Justifying 401(k) Fees: A Challenge for Fiduciaries

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Certitude is not the test of certainty.

—Oliver Wendell Holmes[i]

When legalist methods of judicial decision making fall short, judges draw on beliefs and intuitions that may have a political hue…in legalistically indeterminate cases because the judicial imperative is to decide cases, with reasonable dispatch, as best one can.

—Richard A. Posner [ii]

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[iii]

Underlying the current spate of lawsuits over 401(k) fiduciary misconduct (particularly fee levels, revenue sharing, self-dealing, and active versus passive management) is a simple question: Are participants getting their money's worth for the fees they pay? That seemingly simple question gives rise to a multitude of other questions which are anything but simple.

Conventional wisdom considers the cornerstone of fiduciary responsibility to be the selection and monitoring of actively managed funds. If active management's value proposition is found to be on "shaky grounds", then fiduciaries will have to redefine the 401(k) plan's overall value proposition to participants. Even if the value proposition of active management passes with "flying colors" (and there is much evidence to conclude that selecting consistently "good" performing active managers without the benefit of 20/20 hindsight is fraught with problems), it will still be prudent for fiduciaries to reevaluate how their 401(k) plan is designed and then communicated to employees. After all, what good are the best funds when participants' accounts are "bare cupboards"?

The following brief discussion is an exploration of the issues involved, including the sponsor's goal of having the 401(k) plan viewed as a valued benefit, and highlights the need to expand the components of a 401(k) plan's overall value proposition to participants.

I. What standards should fiduciaries use to determine if fees are excessive or even necessary?

(When ERISA was enacted, defined benefit plans dominated the private pension system. In such an environment, there was no need for Congress to address fee levels since all fees and other expenses are paid by the sponsor rather than the participants. With 401(k) plans, the reverse occurs. Most, if not all of the fees, are paid by the participants.

A. If fund performance is a criterion, the standards used to select funds must have a high accuracy rate for predicting a fund's future performance.

1. Do such standards exist?

"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."[iv]

(The above example was used in a discussion of whether the performance of Legg Mason's highly touted manager, Bill Miller, was due to skill or luck.)

2. If selecting actively managed funds is a "crap shoot", then aren't the fees charged for these funds that exceed those of low-cost indexes excessive?

B. If it is not possible to predict a fund's future performance, can the bundled provider's overall value proposition to both fiduciaries and participants be used to justify the fees charged?

1. If active management cannot predictably and consistently provide greater returns than indexing, and index funds of all types are widely available, most, if not all, of a provider's value proposition must lie someplace other than in the choice of investment options.

2. Would using an unbundled TPA rather than a bundled arrangement provide much greater value for both participants?

3. How should "overall value proposition" be defined given:

i. Inadequate contribution rates:

"Starting at 3 percent and escalating to 6 percent is probably too low. It's a good start, but we need more education to help people understand that this isn't even a floor. It's a basement, and they should move up to a higher target saving rate."[v]

"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."[vi]

ii. Complexity of defining expected post-retirement needs:

"General rules of thumb have been developed using studies that fail to reflect two key components of retirement needs: inflation and increases in medical costs. After adjusting for these factors, projected needs are significantly above traditional targets of 70% to 90% replacement. In fact, the average projected postretirement income replacement need within the study population is 126% of final pay, although it varies significantly by individual based on age, income, and savings rate."[vii]

iii. Failure of the average worker to embrace retirement planning[viii]:

"Four in ten adults (42%) say that they do not like thinking about how much they will need for retirement, and nearly as many (39%) say that it is boring."[ix]

iv. Inability of the average worker to take on the challenges of retirement planning:

"Most Americans are woefully illiterate financially".[x] The average worker lacks the educational skill set and training needed to create and monitor his account's asset allocation.[xi]

Most of the evidence suggests that traditional financial education has, at best, a modest effect on savings.[xii]

II. Does ERISA provide clear-cut guidelines as to how 401(k) fiduciaries should fulfill their duties of loyalty and prudence? After all, the fulfillment of these duties should create a benchmark by which fiduciaries could judge the overall proposition the provider is delivering.

A. ERISA does not provide such guidance:

"How well does ERISA's structure fit 401(k) plans? Not very well, as 401(k) plans have few of the features that ERISA was drafted to protect: no long-term promise, no lifelong retirement income, no government insurance, no central pool of assets, no required employer contributions. These plans are really just investment programs, not pension plans."[xiii]

B. In spite of this fact (point A above), fiduciaries still must decide, and then be able to justify, how they will fulfill these two ERISA mandates.

1. A good beginning would be to extrapolate Congress's desire to protect both workers and taxpayers from fiduciary misconduct:

   "ERISA designates employers as the focal point of its regulatory scheme for two major reasons: (1) to secure the defined benefit promise for workers and (2) to protect the government's interest in the financial health of these plans."[xiv]

2. The next step would be to make all employees fully comprehend that achieving retirement security is their responsibility and no one else's. Thus, embracing retirement planning by enrolling in the 401(k) plan and making adequate contributions are to be considered "must dos".

   i. The Department of Labor and many circuits have concluded that, depending on the facts and circumstances, fiduciaries may have a "duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows that the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person". This responsibility falls on the fiduciary even though the disclosure of such information was not specifically requested by the beneficiary nor required by ERISA or the regulations.[xv]

   ii. Participant communications, regardless of how they are delivered, must be presented "in a manner calculated to be understood by the average 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."[xvi]

3. To demonstrate their value proposition, providers must give fiduciaries detailed plan utilization analyses showing how participants (by demographic groupings) are using, not using, or misusing their 401(k) plan including:

   - retirement readiness assessments that include the number of years, on average, the participants' nest eggs will last;

- how different employee segments have allocated their accounts.

Unfortunately, few fiduciaries routinely receive plan utilization analyses containing this essential information. Thus, fiduciaries have had a hard time determining:

- whether poor or inappropriate plan utilization reflects the "bad" attitudes of the employees or a failure on the part of the provider;

- whether the plan design needs serious rethinking, just some "tinkering" or is just fine as is;

- what messages need to be communicated to each employee segment.

The plan utilization analyses allow the provider and fiduciaries to work together as a team rather than as "lone rangers" or worse, adversaries (as they might be in today's litigious environment).

III. Given all the communications that participants receive, not to mention the education sections on providers' websites, how can anyone argue that the fiduciaries and providers aren't giving participants their money's worth (or a very good value proposition for the fees they pay)?

A. Perhaps the answer to that question is that neither the typical educational section of a provider's website nor its communication pieces resonate with employees.

1. "Vanguard's participant website also features education content and advisory services. Average page hits for these capabilities represented only 7% of total page hits during the first quarter of 2008. This might suggest that these services are considerably less valuable to participants."[xvii]

2. The typical 401(k) plan communications piece (as well as programs) lacks many of the ten rules of effective communication promulgated by the highly regarded pollster and communicator, Frank Luntz, and used in selling everything from political candidates to "value" meals[xviii]:

   - simplicity (do worksheets and their accompanying tables appear simple?);

- brevity (how long is the typical enrollment book?);
- credibility (just think of all the disclaimers in small print and written in legalese);
- consistency [repetitiousness of the message] (how often are participants shown the cost of delay or the inadequacy of their contributions?);
- novelty (is it likely that text-crammed sheets of paper will catch the participant's attention?);
- sound (alliteration);
- aspiration (enabling the participant to correlate the actions the fiduciary and/or provider are recommending with achieving his dreams or peace of mind);
- relevance (making sure the employee realizes that by not contributing up to the match, not only is money being left on the table today but much of his 401(k) account's potential growth is being thrown-out from "day one").

B. Since when is it the responsibility of fiduciaries and providers to sell participants on the need to use their 401(k) plan wisely?

1. The idea that employees wanted to control and were willing to assume responsibility for their retirement savings programs was one of the primary (at least for public consumption) arguments that sponsors and providers used to turn 401(k) plans from supplemental retirement income programs into corporate America's primary retirement program. Unfortunately, as experience has shown, there is no foundation for this argument.

2. By sanctioning full-blown autopilot programs including QDIAs, Congress, via the Pension Protection Act, acknowledged that:

   i. The average American worker has been unwilling, perhaps even incapable, of assuming responsibility for planning and funding his retirement.

ii. Fiduciaries should apply the findings of behavioral economics, and in particular, choice architecture, to designing their 401(k) plans.

iii. Participants need all the help they can get when it comes to their retirement planning.

C. Can a sponsor be forced to “coddle” its employees?

1. No it can’t. An employer is not required to offer a retirement plan.

Employers set up 401(k) plans in order to attract, motivate, and retain employees of the caliber they need to make their businesses successful.[xix] The employers try their best to make their employees view the 401(k) plan as a valuable benefit.

Sponsors are concerned that their employees would not value the 401(k) plan if they realized both:

- the contribution levels needed to achieve a financially secure retirement (assuming a replacement ratio of somewhere between 75% and 125% as discussed above);

- the uncertainties involved in retirement/investment planning, especially in light of the structural economic changes the world is undergoing.

Therein lies the dilemma for fiduciaries, sponsors, and providers: the need to balance the desire for appreciative (although uninformed) employees with the likelihood of “full disclosure” creating disgruntled employees placing little, if any, value on the 401(k) plan.

IV. What are possible types of damages that plaintiffs’ attorneys could argue that participants incurred?

These attorneys will likely argue that sponsors and the fiduciaries they employed deliberately provided participants with misleading communications that omitted material information which their employees needed to make informed decisions. In fact, such a case is now in the Court of Appeals for the Second Circuit.[xx]

(This case centers on the communications that CIGNA gave its employees when the company announced the transition from a defined benefit pension plan to a cash balance plan. The judge concluded that CIGNA deliberately misled (in large part due to omissions) participants in order to maintain "happy campers", and this fiduciary misconduct inflicted significant damages to many of them.

After making his decisions, but before their implementation, Judge Kravitz wanted the Court of Appeals to review the case because the "public interest the Court sees here, and it is a strong one, is for clarity in this muddled yet extremely important area of the law.")

Fiduciaries and sponsors cannot argue that they were unaware of just how misleading their communications were since the ingredients of what goes into successful communications are used on a daily basis in their companies' marketing and sales efforts. In addition, communications, including framing, narratives, and the findings of cognitive science are thoroughly discussed in best-selling books due to the current political environment.

Examples of possible claims and their resulting damages are:

A. Participants incurred damages equal to fees they paid for active management minus well-selected index funds with a fee schedule appropriate for a plan of that size[xxi].

B. The fiduciaries did not make participants aware of their insufficient contributions because they put the sponsor's financial interests (avoiding increased matches) and human resource goals (using the 401(k) plan to attract, motivate, and retain employees) ahead of their duty of loyalty to participants.

   Participants incurred damages because they contributed less than what they would have had the fiduciaries made them aware that their current contribution levels were too low.

   A judge could easily decide that if well-designed targeted communications, on average, get 10% of the workforce to increase their contributions by 4% (going from 6% of pay to 10% of pay), the sponsor should contribute that amount (plus match if appropriate) plus growth for the past "X" number of years.

   A similar argument for damages could be made for failing to encourage more workers to enroll in the 401(k) plan.

C. Participants incurred damages due to their lack of understanding of how to create appropriate asset allocations. These damages equal the difference between what their account would have grown to in a target date fund minus their current account balance.

Sponsors have not encouraged active discussion of these topics for fear that the employer's goal of providing a highly appreciated benefit program would be undermined once employees fully appreciated that:

- achieving a financially secure and comfortable retirement was their responsibility;
- investing involves uncertainty rather than risk based upon known probabilities;
- Social Security and Medicare are financially insecure and that future benefits will likely be reduced;
- their current consumption-driven lifestyles will have to be curtailed in order to generate the funds needed to shore-up their retirement prospects.

V. Summary

The purpose of this discussion was to encourage fiduciaries to review their approach to defining, implementing, and monitoring their 401(k) plan's overall value proposition for employees. Another of the paper's goals was to highlight issues that are typically overlooked or downplayed even though they are critical to helping employees achieve a financially secure and comfortable retirement. Hopefully the issues raised will encourage fiduciaries to expect more of themselves and their providers and, thus, mitigate the likelihood they will end-up in litigation.

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[i] Oliver Wendell Homes, "Natural Law", 32 *Harvard Review* 40, 1918
[ii] Richard A. Posner, *How Judges Think*, Harvard University Press, Cambridge, 2008, p. 79.
[iii] Julius Stone, *The Province and Function of Law: Law as Logic, Justice, and Social Control*, as quoted in Posner, ibid, p. 81.
[iv] Leonard Mlodinow, *The Drunkard's Walk: How Randomness Rules Our Lives*, Pantheon Books, New York, 2008, p. 180.
[v] In an interview in PIMCO DC Dialogue, August 2008.
[vi] Fidelity's Building Futures Volume VIII, 2007, p. 114.
[vii] "Total Retirement Income at Large Companies: The Real Deal 2008", Hewitt Associates.
[viii] See studies such as EBRI's Retirement Confidence Surveys and ING's 2008 Retirement Number Study.
[ix] Press release discussing ING Retirement Number Study, www.ipsos-na.com/news/pressrelease.cfm?id=3823.
[x] Mitchell, ibid.

[xi] 2003 National Assessment of Adult Literacy, U.S. Department of Education.
[xii] Annamaria Lusardi, "Household Saving Behavior: The Role of Financial Literacy, Information, and Financial Education Programs", NBER Working Paper 13824, 2008.
[xiii] Pamela Perun, "Storm Clouds Ahead for 401(k) Plans?", The Retirement Policy Program of the Urban Institute, Brief Series, No. 22, July 2008, p. 5.
[xiv] Ibid., p. 5.
[xv] Amicus brief of the Secretary of Labor as Amicus Curiae in support of plaintiffs-appellants in Dennis Hecker et. al. vs Deere & Company, Fidelity Management Trust, and Fidelity Management and Research Company, No. 07-3605, 08-1224.
[xvi] 29 CFR2520.102-3
[xvii] *How America Saves 2008: A Report on Vanguard 2007 Defined Contribution Plan Data*, p. 57.
[xviii] Frank Luntz, *Words that Work: It's Not What You Say, It's What People Hear*, Hyperion, New York, 2007, p.183.
[xix] 2007 Top Five Rewards Priorities Survey performed by Deloitte and ISCEBS.
[xx] Memorandum of Decision in Janice C. Amara v. CIGNA Corporation and CIGNA Pension Plan, Case No. 3:01CV2361(MRK).
[xxi] Jeremy Braden v. Wal-Mart Stores, Inc. et. al. No. 6:08-cv-3109-GAF.