# 401(k) Fiduciary Responsibility: Conventional Wisdom and the Law of Unexpected Consequences

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*There was only one place to make money in the mutual fund business, as there is only one place for a temperate man to be in a saloon: behind the bar and not in front of it. And I invested in… [a] management company.*

—Nobel Laureate Paul Samuelson[1]

*It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.*

—Mark Twain

**Background**

For almost 30 years, conventional wisdom has maintained that 401(k) fiduciaries can easily fulfill their duties of loyalty and prudence by (1) hiring a competitively priced recordkeeper that routinely deals with plans of their size, (2) using a well-respected investment consultant to advise on selecting and monitoring "competitively" priced investment options, and (3) complying with the letter (as distinct from the spirit) of the law. Conventional wisdom also assumed that employees are rational adults who are fully willing and capable (educationally and financially) of tackling the challenges of achieving a financially secure retirement. Unfortunately, conventional wisdom, more often than not, reflects what we wish to believe rather than fact.

Studies have shown that the average employee has neither embraced (emotionally[2] or through participation and adequate contributions[3]) retirement planning nor is he educationally equipped to do so.[4] It is for these reasons that Congress, based on findings of behavioral finance (that employees must be "nudged")[5], incorporated autopilot programs into the Pension Protection Act of 2006.

The recent dismal performance of so many target date funds (especially those targeting retirement in 2010) only added more "fuel to the fire". Congress, the DOL, and the SEC are now delving further into the construction of these funds, the conflicts of interest that are inherent in them, the lack of transparency surrounding them, and how the value of these funds is communicated to participants.[6] Thanks to the financial press and a myriad of lawsuits over excessive/unnecessary fees and revenue sharing, Congress is also exploring whether mutual fund companies and investment advisory firms are riddled by conflicts of interest and a lack of transparency.

The *coupe de grace*, however, is taking place in the courts (including the Supreme Court) where judges must do what Congress didn't: (1) *legislate*[7,8]the meaning of fiduciary responsibility, (2) set standards for evaluating when fees reflect free market competition or are merely by-products of industry-wide "incestuous" relationships, and (3) determine whether a fee, just because it is "competitively" priced, is reasonable and provides

adequate value for investors. The simple reality is that Congress, when it enacted §36(b) of the Investment Company Amendments Act of 1970 and, four years, later ERISA, "never provided a definition of that [fiduciary] duty, instead appearing content to abdicate the development of the scope and effect of the duty to the judiciary, and the federal courts have since attempted to fill that void."[9]

A recent article in *CFO Magazine* portrayed 401(k) plans as having been transformed from the "goose that laid the golden egg" to the "goose that has been cooked". The author also suggested that 401(k) fiduciaries take proactive steps, rather than waiting for changes in the law, to minimize the likelihood of successful lawsuits against them.[10]

**Proactive steps that fiduciaries should take to minimize successful breach of fiduciary lawsuits against them and the sponsor**

1. 401(k) fiduciaries must recognize that when ERISA was enacted, not only were 401(k) plans not even contemplated, no Congressman expected that a solely, or largely, employee funded arrangement would become America's primary corporate retirement program. Fiduciaries must also factor into their thinking that one of ERISA's primary purposes was to maximize the likelihood that workers would receive their earned retirement benefits. Thus, Congress imposed upon defined benefit plan sponsors minimum funding standards and a requirement to pay premiums to the Pension Benefit Guaranty Corporation.

   It is naïve for fiduciaries to assume that they can throw their 401(k) participants "to the wolves" just because sponsors do not have to fund, let alone guarantee, a benefit. Fiduciaries and sponsors must assume that when the courts legislate how the duties of loyalty and prudence should be implemented, they will look at "social or legislative facts" (such as empirical studies, social and psychological research, history, and current events) to evaluate what the fiduciaries did or did not do and the manner in which it was done[11].

2. 401(k) plans should be described as employer-provided tools which can help employees achieve their retirement goals rather than as retirement plans. To maximize the likelihood of achieving a financially secure retirement, employees must be shown a goal (a specified inflation-adjusted targeted replacement ratio), and the interrelationships among time (both pre- and post-retirement), contribution rates, and how their accounts' growth rates depend upon their asset allocations.

   Widely available and discussed research ("social or legislative facts") has shown that the average employee does not (and may not have the educational background to) understand the above issues; let alone how to apply them to his or her individual situation. ERISA requires, however, that employees receive all material information that they need to use the plan wisely and that "[a]ll such information shall be written 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".[12]

The fiduciary responsibility to communicate complicated concepts to an unsophisticated audience is not a trivial task. However, simple personalized illustrations weaved together into a short brochure is an inexpensive and effective way of presenting hard-to-understand concepts.

Employees must also be told that while the assumptions used in the illustrations seem to be reasonable (at least based upon history), the participants must realize that the future will likely be dramatically different. Thus, employees must be made to understand that monitoring their accounts is a “must” and that this responsibility is theirs and theirs alone. Perhaps the best way of getting this message across is to show employees how their account values and/or retirement income will change if interest rates or Social Security benefits decrease, they live longer than expected, or post-retirement health care needs are incorporated into the targeted replacement ratio.

3. Sponsors must “bite the bullet” and accept the fact that emphasizing that the 401(k) plan is only a tool (and not a pension with guaranteed benefits) might cause employee morale to suffer. However, if this is not done, the sponsors and fiduciaries are setting themselves up to be accused of misrepresenting the 401(k) program. While this misrepresentation might not lead to recoverable damages (as contrasted with excessive or unnecessary fees), it does help create the impression that the fiduciaries and sponsors were accustomed to misleading the employees. Such conduct could easily influence a judge[13] if a lawsuit is ever brought against them.

4. Effectively spending the fees the employees pay for running the plan is a fiduciary responsibility. As such, the sponsor must carefully monitor the effectiveness of their provider’s approach to achieving the desired employee behavior. Thus, sponsors must have a well thought out answer if a sharp plaintiffs’ attorney asks: “Ms. Sponsor, when the company’s money is at stake, such as when you want to do reduce your health insurance program’s cost, you incorporate the latest research from behavioral economics to change your employees’ behavior. However, it is blatantly apparent that this research is not reflected in your 401(k) communications materials. Why?”

5. Fiduciaries must rethink what it means to fulfill ERISA’s mandate of acting "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 the conduct of an enterprise of a like character and with like aims."[14]

6. The opinions in the Deere and Wal-Mart cases clearly show why fiduciaries must insist that their recordkeepers provide them with analyses that document that the fiduciaries are using (and have used) an evidence-based process for running the 401(k) plan. In dismissing the counts that the fees were excessive and unnecessary,

the judges did not pass judgment on the merits of the issues. Rather, dismissal occurred because the plaintiffs' attorneys did not tell a convincing story.

The judges were simply not convinced that the alleged fiduciary breaches probably occurred (their occurrence was not just merely possible but highly plausible—an invoking of the Twombly pleading standards[15]). Thus, fiduciaries should not interpret these dismissals as giving them a "green light" to rest easy and not worry about fee cases. After all, a closer look shows that the judges gave the plaintiffs' attorneys their "marching orders" — define the value proposition the participants should get for the fees they pay, show that it wasn't delivered and/or was delivered in an unsatisfactory manner and/or was delivered at an unreasonable cost, and then quantify the damages.

For a knowledgeable plaintiffs' attorney who can tell a good story, doing this is probably not all that difficult. After all, the attorney could show the judge what was given to the participants and then describe what should have been given if the fiduciaries' goal was to help their participants get on the road to a financially secure retirement (and, of course, helping employees achieve a financially secure retirement is a primary goal of ERISA).

For example, a plaintiffs' attorney could argue: "In any participant population, there are some employees who are not contributing up to the match, others who are entitled to the full match but whose contribution level is still not adequate to achieve retirement security based upon a specified set of assumptions, and other employees who are on-track to meet the targeted replacement ratio. Why hasn't the sponsor ever sent out communications that address the needs of each of these groups? Presumably the provider has the technology to identify the employees in each of these groups and then deliver the appropriate personalized communications to each employee. And by the way, if your provider can't do this, why are you still using that firm?"

7. To protect themselves as well as to fulfill their responsibilities to their employees, sponsors and fiduciaries should demand that their providers, at least annually, provide them with group retirement readiness assessments. These assessments should identify different employee segments, such as by age, and then show for each group:

   - current contribution rates versus suggested ones;
   - percent of employees who are on-track to achieve a financially secure retirement;
   - number of years withdrawals from the 401(k) nest egg, along with Social Security and other company benefits, will provide the targeted inflation adjusted income;

- how each segment is allocating its accounts.

Without such analyses, it will be difficult for the fiduciaries to demonstrate that they implemented a systematic process to: (1) provide participants with adequate value for the fees they pay; and (2) monitor their providers' performances, including critically evaluating the providers' recommendations. Unfortunately, fiduciaries often receive "tons" of data but little meaningful information.

For example, it does little for a sponsor or fiduciaries to know that the average contribution to the 401(k) plan is 4.9% and that to get on track the average participant should be contributing 15.8%. Information starts to become meaningful when the analyses shows that the average participant between 30 and 39 should be contributing 6.8% of pay rather than 4.5%, the current contribution rate, and participants between 50 and 59 should be investing at a rate of 28.1%, on average, rather than at the current rate of 5.0%. Likewise, knowing the distribution of contribution rates within each age group provides even more valuable information. After all, within any age group, the difference between the average (mean) and the median contribution rates can be considerable.[16]

8. A glaring mistake the plaintiffs' attorneys have made, but one which they must correct if the Twombly pleading standards are to met, is not to have pointed out that trying to pick actively managed funds that will do well in the future probably requires a lot of luck. The well-respected money manager Ted Aronson has observed that "under normal circumstances, it takes between 20 and 800 years [of monitoring performance] to statistically prove a money manager is skillful, not lucky".[17]

   Caltech's Leonard Mlodinow takes a different approach to asking whether a manager's performance is due to chance or skill. He compares the ability to identify top performing managers to flipping coins:

   > *Suppose 1,000 [people] had tossed a coin once a year starting in 1991…The chances that, after fifteen years, a particular coin tosser would have tossed all heads are then 1 in 32,768. But the chances that someone among the 1,000 who had started tossing coins in 1991 would have tossed all heads are much higher, about 3 percent.*[18]

   This means that there is a probability of about $(1/32{,}768)^{10}$ of a consultant being able to create an investment menu of ten funds that will perform well over a 15 year period. Even if the probability of selecting a "consistently good performing" manager would increase to 1 in 100, the probability of selecting a fund line-up of 10 good managers would still be pitifully small, $(1/100)^{10}$.

9. Given the difficulty in picking mutual funds whose returns reflect skill rather than simply luck or the popularity of an investment style or asset class, plaintiffs'

attorneys will likely argue that fiduciaries should concentrate on controlling what they can (reducing fees by using index funds) rather than on what they can't (increasing investment returns by trying to identify good active managers).

To make matters worse, good plaintiffs' attorneys will point out that "about 90 percent of the variability in the returns of a fund across time is explained by policy [asset allocation]…and on average about 100 percent of the return level is explained by the policy return level."[19] Little is to be gained, assuming it can even be done successfully, from trying to pick good performing active managers (assuming this research is correct). In any event, fiduciaries must be able to justify how they selected their investment consultants and evaluated the consultants' process for picking funds.

10. Target date funds are very appealing to both sponsors and participants. To sponsors, offering target date funds seems to be the ideal way of addressing the investment naïveté of participants. To participants, investment gurus, using fancy techniques like a Monte Carlo method to decide their accounts' allocations, relieves them of a task they don't want to (and most likely can't) address on their own.

    The recent disappointing performance of target-date funds, especially the 2010 ones, has turned them into ideal targets for plaintiffs' attorneys. The implosion of many of them has also pointed out the way in which their very sophistication has distorted everyone's (providers', investment advisors', fiduciaries', and participants') sense of reality.

    Fiduciaries must remember that even though Congress approved their use as a Qualified Default Investment Alternative, fiduciaries must still justify how they arrived at the termination date of the glide path and why they believe that modern portfolio theory, the foundation for arriving at the asset allocation of each target date fund's glide path , actually works in today's environment. Unfortunately, "black swan" (statistically unlikely, high impact) events and "Minsky moments" (times when a presumably stable economic environment unravels because developing, unappreciated risks finally "exploded") are common occurrences.

    Nassim N. Taleb and his coauthors have succinctly summarized this harsh reality:

    > *[The use of standard deviation] only means that, in a world of tame randomness, around two-thirds of changes should fall within certain limits (the -1 and +1 standard deviations) and that variations in excess of seven standard deviations are impossible. However, this is inapplicable in real life, where movements can exceed 10, 20, or even 30 standard deviations. Risk managers should avoid using methods and measures connected to standard deviations, such as regression models, R-squares, and betas…Anyone looking for a single number to represent risk is inviting disaster.*[20]

(Alas, the only thing a participant is interested in knowing is which, if any, of the thousands of simulations that are used will jibe with his schedule of contributions and withdrawals. This fact and the real purpose of using a Monte Carlo method have been forgotten. That purpose is to demonstrate that outcomes can vary dramatically. Predicting which outcome will jibe with a particular participant's life is way beyond the capabilities of the crystal ball of the fund's advisor.)

Fiduciaries must tread lightly in selecting and then communicating the value of target date funds to their participants. They should keep in mind the words (written back in 2004) of physicist turned financial "quant" Emanuel Derman:

> *Trained economists have never seen a first-class model…"[E]very financial axiom I've ever seen is demonstrably wrong…The real question is* ***how*** *wrong is the theory, and how useful is it regardless of its validity. Everything you read in any theoretical finance book, including this one, you must take with a grain of salt.*[21]

Earlier this year, Derman and mathematician turned "quant" Paul Wilmott wrote:

> *The truth is that there are no fundamental laws in finance. And even if there were, there is no way to run repeatable experiments to verify them…Financial markets are alive but a model, however beautiful, is an artifice. No matter how hard you try, you will not be able to breathe life into it. To confuse the model with the world is to embrace a future disaster driven by the belief that humans obey mathematical rules.*[22]

11. 401(k) fiduciaries may be facing their own Ides of March. With unemployment hovering just under 10 percent, monthly layoffs in the hundreds of thousands, and a jobless recovery anticipated, rounding-up countless laid-off workers to participate in breach of 401(k) breach of fiduciary duties lawsuits should be a fairly easy task. If anyone thinks this statement is an exaggeration, she should recall Ann Minch's recent highly effective *YouTube* rant over Bank of America increasing her credit card rate from 12.99 to 30 percent. After millions saw it on both *YouTube* and the national news, Bank of America was forced to back down.[23] Getting demoralized unemployed workers to sue should not be a difficult chore for any plaintiffs' law firm.

    To make matters worse, fiduciaries can no longer assume that "competitively" priced recordkeeping services represent genuine value to themselves and their participants. Congress and the DOL are exploring ways to insure that how fees are determined and the intricacies of revenue sharing arrangements see the "light of day". They want to take the burden of dissecting the providers' fee structures off the shoulders of fiduciaries and require that all providers make full and unambiguous fee disclosures and reveal possible conflicts of relationships.

In its current session, the Supreme Court will hear *Jones v. Harris Associates LP*[24], a case in which the Justices will interpret: (1) what fiduciary responsibility means under §36(b) of the Investment Company Act and (2) whether or not mutual fund fees are arrived at through realistic arms-length bargaining between the fund's board and its investment advisor. The significance of this case has been bluntly summarized by William Birdthistle:

> *[I]n significant portions of the U.S. retirement savings industry, the professionally incompetent appear to have routinely overcharged the financially unsophisticated.*[25]

Given all that has been written about the absence of most important mechanisms necessary to ensure effective governance in the mutual fund industry, it is truly amazing to understand how 401(k) fiduciaries were able to ignore this topic in their review of the fees the participants pay and the value they receive for them.[26]

**Final thought**

401(k) fiduciaries can no longer assume that the conventional wisdom regarding the duties of loyalty and prudence have much relevancy in today's world. In fact, it is probably wise for them to assume that the standards for evaluating fiduciary conduct are not static but rather a "work in progress".

Whether or not 401(k) plans should be corporate America's primary retirement plan is a critical issue, but it is not one that affects the fiduciaries' responsibilities. Thus, fiduciaries should heed the advice of General Stanley McChrystal, the commander of U.S. troops in Afghanistan:

> *You have to navigate from where you are and not from where you wish to be.*

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[1] Testimony given at *Mutual Fund Legislation of 1967: Hearing on S. 1659 Before the S. Comm. on Banking. and Currency*, 90th Cong. 353 (1967).
[2] ING's *Retirement Number Study*, www.ipsos-na.com/news/pressrelease.cfm?id=3823.
[3] "The average RII [Fidelity's Retirement Income Indicator] score for all active participants was 23% income replacement, far below the 40% suggested income replacement for defined contribution plan savings." Building Futures, Volume VIII, 2007, p. 114; Vanguard's How America Saves and EBRI's periodic analyses are good sources for participation and other plan utilization data.
[4] *2003 National Assessment of Adult Literacy*, U.S. Department of Education; Annamaria Lusardi, *Household Saving Behavior: The Role of Financial Literacy, Information, and Financial Education Programs*, NBER Working Paper 13824, 2008.
[5] See Richard H. Thaler and Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness, Yale University Press, 2008; Dan Ariely, Predictably Irrational: The Hidden Forces That Shape Our Decisions, HarperCollins, 2008.
[6] For an interesting discussion of this topic, see Marla Kreindler and Julie Stapel, *Target-date strategies: On the hot seat*, PIMCODCDialogue, August 2009.
[7] See Richard A Posner, How Judges Think, Harvard University Press, Cambridge, 2008.
[8] For a brief, but succinct discussion of courts legislating, see Jess Bravin, *High Court Agrees to Hear Gun-Rights Case*, Wall Street Journal, October 1,2009, A5.

[9] William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, p. 32, Electronic copy available at: http://ssrn.com/abstract=1412878.
[10] Lynn Brenner, *401(k)risis*, CFO Magazine, April, 2009.
[11] See Ellie Margolis, *Beyond Brandeis: Exploring the Uses of Non-legal Materials in Appellate Briefs*, University of San Francisco Law Review, Winter 2000.
[12] 29 CFR 2520.102-3 - Contents of summary plan description.
[13] For an example of this, see Louise Story, *Plain Talk From Judge Weighing Merrill Case*, Nytimes.com, August 24, 2009.
[14]ERISA Section 404(a)(1)(B).
[15] *Bell Atlantic Corp. v Twombly*, 550 U.S. 544, 127 S. Ct. 1955 (2007).
[16] For an excellent discussion of the pitfalls of relying on averages to make decisions, see Sam L. Savage, The Flaw of Averages: Why We Underestimate Risk in the Face of Uncertainty, John Wiley & Sons, Hoboken, 2009.
[17] quoted in John C. Bogle, The Little Book of Commonsense Investing, 2007, p.98.
[18] Leonard Mlodinow, The Drunkard's Walk: How Randomness Rules Our Lives, Random House, New York, 2008, p.181.
[19] Roger G. Ibbotson and Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90, 100 Percent of Performance?* Financial Analyst Journal, Jan/Feb 2000, Vol. 56, p. 26.
[20] Nassim N. Taleb, Daniel G. Goldstein, and Mark W. Spitznagel, *The Six Mistakes Executives Make in Risk Management*, Harvard Business Review, October 2009, p. 78.
[21] Emanuel Derman, My Life as a Quant: Reflections on Physics and Finance, John Wiley & Sons, Inc., Hoboken, 2004, pp.266-267.
[22] *The Financial Modelers' Manifesto* at http://www.wilmott.com/blogs/eman/index.cfm/2009/1/8/The-Financial-Modelers-Manifesto.
[23] Julianne Pepitone, *YouTube credit card rant gets results*, at http://money.cnn.com/2009/09/29/news/companies/youtube_bank_of_america.
[24] 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 77 U.S.L.W. 3281 (U.S. March 9, 2009).
[25] See endnote 8, p. 6.
[26] An excellent article on this subject is John Freeman, Stewart L. Brown, and Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence And A Fair Fiduciary Test*, Oklahoma Law Review, 61:83, 2008.