

A Proposed Legal, Regulatory, and Operational Structure for an Investment-Based Social Security System

by Karl J. Borden and Charles E. Rounds Jr.

Executive Summary

As Social Security's problems become more apparent, support for the concept of privatizing the retirement program grows. As the debate develops, it becomes increasingly important to move beyond generalizations and to provide detailed proposals for how such privatization could be accomplished. Without endorsing any specific proposal, the Cato Project on Social Security Privatization will, from time to time, present a number of possible privatization scenarios.

In this study, Karl Borden and Charles Rounds offer a proposal for the regulatory and administrative structure of individual accounts. The core of their proposal is the private retirement account (PRA), which more closely resembles the individual retirement account model than the 401(k) model. Under the proposal offered by Borden and Rounds, workers would be able to divert a portion of their Social Security payroll tax to a PRA. Workers would possess full property rights in their account balances and would be responsible for certain elements of investment direction. Employers would continue to operate as middlemen, facilitating the flow of cash and information.

However, they would not serve as "plan administrators" (as the Employment Retirement Income Security Act of 1974 uses the term) and would not bear fiduciary responsibility for account balances or account management. Actual management of investment funds would be handled by private management companies, while collection and distribution of funds, as well as most regulatory functions, would be centralized in one or possibly more national clearinghouses. The national clearinghouses would be quasi-self-regulating bodies, similar to the National Association of Securities Dealers or the Depository Trust and Clearing Corporation. The government's role would be limited primarily to overseeing the system, acting as a court of final appeal for dispute resolution, and maintaining the fiscal integrity of the system.

Relying mainly on market-based structures to provide a quasi-self-regulating framework for privatization would maximize flexibility and innovation. At the same time, the establishment of a centralized collection and management structure would allow economies of scale to minimize costs. The proposed structure would balance the need for basic consumer protections with the desire for maximum independence and freedom of choice.

Armies of accountants, attorneys, and government bureaucrats will try to regulate the new system into oblivion.

Introduction

A consensus is gradually developing that the nation's retirement system needs an overhaul. Social Security, as it is currently structured, fails to create property rights and is unsuccessful at building a pool of national wealth. The current system attempts to combine a taxation scheme and a welfare scheme, although each is legally independent of the other. The government is facing a looming financial crisis and a declining rate of return for young workers, which means that sooner or later Social Security will be transformed into an investment-based system.

Before a system of individually owned, privately invested accounts can be established, serious questions must be answered: What is to be the legal and regulatory framework of a national investment-based Social Security system? Will the legal and regulatory structure that sustains a system of individual accounts look more like the one that supports 401(k) plans or the one that supports individual retirement accounts (IRAs)? How will the system receive funds from individuals? Who will run it? Which government entities and private-sector institutions will be involved, and how will they interact? Who will write and enforce regulations and determine operational details?

Getting from here to there will mean treading a perilous path through armies of accountants, attorneys, and government bureaucrats who will try to regulate the new system into oblivion. Also, the fundamental structure of the new system will be critical to its success or failure. We must pay particular attention to the details that will emerge from the coming political process.

This paper provides a broad outline of an investment-based Social Security system of private retirement accounts (PRAs) that would allow the individual maximum freedom and choice but still provide basic consumer protections. We propose a system that would mirror the IRA model instead of the 401(k) model. We outline a fundamental regulatory structure designed to protect the system, minimize costs, and maximize flexibility and innovation. Finally, we address several specific system elements that would be critical to operational success.

A Proposed Operating System

An investment-based Social Security system

would occupy a unique middle ground in the range of government-sponsored and private pension and retirement programs that is now available to American workers. On the one hand, the system is designed as a defined-contribution system that both mandates and limits contributions but leaves to market forces the exact accumulations and benefits available to individual participants. On the other hand, it is probable that the system will include some minimum level of support guaranteed by the government (thus taxpayers). That guarantee would produce something like a minimum defined benefit and create a number of interesting and complex economic and legal issues.¹

Operating systems for a national retirement program will be critical to its success. Any such program will require literally millions of accounts to be created and administered as hundreds of millions of individual contributions will flow into the system each year. Employees will sometimes generate single paychecks from short-term employment contracts that produce contributions. Those contributions will be measured in cents and will find their way into cumulative balances credited to that individual's account. Unlike Social Security, which merely taxes employers and employees in the aggregate and waits until year-end to sort out who paid how much, a privatized system will have to somehow credit individual accounts and allow participants to start earning a return on their contributions virtually immediately. Moreover, the system will have to ensure that all employers and participants have access to the program, regardless of the size or value (to the administrator) of the management contract.

The operational plan we envision includes the following key players.

PRA Owner

The PRA owner will be the central legal player in the system. The PRA owner will at all times maintain property rights in his account balances, be responsible for certain elements of investment direction, and make personal decisions regarding when to access account balances once threshold values have been achieved. In this sense, the PRA will be much more like an IRA than a 401(k) or 403(b) plan. The employer, for example, will not be a plan administrator. In the PRA world, in fact, there will not be any "plan" in the sense the term is

used in the Employee Retirement Income Security Act of 1974. Title to PRA assets will be in the employee, not in a plan trustee. Millions of individual accounts will be subject to the direction of individual account owners, who will be restricted in their choices only so far as necessary to optimize the achievement of systemwide objectives.²

Employers

Employers will continue to play an important role in the new investment-based Social Security system. As previously mentioned, they will serve as the middlemen in the cash flow process. In fact, under a system of PRAs, their role would probably be enhanced somewhat by the increased data transmission requirements of an investment-based system.³ Again, the fiduciary responsibility for account balances and other account management tasks will not fall on the shoulders of the employer; he is *not* a “plan administrator” (as ERISA uses the term).

Private Financial Services Provider

A private financial services provider (PFSP) is an institution that offers PRA investment account services to employees. Every employee will have to either choose a PFSP or participate in a national clearinghouse pooled fund. Employees will be free to change PFSPs at any time. The PFSP will provide a series of investment vehicles designed to meet system requirements and provide a range of investment choices to PRA owners. The PFSP will not serve as a trustee of the mutual fund participations and will not have contractual rights in the bank accounts, the insurance contracts, or the mutual fund balances that will be managed on behalf of the PRA owner. Instead, the PFSP will act, through its agent, the PRA administrator, much like the custodian of an IRA. An IRA custodian maintains records of withdrawals and deposits and issues statements to ensure convenient upkeep. Legally, the PFSP will be in a contractual relationship with, and be the agent of, the employee.

PRA Administrator

The PRA administrator is an agent of the PFSP, not the employee. The PFSP itself could serve as PRA administrator; that is, it would not have to contract with and act through other agents. “Administration” in this context remains clearly distinguished from the role of

an ERISA plan administrator. A PRA administrator is not in a fiduciary relationship with the employer. The term, as used here, merely connotes a provider of financial administrative services for PRA owners through their employers. The PRA administrator will handle asset custody and transfer, record keeping and accounting, customer contact, and documentation storage, all according to procedures and regulations promulgated and enforced by a national clearinghouse. As an agent of the PFSP, the PRA administrator will be chosen by, and required to work efficiently with, the PFSP in order to ensure a smooth cash flow from employers to accounts to PRA owners. In the system we envision, the PRA administrator will issue an order to an employer to pay withheld funds to that administrator when an employee has chosen a PFSP that handles funds transfers through that administrator.

National Clearinghouse

All PFSPs, PRA administrators, and individual account representatives will be required to belong to a national clearinghouse (NC), a private corporation or trust licensed by the final regulatory authority (FRA) to oversee PRA services and provide common operational functions necessary to the system. An NC will have specific responsibilities. It will do the following:

- Set standards and licensure requirements for PFSPs and PRA administrators and their agents and representatives. That task could include setting minimum capital requirements for PFSPs and PRA administrators.
- Set portfolio diversification standards for approved PFSP funds.
- Approve PFSP-sponsored funds if they meet NC asset allocation requirements.
- Approve life annuity products for PRA owners who have reached hold-harmless threshold values; that is, owners who have accumulated enough in assets and are no longer required to contribute.
- Define administrative and marketing expenses and set maximum expense ratio standards for PFSPs.⁴
- Approve cash flow and participant contribution systems offered by PRA administrators.
- Provide a low-cost forum for dispute resolution.
- Provide a mechanism for the easy electronic transfer, rollover, and/or aggregation of small

What is to be the legal and regulatory framework of a national investment-based Social Security system?

For the proposed national system to be successful, there will have to be an assurance that no one will be left out.

accounts as employees move from employer to employer.

- Maintain a pooled-asset fund into which PRA administrators may pay PRA contributions until balances reach a threshold level that makes them economically attractive as customer accounts. This pooled-asset fund is essential to the smooth operation of the entire system, as it is the default investment for most small accounts and the primary means by which employers are relieved of the burden and the responsibility of ERISA-type plan administration.

A Federal Agency with Final Regulatory Authority

This agency will license NCs, set broad clearinghouse policy objectives and standards for the system, serve as a court of final appeal for NC dispute resolution, and have final authority over and responsibility for the fiscal integrity of the system. On behalf of the taxpayers, this agency will also review NC asset allocation and portfolio diversification standards for investment vehicles, such that the system both avoids asset substitution problems and minimizes poor-portfolio-performance problems (this by determining maximum allowable statistical limits for the expected number of system participants falling into the system's safety net).⁵

The Role of the National Clearinghouse

The NC is arguably the most original element of our proposal. That body would be licensed by the FRA; share regulatory responsibility with the FRA; and exercise its own authority under the guidance of, and with the final approval of, the FRA. Because the role of the NC is central to the operational plan we envision, it is appropriate to first detail in full why this institution is operationally necessary to the system.

First, we must appreciate the magnitude of the task that will confront an investment-based Social Security program and the problems inherent in the mandate of universal employee participation. As William Shipman details in "Administrative Challenges Confronting Social Security Reform," the current cash flow system used by Social Security takes up to 18 months to allow individual employee contribution data to catch up to the aggregate cash flows submitted periodically by

employers.⁶ The process works sufficiently well for a system that maintains no property rights to individual accounts and for which individual returns on investment are irrelevant. A PRA system, however, will depend on intricate record keeping and crediting of returns, and it will therefore be essential not to impose lost-opportunity costs on PRA owners by delaying either accounting recognition of their contributions or, more important, actual investment of their balances in wealth-producing assets.

Couple this task with the reality that there are millions of small employers with just a few employees. In a PRA system, initial contributions will for some be just a few cents to be invested and administered. All employees will be required to choose a PFSP. What incentive will a PFSP have to offer its services to employees with small account balances that generate little fee income? Eventually, most people's individual balances will reach a level that will make it profitable to administer them, and it is tempting to say that market forces will allow a PFSP that invests the carrying costs initially to benefit from profitable account administration later. But that answer ignores three considerations: (1) Individual employees will often be unmotivated to seek out PFSPs or to make choices among competing PFSPs when a choice is offered. (2) Employees may lack the information needed to make such decisions intelligently, even when they are so motivated. (3) Employers will be required to send the withheld funds *somewhere* and to have a default recipient for the funds. Such a recipient will be necessary, lest the employers be charged with making investment-direction decisions for their employees.⁷ In order for the proposed national system to be successful, there will have to be an assurance that no one will be left out.

There are only two feasible methods of paying the carrying costs of small-account maintenance. Either they will be paid by cross-subsidies from larger accounts, or the taxpayers, through the federal government, will have to pay them. The latter solution is appropriate only as a last resort should no private system emerge from the structure we propose. But before we resort to a federal system, we should see what solutions the NC or NCs find to the problem.⁸

An NC will have to somehow provide a mechanism whereby all contributions can move into interest-bearing or other investment vehicles with a minimum of delay. Shipman's suggestion of a three-level system, for instance,

is a promising one: The first level would move capital into a pooled money market fund that would “hold” the contributions and bear interest until individual contribution information “caught up” with the aggregate contribution. Once the individual contribution data caught up, the contribution (plus accumulated proportional interest) would divert from the pooled money market fund into either a (level 2) pooled balanced fund vehicle (for PRA owners whose account balances haven’t yet reached profitable-administration-threshold values) or into (level 3) individual account balances of the PFSPs (if available). PFSPs would be free to “mine” the pooled-fund accounts (level 2)⁹ and offer services to pooled-fund balance holders at any time, each PFSP determining for itself the lower-threshold limits of profitability.

Since all PFSPs and PRA administrators will have to be members of an NC, fees paid for membership will support the work of the NC and the administrative costs of pooled-fund maintenance. In that sense, because the PFSPs will be in the business of profiting from PRA investment and administration, the larger-account holders will effectively cross-subsidize the costs of small-account maintenance. Each PFSP will be required to accept any employee who wants to use its services, even if that means giving that employee access to only the NC’s pooled-fund system.

Is this the only solution to the problem of moving contributions into productive investment vehicles with a minimum of delay? Perhaps—or perhaps not. Friedrich Hayek observes that, for some problems, there is only one best solution.¹⁰ But he also observes that it is a “fatal conceit” to believe that we can *design* that solution in advance. The best solution must be allowed to emerge from a competitive process. Maybe someone has a better idea; maybe technology will provide other solutions. The need to allow for the possibility of alternative designs is one of the fundamental justifications for allowing the emergence of competitive NCs.¹¹

A Quasi-Self-Regulatory Structure

Certainly, it should be left to an arm of the federal government to regulate an investment-based Social Security system. Few people

would argue against some form of governmental oversight, but there is “regulation light” and there is “regulation heavy,” and all the good intentions of those who have worked for the past two decades to make an investment-based system a reality could be destroyed by a Rube Goldberg regulatory structure that would impose huge transactions and compliance costs on the system.

What we propose is a quasi-self-regulatory system, one that balances the role of the federal government in safeguarding and overseeing the system and the role of competitive forces in minimizing compliance and monitoring costs.

Objective of Regulation

The objective of any government regulatory structure should be to ensure the fundamental safety and integrity of the national retirement system. If regulation minimizes dishonesty, optimizes risk taking, and reduces the costs of compliance, it is successful. Unfortunately, the history of government regulation shows that it rarely, if ever, achieves those goals. The incentives and rewards for representatives of the government are largely structured to encourage overregulation and to reduce risk below optimal levels, increasing costs to both taxpayers and system participants.

There is particular cause to be concerned about the regulatory structure that will be imposed on an investment-based retirement system: (1) Politicians will be under tremendous pressure to regulate away “excessive risk taking” on the part of system participants. (2) Currently, numerous private-account retirement plans are regulated by the federal government, and those regulatory structures are ill suited for a privatized system.

The Wrong Model

Some people¹² have proposed adopting the 401(k) and 403(b) regulatory structure, codified in ERISA, for PRA accounts. To understand why the ERISA regulatory structure is inappropriate to the task, it is necessary to understand the legal context within which it has developed.

Congress created ERISA in response to the perception that retirement plan sponsors often breached their fiduciary duties to employees. Therefore, the entire focus of ERISA and its accompanying regulatory structure is on protecting plan participants from either predation

The best solution must be allowed to emerge from a competitive process.

Neither the employer nor the PFSP is in any meaningful sense a fiduciary of the PRA owner.

or incompetence on the part of plan sponsors. In the ERISA world, plan sponsors are fiduciaries for plan participants. But because plan sponsors are frequently in a position to unfairly benefit themselves at the expense of plan participants, and because those plan sponsors make plan-wide decisions that affect all plan participants, it is necessary to provide some oversight mechanism that ensures that those decisions are made fairly and responsibly.

PRAs exist in an entirely different world. A “plan” does not exist because neither the employer nor the PFSP is in any meaningful sense a fiduciary of the PRA owner.¹³ At most, the employer and the PFSP are agents of the employee for the limited purpose of carrying out the employee’s lawful directions regarding the administration of the PRA.

ERISA is an inappropriate regulatory model because the entire focus of ERISA’s regulatory effort is unnecessary in a PRA world of individually owned and managed accounts. It concerns us, however, that the ERISA model may be seen as a “simple” solution to the regulatory question. The argument for the ERISA model will go something like this: “The Internal Revenue Service and the Department of Labor have decades of experience regulating this sort of thing. Let’s just weave the PRA into the ERISA regulatory framework. Let’s not reinvent the wheel.” When someone objects to the unnecessary complexity of the ERISA system, the response may be, “But ERISA has simplified forms, like the 5500EZ, that can be used for PRAs.”¹⁴ That argument ignores the essential point: The PRA structure will not require even information returns to the IRS. The PRA administrator will keep the records. The contributions will be determined by law and will be set by neither the employee nor the PRA administrator. The market values of investment accounts managed by the PFSPs will be based on the asset allocation and diversification standards set by the NC and will be what they will be.¹⁵ The employer will handle the W-2s. Where is there a role for another level of reporting or oversight for which the 5500EZ was designed? The answer is that there is none.

Regardless of how complex or simple one makes the ERISA structure, it proves fundamentally inappropriate for a PRA that will *not be a plan* and that will *have no fiduciaries*. One cannot be a fiduciary for oneself. If we were to impose

the ERISA regulatory structure on PRAs, we would actually have to create plan sponsors and asset trustee analogues, a totally artificial exercise without social utility. By design, IRAs are exempt from ERISA regulation.

Accountants and attorneys train in law and regulation and tend to develop oversight systems that rely extensively on monitoring, audit, and enforcement procedures for their effectiveness. Economists, on the other hand, prefer to create systems that attempt to minimize compliance costs by creating a set of internal incentives that are self-regulating. The uninitiated often wrongly assume that self-regulation is a code word for no regulation, but that is not true. Self-regulatory systems are distinguished from monitoring systems by their objectives. Monitoring and audit systems have as their primary objective the elimination of all noncompliance, with little or no regard for the cost of securing marginal compliance. Self-regulatory systems recognize that imperfect compliance is inevitable, regardless of the approach, and thus seek to minimize costs to achieve an optimal level of compliance. Neither approach, in fact, eliminates noncompliance, but self-regulating systems tend to achieve their objectives at lower economic and social costs.

Self-regulatory systems are relatively rare in practice (most regulatory systems are created, after all, by attorneys and accountants, not economists). Nevertheless, where they have been tried, self-regulatory systems have been extremely effective. Several such systems are already in place in the securities industry and have been models of low-cost, effective self-regulation for the past seven decades—creating, implementing, and enforcing a complex set of industry-wide regulations and professional licensures as well as providing secure mechanisms for handling securities, capital holding, and transfer.

Example One: National Association of Securities Dealers. The NASD thrives as the largest securities-industry self-regulatory organization (SRO) in the United States. Through its subsidiaries, the NASD develops rules and regulations; conducts regulatory reviews of members’ business activities; disciplines violators; and designs, operates, and regulates securities markets and services—all for the ultimate benefit and protection of the investor.

In 1938 Congress passed the Maloney Act as an extension of the Securities Act of 1934. The

Securities Act of 1934 created the Federal Securities and Exchange Commission and charged it with responsibility for regulating securities markets. The Maloney Act “encouraged” the over-the-counter securities market to establish “private trade associations for self regulation.” Congress gave the SEC authority to oversee and to change the rules of those “private associations” and further required such associations to be registered with and approved by the SEC. Effectively, all decisions and enforcement actions by such associations remained appealable to the SEC.

The Maloney Act specifically stipulates that one or *more* associations of brokers and dealers may apply for registration with the SEC, that those groups may regulate themselves within the guidelines laid down by the SEC, and that the groups may grant discounts on securities traded among their members. To date, only one such association of dealers has registered with the SEC under the provisions of the act: the NASD, which has approximately 7,000 member firms that operate more than 20,000 branch offices and employ approximately 500,000 registered representatives who sell securities. The NASD has established a series of tests that must be passed by any individual who wishes to join. The tests are considered the admission ticket to a career in the financial services industry. The NASD establishes and enforces a set of rules prohibiting fraud, manipulation, and excessive profit taking; a uniform-practices code standardizing and expediting routine transactions, such as payments and deliveries; and a procedure for disciplining members who engage in illegal or unethical conduct.

Two elements of the NASD’s status are of particular significance to Social Security privatization: (1) Although the NASD is the only association ever to have applied to the SEC for registration, nothing in federal law prevents another association from coming into existence. Any time the NASD fails to operate efficiently, or becomes too onerous in its regulatory structure, a competitor organization may be formed. (2) This natural brake on regulatory zeal is counterbalanced by the oversight function of the SEC, which is there as a court of appeal and as the ultimate determinant of whether the NASD, as a registered association, is doing the regulatory job that was intended under the act and that the SEC itself considers appropriate. This constant tension between the

standards and levels of enforcement that the SEC expects on the one hand and the potential of a competitor’s entry into the NASD’s market on the other maintains an appropriate equilibrium of enforcement and efficiency.

Example Two: Depository Trust and Clearing Corporation. In September 1999 the SEC established a new holding company, the DTCC, to combine the functions of the former Depository Trust Company and the National Securities Clearing Corporation. The two firms provide the primary infrastructure for the clearance, settlement, and custody of the vast majority of equity corporate debt and municipal bond transactions in the United States. The DTC subsidiary, for instance, provides custody and safekeeping of traded securities, proxy distribution services, principal and income distribution, corporate action processing, withholding tax services, collateral loan services, and delivery and payment services. It also sets and enforces settlement risk controls and provides clearing and settlement links. In other words, the DTC is handling a volume of complex securities transactions, and the accounting and record-keeping functions consequent to those transactions, that far exceeds the transaction volume or record-keeping complexity of an investment-based Social Security system.

With more than \$20 trillion in assets, the DTCC, through its two subsidiaries, is the world’s largest securities depository and the world’s largest provider of centralized clearing services. In a single year, the organization processes hundreds of millions of individual transaction entries and handles securities deliveries totaling more than \$70 trillion.

Firms may choose to be members of the NSCC, and membership is open to any institution that meets DTCC standards. The DTCC itself is a limited-purpose trust company organized under the New York Banking Law, a “banking organization,” a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of sec. 17A of the Securities Exchange Act of 1934, as amended. “Direct participants” in the system include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. Some direct participants—the New York Stock Exchange, Inc.; the American Stock Exchange, Inc.; and

Where they have been tried, self-regulatory systems have been extremely effective.

The SEC is the appropriate federal oversight agency to exercise final regulatory authority over a new investment-based Social Security system.

the National Association of Securities Dealers, Inc.—own the DTCC. Access to the DTCC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a direct participant, either directly or indirectly (“indirect participants”).

The DTCC is an example of a quasi-self-regulating system, in that nothing in the law prevents a second organization from being formed to compete with the DTCC to provide either depository or clearance services. On the other hand, the DTCC is recognized and approved for its activities by the SEC (the FRA), which provides some assurance that the corporation acts in the best interests of the nation and securities customers at large. Once again, the natural tension between competition (or potential competition) on the one hand and federal-agency oversight on the other produces an equilibrium of efficiency and security.

Final Regulatory Authority

One key to the effectiveness of both the NASD and the DTCC has been the ability of the SEC to set regulatory mandates and standards, while also allowing both the NASD and the DTCC to develop their own processes and procedures to implement them. Elaborate “one-size-fits-all” fund collection and investment systems are unlikely to be flexible enough to meet the needs of tens of thousands of employers and millions of participants with differing circumstances. Such a mandated system would be too unwieldy to take advantage of advances in technology or systems design that cannot be foreseen.

The roles of the DTCC and the NASD are not unique within the SEC administrative structure. The SEC is comprised of four divisions.¹⁶ The Division of Market Regulation already serves as the FRA over a panoply of SROs, including the DTCC, the NASD, the Municipal Securities Rulemaking Board, and others. The SEC defines an SRO as “a member organization that creates and enforces rules for its members based on the federal securities laws” and is the federal agency with the most experience in overseeing self-regulatory structures. In addition to its experience with SROs, the SEC plays a role in the securities markets that is analogous to that which would be necessary to oversee a PRA system. The SEC’s Division of Investment Management reviews investment company and investment adviser fil-

ings and mutual funds and “works to improve disclosure and minimize risk for investors without imposing undue costs on regulated entities.”

The SEC has a long history of working with quasi-independent SROs. It understands the securities markets that it is charged with regulating. It is therefore the appropriate federal oversight agency to exercise final regulatory authority over a new investment-based Social Security system.

Questions and Subsidiary Issues

Question

What if no one forms an NC?

Answer

The question reflects a misunderstanding of how the SEC works in relation to the securities industry. If the SEC is authorized to serve as the FRA, the commissioner will take a leadership role in organizing elements of the securities industry to form an initial NC. The important element of the system is that which allows additional, competitive clearinghouses to come into existence. It is the existence, or the potential, of such competitive systems that creates the balance between government’s tendencies toward regulatory overreach and appropriate oversight.

Question

Will PFSPs be required to accept all employees who want to join their system?

Answer

No. PFSPs may “mine” the NC pooled fund for any customers to whom they want to offer services, and we anticipate that a variety of alternative investment vehicles (within the regulatory limits) will be developed to appeal to employees. But PFSPs would be free to set their own criteria for accepting PRA account management.

Question

When can PRA owners access their accounts and take distributions?

Answer

Curiously, one consistent feature of almost every investment-based retirement system that

has been introduced in Congress or proposed by reformers is the dubious assumption that the government should decide when it is appropriate for an individual to remove himself or herself from the workforce. Most commonly, the age 59.5 years has been the touchstone. The provenance of that age is unknown to the authors, but there is no rational economic justification for choosing it or any other fixed point in time.

Let us remember that the only economic purpose of a national retirement system is to limit the social liability associated with people who do not save sufficient resources for their own old-age maintenance and thereby impose a moral hazard on the rest of the population. Once a person has accumulated sufficient resources to indemnify others against this hazard, why not let him choose the timing of his exit from the workforce? For that matter, *why do we assume that the decision to begin drawing on one's accumulated assets is the same as the decision to exit the workforce?* With the establishment of investment-based Social Security accounts, perhaps we can retire the word “retire” from our vocabulary. We suggest referring to “meeting threshold requirements” for hold-harmless status—thereby affording individuals the luxury of making lifestyle choices independent of the need to ensure a minimum standard of living.¹⁷ This converts the Social Security system into a wealth-specific rather than an age-specific system. In a wealth-specific system, the trigger for account access is the amount of wealth accumulated rather than any predetermined chronological age.¹⁸

The objective of the system should be to raise the participants, at some point, to a level of personal wealth that is capable of providing a lifetime income sufficient to meet minimum living standards, thereby removing from others the implied obligation to care for them. The hold-harmless threshold should be the test that determines whether an individual may have access to his or her account balances. One of the authors has suggested, for instance, that PRA fund distribution options could be available under three options:¹⁹

1. A 100 percent payout to purchase a minimum-wage life annuity from the private insurance industry. The NC would set annuitization requirements and regulations.

2. Withdrawals as desired, with only one constraint: the amount remaining in the account after withdrawal must always be at least 110 percent of the amount necessary to purchase a life annuity guaranteeing a minimum-wage income.
3. A combination of options 1 and 2 with the purchase of a partial annuity and voluntary withdrawals up to 110 percent of the amount necessary to purchase the remaining minimum-wage annuity.

For obvious reasons, the amount necessary to purchase such an annuity in the open market would vary by age and other mortality characteristics. The provision of options 2 and 3 would also allow higher-asset individuals to gain access to their accounts at any time without sacrificing their assets to annuitization.

One objection raised to allowing individuals to decide when to access the Social Security system is that many individuals would exit the workforce as a result, reducing economic production and lowering national wealth. This argument fails on two counts:

1. There is no reliable way to predict whether the average person will exit the workforce earlier or later when the “retirement” and “account access” decisions are delinked. Some would doubtless exit early, but others might find the fact of financial independence professionally liberating and move into a series of employment contracts by choice. Moreover, the disincentives produced by the high marginal tax rates imposed by the retirement mandate would disappear.
2. There is no loss of aggregate social utility when an individual chooses to exercise personal value choice and experience leisure. Our national economic accounting system may not record the benefit, but it is just as personally satisfying for person A to lie on a beach in Florida as it is for person B to continue working, receive income that is recorded in the national accounts, and exchange that income for something he values.

Question

Will there be limits on contributions to accounts, and, if so, what will those limits be?

In a wealth-specific system, the trigger for account access is the amount of wealth accumulated rather than any predetermined chronological age.

A replacement rate of 42 percent can be achieved with annual contributions of 4.65 percent of annual earnings.

Answer

The question of what, if any, limits should be placed on contributions to PRA accounts is surprisingly complex, and it bears on issues of system and individual-account risk minimization as well as broader social policy and personal choice issues. Fundamentally, there are two broad areas of concern: How much contribution is needed to reasonably ensure that account balances will grow to the level necessary to achieve the hold-harmless threshold? What are the implications of allowing contributions in excess of that level, and, if such contributions are to be allowed, how will they be treated? How does the system avoid asset substitution problems resulting from the interaction of privatized returns (ownership of PRA assets) and socialized risks (defined-benefit elements of the plan that provide a “benefit floor,” or safety net, for low-income earners)?

How Much Is Enough? In order for an investment-based Social Security system to accomplish its primary objective of indemnifying the taxpaying public against financial irresponsibility on the part of some, it is necessary that a mandated level of system contributions be set sufficiently high that all wage earners, even those on the lower end of the continuum, are able to accumulate sufficient assets to sustain themselves in their nonearning years.²⁰ The exact level of accumulation that will do that varies, of course, with one’s assumptions about what constitutes a minimally acceptable lifestyle.

A reasonable starting point for a new Social Security system, however, is to assume that the new system must at least replace the benefits that the old one provides.²¹ One way to determine that level is to look at the extent to which Social Security “replaces” end-of-earning-years income in its initial benefit payment.²² The amount itself differs by income category and age cohort; it varies from a low of 24.1 percent for a maximum-wage earner retiring in 2030 to a high of 52.8 percent for a low-wage earner retiring in 2000.²³ We will assume a midrange replacement rate of 42 percent as the target rate for an investment-based system.²⁴

The level of contribution required to reach that replacement rate also depends on the rate of return one assumes for an investment portfolio, which in turn depends on the level of risk and portfolio-return assumptions one employs. In our system, it would

be up to the NCs (overseen by the SEC) to set asset allocation and portfolio diversification standards.²⁵

Let us assume the following portfolio allocation: 40 percent large-cap stocks, 20 percent small-cap stocks, 30 percent investment-grade corporate bonds, 10 percent government bonds. Ibbotson Associates provides the following data for nominal rates of return and annual consumer price index (CPI) inflation between 1926 and 2000:²⁶

Large-cap stocks	11.3%
Small-cap stocks	12.6%
Investment-grade corporate bonds	5.6%
Government bonds	5.1%
CPI	3.1%

Adjusting for inflation, then, and allocating assets as above, an assumption that the next 75 years are going to produce economic rates of return similar to those of the last 75 years produces a balanced-portfolio return of $[(0.40)(.113) + (0.20)(.126) + (0.30)(.056) + (0.10)(.051)] - .031 = 6.23\%$. But let’s be conservative and assume that the next 75 years produce a real rate of return 10 percent below that of the past 75 years, $6.23 * 0.9 = 5.6\%$.

The next projection we need is the expected growth in real wages over the coming, say, 75 years. We will use a projection of 2 percent per year.

The final variable needed to calculate a reasonable mandated contribution level is an assumption about longevity. The Social Security system itself projects high, low, and moderate values of expected longevity for a child born 75 years from now. The range (years in retirement after reaching Social Security’s minimum retirement age for benefits) for males is from 16 to 23 years (moderate = 19.7); for females it is 19 to 25.9 years (moderate = 22.6).²⁷ We will use the moderate projections and average them for a postdistribution life expectancy of 21 years.

Using these assumptions, a simple calculation indicates that a replacement rate of 42 percent can be achieved with annual contributions of 4.65 percent of annual earnings.

Can an Individual Make “Excess” Contributions? Excess contributions could potentially arise in any one of four ways: (1) A PRA owner reaches his or her threshold for hold-harmless status but continues contributing to the account above that level. (2) A PRA owner who has reached the threshold and stopped contributing

experiences higher-than-expected growth in account assets. (3) A PRA owner is allowed to make contributions in excess of those needed throughout his contribution history. (4) A PRA owner who is independently wealthy is allowed to contribute to the PRA system in spite of already having sufficient wealth to purchase hold-harmless status.

We see no point in restricting PRA owners from contributing above the legally mandated minimum contribution during the period of building assets toward hold-harmless status. Beyond the accumulation of sufficient assets (or perhaps 110 percent of sufficient assets) to purchase a life hold-harmless annuity, however, excess contributions arising from the third mechanism above should be restricted in order to avoid the use of the system as a means of escaping income taxation.

Question

Should it be possible for someone of sufficient wealth to opt out of the entire PRA system?

Answer

Yes. As long as an individual has purchased an approved life annuity ensuring the availability of a life income stream of sufficient magnitude, that individual should be exempt from paying into a PRA and be able to retain as after-tax income what he would have contributed.

Question

Will there be spendthrift and assignability provisions for PRAs that limit the possibility of PRA owners losing their accumulated assets?

Answer

Yes. One critical element of the body of regulation and law that will evolve around PRA accounts will be those provisions that maintain a firewall protecting account assets both from irrational behavior and from predation. Irrational behavior in this context can take many forms, and any regulations minimizing such behavior are necessarily an infringement of personal liberty. It is probably true that citizens who pose the greatest moral hazard to their fellows are people who are both easy financial prey and most likely to abuse the trust of maintaining their own accounts.²⁸

Spendthrift and assignability limitation provisions are designed to prevent people from

overriding the moral hazard protections inherent in the PRA concept. In the United States it has been a matter of public policy that one cannot place one's property in a trust or an agency account for one's own benefit and keep it beyond the reach of one's creditors.²⁹ While that may be good public policy in general, its application to PRAs would void the public protections inherent in the mandated-retirement concept in the first place.

ERISA provides a partial precedent for removing PRAs from the usual ability of creditors and others to reach trust accounts. An employee benefit plan may well include an associated trust or custodial account that serves as a receptacle for employer and employee contributions. Under ERISA, contributions and the income generated by their investment are entitled to favorable tax treatment *provided the plan meets certain requirements*. One such requirement is that the documentation governing the trust or custodial receptacle must contain a spendthrift (anti-alienation) provision prohibiting the employee from anticipating, assigning, or alienating his beneficial interest. The subject property also may not be subject to attachment, garnishment, levy, execution, or other legal or equitable process.³⁰

In most cases, an ERISA-mandated anti-alienation provision will prevent creditors, including the trustee in bankruptcy, from reaching the debtor's interest in a tax-qualified plan, even though the associated trust would not have enjoyed protection under state law. ERISA preempts state law.³¹ In any case, ERISA does not afford trusts or custodial accounts associated with IRAs any spendthrift protection. Thus, federal bankruptcy law, state statutes, and the common law determine whether property held by an IRA trustee or custodian is reachable by the taxpayer's creditors, including the trustee in bankruptcy.

The lesson for a new investment-based PRA system is that the law must include *an airtight PRA anti-alienation requirement*. To put it another way, the law should avoid merely incorporating by reference the ERISA precedent. Rather, it should explicitly preempt all state laws affording creditors access to assets held in self-settled trusts and custodial accounts, as well as require explicit language in the documentation providing for spendthrift protection. PRA assets should also be off-limits to the trustee in bankruptcy.³²

Spendthrift and assignability limitation provisions are designed to prevent people from overriding the moral hazard protections inherent in the PRA concept.

**Assets in a
PRA should
be per se
unassignable.**

Equally crucial is protection against an account owner's knowingly or unknowingly assigning his or her property rights to others. Assets in a PRA should be per se unassignable. Only lawful distributions out of a PRA should become the subject of an assignment, and then only after the property has left the PRA. Consideration might even be given to subjecting a purported assignor and a purported assignee to criminal liability and criminal sanctions for directly *or indirectly* entering into an assignment of the equitable or beneficial interest in assets that are held in a PRA. Without such provisions, it is a virtual certainty that a market will develop in PRA anticipations and participations (similar to that which has developed around lottery payouts), thus negating the social benefits of the entire system.

All of this, however, can be done simply, with little actual regulatory oversight, as long as the original legislation is carefully crafted and any self-regulatory body (NC) that comes into existence to oversee plan administration is charged with the responsibility to ensure compliance. If the originating legislation is itself well crafted, then the body of case law that develops around it will serve as a shield against abuse.

In the same vein, the trustee, custodian, and/or PRA administrator should not be saddled with any enforcement responsibilities as far as assignments are concerned. All that should be required of the trustee or custodian is that he have on file an affidavit of the PRA owner that there has been no direct or indirect assignment of the equitable or beneficial interest. A fraudulent affidavit should subject the PRA owner to severe criminal penalties, and predators seeking to fraudulently entice PRA owners into assigning their accounts should likewise be subject to severe criminal sanctions. The former, however, should be a matter for the self-regulating PRA oversight agencies and the latter a matter for the criminal justice system. The private PRA administrator and the private financial services provider should not be concerned with any enforcement responsibilities.

Question

How will the complexities of marriage and divorce be handled by the PRA system, and how will it provide for nonearning spouses?

Answer

One of the thorniest issues for an investment-based system, and one where there exists huge

potential for excessive litigation, onerous regulation writing, political mischief, and palpable inequity, is how the system handles marriage and divorce. There is little need to belabor here the inequities and the complexities of the current Social Security system in this regard. Divorce law is generally the province of the states, and it is a legal quagmire everywhere. Add to this the controversial issue of expanding the legal concept of marriage, and the field is set for political battles unending.

Simplicity and clarity in the new system's legal and regulatory structure are crucial. Attempting to regulate perfect equity and fairness into the system will almost certainly result in a cascade of further inequities and an avalanche of litigation and expense.

Whatever specifics emerge, they must address to some extent these fundamental issues:

1. What manner of domestic partnerships will be recognized by the system?
2. What body of law adjudicated at what level of government will apply to the system?
3. What rights does a noncontributing partner have to a contributing partner's account balances in the case of death or separation?
4. How will partnership ownership of account balances affect determinations of hold-harmless status regarding moral hazards and distribution options available to account owners?

There are no simple answers to those questions. Keeping that in mind, however, we offer the following approach. Recognizing that our objective is simplicity and clarity, not the making of social policy, and further recognizing the importance of maximizing personal choice, we propose that individuals in any relationship that is legally defined by and recognized under state law as a "marriage" be required to make contributions to a "marriage" PRA while in that relationship. For PRA purposes, a marriage will be recognized only if it is sanctioned by state law and evidenced by documentation issued by a state or its instrumentalities. No implied marriage or other partnerships will be recognized, regardless of living circumstances or verbal commitments.

Contributions to a marriage PRA will be deemed to be community property. Each partner's 50 percent interest in a marriage PRA

(including any increase in market value of the property and any income thrown off by the property) may not be disclaimed, renounced, assigned, or made the subject of prenuptial agreements and/or equitable division incident to divorce. These state-imposed protections are important in order to avoid the moral hazard associated with a nonearning spouse's being left in the cold as a ward of the state, and also to minimize litigation resulting from separation. Married people would both contribute to the joint marriage account and would not be permitted to maintain separate PRA accounts during their marriage.

We further propose that all matters pertaining to the ownership, disposition, and bequeathal of PRA assets be should federalized and removed from the state courts and all divorce or partnership case law or proceedings.³³ We also suggest the following stipulations.

1. A person while unmarried will contribute to an individual PRA. Property held in an individual PRA also may not be disclaimed, renounced, assigned, or made the subject of prenuptial agreements and/or equitable division. Each married partner, before, during, and after a marriage, will at all times have sole discretion over and property rights to his or her individual PRA.
2. At the time a PRA account is established, the participant, *whether or not that person is married*, will be required to file with the PRA administrator an affidavit of marital status. The participant has the responsibility of filing an amended affidavit each time there is a change of marital status, and failure to file within the time period prescribed causes the affidavit to be deemed fraudulent. The PRA administrator may rely on the marital status information contained in an affidavit of marital status whether or not it has actual notice that the affidavit is fraudulent.

The law should provide a grace period, commencing at the time a participant marries, during which continuing contributions to his or her preexisting individual PRA account are permitted and will not be deemed community property. Failure to file an amended affidavit of marital status and to establish a marriage PRA before the

grace period expires subjects the participant to criminal penalties.

It bears explaining that the affidavit is essential to the marriage provisions of the PRA system because it is the mechanism that allows the system to be self-regulating. Without the affidavit requirement, some oversight, monitoring, or audit mechanism will have to be in place. With it, the fraud statutes and criminal law system will serve as a post hoc self-regulatory mechanism.

3. Only one spouse needs to file an amended affidavit of marital status, provided a duly authenticated copy of the marriage certificate or divorce decree is affixed to the amending document. In the case of marriage, receipt by the PRA administrator will automatically trigger the creation of a marriage PRA. In the case of divorce, receipt will automatically trigger a termination and a 50-50 division of the assets in the marriage PRA.
4. With respect to a marriage PRA, investment discretion will reside jointly in the marriage partners, and all investment directions will be in writing and signed by both partners. The administrator of a marriage PRA that does not have in its files an investment direction that is duly signed by both partners will park the assets of the PRA in a default commingled investment vehicle that is operated by the private financial services provider and that meets the specifications of the self-regulating agency.
5. For PRA purposes, a marriage may be terminated only by death or by a final and legally binding divorce decree issued by a state court as evidenced by appropriate documentation.
6. Upon the termination of a marriage by the death of a spouse, the balance of the assets in the marriage PRA account shall be distributed as follows: 50 percent into the surviving spouse's individual PRA and the other 50 percent in accordance with the terms of a duly executed beneficiary designation form that will be effective notwithstanding the laws of wills and agency of the various states.³⁴
7. Termination of eligibility for hold-harmless status will be made separately for each individual in a marriage. For such determi-

All matters pertaining to the ownership, disposition, and bequeathal of PRA assets should be federalized and removed from the state courts and all divorce or partnership case law or proceedings.

The last 70 years have educated us about the limits of government and the essential wealth-creating role of private markets.

nation, half the value of the marriage PRA is at all times available as a “virtual balance” in a marriage partner’s individual PRA.

Question

Will federal or state law govern PRAs?

Answer

Except as otherwise provided, federal law will preempt state law in matters pertaining to the establishment, administration, and termination of PRA accounts.

Conclusion

The Social Security system was designed almost 70 years ago, when our understanding of financial economic principles was still in its infancy. In those 70 years, we have learned much about how financial markets work, the nature and management of risk, and the inter-generational economic effects of public retirement financing. The social and economic landscape of America in the 21st century bears little resemblance to that of the America of the 1930s. We are a nation of great wealth, with broad public participation in our financial markets and extreme social and economic fluidity.

The last 70 years have seen a huge increase in the scope and power of the federal government and at the same time have educated us about the limits of government and the essential wealth-creating role of private markets. We have experimented with a variety of voluntary personal retirement vehicles [401(k)s, 403(b)s, SEPs, IRAs, Roths, Keoghs] that have been proving grounds for the legal and regulatory structures that are most efficient. It is time now to learn from those years and to reengineer our nation’s retirement system to be consistent with a more mature view of how private financial markets work.

Notes

1. Among them is that of who speaks for taxpayers in the system. If individuals were allowed to direct their own investments, and if PRA owners were allowed to invest in any manner of portfolio, there would be a strong tendency toward asset substitution. “Asset substitution” refers to the tendency of organizations and individuals facing financial distress to substitute more risky assets for less

risky assets. If a safety net provides a minimum level of support, and an individual’s investment portfolio is at a level that provides less, or only barely more, than that minimum level of support, then as that individual approaches retirement he will be more likely to take extreme risks with his remaining assets. Any losses consequent to the risky portfolio mix will be effectively borne by the taxpayers, as the safety net provides a minimum level of support. Any gains, however, potentially benefit the PRA owner by providing a larger-than-minimum level of support. Therefore, there must be some entity at some level to protect the interests of taxpayers and shield them from potential liability.

2. Minimization of the moral hazard associated with individuals’ reaching retirement age with no source of long-term support.

3. Consider, for instance, the fact that employers do not now transfer FICA funds to the government with individual account balance data. Rather, employers simply pay their required FICA taxes in a lump sum. The government has no idea whose tax—that is, which employee’s tax—is actually being paid until after the end of the calendar year, when W-2 forms are submitted with details on employees that must be reconciled with the FICA cash transfers of the previous year. An investment-based system must provide much more detail if individual account balances are to be updated and invested according to the owner’s directions.

4. Defining the terms is probably more important than setting limits, as competitive forces should probably suffice in most circumstances. However, it may be necessary to set outside boundaries on these amounts in order to avoid the worst cases of PRA fraud and abuse.

5. Projections of expected portfolio value variances (based on historical returns for asset categories) can identify probabilities associated with numbers of individuals expected to achieve portfolio values at the extremes of the distribution. The FRA can then set maximum allowable probabilities for expected “safety net utilization,” approve NC portfolio asset allocation on that basis, and avoid the worst cases of asset substitution.

6. See “Administrative Challenges Confronting Social Security Reform,” a working paper published by State Street Global Advisors, March 22, 1999. This otherwise excellent paper is directed primarily toward proposing a cash flow model for system participants’ contributions, but by referring specifically to 401(k) plans as a “model” it may be inadvertently blessing a regulatory structure that is ill suited to this purpose.

7. It is critical that employers not make such decisions. One purpose of the system we propose is to avoid ERISA-style regulatory oversight and the monitoring costs such oversight entails.

8. As we explain in a later section, one or more NCs might come into being. All would be licensed by the FRA. The opportunity for multiple, competitive clearinghouses is essential to the quasi-self-regulating structure we envision.

9. In other words, they would have access to the pooled-fund participant database and could at any time market their services to pooled-fund participants.

10. Hayek actually said, "There may exist just one way to satisfy certain requirements for forming an extended order—just as the development of wings is apparently the only way in which organisms can become able to fly." Friedrich A. Hayek, *The Fatal Conceit: The Errors of Socialism*, vol. 1 of *Collected Works of F. A. Hayek*, ed. W. W. Bartley III (Chicago: University of Chicago Press, 1991), p. 17.

11. In practice, where similar self-regulatory agencies have been created, competitive institutions have not emerged. But the potential of such a competitive organization is an important check on the activities of the agency that is formed.

12. See "Administrative Challenges Confronting Social Security Reform."

13. A fiduciary is a person (e.g., an investment manager or the executor of an estate) or an organization (e.g., a bank) that is entrusted with the property of another party in whose best interest the fiduciary is expected to act when holding, investing, or otherwise utilizing that party's property. The employer may hold an employee's funds for a short time between when they are earned and when they are forwarded to the PRA administrator; the PRA administrator may likewise hold funds in the process of aggregating them and forwarding them to either the PFSP or the NC pooled fund; and the PFSP of course invests the funds according to the PRA owner's direction. But none of those parties is expected to make decisions for the PRA owner. Discretion over account balances, within limits, is always in the hands of the PRA owner.

14. The 5500EZ was designed so HR10 plan sponsors with no employees could report in a simpler fashion.

15. It is unlikely that a lot of active portfolio management will be taking place for PRA accounts. Competition is likely to take place primarily on the basis of client services and administrative costs.

16. The Division of Corporate Finance, the Division of Market Regulation, the Division of Investment Management, and the Division of Enforcement.

17. We use the term "hold harmless" in an economic, not a legal, sense. It refers to attaining a sufficient level of wealth such that one is capable of sustaining a minimally acceptable lifestyle, thereby relieving society of any responsibility for one's care and maintenance.

18. Moving to a wealth-specific system also eliminates system (taxpayer) liability for large, unanticipated increases in life expectancy. As life expectancy increases, the market will automatically reprice life annuity products to reflect the change.

19. Karl Borden, "Dismantling The Pyramid: The Why and How of Privatizing Social Security," Cato Institute Social Security Paper no. 1, August 14, 1995, p. 42.

20. Of course, in no case should contributions exceed the level of the Social Security payroll tax for the current system.

21. This is necessary to provide a rational basis for individual system participants to choose to switch from paying FICA taxes for current benefits. If people are not rea-

sonably assured of achieving at least comparable levels of support with their contributions, the rational choice will be to stay with the old system. It is probable that, at least for some marginal earners within some age range, a choice will be available.

22. Primary Insurance Assessment, or PIA.

23. *2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds* (Washington: Government Printing Office, March 2001), p. 185. Replacement rates at age 65 for low, average, high, and maximum earners in the year 2000 were 52.8, 39.2, 31.7, and 23.7 percent, respectively. For those retiring in 2030 at age 65, the replacement rate drops across the board (except for the maximum earner) to 49.3, 36.6, 30.2, and 24.1 percent. The replacement rate itself is a "moving target" as the current Social Security system alters mandated retirement ages, thus reducing the effective rate for a comparable age. Also, low-income workers tend to have shorter life expectancies than high-income workers. Since the current Social Security system provides no property rights to expected future benefits, low-income workers receive a smaller total income stream than high-income workers. This produces many bizarre results. For example, the RAND Corporation concludes that the net effect of this phenomenon is to produce a cross-subsidy transferring wealth from the poor to the rich and from African Americans to whites. Constantijn Panis and Lee Lillard, "Socioeconomic Differentials in the Return to Social Security," RAND Corporation Working Paper no. 96-05, 1996.

24. The 42 percent figure is, of course, arbitrary, but it is on the upper end of the range and can be used to illustrate the calculation necessary to determine the required contribution level. We recommend choosing a single contribution level and not trying to fine-tune an exact equivalence to prior Social Security benefits for all system participants.

25. We will also assume that the portfolio is adequately diversified to eliminate all nonsystematic risk.

26. Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation* (Chicago: Ibbotson Associates, various years).

27. *2001 Annual Report of the Board of Trustees*, Table V.A3, p. 77.

28. It is likely, in other words, that the same lack of financial sophistication that leads people to plan inadequately for their retirement results also in an inability to distinguish between legitimate investment advice and huckstering.

29. Charles E. Rounds Jr., *Loring: A Trustee's Handbook* (Frederick, Md.: Panel, 2001). It should be noted only as a point of information that recently Alaska, Delaware, Rhode Island, and Nevada have by legislation afforded certain self-settled trusts spendthrift protection that they would not otherwise have been afforded under common law.

30. *Ibid.*, p. 131.

31. There is some legal confusion, however, as to whether a "self-settled" employee benefit plan established by a sole proprietor, a sole practitioner, or a sole shareholder who has no employees is "ERISA-qualified" and thus entitled to federal spendthrift protection in the bankruptcy

context. Ibid., p. 134.

32. Ibid., p. 135.

33. What we recommend here is effectively federal preemption of state statutes to exempt all PRAs from equitable division incident to divorce. Admittedly, Congress cannot prevent a state probate judge from taking the value of a PRA into account for computation purposes, but it should be able to keep the court's hands off the account itself.

34. If no such form is on file, the distribution should be in accordance with the terms of the decedent's own estate-planning documents. If no such documentation is in place

and/or operative, then distribution should be directly to those who would be entitled to take under the laws of intestacy, if the decedent had died intestate at his last domicile, by-passing to the extent possible the decedent's estate. The PRA administrator shall determine who the deemed intestate takers are and its determination should be final and binding on all parties. Distributions to minors may be to those who have custody of such minors. The PRA administrator should be held legally harmless for any mistakes of law with regard to the identity of any deemed intestate takers and minor custodians. The PRA administrator should be entitled to deduct any reasonable compensation from the PRA account for effectuating distribution of PRA assets.