

IS IT TIME TO RE-EXAMINE WHAT IT
MEANS TO FULFILL YOUR 401(K) FIDUCIARY
RESPONSIBILITIES?

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“If you are not at the table, you are on the table.”
Serbian Proverb

“ERISA, and the regulations under it, are often lamentably obscure—to describe them as a tangled web does not due them justice.”

Judge Mark R. Kravitz¹

Risk management should be the mantra of all 401(k) fiduciaries. After all, fiduciaries, especially of large plans, are caught in the midst of a battle. The warring factions are sponsors, disgruntled participants, Congress, and other policy making divisions of the federal government. The prize for which these combatants and their allies are struggling is the most influence in defining what it means “to do right by” the average 401(k) participant.

Issues raised in the lawsuits filed by Schlichter, Bogard & Denton

The lawsuits filed in September 2006 by Schlichter, Bogard & Denton started the fireworks. Their two most troubling allegations are:

- The fees paid by participants are excessive;
- The fiduciaries neither understand why the fees are being charged nor how they are split (relative to both services rendered and who provided them).

These allegations, by their very nature, raise at least four other questions:

- How should value be defined, and should a significant component of value include effectiveness in eliciting behavior that is beneficial to participants (e.g., increasing contributions or signing-up for a professionally managed investment option)? After all, a fee is excessive only if the payer does not receive adequate value for it.
- Can a competitively priced fee still be excessive or even unnecessary?

¹ Judge Kravitz is the United States District Court Judge in *Amara v. Cigna* that will be discussed later in this paper.

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(The significance of the above two questions has taken on even more importance in light of an issue the judge raised in *Tussey v. ABB*². In this case, the defendants argued that the case should be dismissed because they made all the disclosures required by ERISA and the Department of Labor's regulations and that ERISA §404(c) immunizes them from any claimed fiduciary breaches arising from the participants' investment decisions.

Judge Laughrey wrote:

“When a Plan participant chooses an investment with a higher expense ratio, it is logical to assume that the participant thought he or she was getting some benefit in return for the fund's higher overhead. The participant's choice might change if he or she knew that the additional expense was going to the Plan's fiduciary in exchange for choosing that investment company... Thus, where such revenue sharing agreements are not disclosed, a reasonable fact finder could conclude that losses to the Plan as a result of revenue sharing were not caused by the Plan participant who was ignorant of the revenue sharing arrangement when he or she chose their investment” [pp. 6-7].

Behavioral economics provides a firm foundation for the judge's decision. Research has found that people assume that higher priced goods and services offer much more value than lower priced ones.³

- Is it prudent for fiduciaries to rely on their providers' explanations of fair value and what fiduciary responsibility entails? After all, a provider's business model and/or technology may not be in sync with how fiduciaries view their responsibilities or what their responsibilities really are.

(The significance of this question should not be underestimated. The fact is, as Fidelity has pointed out in its *Building Futures VIII*, the 401(k) industry's efforts to get participants to seriously embrace retirement planning is not succeeding [as measured by its Retirement Income Indicator⁴]. Class action lawyers will surely ask: “What is the industry doing wrong and why are fiduciaries still using approaches that aren't working?”)

- If fiduciaries can't provide in-depth answers to the above questions, is it likely that they can demonstrate they have implemented a prudent process for running their 401(k) plan and are acting exclusively in the best interests of the participants?

The issues raised in these lawsuits have serious and wide-reaching implications for the retirement services industry. Less than a month after the lawsuits were filed, Nevin E. Adams, the editor-in-chief of *PLANSPONSOR* magazine, wrote that it would be unwise

² Ronald C. Tussey, et al. v. ABB, Inc., et al., Case No. 06-04305-CV-NKL (Document 209).

³ Dan Ariely, *Predictably Irrational*, Chapter Ten, “The Power of Price”, Harper, 2008.

⁴ Fidelity's *Building Futures VIII*, 2007, p.114.

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to dismiss these cases as the work of “some hack firm trying to make a name for itself...It is clear, however, that a lot of practices this industry has too long taken for granted are now going to be subjected to a fresh — and harsh — degree of scrutiny.”⁵

More lawsuits, other troubling questions

McTigue & Porter, another plaintiffs’ law firm, takes the pursuit of value to a much higher level. In their lawsuit against Citigroup⁶, they bluntly ask: Why use actively managed funds when index funds (with much lower expense ratios) can provide similar returns? If the returns can be shown to be comparable (just as good, just as bad, or just as unpredictable), at least for Citigroup’s investment options, these plaintiffs’ attorneys argue that actively managed funds were chosen solely to generate fees for Citigroup.

The Citigroup case creates two additional problems for fiduciaries (not to mention the threat to the profit margins of most providers). First, fiduciaries will now likely be forced to face the active versus passive management debate head-on. Lest anyone think this issue can easily be dismissed (thanks to the use of investment consultants), they should read both Michael Lewis’ article, “The Evolution of An Investor”⁷ and John Bogle’s latest attack on actively managed funds⁸. (Lewis has authored many books, including *Liar’s Poker* and *Money Ball*.)

Perhaps the bigger problem for fiduciaries is McTigue & Porter’s focus on a conflict of interest issue. The conflict of interest in the Citigroup lawsuit (as well as in their lawsuit against Wells Fargo⁹) applies to the few sponsors who are in the asset management and recordkeeping business. Unfortunately, as discussed below, many other things can be construed as conflicts of interest.

Rethinking the meaning of “solely in the interest of” participants

By endorsing the value and importance of autopilot programs (i.e., sanctioning them in The Pension Protection Act of 2006), Congress has (implicitly) concluded that many, if not most, rank and file employees need help in achieving retirement security. If Congress, in spite of being embroiled in partisan politics, can recognize this reality, the obvious question is: Why haven’t 401(k) fiduciaries come to this same conclusion and routinely used autopilot programs, quick enrollments, gap analyses, and targeted communication pieces that are designed to change participant behavior? After all, fiduciaries presumably attend industry conferences (or at least get a thorough briefing by those who do) and thus should be up-to-date on current research in behavioral finance and 401(k) participant behavior.

One possible explanation for the apparent inaction is that fiduciaries (feel pressure to) place much greater value on keeping their employees happy than on telling them the

⁵ Nevin E. Adams, IMHO:”Best” Cases? Plansponsor.com October 2,2006.

⁶ Leber v Citigroup, U.S. District Court, Southern District of New York, Case 1:07-cv-09329-SHS

⁷ Michael Lewis, “The Evolution of An Investor”, Conde Nast Portfolio, December 2006, p.176.

⁸ John C. Bogle, The Little Book of Common Sense Investing, John Wiley & Sons, Inc. New York, 2007, p. 198.

⁹ Gipson v Wells Fargo et al., Case 1:07-cv-01970-JDB

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truth. In this case, the truth is that getting the most out of a 401(k) plan (i.e., achieving retirement security) involves “pain” (sacrificing immediate gratification for financial security years into the future).

Keeping employees happy (or at least minimizing their discontent) has become a critical issue in *Amara v. CIGNA*¹⁰. Although this case involves the conversion of a traditional defined benefit plan to a cash balance plan, the communication issues raised in the judge’s Memorandum of Decision should set off warning bells in the minds of all 401(k) fiduciaries.

While concluding that the conversion was done correctly, the judge went on to say that:

“CIGNA’s summary plan descriptions and other materials were inadequate under ERISA and in some instances downright misleading.” (p.3)

“For the problem lies not with the volume of information CIGNA chose to provide, but rather with some of the statements made in CIGNA’s disclosures, which the Court finds were not written in a manner calculated to be understood by the average plan participant and which failed to include important details regarding the transition to Part B that reasonable employees would have wanted to know.” (p.82)

“CIGNA employees suffered from the lack of accurate information in CIGNA’s disclosures, and CIGNA was aware of this fact.” (p.83).

The judge’s comments, coupled with the Pension Protection Act and the increased sophistication of class action attorneys, should make fiduciaries rethink the entire 401(k) communication process, and in particular, whether or not additional information should be included in summary plan descriptions and how professionally managed accounts should be described. Issues that need to be re-examined include:

- How complete must the information included in a 401(k) summary plan description (SPD) be?
- How should concepts such as future value, present value, and uncertainty versus probability be presented “in a manner calculated to be understood by the average plan participant, taking into account factors such as the level of comprehension and education of typical participants in the plan and the complexity of the items”?¹¹
- How should fiduciaries communicate that a 401(k) plan is nothing more than a tax-advantaged tool that must be used wisely, and the first step in using it wisely is for the

¹⁰ Janice C. Amara v. CIGNA Corporation and CIGNA Pension Plan, Case 3:01-cv-02361-MRK (Document 269).

¹¹ 29CFR2520.102-3 contents of SPD.

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participant to make adequate contributions since he will most likely have to fund most (especially when post-retirement health care needs are considered), if not all, of his retirement nest egg?

- Since it is unreasonable to assume that the average participant understands either how much retirement income he will need or how much he should save^{12,13} should a personalized gap analysis be included with, or made part of, the summary plan description that each participant receives?
- When an autopilot program is implemented, should all participants receive a personalized gap analysis that compares the projected retirement incomes generated by the default contribution rate and a suggested contribution rate based upon a targeted replacement ratio?
- How should fiduciaries manage participant expectations when professionally managed accounts are introduced? What expectations are generated by the term “professionally managed” or when participants are told that a Noble Prize winner is the founder of the firm or if they contribute at a certain level, they have an 80% chance of achieving their retirement income goals?

The 2007 Top Five Total Rewards Priorities survey¹⁴ supports the view that the desire to minimize employee discontent is widespread and reflects how 401(k) plans are presented. This survey found that having an apparently attractive benefit program is a top corporate priority but that ensuring their employees can actually retire comfortably is not.

For example, 59% of the benefits/human resource personnel who completed the survey said that their number one personal priority is being able to have a financially secure retirement. 75% also reported that their companies place having an attractive benefit program as their number two corporate priority. However, only 25% of the respondents reported that actually enabling employees to have a financially secure retirement is among their firm’s top five priorities.

Recognizing a changing reality

The above questions set the stage for upcoming legal battles. The recent Supreme Court decision in *LaRue v DeWolff*¹⁵ highlighted the reality that defining (or, to use the terminology of behavioral economics, anchoring) 401(k) fiduciary responsibilities in the framework of the defined benefit pension world is a very bad idea. The Justices made it perfectly clear that fiduciary breaches that result to losses to an individual participant’s account are losses to the plan and lawsuits may be used to make the participant whole.

¹² *National Assessment of Adult Literacy, 2003*, U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics shows that the average American has limited math capabilities.

¹³ The 2007 Retirement Confidence Survey 2007, Employee Benefits Research Institute discusses these issues in depth.

¹⁴ This study was undertaken by Deloitte and ISCEBS.

¹⁵ *LaRue v DeWolff et al.*, Case No. 06-856, October term 2007.

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Future court decisions will spell out what 401(k) fiduciary responsibilities really encompass. Are these responsibilities limited to just selecting and/or monitoring the recordkeeper, investment options, fees, and changes in the law? Or does fulfilling one's fiduciary responsibility require actually helping employees achieve a financially secure retirement?

Some would call this latter interpretation "paternalistic". Others would argue that this interpretation simply recognizes that the United States faces an educational and retirement crisis^{16,17} and that judicial decisions¹⁸ and legislative actions reflect reality (both economic and political) as it is and not how we wish it would be.

(Reports such as *Tough Choices or Tough Times*¹⁹ and *Are They Really Ready To Work?*²⁰ simply add "fuel to the fire". These reports address the question: "How can the United States continue to compete in a global economy if the entering workforce is made up of high school graduates who lack the skills they need, and of college graduates who are mostly 'adequate' rather than 'excellent'?"²¹

"If employees are ill prepared to earn a living in today's world, shouldn't fiduciaries incorporate this fact into plan design, the types of services and communications the providers deliver, and how plan utilization is monitored?" will surely be asked by plaintiff's attorneys just as policy makers are asking now.)

If the first (laizze faire) interpretation turns out to be the "correct" one, it will be the employees' responsibility (and theirs alone) to decide whether or not they want to enroll in the plan and, assuming they do, determine how much they should contribute, and then create the asset allocation that is most appropriate for them or seek help in doing it. Whether or not the average employee has the knowledge and skill set required to ascertain his income needs and develop a funding strategy that will accomplish his goals will be deemed irrelevant. Likewise, if sponsors are saddled with a workforce that can't afford to retire, those problems will be the sponsors' and not the fiduciaries'. (Employers should keep in mind that the average worker has not been adequately funding his 401(k) account.^{22,23,24})

¹⁶ Much of the relevant research on this topic can be found at <http://timss.bc.edu>.

¹⁷ For an interesting discussion on these subjects, see Alan Greenspan, *The Age of Turbulence*, The Penguin Press, New York, 2007, chapters 21 and 22.

¹⁸ For an excellent discussion of the legal process, see Sandra Day O'Connor, *The Majesty of the Law*, Random House, New York, 2004.

¹⁹ *Tough Choices or Tough Times: The Report of the New Commission on the Skills of the American Workforce*, National Center on Education and the Economy, December, 2006.

²⁰ *Are They Really Ready to Work? Employers' Perspectives on the Basic Knowledge and Applied Skills of New Entrants to the 21st Century U.S. Workforce*, A consortium of The Conference Board, Corporate Voices for Working Families, Partnership for 21st Century Skills, and Society for Human Resource Management, October, 2006.

²¹ *Ibid*, p. 7.

²² Roger Ibbotson, James Xiong, Robert P. Kreitler, Charles F. Kreitler; and Peng Chen, "National Savings Rates Guidelines for Individuals", *Journal of Financial Planning*, April 2007.

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Alternatively, if fiduciaries are required to consider their employees' actual behavior, capabilities and limitations, the Pension Protection Act provides them with an excellent starting place. Recent technical breakthroughs can provide fiduciaries with retirement readiness assessments for their plan as a whole as well as by individual participant groupings. The ability to segment employees also enables fiduciaries to deliver the relevant messages to each employee segment, thus maximizing the likelihood of getting employees to help themselves.

There is also a "treasure chest" of research²⁵ that can help fiduciaries enhance their 401(k) plans' value, such as by increasing participation²⁶, account growth²⁷, and making communications easier to understand^{28,29}. The work cited in the last two footnotes is especially important because it shows how poorly designed descriptions (e.g., prospectuses) and forms can confuse even the most educated participants (Wharton MBA and Harvard College students and University of Chicago finance and economic professors).

Like most things in life, nothing is black and white, and the legal battles will likely go on for some time.³⁰ In the meantime, fiduciaries are now forced to ask themselves whether or not it is prudent to ignore research findings that, if applied wisely, could increase the likelihood that their employees will achieve financially secure retirements. Perhaps even more important than their conclusion may be the fiduciaries' abilities to document the process they used in arriving at their decision.

²³ Jonathan Skinner, "Are You Sure You're Saving Enough For Retirement", National Bureau of Economic Research, WP 12981, March 2007.

²⁴ Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, "Is There Really A Retirement Savings Crisis? An NRRI Analysis", Center for Retirement Research at Boston College, August 2007, Number 7-11.

²⁵ Examples of such research can be found on the websites of Center for Retirement Research at Boston College, Pension Research Council, National Bureau of Economic Research, and Michigan Retirement Research Center.

²⁶ James Choi, D. Laibson, B.C. Madrian, and A. Metrick, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance", in James Poterba, ed., *Tax Policy and the Economy*, Vol. 16, MIT Press, 2002.

²⁷ Gary R. Mottola and Stephen P. Utkus, "Red, Yellow, and Green: A Taxonomy of 401(k) Portfolio Choices", Pension Research Council, WP2007-14, June 2007.

²⁸ Shlomo Benartzi and Richard H. Thaler, "Heuristics and Biases in Retirement Savings Behavior", *Journal of Economic Perspectives*, Summer 2007, Vol. 21.3, pp. 81-104.

²⁹ James J. Choi, David Laibson, and Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds", NBER Digest, July 2006.

³⁰ If anyone doubts this, visit www.erisa-fraud.com, the website of Keller Rohrback, a well-respected class action lawfirm.