

The Perfect Storm is Brewing for 401(k) Fiduciaries

The gorilla study illustrates two important facts about our minds: we can be blind to the obvious, and we are also blind to our blindness.

—Daniel Kahneman, 2002 Noble Prize Winner in Economics

A perfect storm is brewing in the world of 401(k) fiduciary risk management, and fiduciaries and plan sponsors who do not carefully plot a course forward now risk being sunk. The elements of this storm are:

- **The evolving standard for measuring whether or not fiduciaries are fulfilling their duties is how well the plan is helping participants make progress toward achieving a financially secure retirement.**

From the participant's perspective (and ERISA demands that the 401(k) plan be run for the exclusive benefit of the participants), the goal—the value proposition—of any 401(k) plan is to help them achieve a financially secure retirement. In fact, the primary duty of a 401(k) fiduciary is to ensure that the fees the participants pay for the plan are efficiently used to further this objective—to ensure the participants are getting good value for the fees they pay. If fiduciaries don't monitor how their participants' retirement readiness (overall and by various employee segments) changes over time, can they convincingly argue that they are fulfilling their duties of loyalty and prudence (both procedural and substantive)?

- **Helping fiduciaries understand the value participants are getting for the fees they pay often conflicts with the profit models of plan providers.**

Fiduciaries frequently make the mistake of relying on their providers to monitor themselves—to evaluate whether or not their so-called leading edge products and services actually deliver as promised. Aside from the obvious issue of allowing the fox to guard the henhouse, most providers have never developed the technology required to assess retirement readiness and thus do not and can not include such an assessment as part of the reports they provide to fiduciaries. Thus, most providers' reports leave fiduciaries in the dark as to whether or not the plan is providing participants with good value for the fees they pay. Can your fiduciaries document that your providers' reports provide them with all the information they need to prudently manage the plan?

- **Outside ERISA counsel often have conflicts of interest.**

Fiduciaries cannot rely on their ERISA counsel to make them aware of the issues they face either. Most large law firms with substantial ERISA practices represent sponsors, fiduciaries, and providers simultaneously. Since legal fees are coming under ever intensifying scrutiny, these firms are feeling extreme pressure to minimize fees and to keep all their clients happy (by not rocking the boat and not forcefully challenging—possibly even trying to justify—their clients' business decisions). Thus, it is naïve to expect outside counsel to proactively raise issues with one client that will not only rock the boat, but will irritate other large clients. Does your ERISA counsel proactively address what you need to know and do to fulfill your fiduciary obligation of ensuring that the participants are getting adequate value for the fees they pay? How often does your ERISA counsel raise questions that you've never thought of or never got around to asking? Do you know how many providers your ERISA counsel represents?

- **Target-date funds, managed accounts, and auto-pilot programs are coming under intense scrutiny.**

With the passage of the Pension Protection Act, many sponsors implemented auto-pilot programs and/or added target-date funds and managed accounts to their investment line-up. However, a blind reliance on these tools—ignoring the following realities—will create serious problems for plan sponsors and fiduciaries (not to mention participants): 2010 target-date funds imploded in 2008; target-date funds (regardless of target date) had near zero returns in 2011; the weaknesses of Modern Portfolio Theory have been highlighted by both academics and practitioners; the increasing recognition that all the evidence shows that claiming to possess the expertise needed to make long-term forecasts—as required for constructing the glide paths of target-date funds—is tantamount to selling an “illusion of validity”; and the realization that most auto-enrollment contribution rates are far below the rate most participants should be contributing.

These tools certainly can be useful, but participant expectations regarding both their use and value must be managed in a well-thought-out manner (which is seldom done). Do your participant communications explain the limitations of professional investment management? Are participants provided with gap analyses that show whether or not the default contribution rate is likely to be sufficient to allow them to accumulate an adequate retirement nest-egg?

- **The goals of the sponsor often conflict with the goals of the participants.**

Many surveys have shown that employers want their employees to view the 401(k) plan as a valuable benefit and are hesitant to make participants aware that making sufficient contributions is the most likely determinant of whether or not they will achieve retirement security. After all, how many participants would view the 401(k) plan as a valuable benefit if they felt they had to contribute 15% or more of their pay to the plan and even then they would still be left at the mercy of the unforgiving capital markets. If fiduciaries don't address these issues, can they convincingly argue that they are fulfilling their duties of loyalty and disclosure or that they are running the plan for the exclusive benefit of their participants? Perhaps the fiduciaries are running the plan for the benefit of their employer?

- **The use of social media can enable disgruntled employees and plaintiffs' attorneys to initiate litigation.**

The power of social media to rally together unhappy campers and enable them to reverse corporate decisions has been amply demonstrated recently—Netflix (price increases), Bank of America (debit card fee), and Verizon (convenience fee). Plan sponsors and fiduciaries must accept the reality that disgruntled 401(k) participants can exploit the power of social media and must take steps to manage participant expectations. To do this, however, requires understanding whether or not the 401(k) plan is actually helping participants to retire comfortably. Do your fiduciaries know the answer to this question?

- **Thanks to the new fee disclosure regulations, employees will be able to judge for themselves how good a value their 401(k) plan is.**

Fee disclosure will make it easy for participants to understand the costs of participating in the 401(k) plan and to compare their funds' fees and performances with those touted in the popular press. If participants feel that the benefits of 401(k) participation have been greatly exaggerated or that the challenges of achieving retirement security have been sugarcoated, they will likely air their gripes on social media. Such an airing will increase the chances of litigation. In addition, fee disclosure will pressure providers to lower fees, resulting in reductions in both the quality and type of their services while simultaneously increasing the number of unhappy campers.