013/Kelly_twenty-years-superannuation-guarantee.pdf [perma.cc/6Y7T-7L9U].

162. *Id.* (providing background information and an overview of SG's implementation).

163. *Id.* SG is more like an American DC profit-sharing plan, where the employer contributes money to an account, and less like a 401(k) plan, where employees defer salary to their account and then employers may match those funds with additional money. *See Glossary*, *supra* note 107; *supra* text accompanying note 107.

164. KELLY, *supra* note 161, at 8; *see also* Jonathan Barry Forman & Gordon D. Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems?*, 66 TAX. LAW. 613, 624–25 (2013) (noting the upper limit: employers do not have to make contributions for employees' pay above AUD$45,750 per quarter (for 2012–13 year)).

165. KELLY, *supra* note 161, at 8.

gradually grew to 9%.[166] The contribution rate rose to 9% in 2002–2003, and will eventually rise to 12% in 2019–2020.[167]

Initially, employers were given the choice of the SG fund into which mandatory contributions would be paid.[168] However, beginning in July of 2005, many employees were able to choose the Super fund into which their employer contributions would be paid, as long as the SG fund was considered a "complying fund."[169] If an employee opted not to select the employer's chosen SG, the money would default into a Super fund chosen by the employer.[170] In 2012, Australia enacted a series of reform measures that created MySuper, a superannuation default product.[171] These MySuper funds replaced existing default funds and gave workers access to a Super fund that is low cost and highly diversified.[172] The goal of the MySuper reforms was to improve the success of retirement funds for people who did not wish to actively participate in choosing their superannuation fund, while maintaining that freedom for those who did want to be actively involved.[173]

Importantly, and from the beginning of the SG system, rather than making employer contributions to Super funds voluntary, the Australian government came up with a mandatory system that gave employers a tax deduction for their compulsory employee superannuation contributions.[174] Those employers that did not make the necessary employee contributions were liable to pay a nondeductible Superannuation Guarantee charge.[175] This charge is made up of the employer's superannuation

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166. *Id.*

167. *Id.* The reason for the increase in contribution rates was the realization that the 9% rate would not provide for an adequate standard of living in retirement. *Id.*

168. KAI SWOBODA, AUSTL. PARLIAMENT, MAJOR SUPERANNUATION AND RETIREMENT INCOME CHANGES IN AUSTRALIA: A CHRONOLOGY 4 (2014), *available at* http://apo.org.au/files/Resource/ParliamentaryLibrary_ChronologyOfMajorSuperannuationAndRetirementIncomeChangesInAustralia_Feb_2014.pdf [perma.cc/88AD-EEN3] (noting first time employees had choice in selection of super funds).

169. *Getting Started: Employees*, AUSTL. TAX'N OFF., https://www.ato.gov.au/individuals/super/getting-started/employees/ [perma.cc/XK4U-8AP6]. Complying funds are funds that receive concessional tax treatment and are regulated by Super legislation. *Super Fund Lookup: Glossary*, AUSTL. TAX'N OFF., http://superfundlookup.gov.au/Glossary.aspx. Concessional tax treatment means that participants are subject to paying lower taxes on these Super contributions. *See id.*

170. *See Getting Started*, *supra* note 169. The employee is always able to opt into choosing his or her own super fund at a later time, if desired. *Id.*

171. *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012* (Cth) (Austl.); *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (Cth) (Austl.); *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) (Austl.); *see also Stronger Super: Acts*, AUSTL. GOV'T: THE TREASURY, http://strongersuper.treasury.gov.au/content/Content.aspx?doc=acts.htm [perma.cc/C96D-93ZR].

172. Forman & Mackenzie, *supra* note 164, at 637–38.

173. *Id.* at 639.

174. *See Claiming a Tax Deduction*, AUSTL. TAX'N OFF., https://www.ato.gov.au/Business/Super-for-employers/Paying-super-contributions/Claiming-a-tax-deduction/.

175. *See* Paul M. Secunda, *An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for Detroit and the United States*, 41 FORDHAM URB. L.J. 867, 938 (2014); *see also*

guarantee shortfall, an administrative charge, and an interest component.[176] Additionally, the concept of "vesting" has largely fallen out of the superannuation lexicon. Vesting schedules apply to only a limited number of superannuation schemes, most of which have been in operation for decades.[177] Superannuation funds generally now provide for full vesting immediately in the employer contributions made to their member employees' accounts.[178]

One of the initial issues with the Australian SG was similar to one currently faced by the American 401(k) plan system—account proliferation due to job transitions and failure to roll over balances into new Super accounts to their new employers.[179] Because of the difficulties initially faced with consolidating Super accounts, many people failed to roll over existing account balances into new accounts when they changed employers.[180] As a result, by 2012, there were nearly three Super accounts for every worker.[181] This SG account proliferation issue led to reform measures, known collectively as SuperStream, which were designed to improve the superannuation system in multiple ways, including: (1) facilitating account consolidation, (2) providing better information to account participants, (3) allowing for better monitoring of superannuation accounts, and (4) establishing an advisory entity for maintenance of Super standards.[182]

Automatic consolidation applies to the current account of any superannuation account that has a balance of AUD$1000 or less, unless the member opts out.[183] The

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*Claiming a Tax Deduction*, *supra* note 174 (explaining that superannuation guarantee charges are not tax deductible); *Superannuation Basics for Employers*, AUSTL. TAX'N OFF., https://www.ato.gov.au/General/Other-languages/In-detail/Information-in-other-languages/Superannuation-basics-for-employers/?page=1#What_if_I_haven_t_paid_super_correctly [perma.cc/ML4L-ZQML] (explaining the responsibilities of employers who do not pay the annual super contributions).

176. AUSTL. TAXATION OFFICE, SUPERANNUATION GUARANTEE: HOW TO UNDERSTAND AND MEET YOUR SUPERANNUATION GUARANTEE OBLIGATIONS 17 (2001), *available at* http://www.adegroup.com.au/downloads/SGL%20Superannuation%20Guide%20for%20Employers.pdf [perma.cc/UZY2-PVR4].

177. *Dictionary*, AUSTRALIANSUPER, http://www.australiansuper.com/tools-and-resources/dictionary/v.aspx [perma.cc/M9PK-4SR3] (defining vesting).

178. *Id.*

179. FIN. SERVS. COUNCIL & DST GLOBAL SOLUTIONS, SUPERANNUATION ACCOUNT CONSOLIDATION 1 (2012), *available at* http://www.fsc.org.au/downloads/file/ResearchReportsFile/FSC_DSTaccountconsolidationv20FINAL.pdf [perma.cc/KD2G-SFUC].

180. *Id.*

181. *Id.*

182. *Stronger Super: 3. SuperStream*, AUSTL. GOV'T: THE TREASURY, http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/information_pack/superstream.htm [perma.cc/MB7E-RC26].

183. *Id.* A similar proposal by Professor Friedman of the *Hamilton Project* proposes that Americans have only one retirement account. *See* JOHN N. FRIEDMAN, BUILDING ON WHAT WORKS: A PROPOSAL TO MODERNIZE RETIREMENT SAVINGS (2015), *available at* http://www.hamiltonproject.org/assets/files/friedman_proposal_modernize_retirement_savings.pdf [perma.cc/464U-CHB3] (maintaining that instead of workers accumulating multiple retirement plans, they should combine all types of retirement accounts into a single and portable one).

Super funds themselves are now able to use the Australian Taxation Office registers to help them locate all of their members' Super accounts, and are then able to advise their members of consolidation options.[184]

The reforms were fully phased-in as of December of 2014.[185] Auto-consolidation of superannuation accounts with balances of AUD$1000 or less was phased-in during January of 2014, and by the end of 2014, auto-consolidation was phased-in for superannuation accounts with balances of AUD$10,000 or less.[186] The auto-consolidation process is initiated by the Australian Taxation Office and will continue to be conducted annually.[187]

Having laid out the development of the Australian Superannuation Guarantee, the next section focuses on its general characteristics, especially in comparison to American 401(k) retirement plans.

### *B. General Characteristics of the Australian Pension Scheme*

As can be gathered from the previous section, the Australian Superannuation Guarantee is quite different than its American 401(k) plan counterpart; however, it is also important to understand the government social insurance system that operates in Australia in conjunction with the SG. I therefore pause briefly to discuss Australian Age Pension, as compared to American Social Security, to underscore the importance of the SG to overall Australian retirement security.

#### 1. The Australian Age Pension System

Outside the workplace retirement system, the Australian government pension scheme is starkly differently than American Social Security.[188] Unlike Social Security in the United States, the Australian Age Pension government system is not based on a pay-as-you-go (PAYG) model or funded through current employee's payroll taxes,[189] but is instead funded through general tax revenues.[190] While direct contributions to the Age Pension system are not compulsory, Australians do contribute indirectly through general income taxes and other personal taxes.[191]

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184. *Stronger Super: 3. SuperStream*, *supra* note 182.

185. *See id.*

186. *See id.*

187. *Id.* During this process, the Australian Taxation Office will notify the current Super fund of the accounts. *Id.* That fund is then to advise the employee member of her account and initiate the consolidation process, unless the member opts out. *Id.*

188. Dana M. Muir, *Building Value in the Australian Defined Contribution System: A Values Perspective*, 33 COMP. LAB. L. & POL'Y J. 93, 104 (2011).

189. Jonathan Barry Forman, *Making Social Security Work*, 65 OHIO ST. L.J. 145, 153 (2004) (discussing funding of the U.S. Social Security system).

190. Muir, *supra* note 188, at 104–11 (discussing Australian Age Pension system as noncontributory, means-tested, and funded through general revenues). "The cost of the Age Pension varies over time because eligibility for benefits is negatively correlated with economic cycles." *Id.* at 107. As a result, when retirees experience any reductions in their income, then the cost of the Age Pension goes up. *Id.*

191. *Id.* at 111.

Beginning on July 1, 2017, the "preservation age," when men and women can start receiving SG payments, will gradually increase until it reaches age sixty-seven on July 1, 2023.[192]

Most significantly, unlike Social Security, Australian Age Pension is *means-tested*; an income test and a general assets test are both used to determine eligibility for, and the amount of, Age Pension benefits.[193] As such, the Age Pension system is intended to be a "poverty reduction program rather than an earned right."[194] For those Australians who make more than the maximum amount under a combined income and assets test, the Age Pension payments gradually phase out and retirement security is left to personal savings and their Super accounts.[195] Income replacement is highest for those who earn the least in Australia.[196] Interestingly, it appears to be the Australian government's aim to largely eliminate Age Pension once workers are able to save enough through the Superannuation Guarantee.[197] That point has not been reached yet, and helps to explain why the government will "raise contributions to 12 percent by 2019–20, [as] a 9 per cent level remained too low to oust reliance on the age pension."[198]

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192. *See* Forman & Mackenzie, *supra* note 164, at 624 (citing *Age Pension*, AUSTL. GOV'T: DEP'T OF HUMAN SERVICES, http://www.humanservices.gov.au/customer/services/centrelink/age-pension [perma.cc/P49X-YYDW]).

193. Muir, *supra* note 188, at 109. *See also* Allison Schrager, *Australia's Pension Plan Has the Right Idea—If Only Retirees Stopped Trying to Game It*, QUARTZ (Feb. 21, 2013), http://qz.com/55166/australias-pension-plan-has-the-right-idea-if-only-retirees-stopped-trying-to-game-it/ [perma.cc/KW3J-TDZF] ("One idea that both the left and right, in America, can agree on is to give richer people less benefits for their tax-dollar, through means-testing benefits. Means testing, when the government considers your income and/or wealth to determine if you are eligible for benefits, sounds like the most efficient way to reform pensions."). Two interesting points further here: (1) some Australians have placed most of their wealth in houses which do not count toward eligibility for the Age Pension, Muir, *supra* note 188, at 109 ("Notably, the value of a primary residence is excluded from the assets considered in the assets test."); and (2) anecdotally, the mere mention of a means-tested system in the United States does not sit well with the baby boom generation that has spent its life contributing to Social Security and expects a Social Security check no matter how wealthy they are. *Cf.* VIRGINIA RENO, AARP PUB. POLICY INST., REFORMING SOCIAL SECURITY: OPTION: BEGIN MEANS-TESTING SOCIAL SECURITY BENEFITS 2 (2012), *available at* http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/option-means-test-social-security-benefits-AARP-ppi-econ-sec.pdf [perma.cc/R5PX-K27E] (arguing against means testing).

194. Muir, *supra* note 188, at 109.

195. *See id.* at 104 ("Although the Age Pension provides 'nearly universal coverage,' not all Australians are eligible to receive an Age Pension because it is means tested."); *see also* Schrager, *supra* note 193 ("If your annual income is smaller than [AUD]$7,200 and your assets are less than [AUD]$281,000 (if you're a homeowner) you get the full state pension, [AUD]$28,745.").

196. *See* Terry Carney, *The Future of Welfare Law in a Changing World: Lessons from Australia and Singapore*, 32 SYDNEY L. REV. 193, 201 (2010) ("The Australian age pension is indexed by law to maintain its level at 25 per cent of male average earnings.").

197. *See id.* at 198.

198. *Id.*

### 2. Taxation of the Superannuation Guarantee

The Australian SG is a "regulated and low-taxed savings scheme that is designed to encourage taxpayers to save for their retirement."[199] Mandatory employer contributions to employee superannuation accounts are tax deductible,[200] and employees generally are not taxed on these contributions made by their employers on their behalf.[201] As a way of incentivizing employees to save even more for retirement, Australian workers may make before-tax contributions, called "salary concessions," into their Super accounts.[202]

An employee can also choose to make additional contributions from his or her after-tax income to either (1) his or her own SG account, or (2) the SG account of his or her spouse.[203] Contributions to the SG system are "constrained by a complex set of maximum contribution caps that apply to before-tax employee contributions, after-tax employee contributions, employer contributions, and contributions made by a spouse."[204]

However, despite the overwhelming evidence that additional, voluntary contributions assist in adequately planning for retirement,[205] some experts believe that Australians are not saving at an acceptable rate. A recent Australian Banking System study showed that the voluntary contribution rate has fallen at a consistent pace from 1993 to 2007—going from about half participation to just a quarter (a trend seen among all age groups).[206] Voluntary employee contribution rates tend to increase with age and income, with those closer to retirement and in higher income brackets being more likely to voluntarily contribute to superannuation accounts.[207]

Three other critical factors affecting low voluntary contribution rates are unaffordability, lack of financial literacy, and lack of SG understanding.[208] First, individuals may simply be unable to afford to make voluntary payments to their SG accounts.[209] The survey data directly supported this sentiment; those with a lower income were fearful of an inability to pay for basic needs or to save money for

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199. Forman & Mackenzie, *supra* note 164, at 624.

200. *Id.* at 624–25.

201. *Id.* at 625 (citing *Income Tax Assessment Act 1997* (Cth) §§ 290-60 to -80 (Austl.)); *id.* at 626 ("[I]f contributions are made for an employee in excess of AU$25,000 per year, the employee pays tax of 31.5% on that excess.").

202. *Id.* at 625.

203. Muir, *supra* note 188, at 112; *see also* Forman & Mackenzie, *supra* note 164, at 626.

204. Muir, *supra* note 188, at 112.

205. *See Super Contributions: Grow Your Nest Egg,* AUSTL. SEC. AND INVESTMENTS COMMISSION (Aug. 21, 2015), https://www.moneysmart.gov.au/superannuation-and-retirement/how-super-works/super-contributions [perma.cc/9UQP-C4RV] (discussing employers' contribution to Super accounts, at present levels, may not be enough for adequate retirement savings).

206. *See* Jun Feng, Hazel Bateman & Paul Gerrans, *Why Australians Don't Make Extra Super Contributions*, THE CONVERSATION (Apr. 14, 2014, 10:31 PM), http://theconversation.com/why-australians-dont-make-extra-super-contributions-24841 [perma.cc/S2NC-ZJ8D].

207. *Id.*

208. *Id*.

209. *Id.* (suggesting that household financial barriers, worry about lack of emergency funds, and debt are main reasons why some people do not contribute more to Super accounts).

emergencies if they contributed more.[210] Second, lack of Super knowledge, limited financial acumen, and failure to understand retirement planning also contribute to a lack of voluntary contributions (this is similar to problems with the voluntary American 401(k) system).[211] This lack of education results in individuals failing to monitor their Super accounts, failing to make changes to accounts when needed, and being unable to choose among funds and investment options.[212]

In all, the Australian SG uses the tax system to incentivize employees to save, to make compulsory employer contributions to the SG less painful, and to make voluntary contributions to their SG accounts. However, as in the voluntary retirement 401(k) scheme, employees are reluctant to save for retirement unless they are forced to do so. Consequently, below I consider whether an American superannuation system should require both employee and employer compulsory superannuation contributions.

### 3. Lump Sum Distributions, Annuities, and the Superannuation Guarantee

Another interesting, and somewhat surprising, characteristic of the Australian SG is that roughly 75% of the value of retirement benefits paid in Australia is in the form of small lump sums.[213] Because Super accumulations do not have to be taken as a particular type of income stream or annuity (as is usually the case with traditional DB plans in the United States), a range of annuity products have emerged: (1) superannuation pensions that are paid by superannuation funds; (2) traditional annuities offered by life insurance companies, with products including fixed or indexed annuities for life or an agreed term; and (3) allocated pensions offered by a number of institutions, with annual income payments required to be between minimum and maximum amounts.[214]

Unfortunately, lump sum distributions can create a variety of problems.[215] Consider similar issues that are caused in the American system when employers engage in so-called "pension derisking transactions," in which employers transfer risk to employees and retirees in the form of lump sum buyouts.[216] The danger there, as with the Australian SG system's dependence on lump sums, is that when employees or retirees receive a lump sum rather than an annuity income stream for life, they tend to misuse the funds for purposes other than those for which they have

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210. *See id.*

211. *See* Heather Gasgoine, *Study Finds a Lack of Knowledge and Interest in Superannuation Among Young*, THE AGE (Oct. 13, 2014), http://www.theage.com.au/national/education/voice/study-finds-a-lack-of-knowledge-and-interest-in-superannuation-among-young-20141009-3hl3j.html [perma.cc/T2YF-374Q] (showing that lack of knowledge of even the most basic facts has serious detrimental effect on greater contribution levels).

212. *Id.*

213. Muir, *supra* note 188, at 102 (describing survey results that confirmed that, of the 43% of Australians who had received some form of Super benefit, 75% of them had taken the benefit in the form of a lump sum or a combination of an annuity and a lump sum).

214. Bateman, *supra* note 159, at 3.

215. Secunda & Maher, *supra* note 6 (manuscript at 36) (noting issues with granting lump sums to retirees in paid status in the DB plan context).

216. *Id.* (manuscript at 8–10).

been set aside.[217] Lump sums transfer to unsophisticated and unprepared individuals the responsibility for making saving, investment, and longevity decisions.[218] And those individuals have consistently made poor choices.[219]

Additionally, in Australia, there are other issues surrounding the distribution of superannuation benefits that the United States does not face with its pension benefits. Most notably, there are integration issues with Age Pension system payments and superannuation benefits payments.[220] The problem lies in the fact that an individual becomes eligible for superannuation distributions before he or she becomes eligible for Age Pension distributions.[221] The worry is that an individual will take his or her superannuation benefits as a lump sum, spend it down, and then try to rely on Age Pension benefits for retirement at a younger age.[222]

Integrating superannuation lump sum payments with the Age Pension annuity in order to plan for adequate retirement is often difficult.[223] Further, means-testing eligibility for Age Pension benefits leads to some people needing to rely more heavily on superannuation savings and other retirement savings mechanisms.[224] This can raise potential issues depending on the wealth of the individual who is denied Age Pension benefits.[225]

### *C. Behavioral Economics of the Superannuation Guarantee*

The structure of superannuation in Australia has not been static. Just as in the United States, where there was a significant shift from DB plans to DC plans,[226] a similar dynamic has unfolded in Australia. Under the maturing SG scheme, more choice has been shifted to employees as far as whether they want to be active or passive participants in their retirement planning.

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217. *Id.* (manuscript at 21–25).

218. *Id.*

219. *Id.*

220. *See* RICE WARNER, REFORMING THE AGE PENSION 2 (2012), *available at* http://newcorporate.ricewarnerdigital.com/wp-content/uploads/2015/10/Reforming-the-Age-Pension_August-2012.pdf [perma.cc/73V6-FQS2]; *see also* GEOFF DUNSFORD & MICHAEL RICE, INST. OF ACTUARIES OF AUSTL., RETIREMENT INCOMES INTEGRATION: SUPERANNUATION, SOCIAL SECURITY & TAXATION 2 (2004), *available at* http://dbpensionreview.treasury.gov.au/content/initial_subs/021b_rice_walker_actuaries_integration_paper.pdf [perma.cc/KTU9-BU74] (indicating that the superannuation system and the Age Pension system have developed separately, and "[t]he interaction between them is complex and often inefficient").

221. RICE WARNER, *supra* note 220, at 14.

222. *Id.*; Schrager, *supra* note 193 ("What's even more surprising is once you reach retirement age, you can take your entire Super account as a tax-free, lump sum and spend it however you like or give it your children (though there exists an annual gifting limit). If you're on the margin of receiving state benefits, it makes sense to do just that, and then claim the Age Pension.").

223. DUNSFORD & RICE, *supra* note 220, at 3.

224. *See id.* at 2.

225. *Id.*

226. *See supra* note 45 and accompanying text.

Recall that Australia's SG had been around in some form since the mid-nineteenth century, but was limited in scope and employee coverage.[227] Superannuation did not become a compulsory retirement scheme until 1986, and not nearly universal for all employees until 1992.[228] Choice for employees, as discussed above, was introduced in 2005. In 2012, Australia introduced a new default Super plan called MySuper.[229] The largest impact that this employee choice of fund legislation had was that people could now set their own ideal portfolio to match their risk and return preferences.[230] Yet, despite this freedom, many Aussies, as illustrated by the amount of assets in default plans, do not make their own elections.[231]

Indeed, if an employee does not take affirmative action with regard to choosing Super funds, the employer must now invest them in a MySuper account, which has the advantages of low fees and diversification of investments consistent with modern portfolio theory.[232] Such accounts must be registered with the Australian Securities and Investments Commission (ASIC).[233] The advantage of having MySuper products registered with the ASIC is that participants will be able to compare fees among products and use other comparative data.[234] This default scheme leads to a good amount of stability, as most workers only change superannuation funds if there is a job change, if there is a need to consolidate existing accounts, or as a way to seek out lower investment fees and better investment returns.[235] The trustees of MySuper are

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227. THE REVIEW PANEL, AUSTL.'S FUTURE TAX SYSTEM, AUSTL. GOV'T: THE TREASURY, RETIREMENT INCOME CONSULTATION PAPER app. B at 43 (2008), *available at* http://taxreview.treasury.gov.au/content/downloads/retirement_income_consultation_summary/Retirement_Incomes_Consultation_Paper.pdf [perma.cc/L4H2-9V9E].

228. *See supra* Part III.A. Technically, the modern superannuation scheme is universal, subject to some exceptions based on employee age and salary. *See* Forman & Mackenzie, *supra* note 164, at 624–25.

229. *See supra* notes 29–30 and accompanying text.

230. *See* Joshua Fear & Geraldine Pace, *Australia's 'Choice of Fund' Legislation: Success or Failure?*, ROTMAN INT'L J. OF PENSION MGMT., Fall 2009, at 26, 27 (observing that giving employees more control means more ownership over their future).

231. *See* Adam Butt, Scott Donald, Doug Foster, Susan Thorp & Geoff Warren, *Delegation, Trust and Defaulting in Retirement Savings: Perspectives from Plan Executives and Members* 5 (Ctr. for Int'l Fin. & Regulation, Working Paper No. 065/2015, 2015) *available at* http://ssrn.com/abstract=2638998 [perma.cc/6BKY-WJ4V] ("Default investment options house the largest share of assets of superannuation funds, at around 44% of total funds under management in 2013.").

232. *See* Dana M. Muir, *Default Settings in Defined Contribution Plans: A Comparative Approach to Fiduciary Obligation and the Role of Markets*, 28 A.B.A. J. LAB. & EMP. L. 59, 64 (2012) (citing AUSTL. GOV'T: THE TREASURY, STRONGER SUPER: INFORMATION PACK v (2011), *available at* http://strongersuper.treasury.gov.au/content/publications/information_pack/downloads/information_pack.pdf [perma.cc/GZ2U-P5GR]) ("In general, SG System funds will each be permitted to have one MySuper investment product. MySuper products will provide a limited menu of services and are expected to have relatively low fees. Any fees charged must be reported according to categories established by the regulators to enable comparisons across MySuper products.").

233. *Id.* at 70.

234. *Id.*

235. *See* Bateman, *supra* note 159, at 5 ("[In] an ANOP [Australian National Opinion Polls] Research Services national survey of 25–64-year-olds in the workforce about attitudes

held to high standards of fiduciary performance that are enforced by the government.[236] MySuper is further regulated by the "Australian Prudential Regulatory Authority (APRA), [which] will gather and report data on MySuper product performance and fees to facilitate competition among offerings."[237]

In conclusion, the Australian Superannuation Guarantee has many of the key components that behavioral economics suggest that a comprehensive and sustainable workplace pension plan should have. More specifically, and to quote Professor Muir:

> Two characteristics of the Australian approach offer lessons for the United States. First, Australia recognizes that many people do not want to be actively involved in monitoring the investments in their accounts. Second, employers also may not have the expertise or the inclination to become experts in investment product selection and monitoring.[238]

These characteristics, as applied to a potential SG-type system in the United States, are elaborated upon in the next Part.

## IV. TRANSFORMING 401(K) PLANS INTO SUPERANNUATION FUNDS

The foregoing discussion explains why the Australian Superannuation Guarantee is much more successful than the American 401(k) system in at least five essential ways: (1) mandatory employer participation; (2) near universal employee access; (3) Super fund independence from employer control and administration; (4) lower fees; and (5) the alignment of Super fund managers' interests with those of fund participants through placing fiduciary standards on the MySuper trustees. The ensuing five sections of this Part outline the moves that American retirement policy officials should undertake to transform the current American workplace retirement system into a system based on the actual desires of most employers and the needs of workers and retirees.

### *A. Voluntary Plans Become Mandatory Plans*

ERISA does not require that employers offer retirement benefits; it merely regulates retirement benefit promises that are made.[239] Because of the voluntary nature of retirement promises under ERISA, regulators are often faced with a difficult choice: if the legal rules are too protective of beneficiaries or too burdensome to

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to superannuation fund choice and the influence and likelihood of changing funds in the months following implementation of the legislation . . . . only 5% of those surveyed responded with 'very likely' and 7% responded with 'quite likely.'").

236. Muir, *supra* note 232, at 67 ("The enhanced duties required of MySuper trustees are to (1) promote the financial interests of MySuper members, particularly net returns; (2) annually assess sufficiency of scale; and (3) include in their investment strategy an investment return target and level of risk for MySuper members. In addition, the trustees must be licensed and meet specific standards with respect to the operation of a MySuper product.").

237. *Id.* at 64.

238. *Id.* at 68.

239. *See* Regina T. Jefferson, *Increasing Coverage in Today's Private Retirement System*, 6 DREXEL L. REV. 463, 464 (2014) (noting the voluntary nature of retirement promises).

employers, fewer retirement promises will be made in the first place.[240] In other words, there is much pressure on regulators to balance the objective of DC plan creation against promulgating rules protective of DC beneficiaries. Thus regulators—even if they have great discretion to act—must generally be quite cognizant of ensuring that promulgating protective rules for beneficiaries will not significantly undermine plan creation.[241]

In the Australian SG, however, that pressure does not exist. Because employers must compulsorily contribute to a Super fund for their employees,[242] there is no such balancing of interests that needs to take place. Stringent tax, finance, and investment requirements for Super funds will not threaten pension fund existence as employers will not have a choice but to contribute.[243]

Of course, opponents to this approach might not like the idea of mandatory workplace pensions because such paternalism is inconsistent with the American individual responsibility paradigm. Two responses: (1) behavioral economics explains that sometimes people have to be nudged into doing things they would not do voluntarily (see automatic enrollment and auto-escalation provisions)[244] and (2) to quote Professor Ghilarducci's particularly apt statement: "Get real. Just as a voluntary Social Security system would have been a disaster, a voluntary retirement account plan is a disaster."[245] Human beings are good at some behaviors, but we should also recognize that the current 401(k) system is doomed to fail given first and foremost that employers do not even have to provide a 401(k) plan under the current voluntary ERISA system.

### *B. Inaccessible Plans Become Accessible Plans*

A necessary corollary to the compulsory nature of the superannuation system is that there will be close to universal access (the self-employed may or may not be covered and employees who make too little or too much money may also be excluded, as in Australia). It was not until Australia moved from traditional DB plans

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240. *See* Mertens v. Hewitt Assocs., 508 U.S. 248, 262–63 (1993) ("There is, in other words, a 'tension between the primary [ERISA] goal of benefiting employees and the subsidiary goal of containing pension costs.'" (quoting Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 515 (1981))).

241. *See* Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 225 (2013) ("ERISA's objective of protecting the rights and benefits of plan participants also includes avoiding undue administrative burdens on employers and preserving employers' right to customize plans.").

242. *But see* Eisenberg, *supra* note 26 ("I don't think all the onus should be on the government and employers. Individuals ought to be required to save for retirement, too.").

243. *But see id.* ("There's one hidden catch with The Super's mandatory employer contributions: employees get lower pay and smaller raises than they would otherwise, since the money has to come from somewhere.").

244. *See supra* notes 125–29 and accompanying text.

245. Ghilarducci, *supra* note 4 ("This do-it-yourself pension system has failed. It has failed because it expects individuals without investment expertise to reap the same results as professional investors and money managers.").

to mostly DC compulsory Super funds that the participation rate went from 50% of the workplace population to over 90%.[246]

American policymakers have been utilizing automatic enrollment and automatic contribution escalation to get employees in the plan and then to have them invest in sufficient levels to be retirement ready. Of course, the biggest problem is that the voluntary nature of ERISA means half of the American population does not have access to 401(k) plans at all.[247] This is especially problematic for small and midsize employers who find it too expensive or complicated to sponsor such a scheme. Even though the American government has sought to set up simple 401(k) plans for less cost and with less administrative burden, the participation rate in 401(k) plans is still very low for smaller employers.[248]

And even when employees have access to 401(k) plans, they choose not to participate or they invest their money in such plans unwisely because of a lack of financial sophistication.[249] Behavioral economics and choice architecture suggest that because of the obstacles facing such employees, the better option would be to allow employees to default their contributions into a MySuper-type product, separate and apart from their employer. In other words, if the employee does absolutely nothing, the money is transferred into a MySuper account, which is low-cost, highly diversified, and managed by expert investment managers. Currently, a large segment of the Australian population does just that,[250] suggesting that most people prefer a passive approach to retirement and to have their retirement participation, contributions, and investment strategy done for them.

### *C. Employer-Sponsored Plans Become Super Funds*

Moving from an employer-sponsored system, like the 401(k) scheme under ERISA, to a scheme that largely takes employers out of the equation has a number of benefits. Initially, a significant benefit stems from the fact that the United States government pays an enormous tax subsidy to private employers and employees of over $100 billion to incentivize them to sponsor retirement plans.[251] Outside of the

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246. *See* Bateman, *supra* note 159, at 2 ("In the mid-1980s, less than 50% of the workforce was covered by superannuation"); Butt et al., *supra* note 231, at 5 ("Compulsory participation in the system sets the Australian retirement savings system apart from general auto-enrolment with opt out, as operates in the UK, New Zealand and in some workplaces in the US. Over 90% of the Australian workforce has at least one superannuation account, managed in most cases by a private provider that operates as a trustee of the 'superannuation fund.'").

247. *See supra* note 52 and accompanying text.

248. *See* Copeland, *supra* note 16, at 10.

249. *See supra* Part I.C.

250. *See* Butt et al., *supra* note 231, at 6 ("To that end, a 2010 review of the Australian superannuation system recommended that the interests of defaulting members would be best served by a simple, low-fee, scalable default structure . . . . In the view of the review panel, most members were not engaged enough with retirement savings for the 'system to work properly.'" (quoting THE SUPER SYSTEM REVIEW PANEL, SUPER SYSTEM REVIEW FINAL REPORT PART ONE: OVERVIEW AND RECOMMENDATIONS 9 (2010), *available at* http://www.afr.com/rw/2009-2014/AFR/2010/07/05/Photos/0d280174-87d8-11df-bbd0-8f855dd2fda9_SSR%20Final%20Report%20Part%201.pdf [perma.cc/3N4L-3JWS])).

251. Dau-Schmidt, *supra* note 2, at 397 ("The amount of tax benefit to individuals and

tax deductions granted to employers for Super contributions and the fact that employees do not pay tax on Super contributions made on their behalf, there are no additional tax subsidies to persuade employers to participate because they are required to participate.

Although employers will pay a percentage of each employee's salary into the Super fund, there are fewer, unpredictable expenses associated with breach of fiduciary duty lawsuits. Quite simply, under superannuation, employers are no longer fiduciaries because they do not manage or administer retirement plans the way they sometimes do as dual-role fiduciaries under the American ERISA model.[252] Even in the present 401(k) context, employers have a fiduciary duty to select and monitor the 401(k) investment menu under ERISA section 404(c) and its regulations.[253] If they delegate those responsibilities to a different plan administrator or third-party fiduciary, they still have a residual fiduciary duty to make sure the plan is managed prudently.[254]

Taking the burden off employers to choose whether to sponsor workplace pension plans cannot be underestimated. Most employers are not in the retirement saving business and do not have core competencies in establishing and administering 401(k) plans. Consequently, much of the management of such plans is delegated to financial intermediaries, who many times have conflicted loyalties toward plan participants. These conflicted loyalties have been on display in both recent multimillion dollar class action litigation,[255] as well as a prime area of new regulation under the Department of Labor's (DOL) Employee Benefit Security Administration's (EBSA) conflict-of-interest rules for financial advisors.[256] With independent Super fund trustees this would not be an issue, as the fund trustees would have the ultimate fiduciary duties to act for the sole purpose of providing Super fund members sufficient retirement income.[257]

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corporations in 2012, given in the form of tax deferral in order to encourage the formation of pension plans, has been estimated at about $106.1 billion.").

252. ERISA Section 408(c)(3) permits ERISA fiduciaries to wear different hats and also be the settlor of the plan in establishing, amending, or terminating the plan. *See* Varity Corp. v. Howe, 516 U.S. 489, 526 (1996) (Thomas, J., dissenting) ("Under ERISA, an employer is permitted to act both as plan sponsor and plan administrator. § 408(c)(3), 29 U.S.C. § 1108(c)(3) (1988 ed.). Employers who choose to administer their own plans assume responsibilities to both the company and the plan, and, accordingly, owe duties of loyalty and care to both entities.").

253. 29 U.S.C. § 1104(c) (2012).

254. 29 C.F.R. § 2550.404c-1 (2014).

255. *See, e.g.*, Tibble v. Edison Int'l, No. 13–550, slip op. at 6–7 (U.S. May 18, 2015) (finding potential ERISA fiduciary liability for failing to periodically monitor 401(k) investment selection for continuing reasonableness of investment).

256. *See* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509–10); *supra* text accompanying note 22.

257. *See* Muir, *supra* note 232, at 70 ("[T]he trustees of the MySuper product bear not just the standard fiduciary obligations of fund trustees, but also the enhanced responsibility to ensure that the investments and fees are appropriate for the employees whose retirement savings are invested in their MySuper product. Thus, in Australia, the responsibility for appropriate investment decisions, including decisions that affect product fees, coincides with both the locus of investment expertise and responsibility for investment strategy." (citation

An American superannuation model might work slightly differently, given the difficulty the Australian SG has had with employees making voluntary contributions to their SG accounts. Instead of employer contributions alone to Super funds, an American model could require both employer contributions and employee contributions.[258] Not only will both employer and employee be literally invested in the success of the superannuation fund, but such joint contributions would likely mean that American employers would have to contribute less. At the same time, just like with the SG system, employer contributions to the superannuation funds would be tax deductible.

The biggest advantage to such a setup would be that it would largely take employers out of the pension equation.[259] Because most employers do not have the core competencies to be responsible for setting up investment alternatives for their employees' pension money and wish to avoid the costs associated with pension plans, it is not surprising that many are seeking to exit the pension business in one way or another.[260] Consequently, most employers use a financial intermediary to provide these services to their employees. Because of the manner in which financial intermediaries operate, they tend to be conflicted and do not always act in the employees' best interest.[261] Rather than broaden the fiduciary rule under ERISA, increase the amount of fiduciary litigation, and scare away employers from the ERISA voluntary plan world, just take the employer out of the retirement scheme. Send superannuation funds directly to independent Super funds (which can be industry based, public sector, or retail). The money would be sent to the most sophisticated money managers in the country, who would have the ability to invest that money properly and would have the legal obligation to do so. The size of these mega-pension funds also ensures lower investment fees given economies of scale and intense market competition, which means more retirement savings for individuals over the long term.[262]

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omitted)).

258. *See* Eisenberg, *supra* note 26 ("I don't think all the onus should be on the government and employers. Individuals ought to be required to save for retirement, too—or at least have contributions automatically taken out of their pay unless they choose to opt out."). In other words, we are forcing, especially younger workers, to use some of their income early in their career for retirement (when the time value of money and tax-free investment returns can have their biggest impact).

259. Professor Dau-Schmidt aptly observes that although during the time period after World War II employers used workplace pensions to bind employees to them throughout their careers, in the global service economy "American employers have been much less enthusiastic about offering pension plans in their effort to compete with low-wage foreign labor." Dau-Schmidt, *supra* note 2, at 397.

260. *See* Robert Steyer, *Litigation Heavy on Minds of Defined Contribution Execs*, PENSIONS & INVESTMENTS (Mar. 23, 2015), http://www.pionline.com/article/20150323/PRINT/303239982/litigation-heavy-on-minds-of-defined-contribution-execs [perma.cc/5CJZ-A8G6] ("Defined contribution plan executives are as concerned about litigation as they are about failing to meet their participants' retirement goals.").

261. *See supra* Part I.D.

262. *See* Ryan Alfred, *The One Chart That Explains 401(k) Fees*, BRIGHTSCOPE, www.brightscope.com/financial-planning/advice/article/15556/The-One-Chart-That-Explains-401K-Fees [perma.cc/5GKC-JHNL] ("Large plans (over $100m in assets) almost uniformly

### D. Expensive Plans Become Inexpensive Plans

Of course another advantage of such a compulsory, universal, employer-free system is that it would be substantially less costly and there would be substantially less cost associated with such an administrative apparatus. Quite simply, with Super funds having so much money in their control, not only could the best money managers be hired, but the investment funds' fees would likely be lowered. There are two reasons.

First, Super fund managers that do not have to chase profits would be more likely to adopt highly diversified, low-cost index funds.[263] Second, fees would be generally lower with sophisticated professionals managing these Super funds because most employees do not want to bother with learning how to properly invest their retirement money and monitor the continuing appropriateness of their investment.[264] Therefore, they will not mistakenly engage in active management of their investments, which has the effect of causing the cost associated with their retirement funds to rise and the funds' overall investment return over the long term to drop significantly.[265]

### E. Misaligned Funds Become Aligned Funds

Finally, one of the biggest problems with the current 401(k) plan framework is the lack of alignment between the investment advisors and brokers, who provide investment services, and the 401(k) participants themselves. David Swenson, who runs the investment portfolio at Yale, puts it this way: "Wall Street makes no money on low-cost index funds. That is the problem."[266]

Indeed, the empirical evidence of Wall Street's greed is easy to find when it comes to investment advisor behavior toward employee participants of 401(k) plans. In one study, Professor Mullainathan and his colleagues sent mystery shoppers to visit financial advisors.[267] They found that advisors mostly recommended investment

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have fees below 1%. The largest plans are usually below 0.50%. . . . The small plan marketplace is a different story. Average fees for small plans is between 1.5–2%, with plenty of plans paying more than 2% a year in fees.").

263. *See* Bogle, *supra* note 32, at 1.

264. *See* Muir, *supra* note 232, at 68 ("Members lack awareness of fund performance and fees in part because they do not actively make payments into their accounts and, in many cases, do not expect to access the funds for many years.").

265. The market could also help to protect against rising fees associated with superannuation funds. With funds competing for plan participants, the fees associated with managing the plan assets should stay low. However, there is the worry that if the plan participants do not pay much attention to their fees, funds might increase such fees regardless of the market and competitive forces. One idea to combat this is to develop regulations to "qualify" funds if they meet certain conditions, such as by preventing fees from increasing over a set amount during a specific period of time. Australia has regulated how much MySuper funds may charge in fees. *See id.* at 70 ("[T]he trustees of the MySuper product bear not just the standard fiduciary obligations of fund trustees, but also the enhanced responsibility to ensure that the investments and fees are appropriate for the employees whose retirement savings are invested in their MySuper product.").

266. Porter, *supra* note 5.

267. *See* Mullainathan et al., *supra* note 79, at 2.

strategies that fit the investment advisor's own financial interests.[268] These advisors sought to buttress these individuals' mistaken perception about investing and actually encouraged them to chase returns and advised against low-cost options like low-fee index funds.[269]

Mullainathan and his colleagues are not alone in their findings. Another recent study by Susan Christoffersen and her colleagues found that investment advisors directed more of their clients' money to funds that shared the upfront fees with the advisors.[270] Not surprisingly, returns of these funds were poor compared with alternatives.[271] Generally speaking, when employees are not given responsibility for investing their own retirement monies, these types of behaviors by investment advisors are less likely to occur, solely because most employees, if Australia's SG system provides any guidance, will happily default into a well-diversified, low-fee portfolio without receiving conflicted advice.[272] Or to put it slightly differently, in the MySuper setup with a default to a large, highly diversified, passive account, the interests of the Super fund managers and the plan participants will be better aligned.[273]

An American plan would also consider diversification in the context of providing underlying retirement security to plan participants. Diversification does not stop with merely diversifying the investments among which plan assets are allocated; it also calls for ensuring that part of plan participants' portfolios are allocated toward annuities. Placing plan assets into an annuity form might not maximize the growth in a retirement portfolio the way that certain other investments might, but it provides for underlying retirement security and hedges effectively against market risk or unwise use of lump sum distributions. Equities, fixed income investments, and alternative assets (like private equity, hedge funds, and infrastructure) cannot provide a similar guarantee of lifetime income throughout retirement and thus, these other types of investments do not deal with longevity risk like annuities do. Indeed, although more expensive initially, the best bet might be an annuity that is indexed for inflation (much like U.S. Social Security). Such annuities further protect retirees against large rises in the price of consumer and medical goods.

In order to help individuals prepare for their retirement years, an American plan might consider requiring a certain percentage of plan assets to be allocated toward some form of an annuity. Until recently, the United Kingdom had such a requirement—individuals who participated in tax-favored pension plans were required to allocate 75% of their pension assets in annuities.[274] Singapore has also

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268. *Id.* at 4.

269. *See id.* ("We document that advisers fail to de-bias their clients and often reinforce biases that are in their interests. Advisers encourage returns-chasing behavior and push for actively managed funds that have higher fees, even if the client starts with a well-diversified, low-fee portfolio.") (quote appears within the abstract on an unnumbered page).

270. Christoffersen et al., *supra* note 81, at 229.

271. *Id.*

272. *See* sources cited *supra* notes 230–31 and accompanying text.

273. *See* Muir, *supra* note 232, at 70 ("[I]n Australia, the responsibility for appropriate investment decisions, including decisions that affect product fees, coincides with both the locus of investment expertise and responsibility for investment strategy.").

274. In 2014, the United Kingdom eliminated the requirement that 75% of retirement assets

announced that it will require individuals to annuitize a certain amount of their retirement assets.[275] The United States might follow by example, providing American citizens with a meaningful way to manage the risks of longevity and prevent outliving saved retirement income.

Of course, annuities are not a panacea for all that ails retirement saving in the United States. Part of the problem is that Americans generally do not wish to purchase annuities. Many surveys indicate that while most people prefer a guaranteed lifetime income (like U.S. Social Security), the same individuals rarely will buy such annuities or stick with the pension rather than take a lump sum buyout.[276] This is another aspect of the behavioral economics puzzle explored above: because individuals have to part with such a large sum of money now to receive a comparatively much smaller amount of monthly income in the future, they see the bargain as a bad deal.[277] They fear getting hit by a bus tomorrow and losing the bet.

Perhaps, as some actuaries have suggested, the best path for a retiree, if he or she is healthy, is to buy an inflation-indexed annuity with at least part of his or her 401(k) lump sum money.[278] At that point, the retiree would be better prepared to endure financial market crashes, historically low interest rates, running out of money, or managing their money when they are old and have diminished capacity and may be subject to undue influence by friends and family.

## CONCLUSION

The American 401(k)-dominated system has led to a retirement crisis in this country as a large cohort of baby boomers continue to retire. The retirement crisis can be explained largely by the shift from DB plans, where employers were in control of retirement investment, to DC plans, where employees are now in control. Behavioral economics suggests that by using choice architecture techniques, employees can be nudged into well-diversified, low-fee portfolios, while

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be allocated toward annuities, although it remains unclear why the decision was made. Alicia H. Munnell, *Big Change in U.K. Pension Provisions*, MARKET WATCH: ENCORE BLOG (Apr. 2, 2014, 12:00 PM), http://blogs.marketwatch.com/encore/2014/04/02/big-change-in-u-k-pension-provisions/ [perma.cc/8SGV-2WFY].

275. *CPF Life*, CENTRAL PROVIDENT FUND BOARD FUND SING., https://www.cpf.gov.sg/Members/Schemes/schemes/retirement/cpf-life [perma.cc/5EST-AEH2].

276. *See generally* Rami Hanegbi, *Security in Uncertain Times: Policies for Increasing the Popularity of Life Annuities Among Retirees*, 20 VA. J. SOC. POL'Y & L. 473 (2013) (discussing several surveys indicating the preference for lump sums over annuities).

277. *Id.* at 487 ("[H]olding a life annuity presents potential losses. One is the risk of dying early.").

278. *See id.* at 476–77 ("Traditional life annuities offer a secure retirement income that few instruments can match. Their returns are free from investment risk and longevity risk. Moreover, if they are indexed, they are also free from inflation risk." (citation omitted)). "Since the 1990s, life annuities that are inflation-indexed have also been available in the United States." *Id.* at 476 n.4 (citing Jeffrey R. Brown, Olivia S. Mitchell & James M. Poterba, *The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 7005, 1999)). The percentage devoted to such annuities could be determined based on an overall assessment of the longevity risk the individual faces.

contributing the necessary amounts to be ready for retirement. Although some of these techniques exist in the form of automatic enrollments and automatic contribution escalation, the voluntary, employer-run nature of the 401(k) system inevitably undermines the success of these initiatives.

What would lead to better retirement outcomes for more people is a solution established by well-supported behavioral economic insights. These insights permit employee choice in how retirement money is invested, but recognize that in this complex context, sometimes the choice is to do nothing and let others who are more financially literate exercise that choice on the employee's behalf.

One such workplace pension model would be a mandatory DC system, where employees universally contribute, along with their employers, a sufficient amount of their salary directly into independent superannuation funds that charge low fees for their services, employ sophisticated, non-conflicted fund managers, and align interests appropriately between these managers and participants through enhanced fiduciary duties. Luckily, a very successful DC plan of this variety has existed in one form or another for over twenty years in the form of Australian Superannuation Guarantee. The SG provides compulsory, nearly universal workplace retirement plans through sophisticated professional managers at a low cost and operated in the best interest of supporting the retirement security of member employee participants.

The United States can similarly transform its current 401(k) retirement nightmare (where too few workers have access, participate, or invest wisely) into a successful regime by establishing a universal, mandatory DC scheme run by independent Super fund managers, free from employers and their conflicted financial intermediaries. Although somewhat counterintuitive given the labor-oriented history of such plans, workplace retirement plans should no longer be a part of labor regulation in the United States, but rather a matter of finance, securities, and tax regulation through such agencies as the SEC and the IRS. However, unlike Australia, the U.S. government should continue to push employees to at least partially annuitize retirement portfolios through choice architecture and use of defaults that would have a specified percentage of retirement funds be invested in inflation-indexed life annuities unless employees opt out.