

401(k) Fiduciary Responsibilities

Conventional Wisdom Is No Longer Conventional...Or Wisdom

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Executive Summary

Thanks to the media-driven perception that Wall Street created the global financial crisis, top executives and senior management teams at essentially all large corporations are in everyone's "rifle sights". After all, no one seems to know what "fiduciary responsibility" means or to whom it is owed. Ignoring these questions will be costly mistakes since the values of "stakeholder" or "democratic" capitalism will most likely replace (or dramatically affect the interpretation of) Milton Friedman's "supercapitalism" as the benchmark for judging the conduct of CEOs and their close subordinates.¹

Given the anger that exists over executive bonuses and the fact that ERISA is ambiguous as to the definitions of the duties of "loyalty" and "prudence", blindly accepting conventional wisdom while waiting for the courts to decide how far fiduciaries have to go in helping employees achieve a financially secure retirement will likely prove to be a costly and painful mistake. Investment Horizons' Plan Utilization Analysis, including its Retirement Readiness Assessment, is the tool that makes it relatively easy for fiduciaries to reevaluate how effectively they and their providers have tackled this task.

*"The [American] financial system is seen as having collapsed; and the regulatory framework, as having spectacularly failed to curb widespread abuses and corruption...[A]s Chinese Vice Premier Wang Qishan said more diplomatically, 'The teachers now have some problems.'"*²

—Roger C. Altman

*"Gullibility and greed caused this latest calamity, but what allowed those basic human traits to combine to such catastrophic effect was a legal and institutional framework that resulted from deliberate policy actions."*³

—John Cassidy

*"Because in a bull market, when you borrow and bet \$30 for every \$1 you have in capital, as many firms did, you can do mind-bogglingly well...you can easily persuade yourself that you're just balancing risk and reward—when what you're really doing is betting the firm."*⁴

—Henry Blodget

The Changing Environment

*"You don't know what you don't know,
If you don't know what you don't know."*
—Anonymous

Investment Horizons' 401(k) Plan Utilization Analysis, including its Retirement Readiness Assessment of your employees, is the risk management tool that fiduciaries need in these turbulent times. The harsh realities of today's post-Wall Street meltdown environment are:

- The viability of 401(k) plans (as they are currently structured) as corporate America's primary retirement program is seriously being questioned. Alicia Munnell, director of Boston College's Center for Retirement Research, puts it quite bluntly:

*"The 401(k) system...has failed. As a major source of retirement income, it has shown itself unreliable—a point the financial crisis has driven home."*⁵

- Intense scrutiny will be given to how fiduciaries and providers communicate the benefits of these plans and the employee's role in achieving them. As George Soros puts it, the "financial structure we used to take for granted has collapsed".⁶
- Judges, when determining whether the fiduciaries adequately fulfilled the duty of loyalty and implemented a prudent process for running their 401(k) plan, will likely factor in the social and economic ramifications of their decisions. Policy makers in Washington will do likewise.⁷

No one should be surprised at Congress's and the public's demands for increased transparency and accountability that our Plan Utilization Analysis provides. The litigation surrounding revenue sharing clearly demonstrates that "claiming [as 401(k) providers do] to be transparent is not the same as actually being transparent."⁸

Fiduciaries need transparency to manage the new and evolving risks they face. After all, rapidly sinking 401(k) values are occurring simultaneously with massive layoffs and never-ending press coverage documenting, in the words of Noble laureate Paul Krugman, "a crisis whose only real precedent is the Great Depression" and that the current economic pandemonium is a product of "a runaway financial industry"⁹.

Add to this financial mess the facts that 5 million Americans have no health insurance, Social Security and Medicare benefits will likely be reduced, and there may be 5,000 home foreclosures per day in 2009¹⁰, it should surprise no one that plaintiffs' attorneys are having an easy time finding angry laid-off workers eager to participate in 401(k) and other employment-related lawsuits.¹¹

Managing the expectations of a company's remaining employees is also a serious challenge that fiduciaries and sponsors cannot afford to ignore. Workers now understand

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that 401(k) plans are not pensions (in the traditional sense) but rather tools to be used in funding their own retirement security.

Today, all workers realize that they bear 100% of the risks in achieving retirement security and achieving that goal is expensive and requires much luck. Thus, it is imperative for sponsors and fiduciaries to make sure that:

- the expectations of the remaining employees are realistic;
- there is no let-up in monitoring the “public relations” task of managing employee expectations because participants want one thing—certainty—even though there is none in a world of constantly changing financial and economic interrelationships;
- they keep in mind that sometimes not saying something is just as problematic as saying too much.

Investment Horizons’ Plan Utilization Analysis focuses on how good (or bad, as suggested by Fidelity’s Retirement Income Indicator¹²) a job the fiduciaries and the providers have done at getting employees to take retirement planning seriously. The Plan Utilization Analysis:

- shows how the participants are using, misusing, or simply not using their plan;
- projects the number of years withdrawals from the retiree’s 401(k) nest egg, along with Social Security and a pension benefit (if there is one), will provide the targeted inflation-adjusted income;
- enables the fiduciaries to identify and prioritize issues that need to be addressed if participant expectations are to be managed successfully;
- **establishes a baseline** for where different employee segments are on their road to retirement security, **thus enabling fiduciaries to document why they took the actions they did as well as the effectiveness of those actions;**
- **enables fiduciaries to evaluate** both the effectiveness and objectivity of **their recordkeeper’s recommendations** as well as the value participants receive from using target date funds, managed accounts, and advisory services.

If you feel that you don’t need this information because you have fulfilled all the fiduciary responsibilities as understood by conventional wisdom, recall what the “R”, “I” and “S” stand for in ERISA—Retirement Income Security. Given that conventional wisdom led to the downfall of well-respected firms like Bear Stearns, Lehman Brothers, Washington Mutual, and Merrill Lynch, the undoing of investment banking, and the government’s bailout (and possible nationalization) of the banking industry, is it prudent to put much faith in conventional thinking going forward?

Rita Gunther McGrath of Columbia's Business School succinctly answers this question and points out the need to implement new fiduciary risk management techniques:

*“Virtually everyone reading this blog will be involved with businesses whose fundamental assumptions were created in a radically different economic era... **When uncertainty goes up, the benefits of checking and re-checking fundamental assumptions...increase dramatically.**”¹³*

If you think that conventional wisdom will provide protection for past fiduciary decisions, the words of Judge Mark R. Kravitz should make you reevaluate that hope:

“ERISA, and the regulations under it, are often lamentably obscure—to describe them as a tangled web does not do them justice.”¹⁴

Unfortunately for fiduciaries and fortunately for plaintiffs' attorneys, as Judge Richard A. Posner has pointed out, there is no certainty when it comes to pension law:

“One is led to wonder how the legalist can regard case law [which includes pension law], though it is the bulk of American law, as law at all. How can he defend the overruling of a precedent[?]...If the precedent just doesn't conform to modern conditions, its overruling is a legislative act.”¹⁵

Investment Horizons' Plan Utilization Analysis enables you to view the plan from the vantage point of participants (which is likely the vantage point both Congress and the courts will take going forward). Without such a perspective, you will neither be able to manage participant expectations nor evaluate for yourself whether you are fulfilling ERISA's goal of helping employees achieve “RIS”—Retirement Income Security. It may also be difficult to argue that you were acting solely in the interests of the participants if you have not analyzed the plan from their perspective.

Conventional Wisdom: Where Did It Come From and Is It Still Applicable Today?

“Certitude is not the test of certainty. We have been cocksure of many things that were not so.”

—Oliver Wendell Holmes, Jr.

“The enemy of the conventional wisdom is not ideas but the march of events.”

—John Kenneth Galbraith

“Where the law is silent or unclear the judge must decide the case as if he were a legislator, still sounds strange to us, even after a century of demonstration...that this is what in fact happens daily in our courts.”

—Julius Stone

Before the fall of 2006, with a few notable exceptions such as Enron and other company stock-drop cases, 401(k) fiduciary responsibilities focused primarily on:

- hiring a well-respected, competitively-priced recordkeeper that targeted plans comparable in size to that of plan under consideration;
- selecting and monitoring investment options;
- complying with the letter of the law and regulations;
- documenting the overall decision making process (as defined by conventional wisdom).

There were seven primary reasons why other issues received “benign neglect”:

1. Fiduciaries wanted to believe that conventional wisdom’s definition of their fiduciary responsibilities accurately reflected ERISA’s mandates. Conventional wisdom came about in the early 1980s, was framed from the perspective of “supercapitalism”, and has not changed much since then. What has changed, however, is the role of 401(k) plans (from supplemental to the primary program) and what we know about how the average American approaches retirement/investment planning and uses 401(k) plans.
2. Fiduciaries and their advisors thought that plan design was a settlor function and not a fiduciary one. Thus, the fiduciaries judged their fiduciary performance and the performances of their providers by comparing their plan’s statistics to those of other companies’ plans. Ascertaining whether their employees would be able to achieve retirement security was not considered a fiduciary responsibility.

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In fact, since salaries and contribution rates are not necessary for the recordkeeping function, recordkeeping systems were not designed to store these data points. Without these two data points, it is impossible for providers to perform retirement readiness assessments.

3. Under ERISA Section 404(c), fiduciaries are not responsible for the investment losses incurred by participants if (among other requirements) individual participants are given responsibility for choosing their own investments. In 2006, the Pension Protection Act expanded Section 404(c) protection to cover fiduciaries when participants are defaulted into a Qualified Deferred Investment Alternative (QDIA).

Fiduciaries, however, are still responsible for:

- prudently selecting the plan's investment options and fiduciary advisors;
 - ensuring that participants are getting adequate value for the fees they pay;
 - providing participants with sufficient information to make informed investment decisions.¹⁶
4. Americans like to believe that they are rugged, self-reliant individuals, if not outright entrepreneurs. As Congressman John Boehner declared recently, "Most Americans feel that if they work hard, they will get ahead."¹⁷

A corollary of Congressman Boehner's philosophy became incorporated into conventional wisdom: the average worker does not want, nor does he need, to be told when to save, how much to save, and where to save for his retirement. Thus, the employee was assumed to know whether participating in a 401(k) plan was necessary or even desirable.

Unfortunately, research in behavioral economics, consumer buying behavior, and cognitive science, much of which is readily available to the general public, has shown that most of us have a track record of not acting in our own best interests, including not planning for retirement in a well thought-out manner.^{18,19} Professor McGrath "hit the nail on its head" recently when she commented:

"The smartest behavioral economists in the world run credit card companies. I've always believed that. If you ever wanted absolute proof that the 'rational actor' model of economic behavior is completely unrealistic, you need look no further than the way the credit card industry makes money. They understand exactly how to get people to spend money (often, money they haven't got) and extract the highest possible amount of profit out of their customers."²⁰

To make matters worse, the 2003 National Assessment of Adult Literacy strongly suggests that the average worker lacks the skill set to successfully manage his 401(k) account.²¹ This U.S. Department of Education study found that only 31% of

college educated employees and only 5% of Americans with only a high school education could perform each of the following tasks:

- compare viewpoints in 2 editorials, or
- interpret a table about blood pressure, age and physical activity, or
- calculate the cost per ounce of food items.

To fulfill the duties of loyalty and prudence, fiduciaries must ask themselves what type of communications will enable employees with very limited skill sets to make informed decisions while, at the same time, not making them feel that saving for retirement is a hopeless endeavor. Fiduciaries must also keep in mind that ERISA provides rather difficult to meet, and often ignored, guidelines for communications:

“All 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... Inaccurate, incomprehensible or misleading explanatory material will fail to meet the requirements of this section.”²²

Selecting replacement ratios illustrates how challenging the communications process can be. Conventional wisdom says it should be about 80% of pre-retirement income adjusted for inflation. Fidelity uses 85% in calculating its Retirement Income Indicator (see footnote 12). Hewitt uses a much higher value, 126%, to reflect money for post-retirement health care costs.²³ Neither value factors in the likely reductions in Social Security benefits. This wide range of recommendations makes it apparent that how you communicate the selection of an appropriate replacement ratio to employees is certainly not a trivial task.

If fiduciaries find that they aren't satisfied with their current communications, they must change them and/or, if they find that the communication issues are really a reflection of problems with plan design, reevaluate their plan's choice architecture (plan design).²⁴ Regardless of what they decide, they should incorporate into their decision making process the findings of behavioral economics and related disciplines.

In any event, fiduciaries must monitor the effectiveness of their own ideas as well as those of their providers. **Investment Horizons' Retirement Readiness Assessment and related analyses are crucial quantitative tools for determining what's working and what isn't. These tools also allow fiduciaries to ask “what if” questions, such as what are the effects on contribution rates of changing values for replacement ratios and/or pre- and/or post-retirement investment growth rates? Without such capabilities, it is difficult, perhaps even impossible, to manage participant expectations in a volatile environment.**

5. Americans bought into the idea that if they invested their savings in stocks and adopted a long-term perspective, the stock market would take care of them.²⁵ Today, more and more people are questioning this basic assumption. Further, whether long term meant retirement age or life expectancy or joint life expectancy was not defined. The distinction between creating the retirement nest egg and consuming it was blurred.

Now, outliving one's savings is a hot topic that fiduciaries are being forced to address. The ability to modify assumptions in creating Retirement Readiness Assessments, as discussed above, provides fiduciaries with another "arrow in their quiver" to address how this problem can be communicated.

As fiduciaries evaluate their processes for running their plans and communicating investment issues to participants, fiduciaries should recall the words of Noble prize-winning economist Friedrich Hayek:

"The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

6. **Fiduciaries have assumed that providers are their partners and that providers would act as if they were co-fiduciaries. The litigation over revenue sharing and fee levels should make fiduciaries realize that this is a dangerous assumption to make.** Prudence requires fiduciaries to take a "buyer beware" attitude.

Fiduciaries have to assume that providers are functioning within the constraints of their business and profit models. These models are based on what was acceptable in the past and are not necessarily relevant, let alone appropriate, for today.

For example, target date funds were developed with only the best intentions in mind. The mutual fund industry describes them as a "simple, yet sophisticated retirement solution".

"Target date] funds rely on sophisticated asset allocation using real-time path and Monte Carlo models to simulate probable returns based on historical asset class data from 1960 to the present."²⁶

Since the economic structure of today's world is quite different from what it was during most of the past century, fiduciaries have to decide whether or not it is prudent to use models based on historical data, even though they are founded on modern portfolio theory. Regardless of which models are used, fiduciaries must monitor their performance

to make sure that they are living up to expectations. The fiduciaries must also address the communication challenges that the reliance on historical data presents, namely, making sure that the communications are written in a way that is accurate and not misleading.

Fiduciaries should also reevaluate whether assuming that the analyses the provider gives them is all that they need is a safe bet to make.

7. Breaching a fiduciary duty is one thing. Quantifying the damages to participants that result from that breach is quite another. If participants and their counsel are unable to quantify the damages, a successful lawsuit is out of the question.

Conventional wisdom maintains that, unless a criminal act had been committed, quantifying damages is difficult. Not only are there no guaranteed benefits in 401(k) plans, there are also no well-defined or industry accepted standards, against which to measure damages. Thus, damages were considered to be much more of a theoretical issue rather than a practical one that required risk management.

In the fall of 2006, the well-respected plaintiffs' law firm of Schlichter Bogard and Denton launched a wave of lawsuits against the fiduciaries and sponsors of large 401(k) plans. These class action lawsuits focused on excessive and unnecessary fees, inadequate disclosure of fees to participants, and (implicitly) the definition and quantification of value. The importance of these lawsuits is that they show that damages are easily quantifiable.

Other class-action law firms have joined the fray, and the accusations in their lawsuits go beyond revenue sharing and include self-dealing and the use of actively, rather than passively, managed investment options.²⁷ **As in Schlichter's cases, the purported damages are large and easy to calculate. Thus, conventional wisdom's perspective on calculating damages is "off the mark".**

Blindly following conventional wisdom is no longer an acceptable, let alone wise, strategy for running a 401(k) plan. It is simply not prudent and will likely lead to costly, both in time and money, mistakes. The best strategy for any 401(k) fiduciary to take is grounded in evidence-based decision making with the goals of helping employees to:

- understand that their retirement can't be financed with a credit card;
- get or stay engaged in their retirement planning;
- make adequate contributions to their retirement plan;
- recognize that they must accept and deal with uncertainty and that past assumptions, including contribution levels and asset allocations, will likely have to be revised.

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Investment Horizons' Plan Utilization Analysis, with its Retirement Readiness Assessment and employee segmentation capabilities, is the cost-effective tool that will help 401(k) fiduciaries formulate their prudent strategy, monitor, and then modify it as needed. Our targeted personalized reports can also be used to implement the strategy.

¹ For an interesting discussion of this topic, see Robert B. Reich, Supercapitalism: The Transformation of Business, Democracy, and Everyday Life, Vintage Books, New York, 2007.

² Roger C. Altman, *The Great Crash, 2008: A Geopolitical Setback for the West*, Foreign Affairs, January/February 2009.

³ John Cassidy, *Bailing Out*, The New Yorker, September 29, 2008.

⁴ Henry Blodget, *Why Wall Street Always Blows It*, Atlantic Monthly, December 2008.

⁵ Anne Tergesen, *How to Fix 401(k)s*, Wall Street Journal, December 13-14, 2008.

⁶ David Serchuk, *Davos: Soros And Solutions*, Forbes.com, January 29, 2009.

⁷ Kate Phillips, *Obama, Dodd Slam Wall St. Bonuses*, Nytimes.com, January 29, 2009.

⁸ Warren Bennis, Daniel Goleman, and James O'Toole, Transparency: How Leaders Create a Culture of Candor, Jossey-Bass, 2008, p.2.

⁹ Paul Krugman, *Stuck in the Muddle*, nytimes.com, January 23, 2009.

¹⁰ Linda J. Bilmes and Joseph E. Stiglitz, *The \$10 Trillion Hangover: Paying the price for eight years of Bush*, Harpers, January 2009, p.31.

¹¹ Jonathan D. Glater, *Layoffs Herald a Heyday for Employee Lawsuits*, Nytimes.com, January 31, 2009.

¹² "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.

¹³ Blog of September 26, 2008 at <http://ritamcgrath.com/blog>.

¹⁴ Janice C. Amara v CIGNA Corporation and CIGNA Pension Plan.

¹⁵ Richard A. Posner, How Judges Think, Harvard University Press, 2008, p.83.

¹⁶ 29 C.F.R. § 2550.404c-1(b)(i), (ii).

¹⁷ John Boehner, NBC's "Meet the Press", January 24, 2009.

¹⁸ For entertaining discussions of this topic, see Dan Ariely, Predictably Irrational: The Hidden Forces That Shape Our Decisions, HarperCollins, 2008 and Martin Lindstrom, Buyology: Truth and Lies About Why We Buy, Doubleday, New York, 2008.

¹⁹ Fidelity's Building Futures, Vanguard's How America Saves, ING's Retirement Number Study, and EBRI's Retirement Confidence Surveys illustrate how the average American approaches retirement/investment planning.

²⁰ Blog of December 16, 2008.

²¹ 2003 National Assessment of Adult Literacy, U.S. Department of Education

²² 29 CFR 2520.102-3 - Contents of summary plan description.

²³ *Total Retirement Income at Large Companies: The Real Deal 2008*, Hewitt Associates.

²⁴ For an interesting discussion of this topic, see Richard H. Thaler and Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness, Yale University Press 2008.

²⁵ For an interesting discussion on this and other topics, see William Wolman and Anne Colamosca, The Great 401(k) Hoax, Perseus, 2002.

²⁶ Taken from a 2006 brochure from Vanguard.

²⁷ Jeremy Braden v. Wal-Mart Stores, Inc. et. al. No. 6:08-cv-3109-GAF; Leber v Citigroup, Case 1:07-cv-09329-SHS; Gipson v Wells Fargo et al., Case 1:07-cv-01970-JDB.