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As Teachers Sock Money Into 403(b)s, Few Defenses Exist

Oversight for Retirement Plans
Falls on Patchwork of States;
Districts' Hands-Off Policy

Bayport Takes a \$186,000 Hit

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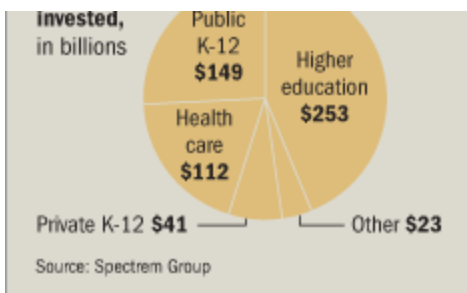
A Long Island, N.Y., school district hired Horizon Benefit Administration Corp. in early 2001 to manage its retirement plan. Within months, teachers in the Bayport-Blue Point Union Free School District began complaining: Money wasn't credited to their accounts or went to the wrong investments. Statements were sent late, to wrong addresses, in unsealed envelopes -- or not at all.

In total, 117 employees complained, but district officials considered the missteps isolated and didn't replace Horizon.

It turns out the teachers were right to be concerned: Last September, Superintendent Richard Curtis told them some of their money had been misappropriated. Ohio securities regulators say in court papers that Horizon's top executive stole the money. A lawyer overseeing the return of the remaining funds says a total of \$1.2 million from 76 districts was missing, or about 10% of the employees' savings.

"We just want to know who can help us, and right now it appears no one can," says Marcia Meiowitz, president of the Bayport-Blue Point Teachers' Association.


That's because, like 1.9 million other public-school employees across the U.S., these teachers have 403(b) retirement plans, which provide investors far fewer protections than 401(k) plans, their better-known cousins offered by corporations. Weakly regulated and frequently saddled with high fees, the 403(b) market is now the scene of numerous fights over alleged wrongdoing by the plans' private vendors.



In San Diego, a former teacher who now sells plans to other teachers made a payment to settle allegations that he made improper trades in a couple's accounts. Many marketers pitch the plans in ways that wrongly suggest they have a school district's official blessing. Teachers are suing a Louisiana plan marketer that promised a "pot of gold" but buried crucial caveats in fine print.

"It's the wild, wild West out there," says Gregory Viviani, an attorney

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who advises school districts on 403(b) issues in Ohio, where state law requires districts to let just about any company offer investments.

Named for a section of the tax code, 403(b) plans are permitted only for school districts and nonprofit groups such as hospitals, universities and charities. In all, there are 6.8 million participants and nearly \$600 billion in 403(b) plans, while 401(k) plans hold three times as much money and have 42 million participants.

The federal Employee Retirement Income Security Act (commonly known as Erisa) requires employers with 401(k) plans to look out for their participants when hiring management companies and providing investment options -- making sure investments are appropriate for their employees and fees are reasonable. Federal rules for 401(k) plans also make employers responsible for plan managers' actions. But that law doesn't cover state and local governments, so school administrators deduct 403(b) money from paychecks but aren't responsible for vetting the investments.

Returns on 403(b) plans often are eroded by fees that are double or triple 401(k) fees, and most penalize switching investments in the early years. Critics say the lack of regulatory and employer oversight makes them vulnerable to abuse.

Limited Oversight

Under Erisa, the Department of Labor oversees the activities of employers offering 401(k) plans, but has no responsibility for most 403(b) plans. Currently, the Internal Revenue Service sets rules for 403(b) plans, but the agency's focus is on whether plans adhere to tax laws. Though the majority of investments in 401(k) plans are overseen by the National Association of Securities Dealers and the Securities and Exchange Commission, that isn't the case for many offerings in 403(b) plans. In the end, oversight often falls to a loose patchwork of state laws.

"Hear no evil, see no evil, speak no evil -- those are the 403(b) regulators," says Dan Otter, a former Maryland teacher who runs a Web site called 403bwise.com¹ to help others navigate the plans.

The tax code has permitted 403(b) plans since 1958, long before corporate 401(k) plans began. For years, the only investments allowed were insurance products and even today, most 403(b) participants invest through an insurance company.

At colleges, the plans have long been dominated by giant money manager TIAA-CREF, which offers investments with lower fees than many other financial-services firms. Many hospitals have improved their 403(b) programs to make them more like 401(k) plans as they have cut back on traditional pensions. But public-school districts have made few changes to 403(b) plans. Unless they are required by regulators, district officials don't want the responsibilities that come with 401(k) plans. Teachers generally get most of their retirement money from pensions, but the extra 403(b) money is important because many pension plans are under strain and it can take decades to fully qualify for them.

Even as lawmakers debate revamping Social Security and expanding other retirement programs, 403(b) plans have attracted little attention in Washington. New York Attorney General Eliot Spitzer is investigating 403(b) plans, including whether district or union officials are improperly influenced by perks from the companies whose products they endorse. Several insurers and a union have been subpoenaed.

"We are very concerned" about 403(b) plans, says David Brown, head of Mr. Spitzer's investor-protection unit.

The IRS is considering rules to make 403(b) plans more like 401(k) plans, but the proposals do little to boost protections, beyond requiring written plan descriptions. One proposal would eliminate a feature that teachers consider a safety valve -- the ability to switch to investments that aren't part of their official plan. A Treasury Department official says that proposal is intended to help track 403(b) money to combat tax evasion.

Insurance companies that run 403(b) plans are resisting these changes and persuading school administrators to send the IRS letters opposing them. Administrators say they fear the proposals are a step toward giving them the same responsibilities as 401(k) employers. "It would be a burden," says Gary Zittergruen, superintendent of the Benton Community School District in rural Iowa.

The hands-off policy, however, has caused problems for districts that hired Horizon. Some have decided to replenish teachers' accounts with taxpayer funds, hoping insurance policies will cover the losses.

Bayport-Blue Point has declined to step in and reimburse its employees for the \$186,000 missing from their accounts. If insurers don't cover the losses, they'll be out of luck, says Marc Merklin, the court-appointed attorney overseeing the return of the remaining money.

The Long Island district and another district also served by Horizon in upstate New York face employee lawsuits alleging negligence. David Cohen, the Long Island district's lawyer, says the misappropriated funds caught administrators off-guard because initial complaints about the company from shortly after it was hired had been rectified.

An attorney for Harold Hopkins, Horizon's former chief executive, says his client denies misappropriating money. No charges have been filed; the investigation by state and federal regulators is continuing. Mr. Merklin says Horizon went out of business earlier this year.

While most 401(k) money is in mutual funds, roughly 80% of 403(b) cash is invested in insurance products, such as annuities. The rest is invested in mutual funds. Annuities pay fixed or variable rates of return upon retirement; heirs get the principal and any appreciation when the holder dies and are guaranteed at least the principal if the holder dies before retiring. Insurance companies invest money in fixed annuities as they see fit. With variable annuities, investors choose where to put their money from a menu of mutual funds, and future payments are based on how the funds do.

Because they come with guaranteed pre-retirement death benefits, variable annuities cost more than investing in mutual funds directly -- and as a result can reduce returns by tens of thousands of dollars over an investor's lifetime.

Selling in School

These investments are pitched by insurance salesmen who are allowed to wander schoolhouse halls. Salesmen can earn twice as much selling high-cost annuities as they can selling mutual funds. Sales contests featuring luxury cruises, trips to Hawaii or other prizes provide added incentives. Generally, such contests are forbidden by NASD rules in the mutual-fund industry.

Some salesmen are teachers, which can help win potential clients' trust. From 1974 to 2003, James Bogart taught in the San Diego Unified School District, most recently as a part-time gym teacher. Despite a district policy against soliciting co-workers for business, he began selling 403(b) investments to fellow teachers for Linsco/Private Ledger Corp. in 1987. Mr. Bogart says he didn't solicit teachers during work hours and doesn't believe he violated the policy.

Mr. Bogart agreed this year to a \$7,000 settlement to resolve allegations that he made improper, repeated trades in a married couple's 403(b) accounts, moving the teachers' money from mutual funds to a fixed annuity and then to a variable annuity, NASD records show. The switches generated additional commissions for him and fees that reduced the teachers' returns. Mr. Bogart says his clients knew how much they were paying and still made money on their investments.

Some districts screen vendors but not based on investment criteria. "We don't have any controls over what the agent might say to someone in their living room," says Cynthia Simpson, benefits coordinator for Fairfax County

Public Schools in Virginia. That district picked seven companies based on their ability to handle accounts for its 30,000 employees and to comply with rules applying to all contractors.

Teachers say they are sometimes left with the impression that certain investments have the district's stamp of approval. At Amherst Regional High School west of Boston, a company printed information about its plan on the same green paper used for formal school-district announcements.

"I've been trusting the county to look out for my interests," says Christina Straight, an elementary-school teacher in Montgomery County, Md., where quarterly statements carry her school district's name.

Betty DuBose, a 64-year-old Grand Rapids, Mich., teacher, says an agent told her that the district had approved a switch to a different annuity. Ms. DuBose says she expressed concerns about whether she would have access to her money. The agent, she says, told her there "were no strings attached." She agreed to the switch.

However, the district had not approved anything regarding her account. The new annuity actually carried substantially higher fees and effectively tied up her money until she's 74. Ms. DuBose complained to the company and got most of her money back.

In North Carolina, teachers received fliers saying their district had "approved" an annuity into which teachers placed pretax money during the year so they could draw summer paychecks. "The interest plus the tax savings on your summer pay is your POT OF GOLD," the marketing materials said. The fine print told a different story: The annuity paid interest of about 5% a year. The summer pay, which was actually a loan, had to be repaid to the annuity account during the school year at 8% interest -- with half the interest going to the company. In effect, most of the annuity's interest came from teachers' own pockets in the early years. (By contrast, when people take loans from a 401(k), all the interest goes back into the borrower's own account.)

The policies, sold by New Orleans-based Teachers Retirement Services, now a unit of **Allstate Corp.**, are the subject of a Louisiana state court lawsuit by teachers in that state. The teachers contend that they were misled about how the plans worked. Lawyers for Teachers Retirement Services and Allstate say participants were fully informed and saw their accounts grow. "The teachers are winners in this," says salesman John Hazard, who created the accounts.

Union endorsements can help sell 403(b) investments. The unions say they aren't paid for endorsements, but there are other potential conflicts.

AIG Valic, part of **American International Group Inc.**, for years rented office space from a union based in Chula Vista, Calif., which had endorsed the company. In Georgia, AIG Valic gave \$15,000 to the charitable foundation of a state teachers union that had endorsed it. Both unions denied any quid pro quo. An AIG Valic spokesman says endorsements "are based on the quality of service," not "indirect or direct compensation."

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