Fiduciary Duties Are A Matter of Facts and Circumstances, and Facts and Circumstances Have Changed Quite A Bit Since 1981

Author
Richard D. Glass

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I. Fiduciary duties are a matter of facts and circumstances, and "facts and circumstances" have changed quite a bit since the first 401(k) plan came into existence. By pointing out how facts and circumstances have changed (thanks to research in a variety of disciplines) since ERISA's inception, a skilled and knowledgeable plaintiffs' attorney could easily argue an excessive fee case that has an excellent chance of meeting the Twombly pleading standards. He could also make a good case that the decision in Hecker v. Deere rests more on Schlichter's poorly crafted arguments than on intelligently presented facts.

   A. A corollary to this legal reality is that whether or not a fiduciary fulfills his duties of loyalty, prudence, and disclosure are also matters of facts and circumstances.

      1. These duties will likely change and/or evolve over time as conditions change and the findings of relevant research get disseminated throughout the 401(k) community.

   B. Our understanding of how American workers approach retirement planning has come a long way since 401(k) plans were introduced in 1981.

      1. Extensive analysis has been done on how American workers are using, misusing, or simply not using their 401(k) plans (see Vanguard's *How America Saves* and EBRI's *Retirement Confidence Survey*).

      2. The concept of the 3-legged stool has gone by the wayside for most Americans. It has already become a 2-legged stool, and unless both Social Security and Medicare become adequately funded, the stool will be left with only one leg.

   C. We also know a lot more about the literacy levels—both verbal and math—of the average American worker.

      1. The average American is not very literate as determined by the U.S. Department of Education (*2003 National Assessment of Adult Literacy*).

      2. The average American lacks an understanding of basic financial topics and "does not plan for predictable events such as retirement or children's college education. Most importantly, people do not make provisions for unexpected events and emergencies, leaving themselves and the economy exposed to shocks" (Annamaria Lusardi, *Americans' Financial Capability*, Report Prepared for the Financial Crisis Inquiry Commission, February 26, 2010).

3. The Conference Board's 2006 report, *Are They Really Ready To Work?*, identifies the educational inadequacies of our country's workforce that will affect its ability to compete in a global economy. If people aren't educated enough to earn a living in today's world, there is little chance that they will be able to tackle the challenges of investment/retirement planning.

D. Conflicts of interest occur because the evolving needs of fiduciaries conflict with the business models of their lawyers, recordkeepers, and investment advisors.

1. Recordkeepers are concerned that:

    a. Documenting the extent to which the participants are using their 401(k), as well as how effectively they are using it, may give the impression—rightly or wrongly—that recordkeepers are not "earning their keep".

    b. To provide fiduciaries with the information they need to make informed decisions, their IT systems will require substantial and costly modifications and/or the analyses will have to be created manually.

2. The clients of large law firms consist of recordkeepers, consulting firms, and investment managers. The interests of these clients often conflict with each other (for examples of such likely conflicts, see Casey Quirk, *Target-Date Retirement Funds: The New Defined Contribution Battleground*, November 2009). Further, the business/profit models of these clients often conflict with the needs of participants and fiduciaries. Therefore, lawyers have to carefully analyze their options for dealing with these conflicts when providing advice to their clients.

    a. Investment Horizons' *Retirement Readiness Assessment*™ and targeted personalized communications can assist lawyers in framing potential conflicts in terms of solutions that circumvent and/or minimize the extent of these conflicts.

3. Investment managers—as well as fiduciaries and sponsors—don't like to address the fact that investing deals with uncertainty and not probability.

    a. Consistently identifying actively managed funds that have a high probability of outperforming low cost index funds is extremely difficult if not impossible.

    b. Target-date funds may sound much better than they actually are:

        (1). The losses of 2010 funds in 2008 shocked participants, fiduciaries, and the fund managers themselves.

(a). What risk management tools are the investment advisors incorporating into the target-date funds, and if they aren't implementing such tools, should they be?

(2). The use of modern portfolio theory (MPT) by highly regarded investment management firms can and often does lead to significantly different asset allocations for the same targeted retirement date, and fiduciaries must understand why this occurs.

(a). If stocks and bonds are projected to grow at 10% and 6% respectively, a portfolio of 50% stocks and 50% bonds should have a rate of return of 8%.

(b). If the projected growth rates of stocks and bonds fall to 8% and 4% respectively, a portfolio of 50% stocks and 50% bonds should have a rate of return of 6%.

(c). If advisor X uses the assumptions shown in *a* above and advisor Y uses the assumptions shown in *b* above, and if the goal is to create a portfolio with an expected return of 6%, advisor X's portfolio will be comprised of only bonds while advisor Y's portfolio will have equal amounts of both stocks and bonds.

(3). The efficient market hypothesis and the belief that stocks are safe long-term investments may reflect conventional wisdom that is founded much more on wishful thinking than on fact.

(4). Under non-stable economic conditions (such as those that exist in today's world), MPT appears to fall apart.

E. The reporting of the current recession—particularly the weaknesses in Wall Street's financial models, financial innovations that generated vast profits for the few while being detrimental to the many (high unemployment), inefficient regulators and regulations, and rating agencies "asleep at the switch"—have created on Main Street a distrust of Wall Street.

1. About two-thirds of Americans support stricter regulations on the way banks and other financial institutions conduct their business, according to a new Washington Post-ABC News poll (http://voices.washingtonpost.com/behind-the-numbers/2010/04/most_back_stricter_financial_r.html?wpisrc=nl_natlalert**)**.

2. Mutual fund scandals constantly appear and result in sizeable settlements, such as Schwab's recent $200 million settlement in a class action lawsuit over its YieldPlus fund (http://advisor.morningstar.com/articles/article.asp?docId=19201&email=ft0423A1).

F. Conflicts also arise due to the needs of sponsors to make their benefit programs look attractive versus the reality that 401(k) plans are not pension plans (in the defined benefit sense) but are simply tools for participants to use to create their own retirement nest eggs (see Deloitte's annual *401(k) Benchmarking Survey*).

G. Judges are forced to make law since the duties of loyalty, prudence, and disclosure are not spelled out in either ERISA or the regulations.

1. If Richard Posner and Elizabeth Warren are not all that far apart when it comes to what is happening to American society, just imagine how the judge that is trying your client's case will react to a well-thought-out complaint?

II. Wouldn't a "prudent expert" incorporate the above referenced facts and circumstances into his process for running the 401(k) plan?

A. What rationale, assuming there is one, could he use to justify not incorporating this knowledge into his process?

B. Didn't Congress, by incorporating auto-enrollment and QDIAs into the 2006 Pension Protection Act, endorse incorporating the findings of behavioral finance into plan design?

1. Could a skilled plaintiffs' attorney make a convincing argument that 401(k) plan design is a fiduciary, and not a settlor, function given that unsophisticated participants assume all the risk?

2. Even if 401(k) plan design is a settlor function, can that issue be avoided by the plaintiffs' attorneys by focusing on the duties of loyalty, prudence, and disclosure?

III. How can the fiduciaries demonstrate that the findings of the above mentioned research (as well as those of cognitive science, behavioral economics, and consumer behavior) are incorporated into their process for running the plan?

A. Employers should carefully define the value proposition they want their 401(k) plan to provide to their employees and then layout guidelines for their plan fiduciaries for delivering and monitoring that value proposition.

B. The ultimate value proposition should be to help their workers achieve for themselves a financially secure and comfortable retirement.

C. Helping does not mean guaranteeing a secure retirement.

D. Helping means making sure that participants get maximum value for the fees they pay:

1. carefully defining how each product and service is meant to help the participants achieve a specified replacement ratio;

2. thoroughly evaluating whether each product and service had its intended effect and if it didn't, attempting to understand what went "wrong";

3. assessing which demographic groups of employees are making real progress towards achieving the targeted replacement ratio and which groups are just "treading water" (or worse);

4. determining what other products and services should be considered so that more participants will be helped as well as what products and services should be dropped or replaced because of their ineffectiveness; and

5. using modern communication means, such as targeted personalized communications and effective graphics, and monitoring whether these communications had the impact they were intended to have.

IV. Does it make sense for fiduciaries to show their employees just how much they will have to save in order to achieve their retirement goals?

A. By not being candid with employees, do fiduciaries likely provide a smart, knowledgeable plaintiffs' attorney with the fodder he needs to make a convincing argument that the fiduciaries put their employer's interest above that of the participants?

1. Since typical 401(k) communications make retirement planning/investing appear easy, could the fiduciaries and their selected recordkeeper/ communications provider be held liable for misrepresenting the realities involved in achieving a financially secure retirement?

B. Are the participants interpreting some of the fiduciaries actions or inactions as implied advice?

1. Recent research has found that participants believe that the fiduciaries are giving them advice when they are defaulted into a QDIA (Michael J. Liersch and Craig R. M. McKenzie, *Can We Put Our Trust In Defaults*, Defined Contribution Insights, November/December 2009).

2. Other research suggests that investors don't heed the disclaimers in fund performance ads (Ahmed Taha, *SEC Issues Worthless Warnings on Fund Performance Ads*, Forbes.com, April 16, 2010).

3. Perhaps auto-enrolled participants will assume—incorrectly in most cases—that the default contribution rate (combined with those resulting from, if there is one, the auto-escalation schedule) is the appropriate rate at which they should be contributing unless the fiduciaries show them otherwise.

V. Why haven't fiduciaries and their recordkeepers been more candid (perhaps honest is a better term) with the participants?

A. There are several reasons for this lack of candor, including:

1. Fiduciaries are often concerned that when employees see how much they have to save to accumulate an adequate nest egg (using both conservative and aggressive assumptions), employee morale will suffer.

2. Maintaining employee morale is in large part a communications issue with which a recordkeeper's off-the-shelf products can't usually deal successfully.

3. Fiduciaries and their advisors also worry that if participants are told that professional investment management not only lacks precision but may totally miss its mark, employee morale will drop even further.

a. "Americans of all ages and income brackets continue to grow increasingly unhappy at work—a long-term trend that should be a red flag to employers, according to a report released today by The Conference Board…'The downward trend in job satisfaction could spell trouble for the overall engagement of U.S. employees and ultimately employee productivity,' adds Franco." (The Conference Board, *I Can't Get No...Job Satisfaction, That Is: America's Unhappy Workers*, Research Report #1459-09-RR January 2010)

4. To make matters worse, it is likely that the vast majority of fiduciaries believe that the combined effect of above points 1, 2 and 3 will likely cause many employees "to give up the ship" and not even bother trying to save for their retirement.

B. These are and should be legitimate concerns. However, it doesn't make sense for fiduciaries to "bury their heads in the sand". After all, the apparent failings of 401(k) plans continually appear in the press, and no rational fiduciary should feel comfortable with the press's framing of these issues for the participants.

1. Investment Horizons has the capabilities to target different demographic groups of employees with the appropriate personalized and customized communications.

VI. Since 401(k) plans are voluntarily offered by employers, doesn't that reduce and limit the fiduciaries' responsibilities?

A. Where in ERISA or the regulations does it say that because 401(k) plans are established on a voluntary basis, the duties of loyalty, prudence, and disclosure can be ignored or that their scope is curtailed? (Yes, ERISA Section 404(c) does provide some limits on fiduciary liability, but how far do those limits go? Further, how comfortable should plan sponsors and fiduciaries be that they are complying in all respects with 404(c), especially with regard to providing appropriate information so that participants can make informed choices?)

B. Aren't complete, accurate, and unbiased communications key components of the value proposition the fiduciaries and their advisors profess to deliver to the participants?

C. Does "following the herd"—using industry standards—offer the fiduciaries any protection?

1. The Supreme Court, in Jones v. Harris Associates, implied that it may not.

2. Years ago, it was shown that using industry standards as a benchmark was an easy way of avoiding both conflicts within the organization and the need to address issues in depth (Richard M. Cyert and James G. March, A Behavioral Theory of the Firm, Blackwell, Malden, 1963, pp. 164-169 that covers the quasi-resolution of conflict and uncertainty avoidance).

3. It is generally recognized that the contribution levels of most 401(k) participants will not generate a large enough nest egg to provide a comfortable and secure retirement. Does the fact that most participants are failing—despite participating in industry-standard 401(k) programs—excuse plan fiduciaries from any responsibility for that failure? Or do fiduciaries bear some responsibility to determine why their participants are failing and to take reasonable steps to address that failure?

4. Think about what inspired Congress to pass the "No Child Left Behind" legislation – the notion that the current state and local system of American public education was failing too many children, and that federal testing and standards were necessary in order to address these shortcomings. If employers and plan fiduciaries continue to ignore the systemic failure of the typical 401(k) plan to provide adequate retirement savings for employees, isn't it only a matter of time before Congress, the agencies and/or the federal courts impose their version of "No Participant Left Behind"?