



## Expanding Connections between the New York Stock Exchange and the Employee Retirement Income Security Act

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My purpose in this essay is to document and analyze connections between the 1975 deregulation of the New York Stock Exchange (NYSE) and the passage of the Employee Retirement Income Security Act of 1974 (ERISA). The removal of fixed commission rates prompted stockbrokers to change the research services they provided and to seek individual investors as clients. ERISA's new standards of fiduciary conduct increased the importance of brokers' research capabilities, providing a larger market. Simultaneously, ERISA increased the time and effort necessary to run private pensions, prompting many pension fund managers to alter or terminate plans in favor of more individualized pensions such as defined-contribution plans. Pension managers' increased fiduciary responsibility, combined with greater attention to, and opportunities for, individual investment, helped shift the burden of investing for retirement toward the individual employee and away from the corporation. Deregulation and ERISA combined to provide encouragement and opportunity for individual retirement investment.

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My purpose in this essay is to document and analyze connections between the results of the deregulation of the New York Stock Exchange (NYSE) in 1975 and the passage of the Employee Retirement Income Security Act of 1974 (ERISA). Both occurred because of the need for pension reform that resulted from the new investment practices of pension funds and the abuses or misuses of the system.<sup>1</sup> The results of these actions, when combined, contributed to the increasing individualization of retirement saving.

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<sup>1</sup> Peter F. Drucker, "The Governance of Corporations," in *A Functioning Society: Selections from Sixty-Five Years of Writing on Community, Society, and Polity*, ed. Peter F. Drucker (London, 2003), 129-36. I explain elsewhere in my dissertation how the expansion of private pension institutions necessitated federal intervention in the operating policies of the NYSE.

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Deregulation and the implementation of private pension regulation under ERISA had ramifications for stockbrokers, for pension fund managers, and for individual investors. The removal of fixed commission rates prompted stockbrokers to change the way they provided research services and to seek additional individual investors as clients. New standards of fiduciary conduct under ERISA increased the importance of brokers' research capabilities, providing a larger market for brokers, while simultaneously expanding the responsibilities of pension fund managers. Many of ERISA's other provisions also had the effect of increasing the amount of time and effort necessary to run a private pension, which prompted managers to alter pension plans, or terminate them, in favor of more individualized pension arrangements such as defined-contribution pension plans. The combination of increased fiduciary responsibility on the part of pension managers and greater attention to, and opportunities for, individual investment helped shift the burden of investing for retirement toward the individual employee and away from the corporation. Deregulation and ERISA combined to provide encouragement and opportunity for individual retirement investment.

### **New York Stock Exchange Deregulation**

The New York Stock Exchange deregulated its commission rate structure on May 1, 1975. Prior to "Mayday," as Wall Street called it, the Exchange set the amount of the commission paid to brokers at a staggered minimum rate.<sup>2</sup> The purpose of fixed commission rates was to insure that brokerage firms were compensated fairly regardless of their size; fixed rates meant that firms could not compete based on the price of a trade. Deregulation allowed competition, opening stock trading to market forces of supply and demand and driving down commissions.<sup>3</sup>

The Securities and Exchange Commission (SEC), Congress, and the Justice Department had various reasons for their collective desire to end fixed commission rates, but the issue that brought the problem of fixed commissions to the forefront was the increase in institutional trading.<sup>4</sup> The

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<sup>2</sup> The commission on one round lot of stock priced at \$1.00 per share was \$9.24 in 1975. The greater the number of shares of stock, and/or the higher the share price, the greater the commission; commissions had been based on a percentage of the sales price since 1915. See Standard & Poor's Corporation, *Security Owner's Stock Guide* (April 1975). The NYSE did not allow odd lot trading until after deregulation; see URL: [www.nyse.com/about/history/timeline\\_1960\\_1979\\_index.html](http://www.nyse.com/about/history/timeline_1960_1979_index.html) (viewed 5 June 2008).

<sup>3</sup> "Commission Rates Keep Tumbling Down," *Business Week* (26 May 1975), 65; David Pauly, Pamela Lynn Abraham, and Rich Thomas, "Securities: War on the Street," *Newsweek* (9 June 1975), 71.

<sup>4</sup> Press Release #72-60, box 1620, Harrison A. Williams Collection [hereafter, HAW Collection], Special Collections, Rutgers University. Processing of the Williams papers was not yet complete in October 2007, and most of the press releases were among the unprocessed materials. Press releases will remain filed in chronological

managers of pension or mutual funds would trade huge blocks of stock at a time, which resulted in correspondingly large commissions. What did not correspond, however, was the amount of work required of the broker in the execution of those trades. Often, the result was a tacit agreement, called a give-up, between brokerages and institutions. A fund manager would direct payment of the commission to several different brokers, although only one would perform the actual trade, and in return, the brokers would provide “free” research to the institution. High commission profits, generated on a comparatively small number of large trades and shared among brokers, gave brokerage firms time to do that research. By 1975, institutional investing made up roughly 70 percent of Wall Street’s volume, and institutional ownership was greater than \$400 billion.<sup>5</sup>

The system was thrown out of balance on Mayday; negotiated commission rates meant that brokers could no longer profit from performing a few large trades with very high commissions. With lower commissions, and lower profit per trade, brokers needed to make up their income deficit in trade volume. Wall Street lost millions of dollars and hundreds of jobs as rival firms slashed commissions in order to maintain or increase market share.<sup>6</sup> Mayday created two significant problems for NYSE brokers. The first was the challenge of increasing volume, and the second was a side effect of the first. By increasing time and effort on the retail side of business, brokerages did not have the resources to maintain the level of research services to which institutional clients were accustomed.<sup>7</sup> In response to these challenges, Wall Street looked for creative ways to increase income, chiefly by pursuing the individual investor. Stockbrokers had to find a way to convince ordinary Americans to invest on the New York Stock Exchange, which had never been an easy feat. The brightest possibility was to encourage Americans to invest for their retirement.<sup>8</sup>

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order. They are identified by number, first by year and then in order of issue—so in this case, 1972, the 60<sup>th</sup> release of that year.

<sup>5</sup> Chris Welles, *The Last Days of the Club* (New York, 1975).

<sup>6</sup> “Competition Bites Wall Street Brokers,” *The Economist* (31 May 1975), 79; “Commission Rates Keep Tumbling Down,” 65; John Carson-Parker, “The Clouds over a Brokers’ Gala,” *Business Week* (26 May 1975), 66; “Research Specialists Scramble to Survive,” *Business Week* (18 Aug. 1975), 90; Ron Chernow, *The House of Morgan* (New York, 1990); Welles, *The Last Days of the Club*.

<sup>7</sup> “Wall Street Goes Slow,” *Business Week* (11 Oct. 1976), 100.

<sup>8</sup> John Carson-Parker, “Wall Street’s Great Non-Event of 1975,” *Business Week* (21 April 1975), 114; “Commission Rates Keep Tumbling Down,” 65. The idea of charging separately for research services was proposed by Merrill Lynch, Pierce, Fenner & Smith, Inc., the nation’s largest brokerage firm, in February 1975, and was supported by the SEC; see “SEC Proposes Letting Brokerage Firms Charge Separately for Investment Advice,” *Wall Street Journal*, 1 April 1975, p. 7. See also NYSE history on Exchange website.

## Pensions in America

For most of the twentieth century, the pension plan was an instrument used by employers and unions to manage employees.<sup>9</sup> No single law or group of laws governed pension implementation and maintenance before the Employee Retirement Income Security Act of 1974.<sup>10</sup> Much of the federal government's prior attention to pension plans stemmed from its role in the payment or deferment of income taxes. Early pension reformers had fought for the employee's "protection against the insecurities of an industrialized economy," but, following World War II, a financially secure retirement came to be seen as more a right than a privilege.<sup>11</sup>

### *Pensions, Pre-World War II*

The first private pensions in America were part of the rise of the corporation in the late nineteenth century. American Express, a railroad freight forwarder, founded the first plan in 1875, and the Baltimore & Ohio Railroad founded the second in 1880. Early plans existed at the employer's discretion; they paid only small amounts and could be terminated summarily. The pension became a full-fledged instrument of corporate efficiency in 1900, when the Pennsylvania Railroad established an internal department to oversee its pension plan, keeping total financial and administrative control within management.<sup>12</sup>

Despite the characterization "welfare capitalism," the pension relationship emphasized stability and efficiency more than employee welfare.<sup>13</sup> Some plans genuinely did have employee welfare at heart; a famous example is Kodak's plan, which included both insurance and vesting years before either was required by law.<sup>14</sup> However, pensions largely served the dual function of securing a stable workforce and removing individuals from that work force at a compulsory retirement age. By replacing older, higher-wage employees with younger, lower-wage workers, firms could achieve significant labor cost savings.<sup>15</sup>

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<sup>9</sup> James A. Wooten, *The Employee Retirement Income Security Act of 1974* (Berkeley, Calif., 2004).

<sup>10</sup> Sylvester J. Scheiber and John B. Shoven, "The Economics of US Retirement Policy: Current Status and Future Directions," in *Public Policy toward Pensions*, ed. Sylvester J. Scheiber and John B. Shoven (Cambridge, Mass., 1997), 1-39.

<sup>11</sup> Dora L. Costa, *The Evolution of Retirement: An American Economic History, 1880-1990* (Chicago, 1998), 27.

<sup>12</sup> Costa, *The Evolution of Retirement*; Steven A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, Mass., 1997).

<sup>13</sup> Sass, *The Promise of Private Pensions*.

<sup>14</sup> Sanford M. Jacoby, "Welfare Capitalism at Kodak," in *Major Problems in American Business History*, ed. Regina Lee Blaszczyk and Philip B. Scranton (Boston, 2006), 264-71.

<sup>15</sup> Sass, *The Promise of Private Pensions*; Wooten, *The Employee Retirement Income Security Act of 1974*.

The Depression sparked grassroots movements for pension reform. Many pension plan administrators had used the funds at their disposal to invest in both their own company securities and in high-risk securities during the 1920s, which resulted in decreased payments after the market crashed.<sup>16</sup> Older workers quickly lost their savings, and were often unable to find work. States did not have the tax base to implement change, and turned to the federal government.<sup>17</sup> The Social Security Act of 1935 assured workers an adequate, if minimal, retirement annuity. Executives reasoned that lower-wage employees were taken care of by Old Age and Survivors' Insurance (OASI), and corporations began to focus private pension plans on higher-paid workers, in order to make up the difference between expected Social Security benefits and the desired level of retirement income. Tax laws skewed pensions toward the affluent throughout the 1930s. The Revenue Act of 1921 amended tax laws so that taxes were not levied on employees' pension assets until they were distributed, making pensions an attractive tax shelter for high earners. Congress raised taxes on high incomes as part of the New Deal, which further pushed corporate executives to shift current salary to deferred pension compensation.<sup>18</sup> Wartime tax rates had much the same effect, producing "a boom in retirement plans," which predominantly benefited the highest earners. Blue collar workers were covered by Social Security, and executives by private pensions, but those who worked at companies that did not sponsor a pension plan had no way to save tax-free for retirement.<sup>19</sup>

#### *Pensions, from World War II through the 1950s*

The government attempted to reform the system with the Revenue Act of 1942, using private pension plans as instruments of public policy for the first time.<sup>20</sup> The law required that plans cover broad groups of employees in order to qualify for preferential tax treatment. The Internal Revenue Service (IRS) recognized the use of pensions for tax avoidance, and the new law meant that executives could no longer use pensions solely as a method for protecting their own earnings.<sup>21</sup> The result was an expansion in pension coverage, to 41 percent of all private workers by 1960.<sup>22</sup>

The labor laws of the New Deal held this expansion in check, however. Corporations often had little incentive to offer pension coverage to union workers, who were covered by the union's pension; in addition, the spread of

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<sup>16</sup> Daniel Kenneth Smartt, "Pension Funds: A Study in Growth and Investment" (M.A. Thesis, University of Texas, 1970). The Supreme Court supported management's position that the pension was a gift to the employee, in *Pennie v. Reis* 132 U.S. 464 (1889).

<sup>17</sup> Costa, *The Evolution of Retirement*.

<sup>18</sup> Wooten, *The Employee Retirement Income Security Act of 1974*; Sass, *The Promise of Private Pensions*.

<sup>19</sup> Wooten, *The Employee Retirement Income Security Act of 1974*, 30.

<sup>20</sup> *Ibid.*

<sup>21</sup> Sass, *The Promise of Private Pensions*.

<sup>22</sup> Costa, *The Evolution of Retirement*.

unions increased corporate use of pensions to secure the loyalty of non-unionized workers. Unions also demanded dismissal only for cause, which did not fit with the compulsory retirement rules of most private pensions.<sup>23</sup> The Inland Steel decision of 1949 sanctioned the pension's role in collective bargaining agreements.<sup>24</sup> An important shift occurred in the 1950s, as the pension evolved from a managerial tool for labor control into a method of shifting income to retired persons.<sup>25</sup>

As pension coverage expanded, concern grew over the relationship between the workers and the corporate executives who managed the plans.<sup>26</sup> Insurance companies and banks handled daily management of pension funds during the 1920s, but the corporations who sponsored plans began to see benefits to maintaining more control within their own organizations. Unions were pleased with the growing integration of pensions into companies' financial management, because it gave them greater leverage to enforce payment. Corporate officials determined their own risk tolerance, and made investment decisions accordingly; professional financial service firms, instead of insurance companies, could then execute those decisions.<sup>27</sup>

Insurance companies fell out of favor with pension funds because of legal limits on their equity holdings; in the early 1950s, pensions began shifting increasing amounts into common stocks. Considered a good hedge against inflation, equities offered an attractive rate of return in the booming postwar economy.<sup>28</sup> With higher returns on pension fund reserves, employers could lower the amount they contributed to the funds, freeing capital for business development. Those plan administrators who worked with fund trustees at banks or insurance companies began to exert more control as well; trustees were amenable to specific direction, as long as they were absolved of fiduciary responsibility under state laws. Many chief financial officers took control of pension decisions from personnel departments, recognizing the pension's uses "as a source of funds, an investment outlet, and a general reservoir of balance sheet slack."<sup>29</sup> In his 1961 study of private pensions, James McNulty found that most employers evaluated pension plan finances "in conjunction

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<sup>23</sup> Sass, *The Promise of Private Pensions*; Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>24</sup> James E. McNulty, Jr., *Decision and Influence Processes in Private Pension Plans* (Homewood, Ill., 1961).

<sup>25</sup> Wooten, *The Employee Retirement Income Security Act of 1974*; see also Laurence J. Kotlikoff and Daniel E. Smith, *Pensions in the American Economy* (Chicago, 1983).

<sup>26</sup> Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>27</sup> Sass, *The Promise of Private Pensions*.

<sup>28</sup> Wooten, *The Employee Retirement Income Security Act of 1974*. By 1956, private pensions were the largest single source of equity capital in U.S. markets. See Bascom H. Torrance, "Legal Background, Trends, and Recent Developments in the Investment of Trust Funds," *Law and Contemporary Problems* 17 (Winter 1952): 128-61.

<sup>29</sup> Sass, *The Promise of Private Pensions*, quotation at p. 172.

with their broader enterprise financial planning,” and that federal tax law provided “substantial room for financial maneuver by employers.”<sup>30</sup>

Companies turned to investment professionals to help manage aggressive growth pension funds, establishing close, profitable relationships. Pension sponsors offered excellent payment and demanded an outstanding level of personal service in return, characterized by Steven Sass as “gift exchange.” Money managers who were paid only a nominal percentage could profit hugely from trades involving millions or billions of dollars.<sup>31</sup> Pension industry observers, however, began to question the wisdom of the close working relationships between plan administrators and money managers, who often had very different professional backgrounds and investment goals.<sup>32</sup> These complicated relationships and their financial ramifications helped spur deregulation at the NYSE.<sup>33</sup>

While employers were happy with the increased financial integration of pensions and general financial affairs, employees began to have doubts. Management’s financial officers could not avoid the influence of many factors other than employee welfare in making pension decisions. The lack of distance between pension finance and other decisions provided plentiful opportunity for creative manipulation of funds.<sup>34</sup> In addition, high-risk stock investments may have garnered high returns, but they did not come with the guarantee of a traditional annuity, which made employees and government observers anxious.<sup>35</sup> This, then, was the conundrum facing pension reformers in the 1960s. Many wanted companies to take an active role in the management of their own pensions, because treating pensions as an unwelcome chore would not be in the best interest of the employees. Nor were companies keen on the idea of increased government involvement, because the pension was part of private enterprise. At the same time, though, the lack of regulation and the integration of pensions into corporate finance provided plentiful opportunities for misuse of pension funds.

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<sup>30</sup> McNulty, *Decision and Influence Processes in Private Pension Plans*, 36-37.

<sup>31</sup> Sass, *The Promise of Private Pensions*; Sass describes payments to investment managers as rents provided in return for a perceived unique ability to manage money.

<sup>32</sup> McNulty, *Decision and Influence Processes in Private Pension Plans*.

<sup>33</sup> See Paula K. Gajewski, “Mayday on Wall Street” (M.A. Thesis, Vanderbilt University, 2005), for more information on the specific causes of commission rate deregulation.

<sup>34</sup> McNulty, *Decision and Influence Processes in Private Pension Plans*, 114: “the manifestations of this financial integration take a number of forms, involving such things as choice of funding agency, annual contribution rates, management of the investment of pension fund assets, and changes in actuarial and investment valuations to go along with the general financial position of the client firms.”

<sup>35</sup> Sass, *The Promise of Private Pensions*.

## ERISA

The reform movement that eventually became the Employee Retirement Income Security Act of 1974 began when president John F. Kennedy ordered the creation of a cabinet-level committee to investigate pensions in 1962. The committee proposed vesting standards as a way to correct the system, but Congress preferred encouraging expanded private coverage.<sup>36</sup> Inquiry under president Dwight D. Eisenhower's administration had resulted in disclosure requirements instead of strict operational regulation, and the business community did not welcome further government interference.<sup>37</sup>

Nor were most unions in favor of reforms: the pension plan was a major issue in collective bargaining, one that gave many unions a great deal of power. Some of the most outrageous cases of fund misuse, however, involved union-controlled pensions, especially among Jimmy Hoffa's International Brotherhood of Teamsters. The United Auto Workers and United Steelworkers of America favored reforms, but they had faced problems with low pension reserves, which, suggests Richard Ippolito, corporations such as General Motors and Ford deliberately kept low as a labor control tactic, reasoning that union workers would not strike or disrupt business if their pensions were dependent on the corporation's continued success.

Senator Jacob Javits, ranking minority member of the Senate Labor and Public Welfare Committee, proposed the original bill that became ERISA in 1967.<sup>38</sup> The numerous versions of the bill that circulated in the House and Senate complicated production of a final bill. As in the 1950s, much of the debate centered on which parts of the government would oversee which parts of the reform package. Pensions were not only a matter of labor and public welfare, but also included financial processes best regulated by the SEC or IRS.

The growing power of Congress through the administrations of Lyndon Johnson and Richard Nixon helped the struggle for ERISA, as did the increasing power of the national media, to whom congressional leaders were quick to provide stories of those whom the current pension system had failed. Completed during the Watergate scandal, ERISA was the first piece of major legislation signed by president Gerald Ford, on Labor Day, September 2, 1974.<sup>39</sup> Its major provisions included standards of fiduciary responsibility; minimum funding and vesting requirements; establishment of an insurance system under the Pension Benefit Guarantee Corporation; and the creation of the Individual Retirement Account (IRA).<sup>40</sup>

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<sup>36</sup> Sass, *The Promise of Private Pensions*; Dan M. McGill, *Fundamentals of Private Pensions* (Homewood, Ill., 1979).

<sup>37</sup> Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>38</sup> *Ibid.*; Sass, *The Promise of Private Pensions*.

<sup>39</sup> *Ibid.*

<sup>40</sup> Wooten, *The Employee Retirement Income Security Act of 1974*; McGill, *Fundamentals of Private Pensions*.

### Connecting NYSE Deregulation and ERISA

The first connections between ERISA and the deregulation of the NYSE are apparent in the reasoning Congress used to achieve both measures. Senator Harrison A. Williams, Jr. (D-NJ), was on the Senate committees responsible for both ERISA and the Securities Acts Amendments of 1975, the Congressional mandate for negotiated commission rates. Williams was second only to Jacob Javits on ERISA, and was chair of the Senate Subcommittee on Securities. His papers provide part of the answer to the connection between investment and pension reform. Deregulation and ERISA were connected through the issue of institutional membership on the stock exchange. Pension fund management companies were, by the late 1960s, looking for a way to avoid the high fixed commissions incurred by their large trades. One solution was to apply for membership on the Exchange, cutting out the third-party broker's commission. The problems of fixed commission rates and spiraling equity investment by pension funds combined to produce an environment on Wall Street, Williams recognized, that was hostile to the individual investor.<sup>41</sup> Similarly, Williams was passionate about pension reform on behalf of individual employees, who were the ones most often hurt by plan termination or under-funding.<sup>42</sup> However, the consequences of ERISA and deregulation, both intended and unforeseen, produced a fundamental change in the nature of retirement planning for individual American workers.

For stockbrokers, the switch to negotiated commission rates produced numerous challenges, but one fundamental problem: brokers had to increase trade volume.<sup>43</sup> ERISA, too, created one key problem for pension fund managers; all its provisions increased the complexity—and hence the supervision required of pension management, which was regulated by ERISA's new standards of fiduciary responsibility.<sup>44</sup> To gain volume, the NYSE sought the individual investor's retirement savings; and, to alleviate the greater burden of regulatory compliance, corporate pension sponsors

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<sup>41</sup> Harrison Williams, "Remarks Before the Harvard Business Club of Minnesota at the Sheraton-Ritz Hotel," Minneapolis, Minn., 14 June 1974, box 1398; Press Release #74-84, box 1619; Press Release #73-122, box 364, all in HAW Collection. This is only a small portion of the story of the intersections between the creation of ERISA and the causes of deregulation.

<sup>42</sup> Harrison Williams, "Speech before the Detroit Chapter of the Financial Executives Institute," 24 Sept. 1973, box 1215, HAW Collection: As head of the Senate Labor Subcommittee Study of Private Pensions, which ran from 1970 to 1973, Williams reviewed approximately 20,000 letters from individuals hurt by inadequate, mismanaged, or terminated pension plans.

<sup>43</sup> "American Brokers: Mayday on May Day?" *The Economist* (26 April 1975), 118.

<sup>44</sup> "... practically every plan will have to be revised to meet the standards," according to Alfred M. Skolnik, "Private Pension Plans, 1950-74," *Social Security Bulletin* 39 (June 1976): 3-17, 5. Most of the new standards required by ERISA went into effect on 1 Jan. 1976.

looked for ways to shift more responsibility for retirement to individual employees.

*“Prudent Man” Rule*

ERISA’s statement of fiduciary responsibility, one of the most contested sections of the bill, was finally defined according to the House of Representatives’ view of the “prudent man” rule, which decreed that all financial decisions relating to pension plan management should 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 conducting an enterprise of like character and with like aims.”<sup>45</sup> This definition expanded pension liability to anyone with any measure of authority or control over any part of the pension itself or over any decisions relating to it.<sup>46</sup> The executives of a corporation that sponsored a qualified pension plan, then, were to be held to the same standard of responsibility as those individuals within the company whose specific role was pension management. Through this regulation, ERISA encouraged corporate executives to pay much more attention to the operation of company pensions.<sup>47</sup>

Specific provisions were included to prevent any financial dealings that were not at arm’s length, including limits on self-dealing, which was the cause of many earlier pension losses.<sup>48</sup> These rules made illegal the kickbacks of money or research services that were prevalent in Wall Street’s dealings with pension fund institutions in the late 1960s. Fiduciaries were to be held personally responsible for any pension losses resulting from their mismanagement or abuse of their roles, and they were required to return any ill-gotten gains acquired through such abuse. ERISA did, however, offer a way to divert some fiduciary responsibility. If a named fiduciary of a plan, or its trustees, could prove to have chosen and retained an investment manager in a prudent manner, then neither the named fiduciary nor the trustees could be held responsible for the manager’s actions or omissions.

Other than simple prudence, ERISA defined responsible pension management as maintaining the actuarial soundness of the plan. For the first time in pension regulation, the IRS was put in a position to determine whether or not pensions had the ability to meet their expected benefit

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<sup>45</sup> McGill, *Fundamentals of Private Pensions*, 54-55, quoting from ERISA; this is a variation of the standard set forth in 1830 by the Supreme Judicial Court of Massachusetts in *Harvard College v. Amory*.

<sup>46</sup> McGill, *Fundamentals of Private Pensions*; Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>47</sup> The plan’s sponsors, rather than its investment agents, caused many pension fund abuses. The corporate plan sponsors “could direct the trustees to buy company securities or invest in Las Vegas casinos, with the presumption that their interest and those of the beneficiaries coincided”; Sass, *The Promise of Private Pensions*, 205.

<sup>48</sup> Alfred M. Skolnik, “Pension Reform Legislation of 1974,” *Social Security Bulletin* 37 (Dec. 1974): 35-42, 41.

obligations. Under previous tax laws, the IRS pressured pension plans to avoid over-funding, but ERISA's emphasis was on creating the proper investment mix of plan funds to prevent under-funding.<sup>49</sup>

### *Research—Pensions*

The purpose of ERISA's fiduciary standards was not only to protect employees from theft or waste of plan assets by administrators; a fiduciary was also required to use prudence in pursuit of providing full benefits to the employees covered by the plan.<sup>50</sup> In an attempt to provide a better guarantee of those benefits, ERISA stipulated diversification of plan assets. The general requirements for diversification included type of investment, geographic location and industrial classification of investments, and differing dates of maturity. Pension managers could no longer pursue high-risk equities to the exclusion of more stable investments. Instead of relying on investment gain to maintain the amount of principal in the fund, corporations discovered that larger amounts of their pensions would have to be funded directly out of the company's own profits.<sup>51</sup>

Pension managers now faced the challenge of achieving a level of diversification that would both maximize expected returns and fulfill fiduciary obligation without unnecessary exposure to risk. The changing nature of investment in the late 1960s and early 1970s made the task all the more difficult; investment vehicles were rapidly diversifying during this period, with widespread acceptance and use of options, for example. With the development of modern portfolio management, investors were beginning to use risk measurements taken from financial theorists, most notably the concept of the portfolio beta to measure volatility. Not all pension fund managers had the professional training necessary to fulfill their investment responsibilities, and many found themselves in great need of professional investment advisors. Although pension managers were now required by ERISA to pay for the research they were accustomed to receiving as a bonus from Wall Street brokers, deregulation simultaneously forced many brokerages to cut back on the overall amount of research produced and to increase research fees.

### *Research—Brokers*

Without the income provided by fixed commissions, many brokerages could not afford to maintain their level of research services: "the availability of research we have been getting more or less for free is diminishing," said Charles W. Brady, president of Citizens & Southern Investment Counseling,

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<sup>49</sup> McGill, *Fundamentals of Private Pensions*.

<sup>50</sup> Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>51</sup> McGill, *Fundamentals of Private Pensions*. A study of private pensions by Merrill Lynch found a decrease in the proportion of funds in equities, from 70% in 1972 to less than 59% in 1975. "Wall Street Goes Slow," 100.

Inc., in Atlanta in an interview with *Business Week* in late 1976.<sup>52</sup> Although some brokers were trying to offer research services for sale, purchasing research was still not a widespread option in the aftermath of deregulation. When brokerages were first hit by negotiated rates, many had to cut costs drastically just to stay afloat. The stockbrokers themselves were needed to try to build sales volume, so back office researchers and staff economists were fired in huge numbers.<sup>53</sup> Many pension fiduciaries found themselves in a precarious position, unable either to perform the necessary research themselves or to purchase it, but still held accountable for every investment decision.

At the same time, Wall Street brokerages were scrambling to recover from the hit of negotiated commission rates. Unusually high volume prevented an initial shock when Mayday arrived, causing some to dub it a “non-event,” but brokers knew they had to prepare for an end to the bullish market.<sup>54</sup> They could be forced out of business entirely if volume fell too low, and, with ERISA forcing pensions out of strong equity positions, brokers could not rely on institutional traders.<sup>55</sup> Pension managers were willing to pay for research, but these fees could not cover the income deficit caused by deregulation. First, stockbrokers were forced to expand the market for research services by offering to share information and the cost to produce it with individual investors. Second, brokers vigorously began to court individual clients.<sup>56</sup>

### *Individual Investors*

Investment on the NYSE was predominately individual for the best part of the Exchange’s existence, but, as Harrison Williams recognized, increased institutional investment in the 1960s pushed many individuals either into mutual funds or out of the market entirely. This push took the form of increasing fixed commissions, which the NYSE steadily adjusted upward to take advantage of the size of institutional trades. In addition, individuals often did not have access to the research required for successful investing.<sup>57</sup> Those individuals who remained active in the stock market could not be called “typical” Americans; the group was composed primarily of affluent, elderly, white males, whose investment objectives included fun as much as

<sup>52</sup> Ibid.

<sup>53</sup> Carson-Parker, “The Clouds over a Brokers’ Gala,” 66; “Research Specialists Scramble to Survive,” 90.

<sup>54</sup> Carson-Parker, “Wall Street’s Great Non-Event of 1975,” 114.

<sup>55</sup> “American Brokers: Mayday on May Day?” 118.

<sup>56</sup> Ingo Walter, ed., *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market* (New York, 1985); “The Bulls Trample May Day Worries,” *Business Week* (10 May 1976), 88; see Gajewski, “Mayday on Wall Street.”

<sup>57</sup> Press Release May 14, 1973, box 1254, HAW Collection; James Burk, *Values in the Marketplace: The American Stock Market under Federal Securities Law* (New York, 1988); Ronald C. Lease, Wilbur G. Lewellen, and Gary G. Schlarbaum, “The Individual Investor: Attributes and Attitudes,” *Journal of Finance* 29 (May 1974): 413-33.

profit.<sup>58</sup> By opening competition and lowering barriers to entry, Mayday did help democratize financial markets, at least in outward appearance. The stock market was made accessible to thousands of average Americans who could not previously afford to pay high fixed commissions. However, many individuals had neither the knowledge nor the inclination to invest.

Stockbrokers knew they had to draw individuals into the market to mitigate the drop in commission profits.<sup>59</sup> Deregulation signaled the arrival of a “new era” in which success, even survival, would be dependent on a brokerage’s capability to merchandise its services.<sup>60</sup> This was a considerable challenge, because public ignorance about the inner workings of Wall Street had kept the system running smoothly for decades; many Americans viewed investing as akin to gambling, in which only the very lucky made any profit. The brightest advertising possibility was retirement, but individuals trusted the pension plans of their employers, and the prevailing social philosophy of the 1970s did not encourage personal provision for the future. Many brokers feared that the growth of the welfare state would transform the act of saving money into a luxury for the rich. By 1975, more and more people were covered by corporate retirement plans, from which they were demanding greater benefits than ever before.<sup>61</sup>

ERISA, however, was a boon to the NYSE. It put retirement front and center in the public consciousness, and the numerous Congressional hearings about pension plan failures and the need for reform encouraged individuals to re-evaluate their own pension situations. ERISA liberalized Keogh plans, which functioned as retirement savings accounts for the self-employed. Even more importantly, ERISA created the IRA, giving stockbrokers the perfect vehicle with which to promote individual investment.<sup>62</sup>

### *Pension Plan Expense*

Corporate pension plan sponsors, too, were looking for ways to encourage individual employees to shoulder more of the burden of retirement saving

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<sup>58</sup> According to a study by the Wharton School, over half the individually owned stock in 1971 was owned by the wealthiest one percent of the population, whose annual incomes exceeded \$50,000; see Welles, *The Last Days of the Club*; “Competition as Regulator: Wall Street’s Taste of Freedom,” *Business Week* (4 April 1977), 91; and Lease, Lewellen, and Schlarbaum, “The Individual Investor: Attributes and Attitudes.”

<sup>59</sup> Carson-Parker, “Wall Street’s Great Non-Event of 1975,” 114; “Commission Rates Keep Tumbling Down,” 65.

<sup>60</sup> David Pauly and Pamela Lynn Abraham, “Wall Street: Competition at Last,” *Newsweek* (12 May 1975), 82.

<sup>61</sup> Welles, *The Last Days of the Club*; Alec Benn, *The Unseen Wall Street of 1969-1975 and Its Significance for Today* (Westport, Conn., 2000). Not only did corporate workers of the early 1970s want a higher level of pension payments than earlier generations, but they also wanted to retire at a younger age, further increasing the payout burden on the pension plans.

<sup>62</sup> McGill, *Fundamentals of Private Pensions*.

and investing. Increased fiduciary responsibility was a burden on pension managers, but ERISA also made pensions very expensive to operate.<sup>63</sup> In fact, the increased administrative costs required just to bring plans into regulatory compliance were enough to force many small plans to terminate.<sup>64</sup> Everything had to be thoroughly documented and summarized in language accessible to the average plan beneficiary. As a result of Congress's decision to solve the question of oversight by splitting responsibility among departments, the appropriate forms had to be filed regularly with a number of government agencies, from the IRS to the Social Security Administration to the Labor Department.<sup>65</sup>

ERISA also created its own entity for pension oversight, the nonprofit insurance corporation called the Pension Benefit Guaranty Corporation (PBGC). All qualified plans were required to pay premiums to the PBGC for plan termination insurance; this created yet another set of paperwork for pension officials, all of which was subject to review or study by the Labor Department.<sup>66</sup> Beyond termination insurance, plan sponsors could purchase insurance to protect their plan assets, and themselves, in the event of fiduciary breaches of conduct, which created an additional expense. Nor could corporations reap any financial benefits from sponsoring a pension plan, because plan assets were kept separate from employer's assets.<sup>67</sup> However, unfunded pension liabilities had to be reported on a company's balance sheet as senior level debt.<sup>68</sup> Even in the event of a plan termination, ERISA stipulated that an employer could recover excess pension funds only if caused by "erroneous actuarial computation," but not if caused by investment gains.<sup>69</sup> Under ERISA, pension plans held little financial benefit but huge administrative expenses for employers.

### *Executive Position on Pensions*

One of ERISA's more insidious influences was its effect on the executive attitude toward company pension plans. Most of the regulation concerned defined-benefit plans, the majority of plans during the period before reforms. Under defined-benefit plans, executives could easily adjust their level of expected benefit. Under the new regulations, though benefits could still be greater for executives than for workers, benefits had to be proportional. That is, the ratio of benefit to other compensation had to be constant for all those

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<sup>63</sup> Scheiber and Shoven, "The Economics of US Retirement Policy."

<sup>64</sup> Martha Remy Yohalem, "Employee Benefit Plans, 1975," *Social Security Bulletin* 40 (Nov. 1977): 19-28.

<sup>65</sup> McGill, *Fundamentals of Private Pensions*.

<sup>66</sup> Skolnik, "Pension Reform Legislation of 1974," 35-42.

<sup>67</sup> McGill, *Fundamentals of Private Pensions*.

<sup>68</sup> E. Philip Davis, *Pension Funds: Retirement-Income Security, and Capital Markets: An International Perspective* (Oxford, England, 1995).

<sup>69</sup> McGill, *Fundamentals of Private Pensions*, 53.

covered by the plan.<sup>70</sup> Under previous plans, benefit levels were generally determined by the average salary over the final few years of work, during which time executive salaries were at their highest. But ERISA put an upper limit on the amount of benefits that qualified plans could provide.

By restricting benefit levels, ERISA encouraged executives to do more of their own retirement investing outside the company. In many cases, this increased attention to outside investment corresponded with decreased attention to corporate pension planning. With much less to gain from an active role in plan selection, executives began to delegate plan decisions, once controlled by corporate finance divisions, to lower-level personnel departments.<sup>71</sup> At the same time, however, while executives had much less to gain from a well-run pension plan, they had much more to lose from a poorly run plan, under the fiduciary responsibility regulations.

Executives short-circuited ERISA regulation by converting their defined-benefit plans into defined-contribution plans, for which most ERISA standards did not apply. Instead of a defined benefit as expected deferred compensation, employees could contribute to the pension plan, but amounts and frequency of this contribution were not standardized. Employees also had a greater degree of control in the direction of the investment of their pension contributions, which benefited those executives with investment knowledge and experience, but left uninformed lower-wage employees exposed to market risk.<sup>72</sup> ERISA included an exception to its fiduciary duty standards, in the case of pension plans in which employees exercise control over their own accounts: no fiduciaries can be held liable for losses caused by an employee's personal investment decisions.<sup>73</sup>

### *Individual Retirement Accounts*

Congress did not intend the IRA to be an escape route for companies to shrug off their pension responsibilities, although some used it in just that way. Congress did recognize that Social Security was inadequate for those retirees who had no company pension; the IRA was meant to supplement the retirement incomes of people in that situation. The IRA was more important as a concept, though, than as an actual financial tool.<sup>74</sup> Indeed, ERISA was perhaps most important in its ideological implications. By implementing vesting and portability requirements, ERISA changed the emphasis of

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<sup>70</sup> Ibid. The IRS requirements related to plan design and equitability created yet more paperwork and administrative expense.

<sup>71</sup> Wooten, *The Employee Retirement Income Security Act of 1974*.

<sup>72</sup> Ibid.; this was the situation at Enron; employees invested too much of their retirement in their own company, which would have been prohibited in a defined-benefit plan regulated by ERISA.

<sup>73</sup> McGill, *Fundamentals of Private Pensions*. Today the most common defined-contribution plan is the 401k, created as part of the Internal Revenue Code in 1978.

<sup>74</sup> Much more legislation was required before the IRA achieved its current form.

pension regulation from maintaining plan assets to upholding the rights of individual employees.<sup>75</sup> Harrison Williams identified this change in 1972:

When private pension plans were in their infancy, they were customarily thought of as a gift from the employer to the loyal, retiring employee—like the traditional gold watch. More recently, pensions have come to be recognized more for what they really are—deferred wages, part of the employee’s just compensation, and payable at retirement.<sup>76</sup>

Corporations had just cause to want to be rid of the burden of pension management. Keeping pension control had no advantages, since the funds were to be kept out of the company coffers, and since regulation diminished the pension’s role in the ongoing struggle with organized labor. In addition, companies could be punished if something went wrong with the pension money. With tacit federal approval of individual retirement planning, corporations could take an altruistic position, giving their employees freedom of choice and the right to determine their own futures, while abnegating an uncomfortable and risky responsibility. ERISA helped push the pension from corporate obligation to individual right.

The deregulation of the NYSE also gave symbolic support to individual pension control; by reducing the cost of trading stock, and theoretically putting trading within reach of the average American, deregulation gave the appearance of democratizing the stock market.<sup>77</sup> This did encourage individual investors and gave corporations the claim that employees could now manage retirement for themselves. Pension fund managers began to realize that their employees now had access to information about the stock market, to investment options such as IRAs and mutual funds, and to individual investing with lower commission rates.<sup>78</sup>

Participation in employer-sponsored pension plans stabilized in the 1970s and then decreased; personal retirement accounts have become the dominant choice of American workers since 1980.<sup>79</sup> The combination of deregulation and the IRA drew individuals into retirement investing; roughly 1.25 million people adopted IRAs in 1975 alone.<sup>80</sup> Simultaneously, ERISA and the side

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<sup>75</sup> McGill, *Fundamentals of Private Pensions*.

<sup>76</sup> Press Release 72-103, box 1620, HAW Collection.

<sup>77</sup> This, too, was more important on a symbolic than a practical level; just as one example, the NYSE had not yet approved odd lot trading, so investing was still well out of reach for many, if not most, Americans.

<sup>78</sup> Walter, *Deregulating Wall Street*; William G. Shepherd, “Swinging with the New IRA Plans,” *Business Week* (30 June 1975), 92; “The Bulls Trample May Day Worries,” 88.

<sup>79</sup> Scheiber and Shoven, “The Economics of US Retirement Policy”; Davis, *Pension Funds*.

<sup>80</sup> Yohalem, “Employee Benefit Plans, 1975.”

effects of deregulation led companies to push retirement out of the corporate sphere and onto the shoulders of individual employees.<sup>81</sup>

## Conclusions

The increased burden of regulation under ERISA, combined with the changing nature of Wall Street's institutional investment practices, as forced by deregulation, created an environment that was not conducive to the growth of private pensions. In 1975, not only did plan terminations increase, but also fewer plans were submitted for approval to the IRS.<sup>82</sup> The complexity of ERISA's regulatory structure resulted, in James Wooten's words, in "incessant legislative activity, which has made the tax laws too complicated for even experts to understand."<sup>83</sup> In seeking to preserve the retirement security of individual workers, ERISA in the end helped shift responsibility for that security from the employer to the employee.<sup>84</sup>

The combination of ERISA and deregulation had long-term positive effects for the New York Stock Exchange. The drive to outsource retirement indirectly led to an increase in pension fund business, and the emphasis on the individual gave stockbrokers a good way to gain and keep new clients, increasing Wall Street's volume and profit. ERISA and deregulation were ultimately very positive for corporations, too. The incentive, and means, to outsource retirement freed companies from a portion of federal control and destroyed a good portion of the power of troublesome labor unions. The situation was ideal for encouraging employees to take responsibility for their own retirement, and corporations could look good in the process.

Congress could claim major successes with both the Securities Acts Amendments and ERISA. It had "democratized" investing, and it had "fixed" the nation's pension system. These actions worked together to promote individual retirement planning. ERISA signaled a change in the American concept of retirement, from the idea that companies were obligated to provide a pension for their workers to the concept of planning for retirement as an individual right. The deregulation of commission rates on Mayday was a key turning point in this process, and the switch to negotiated rates facilitated

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<sup>81</sup> Sass, *The Promise of Private Pensions*. Sass views ERISA as the high-water mark for private pensions in America. Declining participation in employer-sponsored plans may have multiple causes, but Sass admits that ERISA was at fault, at least, in hurrying the end of private pensions: "The law's regulatory burdens, hyper-rational standard of fiduciary conduct, and rising PBGC premiums clearly sped the contraction." 228-29.

<sup>82</sup> Yohalem, "Employee Benefit Plans, 1975," 25: "The number of private pension and profit-sharing plans submitted for approval to the Internal Revenue Service dropped sharply in 1975 while the number of plans that were terminated increased." Plans approved: 1973: 59,605; 1975: 30,039; plans terminated: 1973: 4,130; 1975: 8,108.

<sup>83</sup> Wooten, *The Employee Retirement Income Security Act of 1974*, 277.

<sup>84</sup> Scheiber and Shoven, "The Economics of US Retirement Policy."

changes in investing that made the NYSE the ideal vehicle through which to exercise that particular freedom.

However, the combination of ERISA and deregulation ultimately produced a situation in which employees could no longer depend on the reliability of their employers to insure their pensions. Employers did not provide training for employees on how to arrange retirement investments. The IRA was not yet widely available; its initial form was inadequate as a pension replacement. Investing in individual stocks was still prohibitively expensive for the majority of the population, and most individuals did not have access to the research necessary for informed investment decisions. Most unions were no longer trustworthy vehicles for pension funds. Individuals were given nominal freedom of choice in retirement investing and the right to determine their own futures, but were spectacularly ill-equipped to do so.