

Privatizing Social Security

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TABLE OF CONTENTS

I.	INTRODUCTION	747
II.	SOCIAL SECURITY—BACKGROUND AND GROWTH	749
III.	THE ROLE OF PRIVATE PENSIONS IN AMERICAN SOCIETY	758
IV.	SOCIAL SECURITY VS. PRIVATE RETIREMENT ACCOUNTS	770
V.	SWITCHING OVER TO PRIVATE ACCOUNTS	773
VI.	SURVIVORS AND DISABILITY BENEFITS	779
VII.	PRIVATE SOCIAL SECURITY ACCOUNTS	782
	A. <i>Contribution Requirements and Limitations</i>	782
	B. <i>Custodian Requirements</i>	786
VIII.	INVESTMENT RESTRICTIONS	795
IX.	GOVERNMENT MANAGED PRIVATE ACCOUNTS	806
X.	THE AUSTRALIAN SYSTEM	813
XI.	CONCLUSION	814

I. INTRODUCTION

The 2000 presidential election focused attention on an idea that has been surfacing for some time—the privatization of Social Security.¹

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1. *Calling All Swing States*, NEWSWEEK, Nov. 20, 2000, at 110, 117 (describing attacks by the campaign of Vice President Al Gore on the Bush proposals). Privatization is already well under way for the pension accounts of government employees. The

Long considered the “third rail” of politics, Social Security has historically been immunized from debate or criticism concerning costs or its value to society. That protective cover is now gradually being lifted, and Social Security reform is becoming a topic that may be responsibly discussed, even in a public forum.² Although opposition remains fierce, proposals for privatization have been gradually gaining acceptance as the inadequacy of benefits from the present system become more apparent, and bankruptcy becomes certain in the absence

federal government’s pension plan for civil service employees allows investments in stocks and other securities. The level of benefits these employees receive upon retirement will depend on the success of the investments they select. *See infra* notes 318–21 and accompanying text. State pension funds have for many years invested in common stocks and other securities, and are allowing their employees increasingly to select their own investments. Those individuals’ retirements will be largely privatized since they do not contribute to Social Security. *See generally* Paul Roye, Director, SEC Division of Investment Management, Protecting Pension Plan Participants Through Investor Education, Address Before the International Foundation of Employee Benefit Plans (May 9, 2000), *available at* 2000 WL 563757 (S.E.C) (noting that several states, including Florida, are considering or have already adopted defined contribution plans that will allow state employees to make their own investment decisions). Europeans, who have traditionally been the staunchest supporters of socialized pension schemes, are also considering reduction of the role of government in their retirement programs. France has already adopted legislation for tax advantaged personal pension plans. John Tagliabue, *Europe Rethinks Its Pensions: A Search for Ways to Reduce the Government’s Role*, N.Y. TIMES, Dec. 26, 2000, at C1. Germany is planning to provide for private pension plans that would partially privatize the current public pension system. Christopher Rhoads, *Germany Is Poised for a Pension Overhaul*, WALL ST. J., May 10, 2001, at A13. Chile already has a privatized social security system, and at least seven other Latin American countries are adopting that model in one form or another. Clifford Krauss, *Social Security, Chilean Style; Pensioners Quiver as Markets Fall*, N.Y. TIMES, Aug. 16, 1998, § 4, at 4; *see also* Kristen V. Campana, *Paying Our Own Way: The Privatization of the Chilean Social Security System and Its Lessons for American Reform*, 20 U. PA. J. INT’L ECON. L. 385 (1999) (describing Chilean system). For a description of the privatization of the Australian retirement system *see infra* notes 342–48 and accompanying text.

2. *See e.g.*, Jake Thompson, *Congress Awaits Push on Social Security*, OMAHA WORLD-HERALD, Jan. 11, 2001, at 18 (discussing Social Security as the third rail of politics); Edwin Feulner, Editorial, *Let’s Not Forget Election’s Bright Spots*, CHI. SUN-TIMES, Dec. 2, 2000, at 26, *available at* 2000 WL 6707259 (discussing how the Social Security privatization issue was addressed in last presidential campaign). *See generally* Joe Frolik, *Bush Rides the “Third Rail,”* PLAIN DEALER (Cleveland, Ohio), June 25, 2000, at 5G (describing controversy raised in 1964 presidential campaign when Barry Goldwater suggested that Social Security should be made voluntary). In January 1997, a Federal Advisory Council divided over the issue whether to allow private social security accounts, but seven of its thirteen members wanted to require compulsory saving through individual accounts. 1 REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, FINDINGS AND RECOMMENDATIONS 35–57 (Jan. 1997). A later federal advisory committee unanimously recommended the use of private accounts to supplement Social Security. Richard W. Stevenson, *Bipartisan Plan for Rescue of Social Security Involves Markets and Retirement at 70*, N.Y. TIMES, May 19, 1998, at A17. Following his election, President George W. Bush appointed a bipartisan panel to make recommendations on how to privatize Social Security. Jackie Calmes, *Bush Social Security Panel Doesn’t Fear Painful Solutions*, WALL ST. J., May 10, 2001, at A20.

of additional onerous funding.³ Resistance to privatization largely centers on concerns that existing participants will lose their contributions and that private accounts may result in investment losses, which would leave future pensioners penniless. The disability and survivor benefits of the present Social Security system also raise concerns for the plight of the disadvantaged, should those features of Social Security be eliminated. However, proponents of private accounts argue that such accounts would provide far more social security and retirement benefits than available under the present government system, which offers little more than a poverty line existence to individuals dependent on Social Security for retirement. Contributions to private social security accounts would also make more funds available for investment and thereby strengthen the economy for the benefit of everyone. Proponents further contend that the system can be privatized without undue hardship and that survivor and disability benefits can be privately insured more effectively than through existing governmental programs.

This Article will address the debate and discuss regulatory concerns that would arise with the creation of private social security accounts. As will be shown, the present system fails to provide real social security, and deprives those most in need of a retirement program of an opportunity to increase their wealth or to have a comfortable retirement. Shifting to a private system would be expensive, but could be accomplished through recognition of the benefits of private investments and through a program of tax credits and deductions. Existing regulatory requirements protect private social security account holders from fraud, as well as overreaching and unsuitable investments. The question remains whether the government should be the custodian and provider of investment choices in a "privatized" Social Security system. As explained in this Article, government control would ignite a never-ending war over the role of the government in selecting "socially responsible" investments.

II. SOCIAL SECURITY—BACKGROUND AND GROWTH

As most people are aware, the existing Social Security system is a product of the New Deal legislation that spun out of the Great Depression. Less remembered are the political motivations that were its

3. See generally Ron F. Docksai, Editorial, *Social Security's Promise and Reality*, PITTSBURGH POST-GAZETTE, Jan. 18, 1999, at A15, available at 1999 WL 5252280 (discussing advantages of a privatized Social Security system).

genesis. The widespread hardship engendered by the Depression gave rise to a renewed populist movement, which was exploited by various socialists, demagogues, and even a “radio priest.”⁴ They were promoting various programs that promised wealth to everyone.⁵ Upton Sinclair was among the leaders of this quest for a socialist utopia. He ran for governor of California in 1934 on a platform that he called the End Poverty in California Plan (EPIC). Sinclair proposed to tax corporations to feed the poor, and envisioned the conversion of bankrupt factories and farms into cooperatives.⁶ According to Sinclair, within two years cooperatives would hire the 700,000 workers then unemployed in California.⁷ EPIC further planned to give \$50 per month to Californians over age sixty.⁸ Although he lost the gubernatorial race, Sinclair’s EPIC

4. The Radio Priest was Father Charles E. Coughlin. VINCENT CURCIO, *CHRYSLER: THE LIFE AND TIMES OF AN AUTOMOTIVE GENIUS* 577 (2000). Supported heavily by organized labor, he was an advocate of free silver as a means of inflating the economy. J. Y. Smith, *The Reverend Charles E. Coughlin Dies: Noted as the ‘Radio Priest,’* WASH. POST, Oct. 28, 1979, at C10. At the time he was promoting the widespread use of silver, the good Father and his staff were also secretly speculating on its price through futures contracts. B. H. McCormack, *Decade Saw Advent of SEC, Revamping of Stock Exchange*, WALL ST. J., Jan. 2, 1940, at 16.

5. Populism in America had been fueled in the last quarter of the nineteenth century by the debate over the use of silver and greenbacks to improve farm conditions. The Greenback party, which was formed in 1874, sought a system of paper currency to relieve the plight of the farmers who were suffering from low commodity prices and high debts. DAVIS RICH DEWEY, *FINANCIAL HISTORY OF THE UNITED STATES* 378–79 (12th ed. 1939); JACK WEATHERFORD, *THE HISTORY OF MONEY* 173 (1997). William Jennings Bryan’s famous “Cross of Gold” speech was the high point of the populist movement. See IDA M. TARBELL, *THE NATIONALIZING OF BUSINESS* (1878–1898) 250–51 (1936) (describing speech and exuberant reaction by convention). Bryan lost the presidential race, however, and the United States went onto a gold standard. See DEWEY, *supra*, at 469 (describing Gold Standard Act of 1900); MARGARET G. MYERS, *A FINANCIAL HISTORY OF THE UNITED STATES* 218–20 (1970) (describing the Bryan campaign). The populist movement’s most memorable monument is the book *The Wizard of Oz*, written by L. Frank Baum. Made into a children’s movie, it was originally an allegory on the populist fight against the gold monetary standard. WEATHERFORD, *supra*, at 175–76. Returning prosperity at the beginning of the twentieth century doomed the populists’ cause, at least until the depression in the 1930s gave rise to its resurrection. Franklin Roosevelt tried to harness those forces through an attack on financiers and the existing financial system. See generally ELLIS W. HAWLEY, *THE NEW DEAL AND THE PROBLEM OF MONOPOLY* 322–23 (1974) (stating that the New Deal was seeking to destroy the “Money Power” and “High Finance”). One of Roosevelt’s first acts was to take the United States off a gold standard. WEATHERFORD, *supra*, at 181. Roosevelt then began inflating the monetary system from his bedroom. See Francis Fukuyama, *A Moral Compass to the World*, N.Y. TIMES, Aug. 23, 1998, Book Section, at 6 (describing conflicts between Dean Acheson, then a Treasury official, and President Roosevelt over this cavalier approach to monetary policy); DEAN ACHESON, *MORNING AND NOON* 166–94 (1965).

6. See GREG MITCHELL, *THE CAMPAIGN OF THE CENTURY: UPTON SINCLAIR’S RACE FOR GOVERNOR OF CALIFORNIA AND THE BIRTH OF MEDIA POLITICS* 103–09 (1992).

7. James N. Gregory, *Upton Sinclair*, 30 CAL. J. 45, 45 (1999).

8. Carol Vinzant, *Born to Retire*, FORTUNE, Aug. 16, 1999, at 81–86.

helped push Franklin Roosevelt toward the adoption of Social Security.⁹

Dr. Francis Townsend was another rising populist with a plan for relieving the hardship of the aged. His Old Age Revolving Pensions, Ltd. program sought to have \$200 paid monthly to all of the elderly, provided they were not working and agreed to spend the money when they received it.¹⁰ The "Townsend Plan," as it was generally referred to, sought to fund these payouts through a two percent transactions tax.¹¹ Over 7000 Townsend clubs with 2.2 million members were formed to support this program,¹² and Townsend received some \$1 million in contributions.¹³

That initiative pushed Roosevelt further toward a federal retirement program of his own, but the greatest threat to his administration was a program promoted by "Kingfish" Huey Long, the demagogue, former governor and senator from Louisiana. The first scientific political poll ever undertaken indicated that a Long challenge to Roosevelt would have resulted in the election of Alf Landon.¹⁴ Senator Long was promoting his "Share the Wealth" program, which would have made "every man a king." Long wanted the government to give pensions of \$30 per month to those over age sixty who did not have an income of \$1000 per year or \$10,000 in assets.¹⁵ He wanted each family in

9. Richard Rothstein, *Friends of Bill?: Why Liberals Should Let Up on Clinton*, AM. PROSPECT, Winter 1995, at 32 (while Sinclair was running for governor he headed a movement called End Poverty in California (EPIC), which was later characterized as the "high tide of radicalism" in America); Pat Morrison, *When Public Office Was a Lesson in the Chemistry of Change*, L.A. TIMES MAG., Nov. 14, 1999, at 16. Another government funded retirement scheme was proposed by two Hollywood advertising men. Their "Ham and Eggs" plan would have given \$30 each Thursday to old people. Jack Smith, *United They Fell*, L.A. TIMES MAG., Dec. 17, 1989, at 10.

10. Vinzant, *supra* note 8, at 81-86.

11. Alvin Williams, *Reforming Our Ailing Social Security System: The State of the Current System and Its Impact on African-Americans*, 8 ELDER L.J. 221, 223-24 (2000).

12. David C. Beeder, *Midlands Doctor Assisted in Social Security's Birth*, OMAHA WORLD-HERALD, Feb. 8, 1998, at 3B.

13. Smith, *supra* note 9, at 10.

14. Beeder, *supra* note 12, at 3B.

15. Huey Long, *'Every Man a King' According to the Plan of God*, MINNEAPOLIS STAR TRIB., June 12, 2000, at 11A, available at <http://proquest.umi.com/pqdweb?TS=. . . =1&Did= 000000055116531&Mtd=1&Fmt=3> (last visited Apr. 26, 2001). More recently, in 1998, Senators J. Robert Kerry and Daniel Moynihan introduced legislation that would have provided every child in America with \$1000 at birth and an additional \$500 for each child's first five birthdays to be invested over his life. This proposal was not adopted. Daniel Patrick Moynihan, *Building Wealth for Everyone*, N.Y. TIMES, May 30, 2000, at A23. Another scheme proposed by Senator George McGovern during the 1972 presidential campaign (the "Demogrant") would have given \$1000 annually to

America guaranteed a minimum annual income of \$2000, and his program would have given each family \$5000 to buy themselves a home, an automobile, and a radio. Money to fund this plan would come from confiscating the estates of the rich.¹⁶ Long particularly targeted John Rockefeller for such a seizure.¹⁷

These plans were all a bit hare brained, but did place political pressure on Franklin Roosevelt to do something. After all, these populist programs were attacking his political base.¹⁸ The Roosevelt administration developed an alternative program, designed to remove the focus from the populist, albeit impractical, programs fast gaining support among the masses that were so severely affected by the Depression. The Roosevelt program was enacted into law in 1935.¹⁹ The "Social Security" legislation was crafted by Marion Folsom, the Treasurer for Eastman Kodak Company.²⁰ It created a federal pension system funded by taxes on employers and employees.²¹

The Social Security program as originally enacted did not seek to provide universal coverage for retirement benefits. In fact, it was quite limited in scope. Indeed, benefits were restricted to such an extent that a skeptic might think it was merely a rather cynical political plan designed to divert attention from the more radical proposals of the populists on the far left of the Roosevelt constituency.

Most workers were simply excluded from the Social Security Act. America's largest business was agriculture, yet farm laborers, who had no company pension plans, did not qualify for benefits.²² Also excluded were the self-employed, educators, household servants, casual laborers and the masses of unemployed.²³ This left for coverage the industrial

every man, woman and child in the United States. Charles Krauthammer, *Family Leave Flimflam*, WASH. POST, Sept. 18, 1992, at A21.

16. Thomas DiBacco, *Long Line of the Kingfish*, WASH. TIMES, Aug. 30, 1993, at E4.

17. DAVID M. KENNEDY, *FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929-1945*, at 238 (1999).

18. By 1934, twenty-eight states had adopted some form of old-age pension laws, but funding and benefits were inadequate. Vinzant, *supra* note 8, at 83.

19. Social Security Act, Pub. L. No. 74-271, 49 Stat. 620 (1935). See generally ALEX GRONER, *AMERICAN BUSINESS & INDUSTRY* 299 (Alvin M. Josephy, Jr. ed., 1972) (describing Social Security).

20. David Brody, *Modern Manors: Welfare Capitalism Since the New Deal*, 52 *INDUS. & LAB. REL. REV.* 325 (1999) (book review).

21. PETER FEARON, *WAR, PROSPERITY, AND DEPRESSION: THE U.S. ECONOMY (1917-1945)* 244-45 (1987).

22. Agriculture continues to be America's largest business. Benjamin Schwarz, *Broken Heartland, The Rise of America's Rural Ghetto*, 263 *NATION*, No. 14, at 27 (1996) (book review), available at LEXIS, AllNewsPlus.

23. Social Security Act, Pub. L. No. 74-271, § 210, 49 Stat. 620, 625 (1935); FEARON, *supra* note 21, at 244.

workers who were organized and could pose a political threat to the New Deal. Ironically, among the laboring classes, industrial workers needed Social Security the least. Although their lives were hard and unemployment threatened every day, the industrial workers eligible for Social Security were receiving paychecks that gave them regular sources of income—an advantage denied to many of those excluded from the system. At the same time, industrial workers were already witnessing the development of company pension plans, something unavailable to other classes of workers.²⁴ Those circumstances suggest that the Roosevelt administration threw this sop to the industrial workers because of the political threat posed by organized labor.

Even more cynically, eligibility for Social Security retirement benefits did not begin until age sixty-five.²⁵ At the time of the enactment of this legislation, the life expectancy of Americans was sixty-two.²⁶ Thus, it did not appear that the system really intended to protect anyone, except a very limited class of workers who might exceed their life expectancy, a presumably small group.²⁷

The doctrine of unintended consequences soon intervened to expand Social Security far beyond its original goals. The first Social Security check was mailed in 1940 to Ida May Fuller in Ludlow, Vermont, just as the Depression was ending. Ida May Fuller did not die until 1975, at the age of 100.²⁸ This type of longevity was unforeseen in the midst of the hardships engendered by the Depression. But postwar prosperity and medical advances resulted in a substantial extension of life expectancy, which raised concerns that increased numbers of elderly retired workers would face poverty unless the Social Security system was expanded. Having experienced the ravages of the Great Depression, the American public wanted a safety net for the years in which they would no longer be able to work. As a consequence, Social Security was expanded to reach over nine million people in the 1950s.²⁹ Eventually, the Social

24. See discussion *infra* notes 62–79 and accompanying text.

25. Social Security Act, Pub. L. No. 74-271, § 210, 49 Stat. 620, 625 (1935).

26. Mary Deibel, *Social Security Will Be Major Battleground, Presidential Candidates Have Different Ideas on Saving the Program*, DETROIT NEWS, Aug. 20, 2000, at 18.

27. In fairness, congressional hearings on the Social Security Act found that the number of persons over age sixty-five were increasing and that many in that age group were in desperate circumstances. *Helvering v. Davis*, 301 U.S. 619, 642 (1937).

28. Fuller made \$24.75 in Social Security contributions and received \$22,889 in benefits. Vinzant, *supra* note 8, at 83.

29. HAROLD G. VATTER, *THE U.S. ECONOMY IN THE 1950S: AN ECONOMIC*

Security system became mandatory for almost all workers.³⁰

Today, over 147 million Americans and their employers are paying Social Security taxes.³¹ Coverage has also broadened to include dependents of workers and disabled employees.³² As a result of expanded coverage, more than forty-four million individuals were receiving Social Security benefits in the year 2000.³³

The Social Security system demonstrated several weaknesses beyond simply the scope of coverage. Benefits could be lost if the beneficiary earned more than specified amounts before reaching age seventy-two.³⁴ This provided a disincentive for elderly people to remain in the work force, and those restrictions were eased. Nevertheless, benefits are still lost today as the result of continued employment, until an individual reaches full retirement age, which is being increased to age sixty-seven.³⁵

Social Security benefits were increased for the first time in 1950.³⁶ That increase reflected an inherent weakness in the Social Security system. Benefits were to be paid to workers in defined amounts that were based on several factors, including their contributions to the system and age of retirement. That computation did not take into account the effect of inflation, which could quickly undermine the value of a fixed benefit.

As long as the economy was stable, the defined benefits available from Social Security, though they were small, could be used to maintain a stable retirement program. The elderly did not necessarily escape poverty, but they could subsist. Inflation was moderate after the Korean conflict, but unfortunately that happy circumstance changed in the 1960s. The Vietnam War pushed inflation to new heights. Retirees dependent on defined benefits that were set at preinflation levels were devastated. Congress responded by increasing benefits by 20% in 1972,

HISTORY 198 (1963).

30. This would cause embarrassment for some political appointees who failed to withhold Social Security and other taxes on their baby sitters and domestic help. Zoe Baird was one victim of this requirement. Her appointment as Attorney General in 1993 was withdrawn after it was revealed that she had employed illegal immigrants as domestic help and failed to pay Social Security taxes for them. More recently, the appointment of Linda Chavez as Secretary of Labor was withdrawn on similar grounds. *First Blood*, *ECONOMIST*, Jan. 13, 2001, at 27; William Bradford Reynolds, *Etiquette for the Senate*, *N.Y. TIMES*, Jan. 12, 2001, at A23.

31. Robert Rosenblatt, *A Radical Idea Becomes a Savior of the Elderly*, *L.A. TIMES*, Oct. 16, 1999, at B4.

32. *Id.*

33. *SOC. SEC. ADMIN., SOCIAL SECURITY: BASIC FACTS 1* (2000).

34. *Flemming v. Nestor*, 363 U.S. 603, 608-09 (1960).

35. *SOC. SEC. ADMIN., SOCIAL SECURITY: UNDERSTANDING THE BENEFITS 29* (2000).

36. Vinzant, *supra* note 8, at 85.

and then providing for automatic cost of living adjustments thereafter.³⁷

Lyndon Johnson's Great Society programs extended the safety net further by expanding welfare programs and benefits for the elderly. By the end of the century, the American government would be expending more than \$400 billion per year for Social Security and related programs such as Medicare.³⁸ The growth of such entitlement programs periodically raised funding concerns. Inflation rose by 60% between 1977 and 1981, while wages fell almost 7%. At the same time, inflation-adjusted Social Security benefits were increasing and placing strains on the ability of workers to fund those benefits.³⁹ This resulted in increased withholdings and restrictions on access.⁴⁰ The eligibility age for benefits was also increased for younger participants, and benefits began to be taxed in 1983.⁴¹ Originally, contributions were limited to 3% for the employee and employer on income up to \$3000.⁴² Contributions have since been increased to meet funding requirements, and by 2000 a worker and his or her employer were each required to contribute 6.2 % (a total of 12.4%) of the first \$76,200 earned by the employee.⁴³

Increasing contributions and restricting access to benefits belied another problem. As even the government now concedes,⁴⁴ benefits under Social Security are too meager to allow a comfortable retirement without outside sources of income. It also appears that in order to continue the system, benefits will have to be maintained at a poverty level with increasingly higher years of eligibility and forfeitures for those with other sources of income. As a result, the Social Security system is looking more like a welfare system than like the retirement savings plan that was originally promoted and maintained over the years.⁴⁵

37. *Id.*

38. KENNEDY, *supra* note 17, at 273.

39. JUSTIN MARTIN, GREENSPAN: THE MAN BEHIND THE MONEY 146 (2000).

40. The Social Security system was changed from a pay-as-you-go to a partially funded system in 1977. Daniel Patrick Moynihan, *Building Wealth for Everyone*, N.Y. TIMES, May 30, 2000, at A23.

41. Vinzant, *supra* note 8, at 86. That action was taken by Congress following a report by a Social Security Commission that was headed by Alan Greenspan. MARTIN, *supra* note 39, at 147.

42. Amity Shlaes, *Fixing Social Security*, 107 COMMENT. 38 (1999).

43. SOC. SEC. ADMIN., *supra* note 35, at 8.

44. See *infra* note 50 and accompanying text.

45. The bureaucracy needed to administer Social Security benefits is also massive and imposes costs that effectively tax everyone. That budget has grown rapidly. In fiscal year 1990, the Social Security Administration's budget was about \$4.2 billion.

The system is also bankrupt, at least for those expecting future benefits. Recent legislation required the Social Security Administration to begin providing participants with an annual disclosure of their contributions and expected benefits. Those statements reveal just how ineffective Social Security is as a retirement program. Specifically, the agency was advising participants through those statements that the system will be paying out more in benefits than will be collected in taxes by the year 2015. By the year 2034, Social Security “trust funds will be exhausted and the payroll taxes collected will be able to pay only 71% of benefits owed.”⁴⁶

That hardly sounds like social security. Indeed, it seems to fit closely with the definition of bankruptcy. More troubling is the fact that younger workers will be required to fund benefits for greater number of retirees even while their own numbers are shrinking. Today, there are about 3.25 workers for each retiree. By the year 2030, that ratio will drop to two-to-one.⁴⁷ Future workers will have to give up increasing amounts of their income to keep the Social Security system solvent, crippling their own efforts to avoid poverty and save for retirement.⁴⁸

Robert Pear, *Social Security is Short of Money*, N.Y. TIMES, Dec. 19, 1990, at A22. The Social Security Administrator was seeking \$7.3 billion in funds for his agency’s administrative budget in fiscal year 2001. *Prepared Testimony of Steve Korn Before the House Committee on Ways and Means Subcommittee on Social Security*, FED. NEWS SERV., Mar. 16, 2000, available at LEXIS, News Group File, All. Another problem is fraud. Some 25,000 fugitives from justice were receiving supplemental disability income (which is paid from general tax revenues) from the Social Security Administration between 1996 and 2000 in amounts totaling as much as \$283 million. *Check’s in the Mail, Even if You’re a Fugitive*, NEWS-ENTERPRISE (Elizabethtown, KY), Dec. 27, 2000, at 6A. *But see* HENRY J. AARON & ROBERT D. REISCHAUER, COUNTDOWN TO REFORM: THE GREAT SOCIAL SECURITY DEBATE 86–88 (1998) (contending that collective administrative costs of small, IRA-type privatized accounts would exceed present government expenditures).

46. Letter from the Social Security Administration, to Jerry W. Markham, Professor of Law, University of North Carolina at Chapel Hill 1 (May 9, 2000) (on file with author). More recent projections have pushed the date of the exhaustion of Social Security reserves to 2038. Jackie Calmes, *Bush Social Security Panel Doesn’t Fear Painful Solutions*, WALL ST. J., May 10, 2001 at A20; Peter Spiegel, *U.S. and Canada: Health Reform Next on Agenda*, FINANCIAL TIMES (London), Mar. 20, 2001, at 13, available at LEXIS, News Group File, All. For countervailing views on Social Security bankruptcy, compare SYLVESTER J. SCHIEBER & JOHN B. SHOVEN, THE REAL DEAL: THE HISTORY AND FUTURE OF SOCIAL SECURITY (1999), describing concerns with Social Security, with DEAN BAKER & MARK WEISBROT, SOCIAL SECURITY: THE PHONY CRISIS (1999), contending that concerns with Social Security are overblown.

47. MARTIN, *supra* note 39, at 147. At the time Social Security was adopted there were twenty-five workers for each retiree. Donald B. Marron, *Not Privatizing Social Security Is the Biggest Risk of All*, WALL ST. J., May 18, 2000, at A26.

48. This flaw in the mostly pay-as-you-go financing of the Social Security System has led to its criticism of being a “giant Ponzi scheme.” JOHN ALOYSIUS FARRELL, TIP O’NEILL AND THE DEMOCRATIC CENTURY 570–71 (2001) (describing criticism of Social Security by David Stockman, a Reagan administration official). Another critic called

Already, about 80% of American households “pay more in Social Security than in income taxes.”⁴⁹

The level of Social Security benefits raises additional concerns. Benefits do little more than place recipients at about the poverty level. In statements mailed to American workers, the Commissioner of Social Security noted that his program’s benefits were the largest source of income for most elderly Americans, but he cautioned that: “Social Security benefits were not intended to be the only source of income for you and your family when you retire. You’ll need to supplement your benefits from a pension, savings or investments.”⁵⁰

Certainly, the level of Social Security benefits does not reflect a reward for a lifetime of hard work and saving. The benefits, as will be discussed below, do not provide any meaningful return on the investment of the contributions made by the employee and their employer.

More importantly, these limited benefits fall most heavily on the poor. The more wealthy have alternate retirement plans and to them, as the Commissioner suggests, Social Security is only a supplement to retirement benefits. Wealthier individuals are able to invest their retirement savings in investments that pay market returns and increase their wealth considerably through tax-free compounding during their working years. In contrast, the people most in need of an effective retirement program are those with the lowest income levels. They have little or no discretionary income for private retirement programs. Social Security is their only retirement plan, and it offers little return on their investments.⁵¹ The amount of employee and employer contributions is

Social Security a “pyramid scheme.” Calmes, *supra* note 46, at A20.

49. Moynihan, *supra* note 40, at A23. See generally John D. McKinnon, *Bush Commission Begins to Make Case That Social Security Must Be Overhauled*, WALL ST. J., July 20, 2001, at A12 (describing sharp increases in payroll taxes or reductions in benefits that will be needed to fund Social Security if it is not privatized).

50. Letter from the Social Security Administration, *supra* note 46, at 1.

51. As one critic has noted:

In terms of rate of return on taxes “invested,” Social Security is a bum deal and getting worse. It is particularly bad for dual-income families, who pay the tax twice and pretty much collect benefits once. Also for blacks, who have shorter life expectancies and will receive fewer benefits. According to Heritage Foundation calculations, the inflation-adjusted return for a young working couple with children is 1.23%. Single low-income blacks born after 1959 have negative rates of return—on average paying more in Social Security taxes than they claim in benefits.

Robert L. Bartley, *Economics 101 on Privatizing Social Security*, WALL ST. J., May 22, 2000, at A39. See generally Kevin A. Hassett, *Social Security Reform Can’t Wait*,

considerable over the working life of the employee: 12.4% of annual income up to \$76,200. But the benefits, if paid, will be insubstantial. As a result, the poor are deprived of an opportunity to increase their wealth through a savings program that will offer compounded returns over their working lives. The working poor also will not be able to accumulate estates through Social Security contributions that could be passed to future generations for their education, investment, or improved lifestyles, which would allow an escape from the cycle of poverty.

The present system has other debilitating effects. If someone wants to continue to work after he first qualifies for Social Security, in order to improve his living standard, he will lose Social Security benefits until he reaches the full retirement age (which is being raised to sixty-seven).⁵² Indeed, it seems as if the system were specifically designed to punish the working poor by denying them any opportunity to accumulate wealth. That was not the goal of Social Security, but it is the effect.⁵³ If lower-income workers were able to direct their Social Security contributions and those of their employer to a private retirement account, like those available to the wealthy for discretionary income, they could accumulate estates large enough to provide a comfortable retirement. Perhaps, they could even leave something to their children and grandchildren that would help them improve their lots in life.

III. THE ROLE OF PRIVATE PENSIONS IN AMERICAN SOCIETY

Social Security was founded at a time when private pensions were in their infancy, but such plans received widespread acceptance in subsequent years. Today, private plans form the basis for the retirement of many individuals. As noted previously, Social Security should be viewed as only a supplement to such plans.⁵⁴ Therefore, the history of private plans and their regulation forms an important backdrop for present efforts to privatize Social Security.

The concept of a pension in the form of an annuity, a series of lifetime

WALL ST. J., July 20, 2001 at A10 (noting that low income individuals have shorter life spans and will, therefore, receive less in Social Security benefits than the longer lived more affluent).

52. SOC. SEC. ADMIN., *supra* note 35, at 29. The system also seeks to discourage early retirement by denying full benefits until full retirement age. *Id.* Those persons filing a joint return with combined income of more than \$44,000 will also have up to 85% of their Social Security benefits taxed. *Id.* at 30.

53. Again, in fairness, Social Security has provided a lifeline for many millions who would not have saved for retirement in the absence of a mandatory system such as Social Security. Their income was simply too little to view retirement savings as anything other than a luxury. It is, nonetheless, unfortunate that they do not have a more positive return on their forced savings.

54. See *supra* note 50 and accompanying text.

payments, has been traced back to ancient societies in Egypt, Babylonia, India, China, and Rome.⁵⁵ Annuities also existed in Europe as early as the Eighth century.⁵⁶ King John was providing pensions in the form of annuities in 1214 A.D. They were a precursor to government pensions in modern society.⁵⁷

In America, the federal government experimented with pension schemes on a large scale for the first time following the conclusion of the Civil War.⁵⁸ Pensions for disabled veterans were then being offered freely, and with much abuse, as Congress continually expanded that program. In 1866, there were about 127,000 Union pensioners; Confederate veterans were not invited to apply. Between 1861 and 1887, the United States spent over \$800 million on veterans' pensions, a tremendous sum at the time.⁵⁹ This first federal experiment with a pension plan fully evidenced the fact that such grants of government largess were expensive, difficult to control, and under continual pressure to be increased at the expense of the Treasury.

The first pension plan for municipal employees in America appears to have been created by New York City in 1857, for policemen.⁶⁰ New

55. CLYDE J. CROBAUGH, *ANNUITIES AND THEIR USES* 13 (1933). Soldiers in the Roman legions had a portion of their pay withheld in order to fund their pensions that were available after twenty years of service. Peter Bobbin, *The Principles of Superannuation*, in *SUPERANNUATION—AN INTRODUCTION* 1-2 (Sept. 5, 1997) (continuing legal education seminar papers, on file with author).

56. CROBAUGH, *supra* note 55, at 14.

57. EDWARD BURMAN, *THE TEMPLARS: KNIGHTS OF GOD* 82 (1986). The Corporation for the Relief of Widows and Children of Clergymen in the Communion of the Church of England in America was formed in 1769 to provide annuities for survivors of clergy. 1 JOSEPH STANCLIFFE DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* 81 (Russell & Russell, Inc. 1965) (1917).

58. Those pensions were in response to president Lincoln's second inaugural address in which he asked the Union "to bind up the nation's wounds, to care for him who shall have borne the battle and for his widow and his orphan." *Excerpts From Inaugural Speeches With Challenges*, N.Y. TIMES, Jan. 20, 2001, at A16.

59. ALYN BRODSKY, *GROVER CLEVELAND, A STUDY IN CHARACTER* 181-89 (2000). Pensions were also granted to veterans of the Indian and Spanish-American wars. In 1923, President Calvin Coolidge vetoed legislation that sought to increase pensions for veterans of those conflicts and of the Civil War. ROBERT SOBEL, *COOLIDGE: AN AMERICAN ENIGMA* 279 (1998). Members of the armed services continue to receive pensions that allow them to retire after twenty years of service with cost-of-living adjustments. Maura Dolan, *Military on Defensive in Pension War*, L.A. TIMES, Apr. 20, 1985, at A1. Those individuals, however, are now being allowed to invest their funds in private investments, the success of which will determine their benefit levels. For the legislation authorizing military members to participate in those Thrift Savings Plans, see 5 U.S.C. § 8440e (1994 & Supp. V 1999).

60. AM. COUNCIL OF LIFE INS., 1996 LIFE INSURANCE FACT BOOK 131 (1996).

York's spending generosity would threaten to bankrupt the city on several occasions.⁶¹ The first formal private sector pension plan appeared in 1875 and was the product of the American Express Company.⁶² The B&O Railroad was offering a pension to its employees in the 1880s, supported by both employer and employee contributions.⁶³ The Illinois Central Railroad Company granted a request by employees to allow them to purchase the company's stock.⁶⁴ Railroads were a particularly rich source for pension plan growth. By 1905, twelve railroads had pension plans that covered 35% of railroad workers.⁶⁵

The Procter & Gamble Company created a profit sharing plan for employees in 1886.⁶⁶ The development of other large corporations

61. See VINCENT P. CAROSSO, *INVESTMENT BANKING IN AMERICA: A HISTORY 197-98* (1970) (telling how J.P. Morgan & Co. led emergency refunding of City notes at the outbreak of World War I); JEAN STROUSE, *MORGAN: AMERICAN FINANCIER* 581-83 (1999) (describing J.P. Morgan's rescue of New York City during the Panic of 1907); Ellmore Patterson, *Ellmore Patterson, in THE WAY IT WAS: AN ORAL HISTORY OF FINANCE: 1967-1987*, 521, 524 (Eds. of Institutional Investor eds., 1988) (telling how J.P. Morgan & Co. supplied \$50 million to rescue the City in the 1930's). By 1951, the budget of New York City was second only to that of the federal government, and the City's financial problems were growing as well. George E. Cruikshank, *New York's Furious Fiscal Problems Typify Many a Town's Troubles*, WALL ST. J., Dec. 1, 1951, at 1. The most spectacular of the City's periodic crises occurred in 1974-1975 when the City found that it had outspent its revenues and credit resources. A gigantic rescue effort was launched that included the creation of the Municipal Assistance Corporation ("Big Mac") and a contribution of \$150 million from the New York City teachers' pension fund. GERALD R. FORD, *A TIME TO HEAL: THE AUTOBIOGRAPHY OF GERALD R. FORD* 319 (1979); Felix Rohatyn, *Felix Rohatyn, in THE WAY IT WAS, supra*, at 175; Robert D. McFadden, *Abraham Beame is Dead at 94; Mayor During 70's Fiscal Crisis*, N.Y. TIMES, Feb. 11, 2001, at A1. Lest we be too hard on New York, it should be remembered that during a budget crisis in 1995, the Treasury Department used pension funds of federal employees to avoid a default on federal government debt payments. Adam Clymer, *Treasury Takes Retirement Funds to Avert Default*, N.Y. TIMES, Nov. 16, 1995, at A1.

62. SEC. & EXCH. COMM'N, *SURVEY OF CORPORATE PENSION FUNDS 1951-1954*, at 1 (1956).

63. AM. COUNCIL OF LIFE INS., *supra* note 60, at 131.

64. NAT'L INDUS. CONFERENCE BD., INC., *EMPLOYEE STOCK PURCHASE PLANS IN THE UNITED STATES* 1 (1928). The Firestone Tire & Rubber Company also allowed employees to purchase the company's stock. The Pittsburgh Coal Company and the First National Bank of Chicago allowed employees to purchase company stock on an installment basis. *Id.*

65. SEC. & EXCH. COMM'N, *supra* note 62, at 1.

66. *Id.* Profit sharing was not a new concept. It was used by Albert Gallatin at his Pennsylvania Glass Works in 1795. STROUSE, *supra* note 61, at 428. Several other corporations had profit sharing plans at the beginning of the twentieth century, including the Illinois Central Railroad, the New York Life Insurance Company, the National Biscuit Company, the Pittsburgh Coal Company, the Carnegie Steel Company, and United States Steel. *Id.*; AM. COUNCIL OF LIFE INS., *supra* note 60, at 131. Another early retirement plan was created by the Standard Oil Company of New Jersey. SEC. & EXCH. COMM'N, *supra* note 62, at 1. Some ninety companies had employee stock purchase plans by the conclusion of World War I. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 58 (rev. ed. 1968).

expanded the popularity of pension and profit sharing plans and other employee benefits.⁶⁷ The Teachers Insurance and Annuity Association was created in 1918 by the Carnegie Foundation to supply retirement programs for teachers. It later created the College Retirement Equity Fund (CREF) to allow retirement plans that invested in equities.⁶⁸ Congress began a pension program for federal civil service employees in 1920.⁶⁹ The Revenue Act of 1921 exempted employer contributions to private profit sharing plans from the income tax.⁷⁰

By 1925, about four million employees were covered by 400 private pension plans.⁷¹ In 1928, 64% of companies in America had some form of bonus and profit sharing plan,⁷² which often provided for contributions to be deducted from employee paychecks.⁷³ General Motors created a package of workers' benefits, and Chrysler adopted a similar program in July 1929. The Chrysler benefits package included life, health, and disability insurance, and a stock purchase program for supervisors. A savings and investment program for Chrysler employees matched up to 50% of their contributions. Those savings were invested

67. International Harvester Co. created a pension plan in 1908 that offered an average benefit in 1919 of \$32 per month for employees with twenty or more years of service. HERMAN E. KROOSS & MARTIN R. BLYN, *A HISTORY OF FINANCIAL INTERMEDIARIES* 166 (1971). American Telephone and Telegraph began a pension plan in 1913; Sears, Roebuck in 1916; and U.S. Rubber Co. in 1917. ALEX GRONER, *AMERICAN BUSINESS & INDUSTRY* 217 (1972); PAUL P. HARBRECHT, *PENSION FUNDS AND ECONOMIC POWER* 85 (1959); SEC. & EXCH. COMM'N, *supra* note 62, at 1. By 1923, over 120 companies were offering pension plans to their employees. BERLE & MEANS, *supra* note 66, at 58. Those plans held over \$90 million in assets. Following World War I, deferred annuities were sometimes purchased from insurance companies as a pension for employees. KROOSS & BLYN, *supra*, at 166.

68. ROBERT SOBEL, *INSIDE WALL STREET: CONTINUITY AND CHANGE IN THE FINANCIAL DISTRICT* 226 (1977).

69. SEC. & EXCH. COMM'N, *supra* note 62, at 1. The civil service pension scheme for federal employees was threatening the Treasury in the 1980s and was reformed. For those employed after the adoption of this legislation, a system was implemented similar to modern private sector pensions with matching employer contributions and participation in Social Security. Stephen Barr, *Retiring With Protection, at 55 or Earlier*, WASH. POST, May 8, 2000, at A21. Under this system, the employee contributes the same 6.2% to Social Security as do private employees, except there is no matching employer contribution. Stephen Barr, *Uncle Sam Gets Into the Goodie-Giving Spirit of the Season*, WASH. POST, Oct. 31, 2000, at B2. For a further description of this program see *infra* notes 318–19 and accompanying text.

70. AM. COUNCIL OF LIFE INS., *supra* note 60, at 132.

71. HARBRECHT, *supra* note 67, at 6.

72. John Balkcom & Roger Brossy, *Executive Pay—Then, Now, and Ahead*, 22 *DIRECTORS & BOARDS* 55, 57 (1997), available at LEXIS IAC-ACC-NO: 20219928.

73. NAT'L INDUS. CONFERENCE BD., INC., *supra* note 64, at 15.

in stock, and the program was immediately popular, gaining more than \$200,000 in contributions within a year.⁷⁴ Unfortunately, the stock market crashed in October 1929 and reduced the value of that benefit.

Some employers were more generous than others during the Great Depression that followed the market crash.⁷⁵ General Electric provided employee insurance, mortgage assistance, pensions, bonuses, profit sharing, and other benefits.⁷⁶ The fact remained, however, that very few of the elderly were actually provided any benefits from pension plans, even those of state governments.⁷⁷ Less than 15% of employees were covered by a retirement plan in the 1930s.⁷⁸ Moreover, even companies offering pension plans did so on a voluntary and restricted basis. Generally, employers required several years of uninterrupted service before a pension was awarded. Employers were not required to make plans available or to pay any particular level of benefits, and employees had no vested rights in their pensions.⁷⁹

The number of private pension plans began to increase rapidly after 1937.⁸⁰ By 1950, 25% of workers in the private sector were covered by some form of annuity or pension.⁸¹ Pension fund investments totaled about \$1 billion in 1940,⁸² a number that increased to between \$5 and \$8 billion in 1950.⁸³ The number of employees covered by private pension plans increased even further from 5.6 million to 12.5 million between 1945 and 1954.⁸⁴ By the latter date, pension fund reserves had increased to an estimated \$20 to \$25 billion.⁸⁵ About fourteen million workers were covered by private investment plans by the end of the 1950s.⁸⁶

74. VINCENT CURCIO, *CHRYSLER: THE LIFE AND TIMES OF AN AUTOMOTIVE GENIUS* 569 (2000).

75. The severity of the Great Depression is hard to imagine. Unemployment increased from 3.2% in 1929 to almost 25% in 1933. Wages were cut in half and total national income dropped by more than 50%. PETER FEARON, *WAR, PROSPERITY AND DEPRESSION: THE U.S. ECONOMY 1917-45*, at 137 (1987); WILLIAM K. KLINGAMAN, *1929: THE YEAR OF THE GREAT CRASH* 337-38 (1989).

76. THOMAS F. O'BOYLE, *AT ANY COST: JACK WELCH, GENERAL ELECTRIC, AND THE PURSUIT OF PROFIT* 56 (1998).

77. KENNEDY, *supra* note 17, at 260.

78. SEC. & EXCH. COMM'N, *supra* note 62, at 1.

79. See generally *McNevin v. Solvay Process Co.*, 53 N.Y.S. 98 (1898) (describing limitations of an employee's pension rights in a case where defendant company's pension fund was by its own "voluntary" design and action).

80. SEC. & EXCH. COMM'N, *supra* note 62, at 1.

81. Liz Pulliam, *Employee Benefits: Hard-Won and Ever-Changing Package*, L.A. TIMES, Nov. 21, 1999, at T20; Vinzant, *supra* note 8, at 85.

82. KROOSS & BLYN, *supra* note 67, at 209.

83. *Id.*; SOBEL, *supra* note 68, at 225.

84. S. REP. NO. 84-1734, at 2 (1956).

85. *Id.* Some 90% of workers were participants in public or private retirement plans by 1956. SEC. & EXCH. COMM'N, *supra* note 62, at 1.

86. Jack Hanicke, *Pension Fund's Stock Sways Engineer Though He Owns None*

Corporate income taxes during World War II encouraged private pension fund growth, making pension benefits a useful form of compensation for employees.⁸⁷ The Railroad Retirement Act for railroad pensioners expanded the reach of retirement plans.⁸⁸ The growth of unions after the war furthered pension growth. John L. Lewis, the head of the United Mine Workers, sought pension rights for his union members in 1945. The miners struck and threatened to shut down a significant portion of American commerce. Although the mines were seized by President Harry Truman, an agreement was reached that created an employer financed pension fund for the mine workers.⁸⁹ This spurred other unions to seek similar benefits through collective bargaining. The courts gave impetus to those efforts in 1949 by holding that pension funds could be the subject of mandatory collective bargaining.⁹⁰

In 1950, the General Motors pension plan was funded by the company through the “then-radical idea of investing pension money in the stock market.”⁹¹ To reduce risk, the fund was to put no more than 5% of its assets in any single company’s stock, and General Motors agreed not to purchase its own stock for the pension plan.⁹² The General Motors pension plan became a model for other large companies.⁹³ The market run-up in the 1950s underscored the importance of such investments and encouraged the use of such plans.⁹⁴ Congress further aided the growth of private pension plans in 1954 by allowing tax deductions for contributions to qualified pension plans.⁹⁵

Most retirement plans were defined benefit plans before World War

Directly, WALL ST. J., Aug. 3, 1959, at 1.

87. MARGARET G. MYERS, A FINANCIAL HISTORY OF THE UNITED STATES 396 (1970); SEC. & EXCH. COMM’N, *supra* note 62, at 2.

88. SEC. & EXCH. COMM’N, *supra* note 62, at 1.

89. *E. Enters. v. Apfel*, 524 U.S. 498, 505 (1998).

90. HARBRECHT, *supra* note 67, at 39–40 (1959); SEC. & EXCH. COMM’N, *supra* note 62, at 2; *see also* *Inland Steel Co. v. NLRB*, 170 F.2d 247, 251 (7th Cir. 1948) (holding that pension benefits were subject to mandatory collective bargaining).

91. WILLIAM M. O’BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 18 (1992).

92. *Id.* at 18–19.

93. SOBEL, *supra* note 68, at 226.

94. The stock market increased almost continuously between September 1953 and January 1955. S. REP. NO. 84-1280, at 1 (1955). Stock market prices jumped 43% in 1958. MARTIN S. FRIDSON, IT WAS A VERY GOOD YEAR: EXTRAORDINARY MOMENTS IN STOCK MARKET HISTORY vii (1998).

95. Pub. L. No. 591, 68A Stat. 15 (1954).

II.⁹⁶ Employees received a set benefit based on the number of years with the firm and the amount of the employee's pay while working. Defined contribution plans, which required the employees to contribute to their pension plan, became popular after the war. The employer and employee contributions were then used to purchase stocks, bonds, and other investments. The amount of the employee's pension benefits depended on the market performance of those assets, as well as the amount invested.⁹⁷

A large number of pension plans in the 1950s were self-funded plans kept and invested by a trustee. The Federal Reserve Board authorized commercial banks in 1955 to create collective investment funds for corporate retirement plans.⁹⁸ This allowed banks to pool the assets of small employee benefit plans into common trust funds, which could then be managed collectively.⁹⁹ General Mills started a trend, placing management of pension funds into the hands of professional money managers which were not banks.¹⁰⁰ Some pension funds were managed by insurance companies. Under those schemes, individual pension plan investments were commingled with other investments of the insurance companies.¹⁰¹ As will be discussed below, insurance companies also play a large role in retirement through their annuity products.¹⁰²

The principal investments for pension funds before World War II were corporate bonds.¹⁰³ The rise in the stock market in the 1950s, however, led to much interest in common stock on the part of the pension funds.¹⁰⁴ Restrictions on trustee investments, which were applied to the collective management of pension funds, often precluded investments in common stocks.¹⁰⁵ California, however, allowed its public retirement systems to buy common stocks, and New York authorized corporate pension funds in 1950 to invest up to 30% of their holdings in common stocks. By

96. SEC. & EXCH. COMM'N, DIV. OF INVESTMENT MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 125 (1992).

97. *Id.* at xxi; KENNETH J. THYGERSON, FINANCIAL MARKETS AND INSTITUTIONS: A MANAGERIAL APPROACH 295-96 (1993).

98. 2 JANE W. D'ARISTA, THE EVOLUTION OF U.S. FINANCE: RESTRUCTURING INSTITUTIONS AND MARKETS 309 (1994).

99. SEC. & EXCH. COMM'N, DIV. OF INVESTMENT MGMT., *supra* note 96, at 125-26; *see also* Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 307-08 (discussing value added by the ability to manage trust funds collectively).

100. Robert Kirby, *Robert Kirby*, in THE WAY IT WAS, *supra* note 61, at 51, 52.

101. SEC. & EXCH. COMM'N, *supra* note 62, at 3.

102. *See infra* notes 245-52 and accompanying text.

103. "Before 1950 it was unusual for a pension fund to invest in common stocks." HAROLD G. VATTER, THE U.S. ECONOMY IN THE 1950'S: AN ECONOMIC HISTORY 198 (1963).

104. SEC. & EXCH. COMM'N, *supra* note 62, at 11.

105. For a discussion of these restrictions see *infra* notes 255-64 and accompanying text.

1955, pension funds were purchasing as much as 25% of the outstanding common and preferred shares of “blue chip” companies.¹⁰⁶ Private pension plan assets were increasing at a rate in excess of \$3.5 billion a year in the early 1960s, and a large amount of those funds were being invested in preferred and common stocks.¹⁰⁷ Still, bonds remained a popular investment for the pension funds. In 1958, pension funds held over 10% of the bonds listed on the New York Stock Exchange.¹⁰⁸

Serious problems occurred as a result of the growth of pension plans. Employee rights to benefits often went unprotected. Many employees did not have a vested interest in their pension funds and lost any rights if their service at the company was terminated, or interrupted for any reason.¹⁰⁹ Some pension plans were unfunded. This meant they were on a pay-as-you-go basis, and employees had no protection if the company could not meet its obligations.¹¹⁰ Congress sought to curb abuses in pension fund management through legislation that required pension plans to make disclosures and file financial reports with the United States Department of Labor.¹¹¹ The Employees Retirement Income Security Act of 1974 (ERISA)¹¹² provided further protections for employees covered by defined benefit plans.¹¹³ This legislation was spurred by the failure of the Studebaker Corporation, which left 4000 employees with unfunded benefits. The Pension Benefits Guaranty Corporation was created by ERISA to insure future workers from such shortfalls.¹¹⁴ ERISA imposed on plan fiduciaries “a number of detailed duties and responsibilities, which include ‘the proper management, administration and investment of [plan] assets, the maintenance of proper records, the disclosure of specified information, and the

106. MYERS, *supra* note 5, at 396.

107. HARBRECHT, *supra* note 67, at 3; A. James Meigs, *The Changing Role of Banks in the Market for Equities*, 20 J. FIN. 368, 375 (1965), available at <http://www.jstor.org/> (last visited May 29, 2001).

108. VATTIER, *supra* note 103, at 199.

109. 29 U.S.C. §§ 1001–1461 (1994 & Supp. IV 1998).

110. VATTIER, *supra* note 103, at 199.

111. *Id.*

112. 29 U.S.C. §§ 1001–1461.

113. For a description of ERISA, see *Metro. Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 732 (1985).

114. Thomas Lee, *The Pension and the 401(k)*, SEATTLE TIMES, Apr. 24, 2000, at C1, available at 2000 WL 5532516. There are limitations on this guarantee. For example, for plans with a 1998 termination date, the maximum annual guarantee was about \$35,000. JOHN DOWNES & JORDAN ELLIOT GOODMAN, FINANCE AND INVESTMENT HANDBOOK 498 (5th ed. 1998).

avoidance of conflicts of interest.”¹¹⁵

More significantly, ERISA allowed individuals to create their own individual retirement accounts (IRAs), provided their employer did not maintain a private pension plan. Although Congress cut back the availability of these individual accounts in the Tax Reform Act of 1986,¹¹⁶ it later expanded coverage to allow individuals with employer pension plans to have their own IRA account, and increased contribution limits.¹¹⁷ Still, restrictions were imposed that continue to hamper the use of these accounts as an adequate retirement vehicle. Under that legislation, before-tax contributions from adjusted gross income was limited to \$2000 per year for an individual or \$4000 for married couples who were not covered by a qualified pension plan. If their adjusted gross income was less than a specified amount—\$50,000 for married couples, a number that was gradually being increased to \$80,000—the contribution was still not taxed even though the individual was covered by another qualified plan.¹¹⁸

Taxpayers with incomes in excess of the IRA account limitation may make after-tax contributions to an IRA, but investment returns on such contributions are not taxed until paid out during retirement. Withdrawals by an IRA account holder before age 59.5 are subject to a 10% penalty tax in addition to the normal income tax. Qualified retirement accounts, where the employee changes employment, may be rolled over into IRA accounts.¹¹⁹ After roll-over, these IRAs may become self-directed by the employee. Such accounts must be held by a qualified custodian, such as a broker-dealer, but may be actively managed by the employee.¹²⁰ Withdrawals after age 59.5 are subject to regular income taxes. Mandatory withdrawals must be made after age 70.5.¹²¹

Despite strict contribution limits, the introduction of the IRA furthered capital ownership by employees and encouraged savings. By 1981,

115. *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 251–52 (1993) (quoting *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 142–43 (1985)).

116. *Balkcom & Brossy*, *supra* note 72, at 61.

117. *See generally IRAs: Tax Shelters for Savings May Regain Popularity*, ST. LOUIS POST DISPATCH, Dec. 3, 1991, Dollars/Sense Pull-Out Section, at 5D (describing benefits available from IRAs).

118. Deductability of the contribution is gradually reduced once the taxpayers exceed the maximum level of income. *DOWNES & GOODMAN*, *supra* note 114, at 373. A “Simple IRA” is available where an employer has less than 100 employees and does not offer any other retirement plan. Contributions by the employer and employee of pretax income up to \$6000 per year (adjusted for inflation) are permitted. Penalties for early withdrawal may be higher than those for other IRA accounts. *Id.* at 597–98.

119. *Id.* at 374–75.

120. *Id.* at 585.

121. *Id.* at 598. Payout requirements for individual retirement accounts are exceedingly complex but have been simplified to reduce some of their prior rigidity. Lynn Asinof, *U.S. Treasury Overhauls IRA Rules*, WALL ST. J., Jan. 15, 2001, at C1.

some \$400 billion in assets were being held in IRA accounts. More private retirement accounts were added in later years, including the section 401(k) accounts that were created in 1978.¹²² This is a defined contribution plan that proved to be immensely popular. By the end of the last century, forty-one million employees were covered by such accounts. The section 401(k) account is sponsored by the employer and allows pretax contributions from earnings by both the employer and employee.¹²³ Contributions of up to 25% of earnings are allowed to a maximum of \$10,500 per year. Penalties are imposed for preretirement withdrawals, except that certain withdrawals are permitted for a first home purchase, education expenses and disability. About one-third of employers were offering these pension plans in the late 1990s. As the result of e-commerce advances that simplified access to these accounts through the Internet, that number is expected to double by 2005.¹²⁴

Additional private retirement accounts include Keogh plans for the self-employed, first authorized in 1962 and broadened by legislation in 1981. They permit contributions of up to 25% of earned income up to a maximum of \$30,000. Investment returns are tax-free until withdrawal on retirement after age 59.5.¹²⁵ Simplified Employee Pension Plan (SEP) accounts allow contributions by employer and employee to an IRA. Employee contributions are limited to about 13% of wages and employer contributions are limited to 15%, up to a combined maximum total of \$30,000 per year. These plans are limited to companies having less than twenty-five employees, and at least 50% of employees must participate. Several restrictions exist on these plans, such as requirements for payment of FICA taxes on contributions, and limitations on income levels for tax deferrals.¹²⁶

More retirement programs were added to an already lengthy list of tax-advantaged individual pension accounts. They include: ESOPS (employee stock options plans), Money Purchase plans, and Target Benefit plans. Roth accounts, added in 1997 by Congress, permit

122. Pamela Yip, *Founder Says He Was "Divinely Led,"* NEWS & OBSERVER (Raleigh, NC), Jan. 14, 2001, at E1, available at 2001 WL 3447906.

123. Pamela Yip, *A Look at 401(k)'s Future: Retirement Plan's 20th Birthday Finds Workers Gaining More Control,* NEWS & OBSERVER (Raleigh, NC), Jan. 14, 2001, at E1, available at 2001 WL 3447905.

124. *Electronic 401(k) to Aid Small Firms,* COURIER-JOURNAL (Louisville, KY), Dec. 25, 2000, at F1, available at 2000 WL 7046746.

125. DOWNES & GOODMAN, *supra* note 114, at 399.

126. *Id.* at 598.

individuals to invest up to \$2000 per year. The contributions are not tax deductible, but all earnings and principal are tax free if held in the account for at least five years. Contributions are limited where certain income levels are met: for example, a maximum of \$160,000 for married couples.¹²⁷ Another account, the "Education IRA," allows annual contributions by parents of up to \$500 per child until they reach age eighteen. The contributions are not tax exempt, but investment returns are not taxed and withdrawals are exempt from tax as long as they are used for educational purposes before the children reach age thirty. Roth-style income limitations were also placed on these accounts.¹²⁸ Employees of nonprofit organizations, such as schools, were allowed to create accounts for additional retirement savings.¹²⁹ State and municipal employees were allowed to create tax deferred plans called "457 Plans" in recognition of their tax-deferred status under that section of the Internal Revenue Code.¹³⁰

The tax advantages associated with private retirement accounts fueled their growth. Forty-six percent of private sector employees had some form of private pension coverage in 1980.¹³¹ Pension plans held almost \$570 billion in assets in 1982, and in 1985 such plans owned about 20% of U.S. equity securities.¹³²

Growth in pension plans spiraled during the market run-up in the 1990s. By 1995, 50% of workers in the private sector had retirement programs in addition to Social Security.¹³³ The average balance in employee 401(k) accounts was \$28,509 in 1994. That number increased by 82% to \$51,939 in 1997.¹³⁴ Almost \$2.4 trillion was held in IRA accounts at the end of the century.¹³⁵

Americans in general were also becoming investors as the last century closed.¹³⁶ The percentage of assets of American households that was

127. *Id.* at 373-74.

128. Corie Tuthill, *Tax Incentives for Higher Education*, 71 C.P.A. J. 5255 (2001); Pamela Yip, *Parents Getting More Tax Breaks on School Costs*, DALLAS MORNING NEWS, July 9, 2001, at 1D, available at 2001 WL 24408804.

129. I.R.C. § 403(b) (1994 & Supp. V 1994).

130. *Id.* § 457.

131. Pulliam, *supra* note 81, at 51; Vinzant, *supra* note 8, at 86.

132. D'ARISTA, *supra* note 98, at 24, 223.

133. AM. COUNCIL OF LIFE INS., *supra* note 60, at 53.

134. Yip, *supra* note 128.

135. Brian Tumulty, *Report Says IRA Assets Approach \$2.4 Trillion*, GANNETT NEWS SERV., May 15, 2000, available at 2000 WL 4399492.

136. Actually, Americans have a long history of investment, and the public has been exposed to large investment schemes throughout history. The Continental dollar was after all simply a note that was often sold at a discount and ultimately redeemed at par once the Revolution was won, providing many speculators in these securities with a profit. See generally WILLIAM J. SHULTZ & M.R. CAINE, *FINANCIAL DEVELOPMENT OF THE UNITED STATES 96-98* (1937) (describing efforts of Alexander Hamilton to refund

held in stocks reached a fifty-year high in February of 1998.¹³⁷ American households were then holding 28% of their assets in securities.¹³⁸ The average American home had more of its wealth in stocks than in real estate at the end of the century.¹³⁹ Nearly half of all American households were investing in the stock market in 2000, and one of every three Americans was invested in a mutual fund.¹⁴⁰ Thirty-five percent of shareholders in the market were blue-collar workers, and some 50% of shareholders did not have a college degree.¹⁴¹ The poorest 40% of U.S. households were investing an average of \$1600 in stocks.¹⁴² The bad news was that, in 1999, 40% of the 80 million baby boomers approaching retirement had less than \$10,000 in retirement savings.¹⁴³

the Revolutionary War debt). The sale of Union Bonds by Jay Cooke during the Civil War was largely directed at the public, as were the Liberty loans in World War I and the Victory loans in World War II. See generally 1 ELLIS PAXSON OBERHOLTZER, JAY COOKE: FINANCIER OF THE CIVIL WAR 158-59 (1907) (describing Cooke's bond sales operations during the Civil War); DAVIS RICH DEWEY, FINANCIAL HISTORY OF THE UNITED STATES 506 (12th ed. 1934) (describing Liberty loan programs). The stock market run-up in the 1920s saw a large influx of investors speculating in the market for stocks. By the middle of the 1920s, "an average of one family in every ten held stock in one or more corporations." NAT'L INDUS. CONFERENCE BD., *supra* note 64, at 7. During the 1980s, the New York Stock Exchange boasted of thirty million shareholders nationwide. WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 36 (1987). In 1995, approximately seventy million individuals owned corporate stock directly or through a mutual fund, supplemental retirement fund, or defined contribution pension account. NEW YORK STOCK EXCH., THE FACT BOOK 55 (1999), available at <http://www.nyse.com/about/factbook99.html>.

137. Greg Ip et al., *This Economic Slump Is Shaping Up to Be a Different Downturn*, WALL ST. J., Jan. 5, 2001, at A1; Edward Wyatt, *Share of Wealth in Stock Holdings Hits 50-Year High*, N.Y. TIMES, Feb. 11, 1998, at A1.

138. Wyatt, *supra* note 137, at A1.

139. *Nest Eggs: Betting the House*, N.Y. TIMES, Feb. 15, 1998, § 3, at 2. The average net worth of American households increased 25.7% between 1995 and 1998. Yochi J. Dreazen, *Stock Gains Help to Propel U.S. Wealth*, WALL ST. J., Jan. 19, 2000, at A2. The average household net worth of Americans in 1972 was \$65,517. That amount increased to \$358,297 by 1999. Edward Wyatt, *Does the Dow Measure Up?*, N.Y. TIMES, Mar. 30, 1999, at C1. Another poll, however, indicated that one-third of Americans had no savings and another one-third had saved less than \$2500. Marron, *supra* note 47, at A26.

140. Roye, *supra* note 1, at *1. A survey indicated in 1996, however, that only 18% of investors were literate about financial matters. *Id.*

141. *Declare Victory and Go Home*, ECONOMIST, Aug. 2, 1997, at 17. But see Timothy Aepfel, *At a Job Shop, It's the Year of Living Cautiously*, WALL ST. J., Feb. 8, 2001, at B1 (expressing skepticism with respect to claims that blue collar workers were closely following the market).

142. Maggie Jackson, *Investing in Market American Pastime*, HERALD-SUN (Durham, NC), Sept. 13, 1999, at A1.

143. Carol Frey, *The Price of Job Hopping*, NEWS & OBSERVER (Raleigh, NC).

IV. SOCIAL SECURITY VS. PRIVATE RETIREMENT ACCOUNTS

The issue of whether private retirement accounts are more effective than Social Security for providing a secure and comfortable retirement seems to have already been decided. As noted, the government itself concedes Social Security does not provide adequate benefits for retirement¹⁴⁴ and the system will be strained after the baby boomers begin retiring in 2010 nearly doubling the number of elderly.¹⁴⁵ The most the government can say for the present Social Security system is that it provides a supplement to more productive private retirement programs and acts as a safety net for those who have no other savings.

That claim, however, begs the question of why the entire system should not be privatized. The cost of the supplemental retirement income (or the *only* retirement income in the case of the poor) provided by Social Security is quite high: 12.4% of income under \$76,200 in the year 2000.¹⁴⁶ An individual with an income of \$50,000 contributes \$6400 per year, while an individual with an income of \$25,000 contributes \$3200. In exchange for those contributions, the recipient receives benefits that will, if paid, place them only at the poverty line upon retirement. In contrast, if \$3200 per year were added to an individual IRA by an employee at age twenty-five and compounded for forty years, about the period required for retirement under Social Security, at a 6% interest rate, the account would be valued at \$495,000 upon retirement at age sixty-five.¹⁴⁷ The account would then return almost \$30,000 per year at a 6% interest without touching the principal, which could be annuitized for even greater income or left to future generations. Such a plan would result in funds far beyond the amount available from Social Security.

Let us use the Social Security statements received by the author as further examples of the drawbacks of Social Security as a retirement program. The author started making contributions to Social Security in 1965. By the year 2000, his total employer and employee contributions were approximately \$140,000.¹⁴⁸ The author and his employer must continue to make contributions of approximately \$9500 each year until he retires at the age of sixty-six, the age specified for Social Security

Nov. 7, 1999, at E1.

144. See *supra* note 50 and accompanying text.

145. Letter from the Social Security Administration, *supra* note 46, at 1.

146. SOC. SEC. ADMIN., *supra* note 35, at 8.

147. Savings of \$50 a week invested at 9% would grow to \$1 million in forty years. Jonathan Clements, *Getting Going: What It Means to Be a Millionaire*, WALL ST. J., Feb. 25, 2001, at 3, available at LEXIS, News Group File, All.

148. During six years of law school and federal government service, no contributions were made.

benefits, in the year 2014. This is an additional \$133,000. He will then be eligible to receive benefits of \$1725 per month from Social Security.¹⁴⁹ Assuming death at age eighty-two, the approximate life expectancy of the author's age group,¹⁵⁰ the total benefits the author will receive will be about \$330,000, with some adjustments for inflation. That figure would provide for a total return of less than 20% on the \$273,000 in contributions made over a period of almost fifty years. That is about what those contributions would earn in less than four years in a private retirement account returning 6% per year. In other words, if the funds were placed in a private account at retirement, the author would achieve a higher return on his contributions in the first four years of his retirement than Social Security would pay for the entire expected sixteen years of his retirement—plus, the author would keep the principal. If left in a private account for the additional twelve years of his expected retirement, the total return to the author's estate would be much more than twice the amount paid by Social Security.

This does not make Social Security look like a very attractive investment. Actually, it is much worse than even this analysis suggests. Assume the author was able to exit the Social Security system after receiving his last statement by removing his \$140,000 in contributions and placing that amount in a private IRA account that returned 6% per year. Without contributing an extra penny, by the time of retirement at age sixty-six, those funds would have increased in value to about \$316,000. This would be just \$15,000 less than the total amount that the author could expect under the present Social Security system. If the additional fourteen years of contributions required by Social Security before the author's retirement were added to that private IRA account and compounded at 6% until retirement at age sixty-six, the value of the account would be increased by another \$200,000 or so. Thus, at retirement the author would have in his private IRA account over \$500,000. Without touching the principal, that amount would return over \$30,000 per year if invested at 6%, about \$10,000 more per year than Social Security. If the principal were annuitized over the expected

149. Lower benefits may be obtained if retirement is taken at age sixty-two (\$1260 per month) or higher benefits can be received if retirement is delayed until age seventy (\$2229 per month).

150. Ben Wattenberg, *America by the Numbers*, WALL ST. J., Jan. 3, 2001, at A14. For purposes of the following discussion, the author is assuming that this life expectancy is a certainty, which it is under annuity principles on which life expectancy figures are based.

sixteen years of retirement, the author's annual retirement income would be far higher.¹⁵¹

This still does not fully describe how unproductive Social Security is as an investment. Remember that the author's and his employers' current contributions to Social Security of \$140,000 were made over a period of almost thirty-five years. He received no interest on those contributions during that period, as he would have if they were invested in a private retirement account. If those contributions had been invested at an average rate of 6% in conservative investments and compounded tax free, the author would have accumulated in his private account a substantial amount of money that would be far in excess of the \$140,000 that was contributed to the government without interest for Social Security.¹⁵²

One well-known financial analyst has posited that, if an investor had made contributions at the rate of \$2000 per year between 1963 and 1973, and if those funds had been invested in an account indexed to the Standard & Poor's 500, the account would have been worth \$954,680 in the year 2000. In reaching that conclusion, the analyst assumed that the investor contributed \$2000 for only ten years and then stopped and that the funds were invested each year at the worst possible time, when the

151. A former Governor of the Federal Reserve Board conducted a similar analysis in the *Wall Street Journal* of his personal Social Security statement and concluded that he would actually have negative return on his Social Security contributions because of his tax bracket and the life expectancy figures for his age group. See Lawrence B. Lindsey, *I'm No Social Security Hypocrite*, WALL ST. J., May 26, 2000, at A22. The author of that article noted that his investment in a private retirement plan of about one-third of the amount he put in Social Security is projected to pay twice the monthly amount he will receive from Social Security. *Id.* Other studies show that for younger workers not paying taxes on their Social Security benefits because of low income, the actual rate of return may be a positive 1.7% per year. *Id.* One report notes, however, that minorities in particular are adversely affected by the low returns from Social Security because of their shorter life expectancies. Bartley, *supra* note 51, at A39. Another author asserts that, if a worker earning \$30,000 per year were to invest 1% of his income in stocks and 1% in bonds (instead of the 12.4% required by Social Security), the worker would have \$144,144 after forty-five years based on 1926–1999 real average returns, far outstripping Social Security performance. Marron, *supra* note 47, at A26.

152. The annual Social Security statements sent to participants do not disclose the amount of contributions; they merely set forth the amount of funds subject to withholding. See Letter From the Social Security Administration, *supra* note 46, at 3. Therefore, the projected amount of compounded earnings that could have been earned on those contributions over the course of the author's life cannot be easily determined. For those adventurous enough to do so, however, the Social Security Administration advises that its Web site sets forth the percentage of withholdings each year, and those percentages may be applied against earnings that are set forth in the annual disclosure statement to compute contributions. *Id.* at 4; SOC. SEC. ADMIN., *supra* note 35, at 10 (providing instructions on how to obtain a "social security statement"); Social Security Administration, <http://www.ssa.gov/mystatement> (last visited Aug. 20, 2001). The contributions can then be compounded at an assumed rate to determine possible earnings had they been placed in a private account instead of Social Security.

market was at its peak.¹⁵³ Even assuming the ordinary person might not be so prescient, the hefty contributions required by Social Security would provide the base for a solid investment program over the much longer employment life of the average employee.

Which system makes the author more socially secure? Is it the present Social Security system in which he receives benefits of \$330,000 from an investment of \$215,000 that was saved over a course of fifty years? Or is it the one in which the employee receives compounded returns on his contributions that far exceed the benefits paid by Social Security? The answer is obvious. The private account will generate benefits during retirement that are double or more the benefits that he could receive from Social Security. Similarly, would a poor family be better off with several hundred thousand dollars in accumulated wealth in a private account that will pay far more than Social Security and allow the principal sum to be left to children or grandchildren? When these numbers are coupled with the approaching bankruptcy of Social Security, the system looks less and less like a retirement program and more and more like a tax.

V. SWITCHING OVER TO PRIVATE ACCOUNTS

The most troubling issue for the implementation of private social security accounts is how to switch over from the present system without throwing it into a "tail spin."¹⁵⁴ For example, what is to be done with the elderly who are presently receiving benefits? What is to happen to the contributions made by those who are not yet eligible for retirement? A particular problem is that Social Security has been sold as an investment program. Participants were promised a payout for their contributions. Unfortunately, that is not the way the system was funded. Although there are Social Security trust funds, they will be exhausted in future years, and the system will then operate on a purely pay-as-you-go basis.¹⁵⁵ This will require either onerous increases in contributions by

153. *The Most Important Investing Principle of All . . . \$954,680*, LOUIS RUKESER'S WALL STREET, Jan. 2001, at 3.

154. *See, e.g.*, Kathy M. Kristof & Liz Pulliam Weston, *New President, New Economic Priorities*, L.A. TIMES, Dec. 17, 2000, at C1 (discussing opposition to proposals by President Bush for partial privatization of Social Security on the grounds that it would throw the system into a "tail spin").

155. Presently, Social Security is taking in more than it is paying out in benefits. The surplus is placed in trust funds, which totaled about \$850 billion in 1999. That amount was projected to grow to \$4 trillion, but by 2014, benefit payments will be

young workers to fund retirement benefits, or a drastic reduction in benefits paid to the elderly.

As it stands now, current contributors will lose some 30% of their promised benefits starting in 2034 unless contribution levels are increased dramatically.¹⁵⁶ In view of the lack of return on Social Security contributions, young workers might be forgiven if they think that such a course would simply constitute throwing good money after bad. That being said, how do we deal with the obligations under Social Security while at the same time converting the system to one of private accounts that will provide a market return? The reality is that there is no ideal solution to the conundrum of achieving crossover to private accounts in a fashion that is fair to all. Everyone, except the elderly who are now dependent on current benefits, will have to make some short-term sacrifices and be flexible in the steps needed for a crossover program in order to obtain long run advantages.¹⁵⁷ It is either that, or face large increases in contributions to fund the deficit in the present system.

Several steps are needed to accomplish a privatization of Social Security. The first and most critical is for new entrants to be diverted from the existing system.¹⁵⁸ The system should incur no new liabilities from those just beginning their work experience. Younger workers should, instead, be placed in private accounts immediately. Second, individuals, already in the system, up to some specified age (for example, thirty-eight), should forfeit any interest in benefits from the present Social Security system. Such a forfeit is justified on the ground that individuals can more than make up for this forfeiture through the compounded returns available from private social security accounts.¹⁵⁹

exceeding receipts and trust funds will be exhausted by 2037. SOC. SEC. ADMIN., *THE FUTURE OF SOCIAL SECURITY* 6 (1999). Actually, the trust fund designation is a misnomer. The funds are being used by the government to pay down federal debt. When needed for Social Security, the funds will have to be reborrowed or taken from the surplus funds. There is no "lockbox" where these funds are being held. Robert L. Bartley, *The 'Trust Fund' and 'Lockbox' Fictions*, WALL ST., J., July 23, 2001, at A15; Daniel Patrick Moynihan & Richard Parsons, *Social Security Woes Need a Cure*, WALL ST. J., June 15, 2001, at A14.

156. See Letter from the Social Security Administration, *supra* note 46, at 1.

157. Of course, John Maynard Keynes' familiar *bon mot* must be kept in mind: "In the long run, we are all dead." See Bennett Berger, *Letter to the Editor*, SAN DIEGO UNION-TRIB., Oct. 8, 2000, at G3.

158. President George W. Bush has proposed that younger workers contribute up to 2% of their income, that would otherwise go to Social Security, into a private account. Bartley, *supra* note 51, at A39. Models have simulated potential earnings from such contributions. See Martin Feldstein & Andrew Samwick, *Potential Effects of Two Percent Personal Retirement Accounts*, 79 TAX NOTES 615 (1998); John D. McKinnon, *Social Security Overhaul Is Seen Cutting Benefits*, WALL ST., J., Aug. 21, 2001, at A2 (establishing that a 2% contribution would not aid older workers).

159. As a legal matter, the Supreme Court has held that Social Security contributions are not like payments for an annuity that entitle the payor to some

The next group of participants (age thirty-eight to forty-five) is harder to deal with in terms of an equitable solution for removing them from the existing Social Security structure. The time they have remaining for building a private pension to offset lost Social Security benefits is diminishing. These individuals will also have contributed to the existing Social Security program for some time and will have built up a substantial level of Social Security contributions with no return. One solution would be to grant this age group tax credits or deductions that could be used to fund their private retirement accounts.¹⁶⁰ This would offset their prior contributions, and for that reason such credits or deductions should be considerably discounted for expected returns from investments in their private social security accounts. Even with such adjustments, this proposal would still reduce existing tax revenues, but hopefully the current budget surplus would provide some cushion for those credits. The additional funds placed in private social security accounts should also strengthen the economy and increase government revenues through increased returns from a growing economy.

The next age group, (forty-six to sixty), faces even more difficulties in converting to private accounts. Nevertheless, there are solutions available. First, this age group should be able to opt out of the current Social Security system. In that event, they should be treated with the same deductions or credit for prior contributions that are proposed for the thirty-eight to forty-five age group. In addition, those opting out should be relieved of further contributions to the existing system or at least have those contributions reduced substantially. Instead, those contributions would be diverted into a private account together with other funds that the individual might want to add so that a market return could be obtained until and during retirement. Those funds could then be used for private social security accounts on which a market return can be made.

This proposal, however, might not interest everyone; some people have a significant vested interest in the current Social Security system. There is only a little time remaining for them to receive benefits from an

contractual amount on retirement. *Flemming v. Nestor*, 363 U.S. 603, 610-11 (1960). The Court held that contributions to Social Security were not accrued property rights and that benefits could be removed or changed by Congress. *Id.*

160. The present Social Security system already grants credits to individuals who delay receipt of benefits after they reach full retirement age, which is being extended to age sixty-seven. SOC. SEC. ADMIN., *supra* note 35, at 15.

alternate private social security account. Therefore, greater incentives are needed to remove them from the system. Those incentives can be both the positive ones outlined above and negative ones as well. Negative incentives can be justified by the fact that Social Security is facing bankruptcy. These individuals will receive only a portion of their expected benefits, unless they pay much more into the system. Alternatively, the younger generation must be taxed to the breaking point to avoid a reduction of benefits under the current system. By opting out of the system, however, the forty-six to sixty age group can both avoid additional contributions and spare their children. For those who do not opt out, benefits must be reduced. That is a bitter pill to swallow, but the fact is that the Social Security system is bankrupt, and must be liquidated at less than 100 cents to the dollar unless additional backbreaking amounts of contributions are imposed.

The reduction of benefits for those not opting out could be accomplished on a "progressive" basis. For example, those reporting income over specified amounts (say, \$50,000 per year) might have their benefits reduced entirely. The unfairness of this forfeiture could be at least partially offset by tax credits or deductions.¹⁶¹ The amount of the credit could be time valued and based on the number of years that the individual was denied benefits to which they would have otherwise been entitled.

Another approach would be to establish a form of a Brady Plan such as was employed to refund defaulted Latin American debt near the end of the last century.¹⁶² The nature of these programs varied, but all included forgiving debt in exchange for guarantees of performance or increased interest. Older Social Security participants could be bought out under a similar arrangement that would reduce the system's liabilities and allow a market return for the participant from such debt. To use the author's situation as an example of how this might work: the author and his employers have paid into the system approximately \$140,000. The author would be quite happy if he could exit the system now with a payment of \$50,000 that could be converted into a

161. The estate tax would be an obvious source for such credits. Efforts have been made to eliminate this tax on the federal level. See, e.g., Eric Pianin & John Lancaster, *Tax Cuts Gain Momentum*, WASH. POST, Jan. 23, 2001, at A2 (discussing tax cut proposals that would eliminate the federal estate tax). That repeal met opposition from billionaires and others with a stake in the current system of philanthropy and estate planning, John D. McKinnon & Shailagh Murray, *Taxes Expected to Still Affect Largest Estates*, WALL ST. J., Feb. 20, 2001, at A24, but Congress phased out this tax over an extended period with a possible renewal in later years. The Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

162. For a description of Brady Plan refinancings see *Elliot Assocs., v. Banco De La Nacion*, 194 F.3d 363, 366 (2d Cir. 1999).

contribution into a private IRA account that accumulates tax-free.¹⁶³ If invested at 6%, the \$50,000 payment would recover the \$140,000 in about eighteen years, well before the author reaches the end of his life expectancy.

As noted, another incentive should be reduced contributions to the Social Security system that could be placed instead into a private IRA. In the author's case, over \$100,000 could be placed in an IRA under such a plan, based on the continuance of contributions of 2% into Social Security and the rest paid into a private social security account. This arrangement, at least to the author, is far preferable to holding \$140,000 in a bankrupt system to which an additional \$126,000 or more in contributions must be made. Of course, this will increase demand on tax revenue, but that burden is present in any event—either through continuing and increased assessments for Social Security or because of reduced benefits in the future. A Brady Plan approach can help reduce those obligations and further divert future obligations from the system.

The toughest group to deal with is the seniors over age sixty. Time has run out on them. Individuals in this age group, even those not already retired, will be unable to accumulate savings and receive compounded returns in amounts adequate for their needs. Many members of this age group will be largely dependent on their Social Security benefits. Those individuals must be protected and their benefits continued. Government officials have good reasons to do so. Aside from moral concerns with the effect on low-income elderly, this age group is a powerful political force. Led by the American Association of Retired Persons (AARP) with its thirty-four million members, this group of citizens is the "800-pound gorilla" in American politics.¹⁶⁴ Bill Thomas, Chairman of the House Ways and Means Committee, has claimed that this special interest group has used its political muscle to further government programs, making it the beneficiary of the "largest intergenerational transfer of wealth in history."¹⁶⁵ Reform for this age

163. This payment could be made in the form of a U.S. government bond. Tax credits or deductions in that amount would serve equally well.

164. Clyde H. Farnsworth, *The Discovery of Political Muscle*, N.Y. TIMES, Sept. 11, 1987, at A20; Ira J. Hadnot, *Joseph S. Perkins, Interview*, DALLAS MORNING NEWS, Dec. 28, 1998, at 1J, available at LEXIS, News Group File, All; Editorial, *Social Security Shouldn't Divide Us*, ST. PETERSBURG TIMES, Feb. 22, 2001, at 12A, available at 2001 WL 6964324.

165. Editorial, *Social Security Shouldn't Divide Us*, *supra* note 164, at 12A. Baby boomers, however, may be receiving some of that wealth back in the form of

group will be difficult, but the picture is not entirely bleak. This liability will be largely eliminated over the next twenty years as mortality thins the ranks of this age group. Morbid, yes—but the sad fact is that each succeeding year will witness a reduction in liabilities as death takes its inevitable toll.¹⁶⁶ The problem is one-off in that the liability will not be recurring if younger workers are diverted from the existing Social Security system.

Although the liability to the existing millions of elderly receiving Social Security benefits will be enormous, there are some ways to reduce it. Some of this liability can be met through the Social Security trust funds that have already been built up to meet future shortfalls. Liabilities could be further reduced by full taxation of Social Security benefits. This will conform Social Security income to benefits paid out under private pensions. Another means of reducing liabilities to these seniors would be to cut benefits for those with high incomes, say in excess of \$100,000. Again, this is unfair to those affected, since contributions were made on the understanding that these individuals would receive benefits, whatever their income level.¹⁶⁷ The harshness of this action could be ameliorated, however, by giving a tax credit to such individuals on their estate taxes that would offset the lost benefits.¹⁶⁸

These changes will accomplish a crossover to private pensions for some, but the critical question remains: how to fund benefits payable to those too old to be diverted to private social security accounts. Current estimates of solvency until 2015 are based on continued contributions. That could be offset to some extent by opt-outs and mortality, but the liability remains enormous. Two-thirds of America's elderly are dependent on Social Security as their major source of income. It is the

inheritances from their parents and other elderly relatives. Marsha King, *Boomer Metamorphoses*, SEATTLE TIMES, May 8, 2000, at A1, available at 2000 WL 5534930. The AARP may also be losing some of its power as baby boomers dilute their views. Steven A. Holmes, *The World According to AARP*, N.Y. TIMES, Mar. 21, 2001, at H1.

166. The trend in earlier retirements seems to be leveling off, which should further reduce pressure on the Social Security system from seniors. Mary Williams Walsh, *Reversing Decades-Long Trend, Americans Retiring Later in Life*, N.Y. TIMES, Feb. 26, 2001, at A1.

167. Even though the Supreme Court has ruled that there is no right to accrued benefits from Social Security contributions, *Flemming v. Nestor*, 363 U.S. 603, 611 (1960), in reality, as the Social Security Administration has stated, "Social Security is based on a simple concept. When you work, you pay taxes into the system, and when you retire or you become disabled, your spouse and your dependent children receive monthly benefits that are based on your earnings. And, your survivors collect benefits when you die." SOC. SEC. ADMIN., *supra* note 35, at 7.

168. As noted above, the Social Security Administration is already providing credits and increased benefits for those deferring the receipt of benefits. *See supra* note 160 and accompanying text.

only source of income for one-third of the elderly.¹⁶⁹ The easiest, but still painful, method would be to make those payments out of general taxation so that younger workers could use their existing Social Security contributions to fund private accounts. That would, of course, place enormous pressure on general revenues. Some relief could be obtained from the projected large budget surpluses, but that might conflict with plans for cutting taxes.¹⁷⁰ In any event, the temporary demands of this crossover period would be offset by the eventual elimination of Social Security taxes, and increased investments from private accounts should generate more taxable income.¹⁷¹

VI. SURVIVORS AND DISABILITY BENEFITS

Two other important aspects of Social Security must be considered in switching to a private system: disability and survivor benefits. About one-third of Social Security beneficiaries are not retirees. They include 7.5 million individuals receiving survivor benefits and six million receiving disability benefits.¹⁷² According to the Social Security Administration, its disability benefit is equivalent to a \$233,000 private disability insurance policy,¹⁷³ and its survivor benefits are equal to a

169. SOC. SEC. ADMIN., *supra* note 155, at 2.

170. At year-end 2000, a \$5 trillion federal budget surplus was being projected for the next ten years. Richard W. Stevenson, *10-Year Estimate of Budget Surplus Surges Once More*, N.Y. TIMES, Dec. 29, 2000, at A1. The Democrats, however, wanted to use a portion of that amount to pay off the existing national debt of \$3.4 trillion, while the Republicans were seeking a \$1.6 trillion tax cut over the next decade. *Id.* Nevertheless, President George Bush announced budget plans to set aside a large portion of the surplus to shore up a privatized social security system. *Washington Wire*, WALL ST. J., Feb. 23, 2001, at A1. Although the actual tax cut was smaller than sought by the Republicans, the budget surplus was shrinking as the economy declined in 2001. *See* The Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (setting forth the tax reduction program).

171. *See generally* Pete Du Pont, *Called to Account*, WALL ST. J., June 6, 2001, at A26 (describing how privatized social security accounts could reduce need for Social Security payments). Another method for achieving crossover would be to turn the Social Security system into a needs-based welfare program. This would reduce liabilities but would not, unjustifiably, encounter a storm of opposition from those currently receiving benefits. Such action would electrify this "third rail" of politics and result in turmoil. Many Social Security recipients believe, quite reasonably, that their contributions were made on the promise of future benefits. *See supra* note 155 and accompanying text.

172. SOC. SEC. ADMIN., *supra* note 155, at 3.

173. *Id.* The disability features of Social Security are limited. Unlike many private plans, Social Security does not recognize partial disabilities, at least for younger workers. SOC. SEC. ADMIN., *supra* note 35, at 16.

\$354,000 life insurance policy.¹⁷⁴ As these claims suggest, however, the risks covered by these Social Security benefits may be readily covered by private insurance. The real issue is one of dealing with existing beneficiaries.¹⁷⁵ They cannot simply be cut off, which raises further concerns as to the ultimate cost of transforming Social Security to a private system. The problem is how to get off the treadmill. As is the case for retirement benefits, the key to that conversion is to cut off entry into the system and to then liquidate existing obligations. Once again, actuarial figures for these beneficiaries make this a temporary problem if entry into the system is stopped.

For those not already receiving benefits, private insurance in two forms is needed: disability and life insurance. Life insurance is already an essential part of estate planning for most Americans, having been sold throughout the United States since the nineteenth century and having received widespread acceptance.¹⁷⁶ The assets of life insurance companies grew by over 800% between 1906 and 1938.¹⁷⁷ The assets of insurance companies tripled between 1945 and 1960.¹⁷⁸ In 1982, their assets totaled \$700 billion, which was more than that of the nation's fifty largest corporations,¹⁷⁹ and that number swelled to \$2.1 trillion in 1995.¹⁸⁰ The average amount of life insurance per household was then \$124,100.¹⁸¹ By 1996, 67% of adult Americans and nine out of ten households were covered by life insurance.¹⁸² One hundred fifty-four million Americans were covered by some form of life insurance.¹⁸³ Although this left over 100 million Americans uncovered, presumably many of those individuals were elderly or young people who had no dependents and little need for survivor insurance.¹⁸⁴ Yet, even allowing

174. SOC. SEC. ADMIN., *supra* note 155, at 3.

175. See generally Robert Pear, *Study Says Disabled Would Lose Benefits Under Plan to Revamp Social Security*, N.Y. TIMES, Feb. 7, 2001, at A13 (discussing concerns that individuals currently receiving Social Security benefits could be adversely affected by privatization proposals).

176. For a description of the growth of the insurance industry in the United States, see Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723 (2000).

177. TEMP. NAT'L ECON. COMM., 76TH CONG., INVESTIGATION OF CONCENTRATION OF ECONOMIC POWER, MONOGRAPH NO. 28-28A, at 9 (Senate Comm. Print 1940).

178. MARTIN MAYER, *THE BANKERS* 190 (1974).

179. *Big on Profits, Low on Returns—Insurance, Says Andrew Tobias, Is America's Protection Racket*, PEOPLE MAG., Apr. 12, 1982, at 77, available at LEXIS, News Group File, All.

180. AM. COUNCIL OF LIFE INS. *supra* note 60, at 7.

181. *Id.* at 6.

182. *Id.*

183. *Id.*

184. Although the amount of insurance in force increased between 1975 and 1995, the number of purchasers declined between 1993 and 1995. *Id.* The number of new life insurance policies fell from some 18 million in 1993 to about 11.1 million in 1997, a

for those individuals, a part of the population remains with no life insurance to protect dependents other than that available under the present Social Security system. In order to avoid having survivors of uninsured individuals become wards of the state, private social security accounts should probably include a life insurance feature. Fortunately, this insurance is relatively cheap for most individuals. Further, at least in the case of term insurance, it is the cheapest when needed most—when the insured is young and facing the need for extended survivor benefits for young children.¹⁸⁵ As the insured grows older, the cost of term insurance will increase, but the need for insurance diminishes as dependents become independent and the insured builds an estate for a surviving spouse through the investment features of a retirement account.¹⁸⁶

Disability insurance is also a concern.¹⁸⁷ The United States is becoming less and less a manufacturing nation where there is a high rate of disability from job-related accidents.¹⁸⁸ Nevertheless, disability is three to five times more likely than premature death for younger workers.¹⁸⁹ Workman's compensation provides some insurance for work-related disabilities,¹⁹⁰ and private disability insurance is widely available. Nevertheless, perhaps because of existing Social Security and state disability programs, some two-thirds of workers do not have

reduction of 37%. Joseph B. Treaster, *Life Insurance Loses Ground as Investment Options Grow*, N.Y. TIMES, June 8, 1998, at A1.

185. Term insurance accounted for about 48% of life insurance in 1994, up from 38% a year earlier. AM. COUNCIL OF LIFE INS., *supra* note 60, at 13, 26 (1996).

186. In January 2001, an online service was quoting a ten-year guaranteed maximum annual premium of \$830 for \$350,00 of life insurance for a nonsmoking individual aged fifty-two with no health problems. In contrast, a twenty-five-year-old with the same profile would pay an annual premium of only \$217 for the same amount of insurance. Netquote, at <http://www.netquote.com> (website visited and quotes generated Jan. 26, 2001).

187. Current Social Security proposals envision a reduction in Social Security benefits as they are replaced by private accounts, but there is concern that this will reduce disability benefits for those who have no substitute for such reductions. Pear, *supra* note 175, at A13.

188. Workplace deaths have dropped by nearly half over the last twenty years. *Workplace Fatalities Nearly Halved in 20 Years*, N.Y. TIMES, Apr. 27, 2001, at A17. Presumably, the rate of disabilities has also fallen.

189. Deborah Mendenhall, *A Disabling Omission: Disability Insurance Less Popular Than Life But Can Be More Important*, PITTSBURGH POST-GAZETTE, Nov. 20, 2000, at B1, available at 2000 WL 27786490.

190. See generally Philip Buffone, *Union Employees Have Made Sacrifices, Worked With Falls on Cutting City Costs*, BUFFALO NEWS, Dec. 24, 2000, at NC-2 (describing state disability programs).

disability insurance.¹⁹¹ It is also an expensive item that may require premium payments of three to five percent of a worker's salary, depending on the dangers associated with the employee's occupation.¹⁹² Nevertheless, this still seems small in comparison to the total 12.4% of income demanded from Social Security.

VII. PRIVATE SOCIAL SECURITY ACCOUNTS

Switching to private Social Security accounts raises a number of other issues. For example, should there be minimum contribution requirements to assure that individuals do not become wards of the state in their old age? Should there be maximum contribution limits on these accounts, at least to the extent that they are tax advantaged? What custodian requirements should be imposed, and should these accounts be federally insured in the event of the custodian's insolvency? Should there be restrictions on the nature of the investments in the accounts that would protect account holders from undue risks? What protections are available to protect account holders from fraud, overreaching and unsuitable investment recommendations in the investment of contributions to these accounts? As will be discussed, these are valid, but resolvable concerns.

A. Contribution Requirements and Limitations

Private sector IRA accounts are all spurred by tax advantages in one form or another. Congress, however, has sharply limited their advantages and discouraged such investments beyond minimal levels. Contribution limits and income cut-offs, therefore, assure that these programs have only limited effects in substituting for Social Security. This seems somewhat perverse in view of the fact that savings rates in the United States are at record low levels. They have "dwindled to virtually nothing,"¹⁹³ and even became negative at the end of the last century.¹⁹⁴

191. Marci Bailey, *Financially, More Of Us Are Prepared For Death Than For Chronic Disability: Inability To Work Is Greater Risk For Many, But Few Buy Insurance*, BOSTON GLOBE, Mar. 26, 2000, at F5.

192. *Id.* The cost of private insurance will increase if Social Security benefits are eliminated because most private policies do not cover an employee after he reaches full retirement age (which is being increased to age sixty-seven) under Social Security. The private companies assume that Social Security benefits will cover the employee after that age, and additional rider is required to obtain continuing coverage. Bailey, *supra* note 191, at F5 (discussing a reduction in benefit payments after retirement).

193. Robert D. Hershey, Jr., *Putting the Clamps on Consumers Accustomed to Borrowing Freely*, N.Y. TIMES, May 17, 2000, at C1.

194. Maya MacGuineas, *The Saving Grace of a Little Federal Debt*, WASH. POST, Jan. 7, 2001, at B2 (noting that the savings rate had declined to a negative .08 percent). Retirement savings prognosis has gone up and down with the stock market. Compare John O'Neil & Marjorie Connelly, *As Savings Go Up, Worries Go Down (A Little)*, N.Y.

Moreover, limiting and discouraging retirement savings at a time when Social Security cannot provide adequate benefits, and is itself bankrupt, seems counterintuitive and incongruous. Nevertheless, the government is concerned that retirement programs will become a tax shelter for the wealthy. Without going too far out on the Laffer curve, however, that concern must be weighed in light of the returns from increased investments that can be taxed.¹⁹⁵

Because of such considerations, the minimum contribution requirement seems facially easy to answer.¹⁹⁶ Like Social Security, these accounts will seek to ensure that the elderly do not become destitute once they stop working. The state has an interest in ensuring that they do not become wards who will drain tax revenues through need-based welfare

TIMES, Mar. 21, 2001, at H1 (describing sharp jump in the number of Americans saving for retirement), with Glenn Ruffenach, *Fewer Americans Save for Their Retirement*, WALL ST. J., May 10, 2001, at A2 (discussing survey finding that fewer Americans are saving for retirement). Some economists argue that the savings rate would actually be quite high if retained capital gains are added to the formula. *Exposing the Fraying Edges in the Fabric of the Economy*, N.Y. TIMES, Dec. 18, 2000, at C4. This argument seems to downplay the fact that new funds are not being added to existing savings. An economy cannot depend on the hope that it can fund growth solely through rising market prices. The downturn in the market at the end of the century underscores the danger of such an approach. Conversely, savings alone are not sufficient to fuel an economy that will boost individual wealth. Japan has the highest savings rate in the world and personal financial assets exceed \$12 trillion, but that country's economy has been mired in recession since its own bubble burst several years ago. Those savings have not restored the economy because they are not productively employed. Instead, they are held in postal and other accounts that do not funnel capital to businesses. See generally Michael A. Lev, *Japan's Trillion-Dollar Revolution*, CHI. TRIB., Sept. 10, 1999, § 1, at 1 (discussing Japan's savings patterns and its economy).

195. The Laffer curve theory, named after economist Arthur B. Laffer, who was said to have formulated the concept on the back of a napkin at a restaurant, posits that cutting taxes will increase revenues by increasing incentives to earn additional taxable income. Peter Passell, *Economic Scene: Lower Income Taxes Stimulate the Economy. The Sequel.*, N.Y. TIMES, Dec. 22, 1994, at D2. The theory also recognizes that cutting taxes will at some point cause lower tax revenues, as where the tax is cut to zero. Donald Ratajczak, *Consequences of U.S. Tax Cut Need More Study*, ATLANTA JOURNAL-CONST., July 25, 1999, at D2. Controversy focuses on where that break point is located. *Id.* The Laffer curve was given some credence after Congress cut capital gains taxes substantially. *Id.* Instead of the expected \$50 billion in reduced revenue from that cut, capital gains collections actually increased by \$100 billion. Richard Gilder & Thomas L. Rhodes, *Bush Needs a Bigger Tax Cut*, WALL ST. J., Feb. 8, 2001, at A22.

196. The Chilean privatized social security system requires a payment into a private account of a minimum of 10% of each worker's salary. Clifford Krauss, *Pensioners Quiver as Markets Fall*, N.Y. TIMES, Aug. 16, 1998, § 4, at 4. Australia will be requiring employers and employees to contribute a total of 12% to their private retirement accounts. See *infra* note 342 and accompanying text.

programs.¹⁹⁷ Therefore, mandatory contributions do not seem to be unfair, particularly if those contributions replace the present payroll tax for Social Security contributions. Moreover, a private social security account will belong entirely to the owner, even if access is restricted until retirement. The amount of the minimum contribution will necessarily be tied to the owner's income level, but should be adequate to assure a minimum level of retirement benefits, if invested in instruments with a modest rate of return.

Setting a maximum limitation on contributions raises more complex issues. The concern here is that the accounts will become a tax shelter for the wealthy. This is why income and maximum annual contribution limits are placed on current individual retirement account programs. The present limits on those accounts, however, are quite low and discourage contributions in amounts that would allow a generous estate buildup from compounded returns.¹⁹⁸ More importantly, restrictive limits overlook the fact that income is likely to be low early in one's career, and then rise with maturity. At the same time, the demands of children and home ownership will limit the amount of discretionary income available for retirement contributions in the early stages of a career even while income levels are rising. When income is freed from those family obligations, however, contribution limits and the limited time left to benefit from compounded savings curb the value of the retirement account. More money is needed at the back end to gain the advantages from compounded returns that would have been available earlier if income were greater.

The wiser course here would be to impose very high maximum limits on the amount of untaxed contributions over the life of the individual.¹⁹⁹

197. This authority is justified under the taxing power of Congress because it will be based on tax-advantaged contributions and justified by goals similar to those in Social Security. *See generally* Helvering v. Davis, 301 U.S. 619 (1937) (upholding required Social Security contributions under this authority).

198. Consideration is being given to increasing those limits, but even those proposals are low and inflexible. *See* David Rogers, *Retirement Savings Leads Tax-Cut Initiatives*, WALL ST. J., Jan. 26, 2001, at A16 (discussing proposed legislation that would increase contribution limits); *Tax Report*, WALL ST. J., Jan. 17, 2001, at A1 (discussing an increase of maximum IRA contribution from \$2000 to \$5000 and noting that the present \$2000 maximum limit has been in place since the early 1980s). That legislation did not pass, but efforts continue for its adoption. *House Bill Raises IRA, 401(k) Limits*, NEWS & OBSERVER (Raleigh, NC), May 3, 2001, at D1. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, did allow graduated contribution increases that will reach \$5000 in 2008. Catch-up contributions are also allowed where an employee is over fifty and fails to make a contribution in prior years.

199. One proposal seeks to raise contribution limits by \$5000 for ten years and then remove them entirely in order to encourage savings and investment. Gilder & Rhodes, *supra* note 195, at A22.

Minimum contributions would have to be made each year by the employed, but greater amounts could be contributed up to this limit at any time before retirement. All contributions should be allowed to compound tax free until withdrawn at retirement.²⁰⁰ This system would allow employees with layoffs to make up for lost contributions. Athletes, entertainers, authors and others with a few high-income years could also benefit from such an approach by effectively spreading earnings over their lifetimes for contribution purposes. Individuals with higher incomes at the end of their careers could add greater amounts to make up for lower contributions in earlier years. All would benefit from an increased incentive to save greater amounts earlier in order to take advantage of compounding.

Another consideration is simplicity. Under the current regime of individual retirement accounts, employees may have multiple accounts with varying restrictions and limitations. These might include SEP accounts, Roth accounts, IRAs, Keogh accounts, 403(b) and 403(k) accounts.²⁰¹ Employees are changing jobs with increasing frequency and may have participated in several different retirement programs that cannot always be rolled into one account. They may also have state or federal pension plans and defined benefit plans picked up sometime during a career. The author and his wife, for example, are presently monitoring nine separate retirement accounts in addition to their two Social Security accounts.²⁰² Congress would do everyone a favor by consolidating all individual retirement accounts under a single umbrella with uniform requirements. This would reduce monitoring costs and account fees, and allow cost savings.

For example, many mutual funds have breakpoints that allow reduced commissions for larger purchases, and brokerage firms may charge

200. Additional complex issues are raised by funds remaining in the account at death. For example, should they be taxed as income to the estate at that time or treated as part of the estate for estate tax purposes? Repeal of the estate tax may negate this issue, if that repeal is permanent. See The Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (setting forth the gradual estate tax repeal that will expire in ten years).

201. See *supra* notes 116–30 and accompanying text.

202. This number of accounts would have been even larger had the author and his wife not cashed out their government retirement accounts. As it is, their retirement accounts include Roth accounts, individual IRAs, SEP accounts, a Money Purchase plan, a Keogh plan, a university sponsored TIAA-CREF annuity plan, and a separate 403(b) annuity plan. The Economic and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, does allow some consolidation of IRA and Simple IRA Accounts.

administration fees for each account held by each customer. Spouses should also be able to combine their accounts into joint ownership to further the efficiency of their retirement savings. Joint ownership would also simplify distribution of their property on death.

Another problem that must be addressed is the nature of restrictions on the withdrawal of funds from an individual retirement account. Presently, restrictions on withdrawals are imposed on IRA accounts that are designed to assure that the funds are used for retirement and not as a tax shelter for discretionary income.²⁰³ IRA and similar account holders may begin withdrawing funds at age 59.5, while Social Security provides for reduced payments starting at age sixty-two, higher payments for those waiting until age sixty-seven, and even higher payments for those waiting until age seventy before retiring. Private IRA accounts are required to make minimum payouts once the individual reaches a specified age. Private IRA accounts also allow withdrawals without penalty for certain “emergency” situations such as disability.

Should the present private IRA account restrictions be extended to private social security accounts? The answer is that some restrictions are probably in order. Account owners should not be allowed to withdraw funds before retirement in other than emergency situations, lest they become wards of the state when they retire without adequate resources. The present retirement age of 59.5 for individual IRAs seems reasonable, but account holders must realize that they have a life expectancy well beyond that age and that resources must be conserved accordingly. In contrast, minimum payouts seem to be simply a tax collection measure. Their application to private social security accounts will depend on policies governing the taxing of the elderly and budget demands, rather than economics.

B. Custodian Requirements

Another issue to be addressed for private social security accounts is the nature and scope of custodian requirements—determining where contributions and accrued returns should be held for safekeeping. There are a number of such repositories for private pensions and individual retirement accounts. To the extent that private social security accounts are funded under the umbrella of a defined benefit plan, the Pension Benefit Guaranty Corporation (PBGC) was created specifically to

203. Nevertheless, 20% of individuals spend their 401(k) distributions when changing employment instead of rolling them over into a new plan. Marron, *supra* note 47, at A26.

provide insurance for defined benefit plans that are not properly funded and have more than twenty-five employees.²⁰⁴ In 1997, the PBGC was providing payments to 400,000 workers who were victims of underfunded plans.²⁰⁵ There are limitations on that insurance that limit coverage to about a maximum of \$35,000 per year per person.²⁰⁶ PBGC was also facing a funding crisis in the early 1990s, having a deficit of almost \$4 billion before changes at the agency allowed a recovery and even a surplus in 1996.²⁰⁷ The Retirement Protection Act of 1994 increased funding requirements and imposed restrictions on underfunded plans,²⁰⁸ which resulted in closer policing of underfunded plans. It did not, however, ensure that increased savings and an economic downturn will not result in large amounts of losses that the government might have to bear.

Defined benefit plan obligations also raise concerns of inflation; that is, the defined benefit may be rendered inadequate by inflation, particularly when the retiree is long-lived. Perhaps an indexing requirement could be imposed on such funds that would compensate for the effects of inflation. The employer could guard against the liabilities from such a provision by hedging with derivative instruments.²⁰⁹

Another drawback for defined benefit plans is the fact that the complexities and liabilities imposed by ERISA, as well as the restrictions imposed by the guarantee program, make defined benefit plans expensive, preventing small employers from having such programs and discouraging larger employers from using this type of plan.²¹⁰

204. See *supra* note 114 and accompanying text (describing background of the creation of this agency and insurance limitations).

205. Claudia Levy, *Martin Slate Dies at 51; Led Pension Agency*, WASH. POST, Feb. 26, 1997, at B5. At that time, forty-two million workers were covered by defined benefit plans. *Id.*

206. DOWNES & GOODMAN, *supra* note 114, at 498.

207. Levy, *supra* note 205.

208. The PBGC succeeded in convincing General Motors to add \$10 billion to its underfunded pension plans. *Id.*

209. Several instruments are available for hedging against inflation risks including some federal bonds whose returns are based on increased inflation rates. Of course, some of these instruments themselves may pose investment risks. See generally Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1 (1994) (describing large losses incurred from unregulated derivative instruments).

210. See Philip R. Lochner, Jr., *Economic Regulation and Democratic Government*, 25 J. CORP. L. 831, 834 (2000) (describing how ERISA has discouraged the use of defined benefit plans).

These weaknesses in the defined benefit plan are dramatically apparent from their declining popularity. The number of defined benefits plans decreased from 114,000 in 1985 to 40,000 in the year 2000.²¹¹ An alternative is the defined contribution plan that provides a means to guard against the risk of inflation.²¹² By the end of the century, defined contribution plans outnumbered defined benefit plans by a ratio of four-to-one.²¹³ From these figures, it would appear that America has decided that defined benefit plans are not the best method for assuring a comfortable retirement, which brings us back to the individual retirement account.

The maintenance of individual social security accounts raises some complex custodial issues since there are alternatives available that vary in their nature and are subject to differing regulations having disparate insurance schemes for protection from insolvency. For example, commercial banks, which have had considerable experience in administering common trust funds and pension funds,²¹⁴ are a logical custodian for private social security accounts and appear to be safe. Banks are subject to intensive regulation at both the state and federal level.²¹⁵ Banks must meet complex capital and reserve requirements designed to assure their financial stability.²¹⁶ Regulations are in place for the handling of trust funds.²¹⁷ Presumably, the trust departments are shielded from the claims of general creditors in the event of bankruptcy since this is not bank property. This might provide protection in addition to that available from the FDIC. Bank customers are insured by the FDIC for up to \$100,000 for funds on deposit at the banks,²¹⁸ which is less than the total

211. Lee, *supra* note 114, at 2000 WL 5532516.

212. See generally Albert B. Crenshaw, *Redefined Retirements: Today's Plans Put Workers on the Hook for Their Benefits*, WASH. POST, Jan. 28, 2001, at H2 (describing defined contribution plans and their increased popularity and risks).

213. Pulliam, *supra* note 81, at T51.

214. See generally *Inv. Co. Inst. v. Conover*, 790 F.2d 925 (D.C. Cir. 1986) (holding that banks could properly manage a collective trust for individual retirement accounts).

215. See, e.g., *In re Bank of New York*, 323 N.E.2d 700 (N.Y. 1974) (explaining that bank-administered common trust funds are examined periodically to judge the prudence of investments).

216. For a discussion of bank capital requirements see BD. OF GOVERNORS OF THE FED. RESERVE SYS., TRADING AND CAPITAL-MARKETS ACTIVITIES MANUAL, § 2110.1 (Apr. 2000). For reserve requirements see Reserve Requirements of Depository Institutions (Regulation D), 12 C.F.R. pt. 204 (2001); see also *First Bank & Trust Co. v. Bd. of Governors of the Fed. Reserve Sys.*, 605 F. Supp. 555 (E.D. Ky. 1984) (describing extension of federal reserve requirements to state banks).

217. See generally *Cent. Nat'l Bank of Mattoon v. United States Dep't of Treasury*, 912 F.2d 897 (7th Cir. 1990) (describing Comptroller of the Currency's regulation of trust department activities of national banks); *In re Bank of New York*, 323 N.E.2d at 700-04 (describing state regulation of state bank fiduciary activities).

218. 12 U.S.C. § 1821(a)(1)(B) (1994).

available from the PBIC.²¹⁹ The amount of FDIC insurance seems a bit low in that most private social security accounts will exceed that level after several years of saving. The customer could split their investments among a number of banks, but this would be inconvenient. The customer could have brokers do this for them, but there are currently restrictions in place on the use of brokered deposits.²²⁰ Congress may also be reluctant to increase insurance levels, particularly after the debacle in the savings and loan industry in the 1980s that nearly bankrupted the deposit insurance system and resulted in a massive regulatory restructuring.²²¹ Consequently, private social security account holders may be left to do their own shopping for multiple bank custodians for their private social security accounts.

Another currently popular depository for retirement funds is with broker-dealers in the securities industry. They too are elaborately regulated.²²² The Securities Exchange Act of 1934 requires broker-dealers to pass a background check and register with the Securities and Exchange Commission.²²³ They must meet extensive books and record keeping requirements.²²⁴ The SEC mandates a complex accounting scheme for its net capital rule that is designed to assure that the broker-dealer has adequate funds on hand to meet customer obligations.²²⁵ Early warning requirements are imposed where a broker-dealer is having

219. For a discussion of aggregation issues raised by the \$100,000 account limitation for retirement accounts see FDIC, *Federal Deposit Insurance Corporation: Your Insured Deposits*, at <http://www.fdic.gov/deposit/deposits/index.html> (last visited Jan. 27, 2001).

220. See generally *FAIC Sec., Inc. v. United States*, 768 F.2d 352 (D.C. Cir. 1985) (striking initial attempt to regulate deposit brokers); 12 U.S.C. § 1831f(a) (1994) (prohibiting banks that are not well capitalized from accepting brokered deposits).

221. See generally H.R. REP. NO. 101-54, pl. 1 (1989) (describing the savings and loan debacle); KITTY CALAVITA ET AL., *FRAUD AND POLITICS IN THE SAVINGS AND LOAN CRISIS* (1997) (same).

222. See generally 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, *BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES CREDIT REGULATION AND CUSTOMER PROTECTION* (2000) (describing SEC regulation of broker-dealers); David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899 (1987) (same).

223. 15 U.S.C. § 78o (1994) (outlining registration requirements); 17 C.F.R. § 240.17f-2 (2000) (regarding fingerprinting requirement for background checks of associated persons employed by broker-dealers).

224. 17 C.F.R. § 240.17a-3 (2000).

225. 17 C.F.R. § 240.15c3-1 (2000). See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 570 n.10 (1979) ("The net capital rule requires a broker to maintain a certain minimum ratio of net capital to aggregate indebtedness so that the broker's assets will always be sufficiently liquid to enable him to meet all of his current obligations").

financial difficulties that are impairing its capital, and broker-dealers must cease business when they fail to meet the required minimums.²²⁶ Customer funds must be held in special custodial accounts that are designed to protect customer assets from the claims of creditors.²²⁷ In the event of bankruptcy of a broker-dealer, the customer is insured by the Securities Investor Protection Corporation (SIPC), but that insurance covers only losses due to the broker-dealer's insolvency, such as missing securities. It does not cover losses on investments held by the broker-dealer. SIPC insurance is now \$500,000 per customer, of which \$100,000 may be in cash.²²⁸ Many broker-dealers also have private insurance for amounts even beyond this figure.²²⁹

The federal securities laws provide other protections for individually managed retirement accounts. For example, broker-dealers are prohibited from making recommendations for unsuitable investments.²³⁰ Broker-

226. 17 C.F.R. § 240.17a-11 (2000) (concerning early warning requirements). The SEC staff has stated that:

[T]he net capital rule . . . is an integral part of the Commission's financial responsibility program for broker-dealers. The rule prescribes minimum liquidity standards for broker-dealers, its purpose being to ensure that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers, plus a "cushion" of liquid assets in excess of liabilities to cover potential market and credit risks. In addition to the net capital rule there is an "early warning requirement." The "early warning requirement" serves to give the Commission advance notice of a broker-dealer approaching its minimum net capital requirement in which event the Commission monitors the financial health of the broker-dealer.

Mr. & Mrs. Glenn Gregory, SEC No-Action Letter (Feb. 8, 1983), 1983 SEC No-Act LEXIS 2335.

227. 17 C.F.R. § 240.15c3-3 (2000). The SEC has stated that:

Rule 15c3-3 has two major components. First it provides a "formula" for the determination of reserves. The Reserve Formula is designed to eliminate the use of customers' funds and securities by broker-dealers in financing firm overhead and such dealer activities as market-making, trading and underwriting. Second, the rule codifies the obligation of broker-dealers to establish procedures for insuring the prompt physical possession or control of all fully-paid and excess margin securities carried for the account of customers.

SEC Study on the Financing and Regulatory Capital Needs of the Securities Industry, Fed. Sec. L. Rep. (CCH) No. 1109, at 7 (Jan. 23, 1985).

228. 15 U.S.C. § 78fff-3(a) (1994). *See generally* 15 U.S.C. § 78aaa-78lll (1994) (legislation creating SIPC to administer insurance scheme). *See also* Amendments to the Securities Investor Protection Act, Pub. L. No. 96-433, sec. 1, 94 Stat. 1855 (Oct. 10, 1980) (increasing insurance limits to \$500,000).

229. Kathy M. Kristof, *T+3 Rule: Living With Tighter Deadline on Trades*, L.A. TIMES, May 28, 1995, at D4. *See also* Herb Greenberg, *From the Mailbag—More on the Dangers of Buying IPOs*, S.F. CHRON., May 6, 1995, at B1 (noting that private coverage may be up to \$10 million for small accounts and \$25 million for larger accounts); Herb Greenberg, *The Mailbag—Can You Be Sure Your Broker Isn't a Crook?*, S.F. CHRON., Sept. 6, 1997, at D1 (noting that private insurance may be canceled or may not cover a particular risk and that an insurance company could itself become bankrupt).

230. Suitability rules are imposed by self-regulatory organizations such as the NASD and the New York Stock Exchange, as well as the SEC. *See* 23A MARKHAM &

dealers cannot recommend an investment for a retirement account that is unsuitable for the investor in light of his or her particular investment needs and objectives.²³¹ Account executives must be supervised to assure compliance with this requirement.²³² Restrictions are placed on the amount of markups that may be charged to customers,²³³ and switching,²³⁴ churning,²³⁵ and other fraudulent practices are prohibited.²³⁶

A third custodian for individual retirement programs is the insurance industry. The sale of insurance in the United States, unlike other financial service sectors, continues to be regulated principally by the states.²³⁷

HAZEN, *supra* note 222, § 9.01. The SEC has special suitability requirements for dealers of penny stock (low-priced speculative securities). 17 C.F.R. § 240.15g-9 (2000). The weight of the authority is that there is no private right of action for suitability violations, but damages may be recovered where an unsuitable violation involves deception. *See* 23A MARKHAM & HAZEN, *supra* note 222, § 9.09.

231. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999) (describing suitability requirements). Bank regulators adopted an "appropriateness" requirement, akin to the SEC suitability rule, discussed *supra* note 230 and accompanying text, to protect institutions from improper recommendations for derivative transactions by banks or their affiliates. *See* Press Release, Comptroller of the Currency, OCC Releases Answers to Banker Questions About Derivatives (May 10, 1994), 1994 OCC Enf. Dec. LEXIS 109 (citing OCC Banking Circular No. 277 explaining the appropriateness requirement).

232. *See generally* 23A MARKHAM & HAZEN, *supra* note 222, §§ 7.9–12 (describing SEC supervision requirements).

233. The SEC and the NASD prohibit broker-dealers from charging customers excessive markups for securities sold from the broker-dealers own inventory. *See* 23A MARKHAM & HAZEN, *supra* note 222, § 9.21 (describing markup restrictions).

234. Switching involves moving customers from one mutual fund to another to generate commissions. *See, e.g., In re Krull*, Exchange Act Release No. 34-40768, 68 S.E.C. Docket 2223 (Dec. 10, 1998), 1998 WL 849545 (upholding NASD disciplinary action for switching).

235. Churning occurs where a broker controls a customer account and trades it in order to generate commissions without regard to the customers needs and objectives. *See generally* 23A MARKHAM & HAZEN, *supra* note 222, § 9.23 (describing churning).

236. *See generally id.* §§ 9.01–29 (describing prohibited practices).

237. Following the decision of the Supreme Court in *United States v. S.E. Underwriters Ass'n*, 322 U.S. 533, 553, 560 (1944), which held that insurance involved interstate commerce and was subject to the antitrust laws, Congress passed the McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–15 (1994)). That legislation immunized the insurance companies from the antitrust laws to the extent their activities were regulated by state law. It did not, however, preclude the application of the federal securities laws when insurance companies sell securities instead of insurance products. *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 72 (1959); *see infra* note 249 and accompanying text. After some forty large insurance companies failed, Congress considered legislation in 1992 that would have created a Federal Insurance Solvency Commission to establish national standards for the financial soundness and solvency of insurance companies. That legislation was not enacted. John L. Ingersoll et al., *Federal Regulation of Insurance: The Industry's*

The states have adopted elaborate regulatory structures to regulate this business.²³⁸ Those structures include licensing requirements to ensure competency and integrity, restrictions on fraudulent sales practices, underwriting requirements, and reserve and capital requirements.²³⁹ The National Association of Insurance Commissioners (NAIC) has sought to create some uniformity in state insurance regulation through model laws, but regulation remains uneven.²⁴⁰ NAIC sought to further its testing of the adequacy of insurance company reserves by creating risk-based capital tests.²⁴¹ On balance, the insurance industry has performed well and customer losses have not reached any great magnitude.²⁴² A number of class actions have been brought in recent years charging fraud in sales practices of various insurance companies, many of which have been settled. Insurance regulators are also becoming more aggressive in attacking improper sales practices and thereby increasing customer protection.²⁴³

About sixty-five million workers were covered by retirement plans in 1995 that were maintained with life insurance companies.²⁴⁴ Many workers fund their retirements through annuities underwritten by insurance companies. Unlike life insurance, which seeks to create an estate upon the death of the insured, the annuity is designed to assure

Response to H.R. 4900 and H.R. 1290, 23 A.B.A. BRIEF 10-11 (Spring 1994); Scot J. Paltrow, *How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb 5, 1998, at 1. See generally SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES (Comm. Print 1990) [hereinafter FAILED PROMISES] (describing insurance company failures).

238. The states have insurance guaranty funds, most of which try to protect life policies to a limit of \$300,000 in death benefits, \$100,000 in cash or withdrawal value, \$100,000 in the present value of annuity benefits and \$100,000 in health benefits. ALAN GART, REGULATION, DEREGULATION, REREGULATION: THE FUTURE OF THE BANKING, INSURANCE, AND SECURITIES INDUSTRIES 215 (1994).

239. See, e.g., N.C. GEN. STAT. §§ 58-1-1 to 58-88-30 (1999) (regulating insurance company sales and operations).

240. NAIC created a joint reporting and surveillance system for large interstate insurance companies. See D'ARISTA, *supra* note 98, at 304-05 (describing NAIC and its activities). Most states do not require independent audits or reviews of actuaries in setting reserves. International reinsurance issues are also often outside their jurisdiction. FAILED PROMISES, *supra* note 237, at 63.

241. Before the introduction of risk-based capital requirements, most states imposed reserve requirements and static minimum amounts of capital and surplus. Risk-based capital standards changed this to require capital levels based on the risk of the investments in an insurance company's portfolio. Larry G. Mayewski et al., *RBC: Beauty Contest or Non-Event?*, BEST'S REVIEW, Mar. 1994, at 33-34.

242. More than forty multistate insurance companies did fail in the early 1990s. Broome & Markham, *supra* note 176, at 739. See generally FAILED PROMISES, *supra* note 237 (discussing failures of large insurance companies).

243. See Broome & Markham, *supra* note 176, at 740 (providing a description of sales practices cases involving insurance companies).

244. AM. COUNCIL OF LIFE INS., *supra* note 60, at 56.

that the annuitant does not outlive his or her estate. Under the traditional "fixed" annuity, the purchaser receives a fixed amount of income based on his or her premium payments, life expectancy, and an assumed rate of return on the premium payments. The insurance company has to bear the risk that the purchasers will live longer than expected and that returns on the investment of premiums may be less than projected. The insurance company can model these risks based on mortality rates and expected rates of return. This assures that the annuitant will have income in the specified amount for the remainder of his or her life, however long or short.²⁴⁵

The fixed annuity assures that the annuitant does not outlive his or her income only if the insurance company remains solvent.²⁴⁶ Another concern is that because payments are fixed in amount, inflation can undercut the value of the income received under a traditional annuity, causing hardship to the annuitant.²⁴⁷ Variable annuities were created to deal with the inflation risk. This product was introduced in 1952 by the College Retirement Equities Fund (CREF), which was affiliated with the Teachers Insurance and Annuity Association (TIAA).²⁴⁸ Variable annuity

245. See generally Albert B. Crenshaw, *The Baby Boomers' Heir-Cut: Study Advises Generation Against Counting on Inheritance*, WASH. POST, Dec. 10, 2000, at H2 (describing annuities); Terry Savage, *Don't Overlook Benefits of Immediate Annuities*, CHI. SUN-TIMES, May 2, 1999, Financial Section, at 61, available at LEXIS, News Group File, All (same). In contrast, an endowment policy combines a savings feature with a life insurance feature. At the end of the endowment period, the face amount of the policy is paid to the beneficiary. TEMP. NAT'L ECON. COMM., 76TH CONG., *supra* note 177, at 182.

246. A case in point was the failure of Baldwin United, a company that had sold pianos before becoming an underwriter of single premium deferred annuity contracts that offered an attractive return as a guaranteed pay out. The company was unable to meet the investment performance required to meet that guarantee and defaulted. See D'ARISTA, *supra* note 98, at 197-98, 316-17, 331 n.58 (describing the Baldwin United problems); *Id.* at 359, 370, 372 (describing lawsuits brought against distributors of the product and state insurance guaranty funds and their inadequacies). Another company, Charter Company, which sold single premium deferred annuities, also failed. BARRIE A. WIGMORE, *SECURITIES MARKETS IN THE 1980S: THE NEW REGIME, 1979-1984*, at 53-54 (1997) (describing Baldwin United and Charter failures). Another debacle for the insurance industry was the guaranteed investment contract (GIC) that assured a specific return from investments in a retirement plan. Insurance companies offering this product underestimated the risks and lost money when they had to meet this guarantee. JOHN ROUSMANIERE, *THE LIFE AND TIMES OF THE EQUITABLE* 263-302 (1995) (giving an overview of GICs); Michael Quint, *Aetna Life to Cut 4000 Jobs and Take \$1.3 Billion Charge*, N.Y. TIMES, Jan. 29, 1994, at 35 (describing losses from GICs and single payment annuities).

247. DOWNES & GOODMAN, *supra* note 114, at 9-10.

248. CEDRIC V. FRICKE, *THE VARIABLE ANNUITY: ITS IMPACT ON THE SAVINGS-*

premiums are invested in securities and the performance of those investments determine the amount of the income from the variable annuity, rather than the assumed interest rate that is used for the fixed annuity. The purchaser of a variable annuity bears the risk that investment returns will be less than expected. Returns may also be higher than those of a fixed annuity if the investment of the variable annuity premiums exceeds the rates assumed for the return on the fixed annuity.

The creation of the variable annuity represented an effort by the insurance industry to take advantage of investor interest in the stock market, which was rising during the 1950s. The insurance industry wanted a product to compete with mutual funds, and the variable annuity filled that role. The variable annuity, however, was held to be a security by the Supreme Court in *SEC v. Variable Annuity Life Insurance Co.*²⁴⁹ This meant that variable annuities were subject to regulation by the SEC under the federal securities laws, and investors were given the protections those laws afford.²⁵⁰ The product was in all events a popular one. By 1995, about 12.8 million individuals had variable annuity plans, mostly deferred annuities.²⁵¹ The nature of variable annuity programs varied widely. In 1998, over 100 insurance companies were offering

INVESTMENT MARKET 2 (1959). These contracts were only available to teachers, but the Participating Annuity Life Insurance Company offered variable annuity contracts to the general public in 1954. AM. COUNCIL OF LIFE INS., *supra* note 60, at 132.

249. 359 U.S. 65 (1959). See generally *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (holding again that variable annuities were securities subject to regulation by the SEC).

250. SEC regulation meant, among other things, that insurance companies selling variable annuities and other insurance products that had an investment component were required to establish "separate" accounts to hold their reserves for these products. See *Prudential Ins. Co. of Am. v. SEC*, 326 F.2d 383, 388 (3d Cir. 1964) (holding that the separate accounts for a variable annuity contract were a separate legal entity from the insurance company, which meant those accounts would be regulated as investment companies). The SEC granted relief to allow the insurance companies to avoid most of the effects of this regulation. Lawrence J. Latta, *Federal Regulation of the Contracts Issued by Life Insurance Companies*, in *THE FINANCIAL SERVICES REVOLUTION: UNDERSTANDING THE CHANGING ROLE OF BANKS, MUTUAL FUNDS, AND INSURANCE COMPANIES* 29, 39 (Clifford E. Kirsch, ed. 1997). The SEC did set forth requirements that insurance companies had to meet in order to sell securities to retail customers. Chubb Sec. Corp., SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,829 (Nov. 24, 1994).

251. AM. COUNCIL OF LIFE INS., *supra* note 60, at 38. The assets held in those separate accounts were in excess of \$400 billion by 1995. *Id.* at 7. This was an increase of over 30% from 1994. *Id.* Common stock constituted over 60% of those assets. *Id.* The appeal of variable annuities was hurt by changes in the tax laws that reduced capital gains taxes for competing investments. Rick Bloom, *Variable Annuities Short-Change Buyers*, DETROIT NEWS, May 21, 2000, at 3B; see also *The Motley Fool: The Fool School—On Variable Annuities*, DALLAS MORNING NEWS, Oct. 16, 2000, at 4D (discussing the disadvantages of variable annuities).

some 260 different variable annuity products.²⁵²

Barring an unforeseen catastrophe, banks, broker-dealers and insurance companies all seem to be appropriate depositories for private social security accounts. The difficulty lies with their differing regulatory structures, particularly the insurance features available for private retirement accounts placed with one or the other of those entities. Obviously, the government cannot insure these accounts against investment losses, and insurance coverage that is too broad or unregulated will only encourage the repeat of a debacle such as that experienced with the savings and loan associations in the 1980s.²⁵³ Nevertheless, more uniformity is needed to reduce consumer confusion and disparity of coverage.²⁵⁴ This will be a difficult task. Currently various insurance regulators (FDIC, SIPC, PGBC and state insurance commissions) cover redundant different types of products. For example, FDIC insurance covers bank products, while SIPC covers only losses from broker-dealer insolvency.

VIII. INVESTMENT RESTRICTIONS

A significant issue in privatization of Social Security is whether restrictions should be placed on the type or nature of the investments placed in such accounts. The concern is that an investor will bet the ranch on a risky investment. If the government steps in to protect such persons when they inevitably encounter disaster, the situation becomes a "heads, I win; tails, you lose" proposition. That is, if the investor is lucky on the investment, he becomes rich. If not, the government steps in to protect the investor from his own folly. Without market discipline and the hardships associated with that discipline, investors are encouraged to incur inordinate risks. Nevertheless, society will be reluctant to turn its back even on gamblers who lost it all on the red nine in Las Vegas.

252. Deborah Lohse, *Shelf Space Gets Scarce for Annuities*, WALL ST. J., Aug. 17, 1998, at C1. These investments are not free from fraud. Investors have been subject to improper recommendations urging them to switch from one variable annuity to another in order to generate commissions for their broker. Jeff D. Opdyke, *Shifting Annuities May Help Brokers More Than Investors*, WALL ST. J., Feb. 16, 2001, at C1.

253. See *supra* note 221 and accompanying text.

254. A former SEC commissioner has expressed concern that privatizing Social Security will result in a demand for more regulation. See generally Roberta S. Karmel, *The Challenge to Financial Regulators Posed by Social Security Privatization*, 64 BROOK. L. REV. 1043 (1998) (discussing SEC regulatory issues that would arise upon the privatization of Social Security). This would turn back ongoing efforts to cut back on regulation in order to make the securities markets more efficient and competitive. Uniformity in other areas of regulation is also needed.

To guard against undue investment risks, the Department of Labor under ERISA has set investment standards for trustees handling and investing pension funds. That standard has a long history that has relevance to investment of private social security accounts. Early English court decisions had allowed trustees to invest trust funds in real estate and joint-stock companies, including those of the East India Company.²⁵⁵ Trustees could not lend on the credit of individuals, no matter how “unimpeachable their credit.”²⁵⁶ The South Sea Bubble changed the attitude of the English courts, and trustees found themselves bound by legal requirements that restricted their investments mostly to government securities.²⁵⁷ In America, the decision of the Massachusetts court in 1830 in *Harvard College v. Amory*²⁵⁸ imposed the “prudent man” rule on trustee investments. The court held that in making trust investments trustees must use “sound discretion” and must act in the same manner as “men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”²⁵⁹ The courts in America split on whether this rule would allow investments in common stock.²⁶⁰ Later, states adopted legislation that created “legal lists” that specified what securities were prudent investments for trustees. Initially, those lists did not include common stocks.²⁶¹

State law changed after World War II permitted trustees to purchase stocks. Colorado, for example, amended its constitution in 1950 to allow trust funds to be invested in common stocks and corporate bonds.²⁶² Twenty-two states enacted the Model Prudent Man Investment Act in 1963 that eased restrictions on fiduciary investments. Gradually, these state statutes and court decisions allowed fiduciaries to invest

255. See generally Ellen L. Nylund, *Investments by Trustees*, 20 CHL.-KENT L. REV. 331–32 (1942) (discussing English chancery decisions allowing investments in stocks).

256. Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199, 212 (1992) (citing *Practical Summary of the Law of Trustees*, 27 LAW TIMES 170 (Mar. 29, 1856)).

257. See Stephen M. Dickson, Note, *Trust Administration in Georgia and the Prudent Investor Rule: May Trustees Delegate Their Investment Powers?*, 14 GA. ST. U. L. REV. 633, 637–38 (1998) (discussing the collapse of the South Sea bubble on the powers of trustees).

258. 26 Mass. (9 Pick.) 446 (1830).

259. *Id.* at 462.

260. See Ernest G. Strand, *New York's Partial Prudent-Man-Rule*, 25 N.Y.U. L. REV. 583 (1950).

261. Gustav B. Margraf, *Laws Relating to the Investment of Trust Funds, 1930–1937*, 5 LAW & CONTEMP. PROBS. 399 (1938); William R. White and Irving A.J. Lawres, *The Modernization of Legal Lists*, 5 LAW & CONTEMP. PROBS. 386 (1938).

262. Charles A. Baer, *The “Prudent-Man Rule” Now Applies to Investments by Fiduciaries*, 28 DICTA 213 (1951).

greater amounts into corporate stocks.²⁶³ Also, the courts restricted fiduciaries from commingling funds of trust estates for investment purposes, which prevented trustees from managing funds on a large-scale basis. Court decisions and various statutes later relaxed those restrictions.²⁶⁴

ERISA adopted a prudent man standard requiring investments to be made with “the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”²⁶⁵ Later, a more sophisticated standard for trustee investments gradually shunted the legal list and prudent man restrictions aside. Something called “modern portfolio theory” sought to diversify investments across a wide spectrum. This theory was based on a belief that price changes in an “efficient” stock or other market are dependent on the introduction of new information.²⁶⁶ This means that stock prices are as predictable as a “random walk” down Wall Street²⁶⁷ and that even the best portfolio manager cannot out-guess the market over a sustained period.²⁶⁸ Therefore, under modern portfolio theory, the portfolio manager should diversify investments across the market, which

263. Meigs, *supra* note 107, at 371 n.9 (1965).

264. CHAIRMAN OF THE S.E.C., INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-476, at 5 (1939). Banking regulations require banks to invest fiduciary funds in a manner “consistent with applicable law.” 12 C.F.R. § 9.11 (2001). This requirement has been interpreted liberally. RAYMOND W. GOLDSMITH, INSTITUTIONAL INVESTORS AND CORPORATE STOCK—A BACKGROUND STUDY 70 (1973).

265. 29 U.S.C. § 1104(a)(1)(B) (1994).

266. For a discussion of efficient market theory see *Central Nat’l Bank of Mattoon v. United States Dep’t of Treasury*, 912 F.2d 897, 901–02 (7th Cir. 1990). Critics have contended that such things as “noise” trading by uninformed investors and something called the “efficiency paradox” preclude the existence of a truly efficient market. JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 256–57 (1995).

267. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 24 (1999).

268. ROGER LOWENSTEIN, BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST 307 (1995). One senator tried to prove this point by throwing darts to select stocks for a portfolio. His selections did better than those chosen by the average mutual fund. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 365–66 (1982). One study evidenced that mutual fund investors would have been better off in a fund that simply mimicked the stocks listed on the New York Stock Exchange, rather than placing themselves in the hands of a portfolio manager that sought to do better than the market. Adam Bryant, *Jean Crockett, 79, First Woman to Lead the Philadelphia Fed*, N.Y. TIMES, Oct. 7, 1998, at C23; see also Jonathan Clements, *Resisting the Lure of Managed Funds*, WALL ST. J., Feb. 27, 2001, at C1 (concluding that over a thirty-six year period, investors in actively managed mutual funds would have received a higher return from passively managed indexed funds).

will allow the portfolio to at least match market performance since it cannot outperform it. Modern portfolio theory encourages passive investment in which a portfolio is diversified to track some stock market index that broadly reflects over-all market movements.²⁶⁹ Modern portfolio theory allows the introduction of risk into the portfolio as a part of diversification.²⁷⁰ This permits even speculative investments as a portion of the portfolio.

Modern portfolio theory has gained wide acceptance. The Department of Labor was among those adopting prudential investment standards for pension fund managers that allowed implementation of modern portfolio theory.²⁷¹ Investments of the portfolio manager would be viewed in the context of the overall portfolio and not just on whether a particular investment was a risky one.²⁷² Modern portfolio theory avoids concentration of risks into the portfolio. Consequently, a single failure or even a drop in a sector of the economy will not destroy the value of the portfolio. Diversification also envisions capturing profits from various sectors as they outperform others. An overall economic drop may affect the portfolio adversely, but this would generally reflect an overall disinflation that would be captured in a diversified investment strategy.²⁷³

269. See generally Dolores Kong, *What's Best Financial Advice You've Received?*, BOSTON GLOBE, Mar. 5, 2000, at H6, available at http://secure.boston.com/bg_archives/newarch.cgi (last visited June 3, 2001) (describing advantages of passive investing); Phil Porter, *Savers Should Switch to Safer Passive Investments*, COLUMBUS DISPATCH, May 31, 1992, at 1G, available at LEXIS, News Group File, All (describing modern portfolio theory and passive investing); Liz Pulliam Weston, *Pros, Cons of Top 401(k) Advice Web Sites*, L.A. TIMES, Oct. 6, 2000, at C4 (describing modern portfolio theory and diversification).

270. Modern portfolio theory includes the concept of:

[C]ovariance . . . which is intended to provide a constant overall return on investment under divergent circumstances. Some investments are made in anticipation of specific circumstances; others are made in anticipation of contrary circumstances. An over-simplified example is a portfolio including investments in umbrellas as well as sunscreen in anticipation of rainy as well as sunny weather.

In re Piper Capital Mgmt., Inc., Admin. Proceeding File No. 3-9657 (Nov. 30, 2000), 2000 SEC LEXIS 2626.

271. See *Laborers Nat'l Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999) (describing Department of Labor regulations that adopt the modern portfolio theory, 29 C.F.R. § 2550.404a-1b(b)(1)(i)-(ii) (2000), cert. denied, 528 U.S. 967 (2000)).

272. LOWENSTEIN, *supra* note 268, at 319; see also Rona Kobell, *Executive in the Spotlight: Robert Wolf, an Estate Lawyer Who Thinks Like a Money Manager*, PITTSBURGH POST-GAZETTE, Oct. 31, 1999, at C5, available at <http://www.post-gazette.com/businessnews/19991031exec4.asp> (stating that modern portfolio theory allows trustees to look at total return rather than the performance of each security in the portfolio) (last visited June 3, 2001).

273. The 1970s, however, were marked by a period of "stagflation" in which unemployment and inflation rose while the stock market dropped. Jim Gallagher,

ERISA thus has in place fairly sophisticated standards for defined benefit plans, but that protection does not extend to private IRAs. This raises the issue of what standard should be applied to the individually managed accounts of individuals who may not have access or choose not to use professional investment managers. Presently, Keogh and other IRAs permit such self-management with few restrictions, and self-directed accounts may not always be prudentially managed. An individual may fancy himself a stock picker who can out-guess the market. What is to become of that individual when he learns that a random walk down Wall Street or the use of darts would have been more profitable?²⁷⁴ What about the investor who invested heavily in Internet stocks in the last market bubble, only to see them drop to less than one-half of their purchase price?²⁷⁵ If a private social security account were the only retirement source for this individual, what responsibility does society have to protect him from himself or to rescue him after his poor judgment renders him impecunious.

Where, Oh Where, Is Big, Bad Bear?, ST. LOUIS POST-DISPATCH, July 28, 1997, Business Plus, at 7, available at LEXIS, News Group File, All; *Eight Years And Counting*, USA TODAY, Apr. 1, 1999, at 14A. Of course, this might suggest even broader diversification into such things as bullion and art that increase in value during inflationary periods. See generally, Tom Petruno, *Internet Stocks: The Mania That Wouldn't Die?*, L.A. TIMES, Nov. 28, 1999, at C1 (describing the run-up in gold prices in 1979–1980 when prices increased from \$232 to over \$800 per ounce and then back down to \$320 in 1982 as inflation abated). Cf. James Grant, *When Money Becomes a Confidence Trick: The Flipside of Investors' Persistent Lack of Interest in Gold is an Unquestioning Faith in Money*, FINANCIAL TIMES (London), July 10, 2000, at 19, available at <http://globalarchive.ft.com/globalarchive/articles.html?print=true&id=000710001656> (describing falling gold prices and the decreased dependence on gold reserves by central banks) (last visited June 4, 2001).

274. Market timing investment strategies also face risks. One analyst notes that even an investor with perfect timing techniques will fare less well than an investor with a steady program of long term investment that can grow through accretion of investment returns, rather than market timing. *The Most Important Investing Principle of All . . . \$954,680*, supra note 153, at 3. New York has a College Savings Program that provides tax-advantaged investments for college expenses. Under that program, more risky investments are used in the early years of saving in order to build up the account of younger parents. Thereafter, less risky investments are used to preserve the capital in the account for college expenses. The program resulted in losses of one-third of the amounts held in those programs for riskier investments when the market plunged. Jay Gallagher, *N.Y. College-Savings Fund Dives: Tumbling Stock Market Means Thousands Lost Third of Investment*, ROCHESTER DEMOCRAT & CHRON., May 21, 2001, at 1B.

275. See generally Greg Ip, *A Year of Living Dangerously*, WALL ST. J., Jan. 2, 2001, at R1 (stating that the 54% “peak-to-trough” drop in the Nasdaq market saw a drop in values of \$3.3 trillion, which is equal to about one third of the value of all homes in America).

Presently, IRAs can be invested in almost every kind of instrument including stocks, bonds, mutual funds, certificates of deposit, annuities and precious metals. However, “[p]hysical real estate cannot be among an IRA’s assets.”²⁷⁶ A wide range of investments is also permitted for Keogh accounts, except precious metals and collectibles are excluded.²⁷⁷ IRA account holders have also been fairly active traders with an average annual turnover ratio of 67.6% between 1991 and 1996. On average, a little over two-thirds of the assets in private retirement accounts were bought and sold in a single year. Individual investors were even more active in nonretirement accounts, with 89% in annual turnover during that period.²⁷⁸ These turnover figures seem quite high in view of the fact that the classic strategy for the individual investor is to buy and hold.²⁷⁹ That strategy is driven by the fact that individual investors have cost, time, place, and informational disadvantages that seriously handicap them in any aggressive and active trading program.²⁸⁰ The cost disadvantage is due to the fact that individual investors do not own exchange memberships or have institutional bargaining power that allows them to trade cheaply. Each transaction results in a commission charge that must be recovered before a profit is made. This will require an increase in value of the investment that will generally require some period of time. Even then, the commission charge may cut the percentage of return substantially unless amortized over a long period.²⁸¹

Time, place, and informational advantages are also ceded to the professional trader because the trader can operate on the trading floor or have access to information that has market effect more readily than a

276. DOWNS & GOODMAN, *supra* note 114, at 374.

277. *Id.* at 399.

278. David Robinson, *Retirement Accounts Aren't for Frenetic Trading*, BUFFALO NEWS, Mar. 19, 2000, at B14, available at 2000 WL 5671340.

279. See generally Roger Thornham, *Survey Online Investing: In Search of an Education—If Brokers Want Online*, INVESTORS CHRON., Jan. 19, 2001, at 107, available at 2001 WL 7013638 (discussing buy and hold strategy). Cf. Gregory Zuckerman & Ianthe Jeanne Dugan, *Folks Who Like to Buy a Stock and Forget It Face Rude Awakening*, WALL ST. J., Feb. 7, 2001, at A1 (discussing the dangers of buy and hold strategies for small investors).

280. See generally Bill Brashler, *Taking Stock of E-trading*, CHI. TRIB., May 7, 2000, Mag., at 10 (describing traditional market advantages of professional traders), available at 2000 WL 3663305.

281. Courts have traditionally considered an annual turnover ratio of six (i.e., the assets in the accounts are sold six times within a year) to be fraudulent when a customer's account is controlled by a broker-dealer because such high volume trading indicates that the account is being traded to generate commissions, rather than for the long-term interests of the customer. See generally Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967) (describing the phenomenon of churning); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 824–25 (9th Cir. 1980) (same). Higher ratios may be justified where a customer has an aggressive trading strategy. *Newberger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977).

small investor. The exchange specialist, for example, has greater access to order flow and other information than a small investor.²⁸² The individual seeking short-term profits is thus severely handicapped in trading against more informed and nimble institutional competitors.

The Internet and discount brokers are removing some of the advantages enjoyed by institutional investors. Even small traders may obtain reduced commissions if they forsake advice and information that is provided by the “full-service” broker-dealer.²⁸³ The Internet is also helping to lessen the time and place advantages of professional traders and is equalizing information flows among all classes of investors. Online trading provides individual investors with quicker and cheaper access to the market.²⁸⁴ Some individual investors used that advantage to engage in “day trading,” that is, rapid in-and-out trades that seek quick profits. This professional style of trading became popular in the market run up at the end of the last century. Unfortunately, the results were not all that great, even disastrous for many.²⁸⁵ Other innovations include Internet connections that allow investors to create their own stock funds customized for their particular goals or trading objectives.²⁸⁶

Notwithstanding concerns with the investment strategies of the individual investor, there have been no great scandals in which massive numbers of IRA account holders were left destitute by bad investment choices.²⁸⁷ Surely, there have been losses that have been masked by

282. See generally *ECNs Ask: Why Don't Exchanges Keep Pace?*, SECURITIES INDUSTRY ONLINE, Apr. 17, 2000, at <http://www.securitiesindustry.com/issue.cfm?id=153&aid=5538> (last visited June 3, 2001) (discussing traditional time, place, and informational advantages of the exchange specialist).

283. See generally Arthur M. Louis, *Coming to Clients' Rescue*, S.F. CHRON., May 9, 2000, at D1 (describing traditional roles of discount broker and full service firms and how their distinctions are now blurring).

284. Some 10.5 million accounts were trading online by mid-1999. Richard J. Hillman, *On-Line Trading; Better Investor Protection Information Needed on Brokers Web Sites*, GAO REPS., May 9, 2000, at 1, available at LEXIS, News Group File, All.

285. Various studies found that day traders tended to lose rather than make money. See Rebecca Buckman, *Report on Day-Trading Firm's Accounts Finds Nearly Three-Quarters in the Red*, WALL ST. J., Aug. 9, 1999, at C15; Gretchen Morgenson, *Day Trades: Big Growth, Big Risks*, N.Y. TIMES, July 31, 1999, at A9; Michael Schroeder, *Day-Trading Firms Rebuked by Group of State Regulators Over Marketing*, WALL ST. J., Aug. 10, 1999, at A26; Ruth Simon, *Senate Heaps New Grievances on Day-Trading Firms*, WALL ST. J., Feb. 24, 2000, at C1.

286. Patrick McGeehan & Danny Hakim, *Two Fund Giants to Introduce Self-Directed Portfolios for Investors*, N.Y. TIMES, Feb. 14, 2001, at C1.

287. Market downturns will inevitably take a toll on retirement accounts. Section 401(k) accounts experienced an average loss of \$4821 during the market downturn in

Social Security, which provides a backstop for those using bad judgment in their investment choices. Such insurance will be lost if Social Security is completely privatized, and the dangers of poor individual investment choices will become more apparent.

Still another concern is investment fraud. Retirees and unsophisticated investors are prime targets for securities fraud.²⁸⁸ They will also be tempted to take larger investment risks if a period of inflation reduces the purchasing power of their low-risk portfolios. These dangers are all real, but the present system of private pension fund accounts and individual investment holding is a far cry from the situation that gave rise to Social Security in the 1930s. Americans are becoming more experienced investors, they have overall handled their investments wisely, and the federal securities laws provide protection from widespread fraudulent activities.²⁸⁹ There is also a vast regulatory and administrative infrastructure now in place for handling and protecting private retirement accounts.²⁹⁰ The SEC is already stepping up investor education efforts as more pension plans become self-directed.²⁹¹

It is, nevertheless, tempting to propose investment restrictions on private social security accounts. Society has an interest in protecting itself from destitute victims, even when that circumstance is due to their own folly. But the adoption of new “legal” lists for approved investments can hardly be justified in light of their abandonment as a standard for professional trustees. Those lists were simply too restrictive for changing economic conditions and investment theory. Any effort to specify appropriate investments will encounter those same problems. The adoption of modern portfolio theory and passive investing standards may be a more flexible approach.²⁹² Yet, who is to say what investments meet those

2000 and more losses were expected. *House Bill Raises IRA, 401(k) Limits*, NEWS & OBSERVER (Raleigh, NC), May 3, 2001, at D1, available at 2001 WL 3463363; see also *New York Governments May Have to Contribute to Employees' Pensions*, WALL ST. J., Mar. 27, 2001, at A4 (noting that a state pension fund lost \$6 billion in value due to market drop). Under modern portfolio theory, however, such losses are expected, as are market recoveries. Over the long run the market should return a higher amount than other investments. *Supra* notes 266–73 and accompanying text. Of course we should remember it was not until 1954 that the stock market recovered to the level that it had peaked at in 1929. SOBEL, *supra* note 68, at 225.

288. See generally Evan Perez, *Drive Is Launched on Investment Fraud Targeting Florida's Retirees, Foreigners*, WALL ST. J., Jan. 12, 2001, at C16 (describing formation of a federal task force to combat telemarketing and Internet fraud schemes directed at the elderly).

289. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2 (3d ed. 1996) (describing federal securities laws that were enacted in the wake of the Stock Market Crash of 1929).

290. See *supra* notes 204–43 and accompanying text.

291. See generally Roye, *supra* note 1.

292. By 1986, over \$100 billion was being passively invested. LOWENSTEIN, *supra*

standards?²⁹³ Is it a portfolio indexed to the Dow Jones Industrial Average, the S&P 500 or the Russell 2000 index of smaller companies? Even if all of those indexes are selected, how will diversification into the bond market be handled?²⁹⁴ Most analysts will not recommend 100% stock market exposure.²⁹⁵ Assuming that a properly diversified bond index is also incorporated, what about real estate and commodity exposure to assure a truly diversified portfolio? Can an unsophisticated investor deal with the complexities required to maintain a diversified portfolio?

There are a number of ways to deal with these concerns and there already appear to be several private solutions to the dilemma of investment choices, including a broad range of diversified mutual funds. We must also not forget the need for life and disability insurance for the account holders. Numerous forms of insurance and annuity programs are available that could be used to meet the concern of inadequate savings or poor investments. For example, term insurance can be adjusted to meet changing needs.²⁹⁶ In addition, "whole life" or "ordinary" life insurance is a traditional approach to life insurance and estate building.

note 268, at 319.

293. Asset allocation, which involves the shifting of investment funds among stock, bonds and other investments as market conditions change, is a popular investment technique. *Id.* at 303. Dynamic hedging and program trading are other popular trading methodologies. They rely on computer technology and sophisticated database analysis for portfolio adjustments. Such methodologies were blamed for accentuating the market plunge during the stock market crash in October 1987. See generally Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993 (1988) (describing these trading techniques and their role in the October 1987 market crisis).

294. Even if bonds are added to the portfolio, diversification of counter party risk is needed unless investment is limited to U.S. government bonds (a shrinking market as the national debt is paid off), housing agency securities such as those issued by GNMA, and government insured products such as certificate of deposits. Further, bond investing can be a complicated matter unless the instrument is held to maturity, which may be undesirable in a changing market. Those trading bonds must consider such things as "duration" risk, i.e. the price reaction of a particular fixed income instrument to changes in the yield curve. The "convexity" of a particular instrument's duration will measure its sensitivity to interest rate changes. *In re Piper Capital Mgmt, Inc.*, *supra* note 270, at 24 nn.13–14.

295. Modeling even a diversified portfolio for predicted returns is still an uncertain business at best. See Jonathan Clements, *Retirement Models That Let Reality Bite*, WALL ST. J., Feb. 20, 2001, at C1 (stating that "deterministic" retirement models are unrealistic because they rely on a presumed rate of return and "probabilistic" models are needed to assess chances of success for a particular strategy).

296. See *supra* notes 184–85 and accompanying text.

This policy combines a saving feature with life insurance through level premium payments. The premium reflects both a savings program and a mortality feature. The premium for these policies in earlier years will be more than term insurance because the insured is building up savings that will provide a return and offset higher mortality charges in later years. The savings value built up in the policy has a loan value and can be used to pay premiums, again as a loan, where the insured is unemployed for a time and unable to make payments. In 1996, there was \$7 trillion of ordinary life insurance in effect.²⁹⁷ Whole life policies constituted about two-thirds of the life insurance policies written in 1997.²⁹⁸ These policies have, however, traditionally been poor investments in that they have had a low rate of assumed return and do not account for inflation.

A number of other insurance products are available that provide savings features, as well as cover mortality risk. For example, "universal" insurance products provide more flexibility than is available under traditional whole life policies. These policies unbundle the life insurance mortality costs and the interest credited on policy values and expense charges.²⁹⁹ This allows the policyholder to vary the amount or timing of premium payments.³⁰⁰ Some of these policies have a level death benefit and others have a variable death benefit, depending on the level of payments being made. If premiums are not paid, the cash value of the policy can be used to meet minimum premium requirements.³⁰¹

Universal life insurance became a popular product and was accounting for 38% of the industry's premiums by 1985, up from 2% in 1981.³⁰² "Variable" insurance is a product that offers even greater flexibility. These policies allow the policyholders to invest premiums in investments that provide an opportunity for a greater return than available from traditional whole life insurance. Coverage from such products increased from about \$6.8 billion in 1985 to \$83.6 billion in 1995.³⁰³ Flexible premium variable or universal variable life insurance had the features of universal life insurance and had death benefits that would vary according to investment performance of assets under the contract.³⁰⁴ Variable products would have to be given tax-advantaged treatment for premiums

297. AM. COUNCIL OF LIFE INS., *supra* note 60, at 5.

298. Karine Michael, *Selling Security: Companies Drop Premium Rates on Term Life Insurance*, HERALD-SUN (Durham, NC), Jan. 10, 1999, at F1.

299. GARY SCHULTE, *THE FALL OF FIRST EXECUTIVE: THE HOUSE THAT FRED CARR BUILT* 46 (1991).

300. AM. COUNCIL OF LIFE INS., *supra* note 60, at 27.

301. Latto, *supra* note 250, at 50.

302. Irwin W. Goldberg, *What's Hot and What's Not*, BEST'S REVIEW, Feb. 1987, at 24.

303. AM. COUNCIL OF LIFE INS., *supra* note 60, at 10.

304. *Id.* at 27.

in order to make them viable for retirement planning. More importantly, life insurance seeks to create an estate upon the death of the insured, rather than assure that the insured will not outlive the assets in their estate. The latter is the concern of a pension, but another insurance product, the annuity, is also directed toward meeting that problem.

Fixed annuity contracts raise concerns with inflation; their level benefits may be undercut in purchasing price by inflation. Variable annuity contracts are an investment mechanism that can be used to provide a lifetime stream of income that will reflect the benefits of investment returns. The annuity can be combined with a mortality feature and disability insurance. In some instances, variable annuities provide for fixed periodic payments once the accumulation stage ends (the period when contributions are made) and the annuitization stage begins (the period of retirement). Other variable annuities make payments based on accumulated investments and their current value at the time each payment is made. Some annuities may provide a combination of both fixed and variable payments and may have a mortality feature that provides for a return of the accumulated funds in the event of death before predicted life expectancy.³⁰⁵

A product of some interest is the so-called "Retirement CD," which was being sold by the Blackfeet National Bank under a license from the American Deposit Corporation in Pine, Colorado.³⁰⁶ This tax-advantaged product required the customer to make an initial deposit with the bank, and the customer selected a maturity date, presumably the date of his or her retirement.³⁰⁷ The interest rate was fixed for a period of one to five years, as selected by the customer. Thereafter, and until maturity, interest rates for investment return fluctuated with the market but were not allowed to drop below 3%. Upon maturity, holders of the retirement CD were allowed to withdraw a portion of the funds (up to two-thirds including accrued interest), but the rest were paid out on a fixed annuity basis for the rest of their lives, even if the account balance was below zero.³⁰⁸ If a holder died before the account reached zero, the balance remaining in the account was paid to his or her estate in a lump sum. The amount of the payments made to customers during the annuitization

305. *Id.* at 38.

306. *See* Am. Deposit Corp. v. Schacht, 84 F.3d 834, 836 (7th Cir. 1996).

307. *Id.*

308. *Id.*

phase of this product was based on mortality tables.³⁰⁹

This product, while not perfectly fitted for a private social security account, demonstrates the imaginative way in which private accounts can be structured. The Thrift Retirement CD also combined tax-advantaged accumulation with a FDIC guarantee of the deposit up to permissible limits. Unfortunately, state insurance regulators were allowed to impede the sale of these instruments. Federal banking regulators had approved this product for sale by banks, but the courts held that it was actually insurance and not a bank product whose regulation would be preempted by federal regulations.³¹⁰ The product was also later denied deferred tax advantages by the Internal Revenue Service.³¹¹ Nevertheless, if preempted and tax-advantaged, this type of product could be used to provide some degree of safety of principal to the owner of a private social security account, while allowing accumulation at market interest rates. The banks have also offered CDs with returns that are based on market returns of an index of stocks, allowing market participation with a guaranteed floor feature.³¹² The federal government's inflation indexed bonds are another example of how instruments have developed to deal with the risk that retirees fixed payments are undercut by inflation.³¹³

IX. GOVERNMENT MANAGED PRIVATE ACCOUNTS

A number of instruments are available to provide flexible means for mortality, disability, inflation, and other investment risks. The only issue is whether the government should mandate one or the other. The answer is probably not. This would stifle innovation and would undoubtedly interfere with investment performance. On balance, the

309. *Id.*

310. *Blackfeet Nat'l Bank v. Nelson*, 171 F.3d 1237, 1247 (11th Cir. 1999); *Am. Deposit Corp.*, 84 F.3d at 841-42.

311. Legislation was also introduced in Congress to deny them FDIC insurance. Press Release, Comptroller of the Currency, Remarks by Eugene A. Ludwig Comptroller of the Currency Before the American Bankers Association Annual Convention Honolulu, Hawaii (Oct. 5 1996), LEXIS Banking Bulletin.

312. *See generally* *Inv. Co. Inst. v. Ludwig*, 884 F. Supp. 4-5 (D.D.C. 1995) (describing indexed certificate of deposit). Another product attacked by regulators was the "callable CD," which was criticized because of its long-term maturity, which made it illiquid. The call feature also gave the issuer an advantage in the event of rising interest rates. *Edward Jones Fined \$200,000 by NYSE in Callable-CDs Case*, WALL ST. J., Dec. 21, 2000, at B11.

313. *See generally* Jonathan Clements, *Need a Lift? Inflation Bonds Are Handy*, WALL ST. J., Dec. 12, 2000, at C1 (describing inflation bonds as increasing principal by rate of principal plus additional interest on the increased sum). In July 2000, these government "I" bonds were paying a base rate of 3.6% plus a semi-annual amount based on the rate of inflation as determined by the Consumer Price Index. The "I" bond was then providing a total return of 7.49%. Terry Savage, *Savings Bonds Offer Peace of Mind*, CHI. SUN-TIMES, July 6, 2000, at 50.

millions of consumers directly affected by their investments are in a better position to decide the nature of their retirement programs. Mistakes will be made, but hopefully they will be isolated, and not systemic, as are the flaws built into the Social Security system. Nevertheless, there will be efforts made to keep even private market investments under government control.³¹⁴ President Clinton proposed in his State of the Union Address in 1999 that the government invest in the stock market on behalf of Social Security programs in order to boost benefits. Clinton's proposal would, however, have kept those investment decisions out of the hands of individuals; he was concerned that people would lose their money in the market or become victims of fraudulent investment schemes.³¹⁵ This "nanny" state proposal was a nonstarter. Critics raised concerns that the government would be put in a position to socialize business in America, or to at least try to control the activities of corporations for noneconomic reasons. Clinton abandoned this effort as a result of that opposition.³¹⁶

Nevertheless, suggestions have been made that private investments could be made in Social Security accounts without undue governmental regulation.³¹⁷ The model for such claims is the federal civil service retirement system that was privatized in the 1980s.³¹⁸ Civil service

314. One study concluded that Social Security trust fund assets should be invested in private securities in order to increase investment returns and reduce the pay-as-you-go burden of the present system. MICHAEL LEIDY, *INVESTING U.S. SOCIAL SECURITY TRUST FUND ASSETS IN PRIVATE SECURITIES* (Int'l Monetary Fund, Working Paper, Sept. 1997).

315. David E. Rosenbaum, *Road to Reconciliation Appears Long and Hard After Acquittal*, N.Y. TIMES, Feb. 14, 1999, at A1.

316. Krzysztof M. Ostaszewski, *Privatizing the Social Security Trust Fund? Don't Let the Government Invest*, 6 SOC. SEC. PRIVATIZATION 1 (Jan. 14, 1997), at <http://www.ato.org/pubs/ssps/ssp6.html>; Richard W. Stevenson, *Clinton Abandons Idea of Investing Retirement Funds*, N.Y. TIMES, Oct. 24, 1999, at A1. In a related context, concerns have arisen that government surpluses may have to be invested in private securities markets. Unless the surplus is spent or revenue is cut, suggestions have been made that the government could own as much as 20% of all domestic equities in twenty years. Kevin A. Hassett & R. Glenn Hubbard, *Where Do We Put the Surplus?* WALL ST. J., Jan. 29, 2001, at A26. No less a personage than Alan Greenspan has stated, however, that "[t]he federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government's investment decisions from political pressures." *Id.*

317. See Laurence S. Seidman, *Funding Social Security*, 81 TAX NOTES 241, 241 (Oct. 12, 1998) (proposing funding Social Security through private investments managed through contracts between the Social Security Administration and private investment firms).

318. This retirement program is called the Federal Thrift Savings Plan. It is managed by a Federal Retirement Thrift Investment Board that is composed of three

employees previously were given a defined benefit pension that was based on pay level and number of service years. Now, civil service employees have access to a defined contribution program in which they are given a choice of investment funds to which their retirement savings can be directed. They may allocate those contributions in indexed stock funds that mimic the S&P 500 stock index or they may select a Smallcap index or an international investment fund for a portion of their retirement funds.³¹⁹ Also available are bond funds and U.S. government securities.³²⁰ Those investments provided a 13.19% return on investments in fiscal year 2000, far outstripping the return available from Social Security.³²¹

Investments for the civil service pension scheme are made passively on the basis of indexing and not on the basis of the product, management or performance of any individual company. Advocates of a government-managed scheme argue that such passive investing avoids the concern that the government would try to socialize business through selective investment or through its voting power as a shareholder.³²² To further insulate the government from seeking to exert influence over business decisions, proponents have suggested the creation of an independent board that would select private fund managers to decide on passive investment strategies.³²³

These schemes overlook the fact that a massive amount of funds will be pouring into the market if Social Security is privatized.³²⁴ If managed

members appointed by the President with the advice and consent of the Senate and in consultation with certain House leaders for two of those appointments. 5 U.S.C. § 8472 (1988). The Board is advised on investment policy by an Employee Thrift Advisory Council composed of fourteen representatives of employee organizations. 5 U.S.C. § 8473 (1988). An Executive Director is given overall responsibility for implementing investment policy, and the Board is barred from interfering with specific investment decisions of the Executive Director. 5 U.S.C. §§ 8472(g), 8474(a) (1988). Fiduciary duties are imposed on the Executive Director and to private sector advisers investing funds. 5 U.S.C. § 8477 (1988 & Supp. V 1994).

319. Stephen Barr, *C Fund Investors Should Take Comfort in the Long Term*, WASH. POST, Jan. 9, 2001, at B2.

320. Federal employees fully participating in the Thrift Savings Fund may contribute up to 10% of their pretax income (up to a maximum of \$10,000) to the Federal Thrift Savings Plan, and the government makes matching contributions of 5%, all of which remains untaxed until withdrawal. ARTHUR ANDERSEN, FINANCIAL STATEMENTS OF THE THRIFT SAVINGS FUND—1999 AND 1998 at 3 (Mar. 2, 2000).

321. Donald B. Marron, *A Safe Rescue for Social Security*, N.Y. TIMES, Oct. 12, 2000, at A29.

322. *The Social Security Divide*, BOSTON GLOBE, Dec. 16, 1998, at A26.

323. Henry J. Aaron & Robert D. Reischauer, *To the Market*, WASH. POST, Feb. 23, 1999, at A19.

324. The Federal Thrift Savings Plan had some 2.4 million participants in 2000 and had assets of only \$94.5 billion. ARTHUR ANDERSEN, *supra* note 320, at 2–3. That number will be substantially expanded by legislation that now allows the military to participate in this program. National Defense Authorization Act for Fiscal Year 2000,

by the government, those investments will all be chasing the same indexed funds. This will of course cause a pleasing rise in prices for the securities in the indexes. It will not provide a direct incentive for further investment, except to the extent that smallcap stocks are encouraged to go public in order to share in the largess. Private placements and venture capital offerings will also have to be included in one fund or another in order to encourage new ideas and growth. Even with such broadening, the capital markets will be skewed by the government's investment requirements.³²⁵

The larger issue is whether the government will in fact remain passive. Large institutional investors occasionally like to flex their muscles, and the temptation for politically correct investing has proven to be too large to resist. Selection of fund managers will be further temptation to politicians who have a tendency to reward friends and punish enemies, rather than to select on the basis of qualifications. Calpers, the \$170 billion retirement fund for California public employees, which is now the largest pension fund, is a case in point.³²⁶ It has adopted a socially responsible investing strategy that excludes investment in tobacco stocks and companies with foreign operations that do not protect workers' rights. The fund additionally directs investments into inner cities and urban areas lacking in development.³²⁷ The selection of "good" foreign stocks that meet its criteria requires Calpers to use active rather than passive portfolio management. Calpers has also been active in corporate governance issues, eschewing the passive role that most institutional issuers take with respect to company management.³²⁸

Pub. L. No. 106-65, sec. 661, § 211, 113 Stat. 512, 670 (1999).

325. A similar event occurred before World War II when insurance companies were largely restricted to investments in bonds. A government study found that the enormous investments in bonds by insurance companies were skewing corporate balance sheets by unbalancing debt-to-equity ratios, increasing leverage, and restricting access to equity capital. TEMP. NAT'L ECON. COMM., 76TH CONG., *supra* note 177, at 378.

326. The New York City Employees' Retirement System is another government pension fund that pursues social investing goals by using its shareholder status as a "bully pulpit." *New York City Employees' Ret. Sys. v. SEC*, 45 F.3d 7, 9 (2d Cir. 1995); *see also* David J. Friedman, SEC No-Action Letter (Dec. 19, 2000), 2000 SEC No-Act. LEXIS 1012 (describing a proxy proposal by the Minnesota Investment Board seeking to require a company in which it was a shareholder to determine whether the company's advertising was having an undue effect on children).

327. Danny Hakim, *On Wall St., More Investors Push Social Goals*, N.Y. TIMES, Feb. 11, 2001, at 1.

328. *Largest Pension Fund Adopts Social Responsibility Standards*, HOUSTON CHRON., Nov. 15, 2000, at C6, available at 2000 WL 24526652.

The activist approach to investing espoused by Calpers may be laudable if you happen to agree with those particular goals. Calpers, however, forces those contributing money to the pension fund to support at least some of its declared social goals whether they agree with them or not, and that support is required even if it costs the contributors money. They must give up what they might rightly view as their property to support those programs even if they believe they are socially, as well as economically, suspect (for example, xenophobic “buy America” programs that support economic inefficiency). By the same token, if the pension fund were to drop its social investing and corporate governance strategies, and adopt a purely passive investment strategy, those supporting such political actions would be forced to spend their money on tobacco stocks and foreign operations that they morally detest.

In America, there is a sharp divergence of opinion on what are appropriate social goals. Even where there is general agreement, a sharp division often exists on how to accomplish a particular goal. Tobacco stocks are repulsive to many nonsmokers, but tobacco farmers, tobacco company employees and suppliers for the tobacco companies, as well as members of their families, might be expected to support such investments. Those opposing the use of contraceptive devices might seek to block investments in pharmaceutical companies that produce a morning-after pill, while others might support such investments. Right-to-life proponents may not want to invest in hospitals or clinics that provide abortion services, while prochoice advocates might support such investments. Some individuals may oppose investments in fossil fuel companies and demand that, instead, investments be made in alternative energy sources. Others might want investments in gas and oil exploration in remote wilderness areas in order to increase existing fuel supplies, an investment strategy that many oppose. Some might not want to invest in companies involved in defense work, while many support those enterprises. Others might not want to invest in meat packing companies that slaughter animals, while still others might not want to invest in entertainment companies that do not reflect their moral values in programming content. Surely, investment programs will be needed for the Luddites who oppose advances in technology, for the antiglobalization crowd and for militia members who may want to invest in companies making advances in private weaponry or night scopes. Hunters might want to invest in gun manufacturers, while others object to such activity. The list is endless and would exclude many businesses in America as an investment, if everyone’s social goals were to be satisfied.³²⁹ On balance, it would seem best that the government not be

329. Many industries in America could be objectionable to at least some investors.

the arbiter of the investment choices for individuals.³³⁰

Corporate governance raises other issues. Should the government vote stocks held in Social Security accounts in favor of management and against dissidents or vice versa? SEC regulations require corporations to include various shareholder proposals in their proxy materials at the corporation's expense.³³¹ Many of those proposals involve social goals, including such things as: to determine whether a company should sell pate made from geese that have been force fed to engorge their livers,³³² to have a company stop making napalm for use on human beings,³³³ to accelerate a company's schedule for phasing out its production of chlorofluorocarbons and developing substitutes,³³⁴ to decide whether companies should be involved in cigarette manufacturing or packaging,³³⁵ to discontinue discriminatory hiring practices such as those based on the

Nuclear energy, hydroelectric construction, products requiring animal testing, genetic engineering and cloning, automobile manufacturers (polluting engines), gambling, and the construction of single family dwellings have all raised objections. It is foreseeable that some shareholders will demand that companies affirmatively direct their activities into particular areas, such as mass transit, even if it is not economically viable. Other concerns turn on the activities of officers and directors. For example, when the founder of Domino's Pizza, himself an orphan, spoke out against abortion, the National Organization of Women organized a boycott of Domino's Pizza. Jim Suhr, *Pizza Magnate Puts His Fortune Where His Faith Is*, CHI. TRIB., Nov. 10, 2000, § 2, at 8. What should the role of a government pension fund be in such a dispute, especially where shareholder action is sought to remove the official?

330. Of course individuals may themselves choose social goals as a basis for their investments, and there are a number of investing programs available to those so inclined. See generally Hakim, *supra* note 327, at 1 (describing popularity and the various goals of those involved in "socially responsible investing").

331. 17 C.F.R. § 240.14a-8 (2000).

332. *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554, 556 (D.D.C. 1985).

333. *Med. Comm. for Human Rights v. SEC*, 432 F.2d 659, 661 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403, 405 (1972).

334. *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 417 (D.C. Cir. 1992).

335. Philip Morris Companies, SEC No-Action Letter (Feb. 4, 1997), 1997 SEC No-Act. LEXIS 271 (stating that company could exclude shareholder proposal regarding curbing teen smoking); Mobil Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,709, at 78,235 (Feb. 28, 1991) (regarding smoking proposal); see also Aetna Life & Casualty Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,705, at 78,219 (Feb. 28, 1991) (discussing shareholder proposal to require insurance company to examine the cost of smoking to its business and to decide what investment policies should be followed in light of the findings of that study); Hartford Financial Group, Inc., SEC No-Action Letter (Mar. 18, 2000), 2000 SEC No-Act. LEXIS 455 (regarding proposal to exclude purchase of tobacco stocks by an insurance company).

employee's sexual preferences,³³⁶ and to limit excessive executive compensation,³³⁷ to name just a few.³³⁸ Most of these proposals fail, but a government fund holding vast amounts of stock could play a significant role in that voting.³³⁹ Who will decide how that vote is to be cast? Even failing to vote or abstain will act as a no-vote, since most corporate governance schemes require an affirmative majority vote for shareholder action.³⁴⁰

A middle ground, if it is deemed necessary for the government to act as custodian and provider of investment choices, is to duplicate the private sector that is now offering a wide range of investment choices for social investing, as well as choices focused solely on economic return. Such a system would allow investors to choose funds that would provide stock and bond market exposure and allow those so inclined to make social investments that meet their ideological requirements. Of course, the government would have to be neutral on the range of social investments available and not favor one ideology over another. This will cause some constitutional problems, for example where members of a particular religion demand investments only in companies that agree to ascribe to their religious tenets. Undoubtedly, there will also be those whose ideas pertaining to social investing will be noxious to many Americans. The business of pornography in its various forms comes to mind as an industry that will at some point offend many. Yet, it is a lucrative business and is protected to a great degree by the First

336. *N.Y. City Employees' Ret. Sys. v. SEC*, 45 F.3d 7, 9 (2d Cir. 1995).

337. Statement of SEC Chairman Richard C. Breeden on Executive Compensation Issues, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,926, at 82,464 (Feb. 13, 1992).

338. For a discussion of the use of the SEC proxy rules by shareholders to advance social goals, see generally HELEN E. BOOTH, *THE SHAREHOLDER PROPOSAL RULE: SEC INTERPRETATIONS AND LAWSUITS* (1987); David E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635 (1976).

339. A pension fund controlled by the federal government should in all events be prohibited from owning more than a very small percentage of any one company, both as a diversification and risk limiting measure, and as a way to keep American industry from being socialized through the vast amounts of funds that will be held in a privatized social security system. The Investment Company Act of 1940, for example, restricts "diversified" investment companies from owning more than 10% of the stock of any one company. 15 U.S.C. § 80a-5(b) (1988). As the size of a government controlled pension plan grows, however, the number of available investments will shrink, and such a limitation may be hard to enforce. Moreover, stock ownership is often widely dispersed and even a small minority position may give the government effective control over a business.

340. See, e.g., DEL. CODE ANN. tit. 8, § 216 (1991). The government might find itself in an awkward position on some issues, such as claims that a company should not be involved in defense work. One recent shareholder proposal sought to have Microsoft sue the federal government for shareholder losses caused by the government's antitrust action against the company. Microsoft Corp., SEC No-Action Letter (Sept. 15, 2000), 2000 SEC No-Act. LEXIS 846.

Amendment; it could no more be excluded from investment choices than could major newspapers whose editorial views cause offense.

X. THE AUSTRALIAN SYSTEM

Australia is implementing a privatized retirement system that might provide a model for reform in the United States. The key to the Australian scheme is something called "superannuation."³⁴¹ This is a system of private, tax-advantaged retirement accounts that have mandatory contribution requirements. When fully implemented, employers will be required to contribute 9% of each employee's earnings up to a specified maximum earnings level (of about 26,000 Australian dollars per quarter) into a private retirement account. If this contribution is not made, the employer will be taxed for the required amount, and the government will make the contribution. Employees must also contribute 3% of their salary up to the specified level. The contributions are taxed at levels much lower than ordinary income up to specified maximum limits. Restrictions are placed on withdrawals, but emergency access is permitted before retirement age. Some funds provide disability and life insurance, as well as retirement benefits.³⁴²

Contributions are invested in regulated superannuation funds. These are trust funds that are managed by private trustees. These trust funds may be employer-specific, industry-specific, or available to any member of the public. Three regulatory bodies are given jurisdiction to assure that these trust funds are invested and managed properly. They are the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, and the Australian Taxation Office. Local trust law also applies to provide protection, and auditors and actuaries must report to regulators violations of legislation that provides for the protection of superannuation funds. Investors are often given a choice of investment strategies that range from "guaranteed" minimum returns to funds with significant investment risk. Investors may be able to spread or switch their investments among funds with varying strategies. Defined benefit plans are also allowed.³⁴³

341. See generally NAT'L INFO. CTR. ON RET. INVS. INC., A SUPER GUIDE (July 24, 2000) (providing an overview of "Superannuation").

342. *Id.* at 15, 19.

343. *Id.* Unlike the Australian model, Singapore utilizes a Central Provident Fund (CPF) that originally required matching employee and employer contributions of 5% of wages for withdrawal at age fifty-five. Later this scheme was expanded and was used to

Backstopping the superannuation funds is a social security network. The Australian government thus provides an “Age Pension” for the elderly, at an age that is moving toward sixty-five.³⁴⁴ It is the equivalent of our Social Security pension, except that it is needs based and funded from general revenues. Unlike Social Security, the Australian Age Pension is viewed as a “safety net” for those unable to provide for themselves in retirement.³⁴⁵ This is true despite the fact that most Australians qualify for an Age Pension. Income to the recipient of an Age Pension or assets (excluding the pensioner’s home and capital value of superannuation funds) in excess of specified levels will, consistent with that concept, result in the reduction or elimination of benefits.³⁴⁶ Benefits that are paid are inflation-indexed and tax-exempt up to specified amounts.³⁴⁷

Income from superannuation funds (as opposed to capital in those funds) is used by the government to compute eligibility for Age Pensions. It is believed that, as savings build up in superannuation funds, the need for Age Pensions will be eliminated by 2005 and will be replaced by a destitute supplement or payment only.³⁴⁸ Australia is thus adopting a privatized, mandatory retirement system in which investments are held entirely in the private sector. The government maintains an oversight role over the trustees of those funds and their custodians, but does not itself engage in direct investments, even passively. At the same time, it is hoped that the current Age Pension that is widely utilized by the population will become simply a welfare measure. The United States could adopt a similar approach in its changeover from a governmental to a private social security savings system.

XI. CONCLUSION

Social Security is now a key part of the retirement system for the elderly. Conceived in the New Deal in response to more radical socialist and populist proposals, it grew into a behemoth as its coverage and benefits were expanded. That extended coverage in turn required

fund home purchases. CPF funds may also be invested at the workers’ discretion and were used to privatize government owned businesses, as well as for investment in already private enterprises. Unlike the Social Security system in the United States, the CPF is self-funded; it is not a pay-as-you-go system. LEE KUAN YEW, *FROM THIRD WORLD TO FIRST: THE SINGAPORE STORY: 1965–2000* at 96–105 (2000).

344. CENTRELINK, *AGE PENSIONS: ALL YOU NEED TO KNOW* 4 (May 2000).

345. *Id.*

346. *Id.* at 7.

347. *Id.* at 11.

348. Bobbin, *supra* note 55, at 9–10.

increased contributions. Today, workers and their employers are collectively contributing 12.4% of each employee's pay in FICA taxes to support Social Security. In return, the employees will receive an annuity that the government concedes is inadequate for them to live on when they retire. Participants in the present Social Security system can thus expect to receive a negative, or at best very small, return on their investments. Moreover, even that return will be reduced substantially in future years when the system becomes bankrupt. Contributing further to the inadequacies of the system, the ratio of contributors to recipients will be changing adversely, requiring the imposition of a massive burden on future generations to keep even a bankrupt system operating at reduced benefits. This unhappy state of affairs must be contrasted with the benefits available under a private retirement program. A lifetime savings program provides compounded earnings that create an investment fund that will lay the groundwork for a comfortable retirement and, perhaps, even create an estate for the benefit of future generations.

The principal risks presented by private social security accounts are: (1) inadequate savings, life, and disability insurance; (2) bankruptcy of the custodian of the investment assets; (3) investment losses caused by unsuitable investments recommended by a professional adviser or poor decision making; and (4) inflation. The first of these concerns can be met by mandated savings and insurance. The second concern, bankruptcy of the custodian of the assets, is already a matter of a great amount of regulation, requiring only perhaps more uniformity in account insurance and some increase in the amount of account insurance available (which could be privately obtained). Similarly, unsuitable investment recommendations by professionals are currently the subject of regulation. This brings us to the third concern of poor decision making by the account holder. Certainly, some investment losses can be expected if investment choice is left to the individual account holder. That danger, however, probably does not justify government intervention to protect individuals from poor investments. The present return on Social Security offers no hope that the government is capable of running a profitable investment program, and individuals can be expected to protect their own assets, just as they protect their homes. Nevertheless, more investor education is needed to assure that everyone is familiar with investment basics.

The partially privatized civil service pension scheme suggests that pension funds can be invested under government control in private

investments in a passive manner. That passive investment strategy, however, will undoubtedly come under attack by those who do not want to invest in particular companies, even passively. People may also want their shares voted in support of or against management actions they deem to be inconsistent with their own social goals. Selecting companies on the basis of social goals and seeking to affect management policy is inconsistent with a passive investment policy. We can “just say no” to such concerns, but at some point the door will likely be opened by a special interest group with a particularly appealing goal that will obtain the support of one political party or the other. Once opened, the choice of desired social goals for investing will become another ideological battleground that will be fought over by the contending parties and will require, in the end, that all social views be recognized regardless of their offense to others.

Alternatively, private social security accounts could be opened and managed just like current IRA accounts that provide for a third party custodian such as a bank, broker-dealer or insurance company. Those accounts grant the account holder discretion to manage their own investments. If this course is taken, the current chaos engendered by numerous tax-advantaged accounts must be eliminated. A single retirement account should be permitted with a large cap on contributions that will allow the accumulation of an amount that will provide for a comfortable retirement. The Australian system is perhaps a model that can be followed in the United States. Employers and employees are there required to make mandatory contributions into tax-advantaged trust funds that are carefully regulated. That scheme is expected to replace the existing widely-used Australian government’s Age Pension, leaving the government to protect only the destitute.