Value and Prudent Process:

Redefining Both Terms in Light of the Recent Spate of Class Action Lawsuits over 401(k) Fees

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The spate of class action lawsuits recently filed against several large 401(k) sponsors has sent shock waves through the 401(k) community. In these cases, Schlichter, Bogard, and Denton allege (among other things) that plan fiduciaries breached their ERISA responsibilities by failing to:

- control and account for their plan's investment expenses;
- be aware of all the parties that had been and are currently being compensated by plan assets;
- determine the reasonableness of the compensation that each party received in light of the level, appropriateness, and quality of the services they (had) provide(d).

The 401(k) community is concerned that these lawsuits are the harbinger of things to come. After all, at the heart of these lawsuits are the merits of four basic assumptions that sponsors, fiduciaries, and their legal counsel take for granted:

- Large recordkeepers understand the needs of fiduciaries and participants and have developed business models to efficiently fulfill those needs.
- All the provider's services are necessary and appropriate (and thus have significant value).
- If the plan's overall fee structure is competitively priced, the fees are reasonable and incurred solely for the benefit of the participants.
- By selecting a large recordkeeper that routinely administers 401(k) plans of comparable size and complexity to their plan, the fiduciaries should feel assured that are fulfilling ERISA's requirement of exercising "the care, skill, prudence, and diligence that a person would when acting in a like capacity and familiar with such matters." [1]

Plaintiffs' counsel is arguing that these assumptions are erroneous and that:

- Providers should not be viewed as trusted advisors to fiduciaries and participants since they are profit driven corporations constrained by their business models, legacy technology, and profit goals.
- A competitively priced fee structure is neither synonymous with the reasonableness of fees nor indicative of the value propositions of a provider's products and services.

These lawsuits are now forcing fiduciaries to critically reexamine their approach to a "prudent process" that delivers "value" to participants. In performing this analysis, the fiduciaries should keep in mind the advice of Jim Collins, the best selling author of *Good to Great*:

[1] ERISA §404(a)(1)(B)

> "When you conduct autopsies without blame, you go a long way towards creating a climate where the truth is heard. If you have the right people…(you) need only to search for understanding and learning."[2]

In this paper, a new perspective on "prudent process" and "value" will be introduced, and the traditional definitions will be challenged. Fiduciaries will also be shown the type of quantitative data they need to objectively determine if their "prudent process" is actually delivering "value" to their participants.

Defining a "prudent" process

When ERISA became law in 1974, defined benefit pensions were the primary retirement vehicles of large corporations. 401(k) plans neither existed nor were they contemplated.[3] Conventional wisdom maintained that income from a defined benefit pension, along with Social Security and personal savings, would provide retirees with a comfortable standard of living.

Since the purpose of ERISA is to make sure that corporations deliver the pension benefits they promise, 401(k) fiduciaries have to extrapolate as to how the courts will interpret ERISA's mandate to act "solely in the interest of" and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan."[4]

Perhaps a good place to start is to frame the problem from the perspective of the employee. In essence, 401(k) plans have become the American worker's primary tool for accumulating a retirement nest egg (in contrast to a defined benefit pension that provides a guaranteed income). In 401(k) plans, workers assume all the risks of funding their retirement. In addition, participants pay (via asset-based fees) most of the costs of running their 401(k) plan. (This is in sharp contrast to the executive compensation programs that financially savvy senior executives receive. In these arrangements, shareholders bear the program's full cost.)

Given these realities, plaintiffs' attorneys will surely argue that, for participants to get their money's worth (value) and have a good chance of achieving retirement security, the fiduciaries must implement a prudent process that recognizes:

- When existing defined benefit pensions are frozen, workers with many years of service, but who are still relatively young, incur significant and unexpected reductions in projected retirement benefits.

- In the future, benefits from both entitlement (Social Security and Medicare) and employer sponsored programs will likely be reduced, thus imposing upon future retirees financial demands to which earlier retirees were not subjected.

- The average American lives for today, thrives upon immediate gratification, and defines himself through material possessions.

- The average worker does not have the educational background to grasp and/or the time and/or temperament to adequately embrace retirement planning and portfolio management as judged by:

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[2] Jim Collins, *Good to Great*, HarperCollins, 2001, p.86.
[3] Admittedly some self-directed thrift plans existed in corporate America. However, they were few in number and were usually the supplemental rather than the company's primary retirement program.
[4] ERISA §404(a)(1)(A)

- their lack of knowledge of investing;[5]

- the percent of workers who have not calculated what their retirement income needs are projected to be;[6]

- their literacy levels for both verbal and math skills;[7]

- the amounts invested in employer stock;[8]

- participation and contribution rates and number of investment options utilized.[9,10]

The fiduciaries' process should focus on effecting and then reinforcing desired behaviors rather than trying to educate participants. The fact that full blown autopilot programs (auto-enrollment, Save More Tomorrow (SMarT) feature, and a default investment option) are such hot topics today and are being implemented in many large corporations appears to validate this conclusion.

Therefore, the most basic fiduciary tasks must include communicating in blunt, unambiguous language and in a visually inviting layout that will catch the participants' attention and resonate emotionally with them the following unappreciated facts and "rude awakenings":

- a definition of what retirement security means and how corporate sponsored programs dovetail to help employees accomplish this goal;

- the risks participants face in achieving their retirement income goals;

- the value of the employer's match;

- a suggested contribution rate (usually much higher than the default rate when auto-enrollment is used);

- the role time plays in determining the projected contribution rate needed to reach the targeted nest egg (including an explanation of why participants should increase their contributions today rather than wait for them to increase via the plan's S.M.A.R.T feature);

- the advantages of using targeted maturity funds and other professionally managed investment options (however, participants must be told that managers of these products have yet to demonstrate that they have good crystal balls);

- the pitfalls of being over-invested in employer stock;

[5] Annamaria Lusardi and Olivia S. Mitchell, "Financial Literacy and Behavioral Finance:Implications for Retirement Wellbeing", Michigan Retirement Research Center, Working Paper WP 2005-108.
[6] EBRI Issue Brief No. 280, April 2005.
[7] National Assessment of Adult Literacy, 2003, U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics.
[8] " How America Saves: A Report on Vanguard 2005 Defined Contribution Plan Data", September 2006.
[9] Ibid.
[10] For a discussion of the above issues, see Richard D. Glass, "Have 401(k) Fiduciaries Gone Astray? Creating a Prudent Communication Process in Today's Turbulent World", *Benefits and Compensation Digest*, October, 2006.

- periodic reports showing the participant's progress towards achieving retirement security (regardless of whether a participant enrolls in an advisory program).

By delivering these "rude awakenings" and periodically reminding employees of them, fiduciaries avoid the serious possible accusation that they are trying to mask just how difficult it is to achieve retirement security.

So why hasn't a behavioral approach to helping employees been used in the past?
To begin with, providing investment/retirement education and/or advice is not mandated by ERISA. Thus, it has been easy for fiduciaries and their advisors to conclude that their role is to focus on providing the tools needed to achieve retirement security rather than on how those tools should be used. A corollary to this conclusion is that workers must fend for themselves.

The fiduciaries, therefore, have concentrated their efforts on recordkeeping efficiency, the selection and monitoring of investment options, providing paper and/or web-based tools, and possibly offering a third-party advisory service (and now managed accounts) that participants can use if they so desired.

Bundled providers (including the large recordkeeping/consulting firms) also assured fiduciaries that their "best of class" participant communication/education materials and programs enabled workers to address their needs. If employees did not enroll in the 401(k) plan or take full advantage of it, the employees would have no one to blame but themselves if they could not retire comfortably.

On the surface, these arguments seem to make sense. Class action lawyers will certainly remind fiduciaries, however, that employees' ignorance of investment and retirement issues was not one of the problems that Congress was trying to remedy when ERISA was drafted. In defined benefit pensions, participation is automatic, and participants do not make the investment decisions. Thus, justifying fiduciary conduct on the basis that education is not mandated in ERISA is an argument that lacks substance.

The plaintiffs' attorneys will also point out that they are not making a case for investment education or for the sponsor to offer advice. Rather, they are arguing that *communicating* in a clear, concise, and attention grabbing manner the importance of the 401(k) plan and the employee's role in using it wisely is an important fiduciary responsibility. Therefore, the fiduciaries either have to make sure that their recordkeeper does this or find another communications firm that can deliver such messages.

By shirking this responsibility, the fiduciaries are setting themselves up to be accused of wasting the fees the participants paid and, worse, causing the participants financial harm.

The class action lawyers will also likely purport that at least some fiduciaries, as well as the provider's communication team, should be familiar with the relevant research findings in the fields of marketing, behavioral finance, consumer behavior, and psychology. The lawyers will then argue that these fiduciaries and communications consultants should have known that:

- Uninviting pieces, such as those cluttered with text and small print, are not read.

- One-size-fits-all communications, the communications workhorse of the 401(k) industry, are ineffective at getting messages across, let alone effecting behavioral change, when the target "market" is composed of many subgroups, each with different needs and frames of references.

- "One-to-one" (targeted personalized) communications are the best way of reaching diverse audiences especially when they are also subjected, as the American worker is, to extreme information overload and a "catch me if you can" mentality.[11,12]

It is also likely that the plaintiffs' attorneys will argue that fiduciaries have at least two other responsibilities when it comes to communications:

- Fiduciaries must determine if their provider has the technology to implement effectively and in a cost-efficient fashion targeted personalized communications campaigns. Such campaigns require the ability to segregate employees into groups and then provide each group with the appropriate targeted (often personalized) messages and/or programs.

  The provider's technology, then, must be able to easily implement multipurpose campaigns. For example, one group of participants could be encouraged to increase their contributions at least up to the level of the match, another segment that is poorly diversified could be reminded that a lifecycle fund may be appropriate for them, while a third group could receive a message describing the dangers of being overconcentrated in employer stock.

  If the plan's recordkeeper does not have the technology to readily develop, implement, and then evaluate targeted campaigns, then it is the fiduciaries' responsibility to hire a communications vendor who can. The fiduciaries must also ensure that the recordkeeper provides the communications vendor the required data in an agreed upon format without charging "an arm and a leg".

- Fiduciaries must determine exactly what the provider means when it says it has "best of class" educational programs. Do the provider's programs actually change participant behavior and, if they do, to what extent and by what means? Or, is the phrase "best of class" being used as a "semantic stretch" that gives fiduciaries an emotional "kick"[13] but provides participants with little or no value?

A good communications program, then, benefits the fiduciaries by providing a paper trail demonstrating that they take seriously ERISA's mandate to act "solely in the interest of" and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan." In addition, a good communications program in and of itself amply demonstrates that the participants received reasonable value for the fees they paid.

Other components of a value driven, results oriented prudent process

In *Good to Great*, Jim Collins coined the term "brutal facts" to refer to the harsh realities that companies have to recognize and then confront if they are to successfully make the transition of going from being a good company to becoming a great one. Today's 401(k) fiduciaries now have to face brutal facts which their predecessors could ignore, including:

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[11] For an excellent review of the latest research in making ideas "sticky" (or conveying ideas effectively), see Chip Heath and Dan Heath, Made to Stick: Why Some Ideas Survive and Others Die, Random House, New York, 2007.

[12] For a discussion of these issues as they apply to 401(k) communications, see Richard D. Glass, "Stop, Look and Listen: Your Profitable Participants Remain Hidden in Plain View", LIMRA's MarketFacts Quarterly, Spring, 2005.

[13] Chip Heath and Roger Gould, "Semantic Stretch in the Marketplace of Ideas", working paper, Stanford University, 2005.

- The United States faces a retirement crisis, and academic studies and industry surveys are continually pointing this out.[14]

- Employees have tough financial decisions to make (and many may need help making them) since "more and more economic risk has been offloaded by government and corporations onto the increasing fragile balance sheets of workers and their families".[15] This reality only reinforces the need to eliminate the "sugarcoating" and ambiguity that is often employed in the hope of making messages more palatable.

- Industry standards are not necessarily the appropriate benchmarks by which to judge a fiduciary's performance. For example, until quite recently it was acceptable that approximately 30% of eligible employees didn't enroll in 401(k) plans even though 30% is judged to be a very high failure rate by most business standards. Now, thanks to auto-enrollment programs, a participation rate close to 90% is now considered quite achievable.

  Asset based fees, another standard industry practice, are now coming under scrutiny, and their reasonableness must be justified. The lawsuit against Fidelity and Deere & Co. attacks this practice head on:

  > "As the years pass, and as participant's retirement savings grow, the amount of money available for revenue sharing payments increases, even though no additional services may be provided to the plan…"[16]

But perhaps the most brutal fact of all is the need for fiduciaries to recognize that, at any point in time, different employee segments face different challenges and thus have varying needs. In order to give participants their money's worth, the problems of each segment will have to be simultaneously identified and addressed.

The fiduciaries must recognize that this evaluation process should not be an infrequent event. Rather, it must occur frequently since participants' needs will change as they move, over time, from one segment to another. External events, such as new legislation, court decisions, and/or changes in the sponsor's business strategy, will also introduce new issues that will have to be tackled.

To successfully meet these new challenges (and to make it much more difficult for class action attorneys to wage time consuming and costly lawsuits), the fiduciaries will require much more extensive plan utilization analyses than they have received in the past. Global plan analyses (or what the plan looks like in the aggregate) will be recognized for what it is: a great way to mask problems rather than being an effective tool for identifying issues.

Going forward, fiduciaries must demand that their recordkeepers routinely provide them with analyses that "slice and dice" utilization by combinations of data points reflecting demographic groups, locations, contribution rates, and asset allocation (such as participants misusing lifecycle funds or having accounts that are not diversified).

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[14] The publications of the Center for Retirement Research at Boston College and the Employee Benefit Research Institute are two sources of excellent analyses of this country's retirement crisis.
[15] Jacob S. Hacker, *The Great Risk Shift*, Oxford University Press, 2006, p. ix.
[16] An article from the December 14, 2006 issue of the "Wall Street Journal" discussing this lawsuit may be found at www.uselaws.com/news/news.php?id=60.

For example, fiduciaries should always know (and should know how these statistics change over time) for the overall employee population as well as the various groups of employees:

- What percent are projected to be on track for a financially secure retirement?
- For those who are not on track, on average, by how much should they be increasing their contributions (after factoring in both federal and plan constraints)?
- For those who are not on track, on average, how long will their retirement nest eggs last?

It is only with such knowledge that plan utilization becomes transparent, thus enabling fiduciaries to proactively address issues as they emerge rather than running the risk of having to react to issues that are framed in a hostile fashion.

Summary

Perhaps the words of Mikel Harry and Richard Schroeder, pioneers of the Six Sigma movement, best capture the essence of a value driven, results oriented prudent process for running 401(k) plans:

> "We can't do what we don't know.
> We won't know until we measure.
> We don't measure what we don't value.
> We don't value what we don't measure."