Fiduciary Focus: The Night of the Living Dead Retirement Plan Participants

by W. Scott Simon | 05-01-08

ERISA section 404(a)(1)(A) states that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."

The foregoing, one of the most basic fiduciary duties of plan sponsors under ERISA, requires them to identify and understand plan expenses so that they can determine whether they're reasonable. As the U.S. Department of Labor notes, plan sponsors must "ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided." (See "A Look at 401(k) Plan Fees," Aug. 3, 2007.) This duty obviously requires some degree of specificity in matching fees paid to service providers and other expenses of the plan to the products and services they are supposed to pay for. In addition, ERISA section 404(a)(1)(D) requires, as a matter of retirement plan qualification, that a plan be operated in accordance with the terms of its plan documents (but only, of course, to the extent that such terms don't conflict with ERISA). If products and services provided and charged to a plan are not required by the terms of the plan or are otherwise unreasonable in cost, then the plan can be disqualified, resulting in taxation of plan assets.

The Great Disconnect in the ERISA Statutory Scheme

A highly disturbing fact is that many plan sponsors fail to discharge their ERISA section 404(a)(1)(A) duties because they don't know about--much less understand--the total economic impact that the hodgepodge of both "visible" costs (e.g., the annual expense ratio of mutual funds) and "invisible" costs (e.g., the bid-ask spreads of mutual funds) can have on the account balances of the participants in the plans provided to them by the sponsors. This failure is caused by a gaping "disconnect" in the ERISA statutory scheme: non-fiduciary plan providers have no duty to disclose the total economic impact that these costs can have on plan participants to fiduciary plan sponsors who, as noted, have the duty to identify and understand such costs with some specificity.

This great disconnect creates a crazy situation which is akin to allowing plan provider inmates to run the asylum even though plan sponsor wardens clearly have that responsibility--not to mention personal liability for any failures to meet that responsibility. The disconnect of allowing non-fiduciary inmates to control fiduciary wardens creates two immediate problems, both of which could have long-term consequences for American society.

The first problem is that many plan participants (and their beneficiaries) have way too much money needlessly deducted from their retirement plan accounts which, as sure as the morning follows the evening, will net them far less money for retirement. The end result of that could well be millions of retired participants with plan balances in the five figures and decades of life expectancy ahead of them wandering America like the zombies in "The Night of the Living Dead." Do we, as a nation, really want to keep allowing the kind of public policy that could lead to such a spectacle?

The second problem is that many plan sponsors are placed in needless legal jeopardy because they cannot carry out one of their basic ERISA fiduciaries, which is to conduct a meaningful analysis of the total economic impact that visible and invisible costs have on the account balances of the participants in the plans they sponsor. This impact is often unnecessarily far too great in cases where plan providers present plan sponsors with plans riddled with high and hidden costs. Under the current system, many plan sponsors are, in effect, unwittingly held hostage by, and are therefore at the mercy of, those that provide products and services to the plans they sponsor. Some of these providers, primarily insurance companies and mutual fund companies, show up over and over alongside plan sponsors as codefendants in lawsuits involving accusations of retirement plans associated with high and hidden costs. That fact surely isn't going to change in the foreseeable future.

Current Attempts to Bridge the Disconnect

H.R. 3185, now winding its way through the House of Representatives, is a legislative attempt to correct the great disconnect in the ERISA statutory scheme that I have described. The Department of Labor, in its regulatory attempt to bridge this disconnect, held a "Hearing on Reasonable Contracts or Arrangements Under Section 408(b)(2) - Fee Disclosure" on March 31 and April 1.

The title of that hearing literally demands that plan providers provide plan sponsors with a full and fair disclosure of fees; after all, that's the only way sponsors can determine whether the contracts or arrangements they have with plan providers are reasonable. If plan sponsors cannot make that determination, then they have not prudently discharged their duties to plan participants and their beneficiaries, and that failure can harm them. Basic ERISA law outright forbids such outcomes.

The Dark Side Likes the Disconnect Just Fine

There are, of course, many groups that have little interest in seeing H.R. 3185 become law or in having the Department of Labor enact any meaningful regulations. These groups, comprised of many insurance companies, mutual fund companies and others benefit directly from keeping plan sponsors in the dark about the total economic impact that the plans they provide to sponsors have on plan participant account balances. Depending on the outcome of this tremendous legislative and regulatory fight, hundreds of billions of dollars will end up either in the pockets of these groups or in the account balances of plan participants.

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A Conversation with a Fiduciary

The head of one such group typifies how they regard plan participants and their ability to understand the myriad of costs inherent in their plans: "We don't want to give [participants in retirement plans] information [about the total economic impact of visible and invisible costs] that they can't handle.to explain how all these fee structures work to them I think is really beyond the [retirement plan] system." (Remember what the insurance company vice president cited in this column last July said: "I'm afraid the revenue-sharing would just confuse people." Is it possible that these two are reading from the same talking points? Nah.)

Plan participants may miss the subtlety of this person's point so he provides a helpful analogy to keep it simple for these country bumpkins.uh, plan participants: "It's like a person who buys a car. They want to know what the price of the car is. They don't want to know what the price of the engine is, what the price of the front door handle is. What they want to know is what's the total cost."

This person has analogized the total cost of purchasing a car to the total costs borne by participants in retirement plans such as 401(k) plans. This analogy, which appears to be somewhat imprecise (why of course we don't want to know the cost of each component of a car but we certainly want to know the car's "sticker" price), is often tossed out to the media by those that have no interest in letting the unwashed (e.g., dumb plan participants) know about the total economic impact that the plans they provide to plan sponsors have on the account balances of the unwashed. Many of the components that comprise this impact are filched from the pockets of the unwashed (e.g., real flesh-and-blood plan participants) in the dark of night.

Perhaps a more precise analogy would be: what we need to know are the cost components involved in financing a car (akin to invisible investment costs) plus the sticker price of the car (akin to visible investment costs)--not the cost of each component of the car--so that we can know the total cost of the car (invisible and visible investment costs) and therefore know whether to purchase it. So, yes, I'm in agreement with this person when he says: "What they want to know is what's the total cost."

The big problem with all this, of course, is that many insurance companies, mutual fund companies and others follow business models that profit from the scandalous obfuscation of the cost components of retirement plans so there's simply no way to know "what's the total cost" unless, of course, an intrepid plan sponsor hires, say, a moonlighting FBI forensic accountant to ferret them out. Those following these models actively promote such obfuscation, despite their lame (there's really no other word for it) denials.

Bridging the Disconnect With a Simple Yet Comprehensive Cost Matrix
Matt Hutcheson, a well-known independent fiduciary, testified last month at the Department of Labor hearing, noted previously. He proposed, among other things, that plan providers provide plan sponsors with a simple yet comprehensive gross-to-net cost matrix which standardizes disclosure across all kinds of investment products. This matrix shows gross returns and then net returns with the difference being costs, which can then be broken down into visible (e.g., an annual expense ratio) and invisible (e.g., bid-ask spreads) costs. The cost matrix also benchmarks against performance.

Two vitally important goals are accomplished through use of this matrix. Not only can the total costs of a plan be measured accurately (based on readily available data already compiled by plan record-keepers; those trying to spook legislators and regulators by whining about the need to build "costly" and "burdensome" new data-gathering and generating systems should therefore be ignored), but any opportunity costs that might have been lost can also be known. This is a simple and very effective solution to bridging the disconnect--which, of course, is why those with an interest in preserving that disconnect don't like it.

With this kind of cost matrix in place, those entities such as a well-known life insurance company profiled earlier this year in the media would be forced to acknowledge that the total economic impact on plan participants in a plan they service is about three times what they claimed initially, once both visible and invisible costs are taken into account. (For those who want to see this as well as a whole lot of people who have no idea how much they're paying for their retirement plans, tune in to Bloomberg TV on May 8)

There are, of course, those that say invisible costs such as bid-ask spreads and market impact costs are not hidden at all because their impact is netted out and reflected in the performance of a fund. That kind of assertion is valid only if gross returns are known so that they can be compared to net returns for analysis in a proper context. Hutcheson's cost matrix does this nicely and will reveal the presence of cost-efficient or cost-inefficient (and those in between) retirement programs.

This approach is much more sensible than eye-balling a net return and having no idea how cost-efficiently it was arrived at. Hutcheson's cost matrix also has the advantage of keeping retirement plan decision-makers focused on costs, which can be controlled, rather than eye-balling returns which are uncontrollable since they're nothing more than random variables subject to uncertainty (indeed, nobody on this Earth can know--fer sure, fer sure--what the price of a particular asset class, mutual fund or individual stock will be one year or one month from now, much less one week from now).

A plan provider focused on the extraordinary importance of the total economic impact that visible and invisible costs can have on the account balances of plan participants brings far, far greater value to both plan participants and plan sponsors than many, many of those that comprise the current crop of providers. This kind of provider can make available to a plan sponsor (and, in turn, to plan participants) a high quality, institutional level retirement plan that features sophisticated, broadly diversified model portfolios

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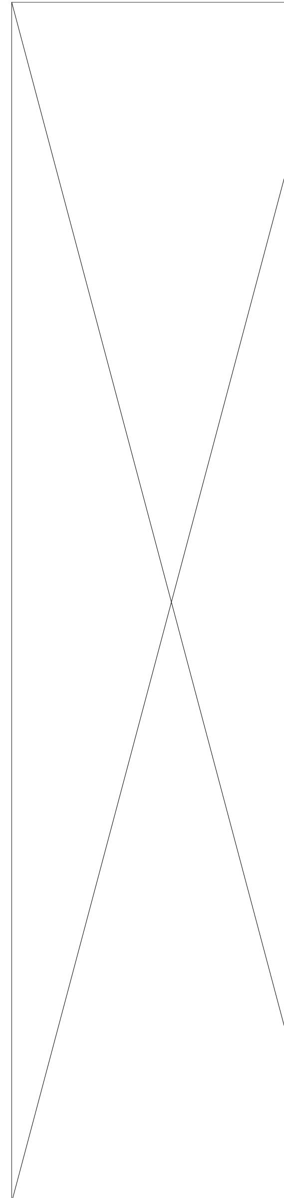

with a total economic impact on participants of 1% or less (and a slightly higher impact for plans with $10 million or less) per year. The all-too-common alternatives provided by the dark side are low quality, retail level retirement plans featuring an unhealthy smorgasbord of poorly diversified investment option leftovers with a total economic impact on participants of 3%-4% (or even 5%) per year. That seemingly small 2%-3% (or even 4%) annual differential--which demonstrates to us yet again that investing is a game of inches, not of yards--can mean a very comfortable retirement or one spent wandering around like a zombie in some bad movie.

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W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

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