Challenges Mount for 401(k) Fiduciaries

By Robert Huebscher
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The Department of Labor (DOL) last week announced plans to expand the requirements for fee disclosure to 401(k) participants. The details of the plans were widely reported in the media (see, for example, the Wall Street Journal). In general, the plans call for clearer disclosure of 401(k) fees and expenses, investment options, and performance against benchmark indices. Disclosure must be on a regular basis, as well as when a participant enrolls in a plan.

The DOL's proposed regulations are now open for comment, with a target implementation date of January 1, 2009.

We spoke with David Loeper, President of Financeware, to understand the impact of these new requirements on the 401(k) industry and on financial advisors. Loeper has been an outspoken advocate for broader disclosure of 401(k) fees, through his www.401kripoff.com web site and his book, Stop the 401(k) Rip-off.

Loeper believes the DOL has done an excellent job tackling a very important issue, but he also fears that the industry may ultimately squash the progress being made. "I hope these regulations become law and are actually enforced," said Loeper. But he added "the danger exists that they won't become law or that they won't be enforced."

Earlier this year, the Supreme Court decision in *LaRue v. DeWolff, Boberg & Associates, Inc*. established that plan participants can sue plan fiduciaries if fiduciaries "impair the value of plan assets in a participant's individual account." Loeper thinks this ruling will evolve into a new standard under which plan fiduciaries must operate, and holds them legally (and financially) responsible if they fail to meet these standards.

"The combination of the new DOL rules and the LaRue ruling may create an army of lawyers going after plan sponsors, advisors and investment providers," says Loeper. There are approximately 65 million participants in 401(k) plans currently, and the number is growing. The challenge for plan fiduciaries is in the broader issue raised through the LaRue case. If the fiduciary makes a bet against the investment policy market benchmark for an investment option, even if just for one year, and that results in an *impairment of an individual's plan assets*, then a legal threat arises. If plan assets are not prudently diversified, the

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fiduciary could be at risk. ERISA requires diversification “unless it is *clearly prudent* to do otherwise.”

“Advisors and plan sponsors need to change their procedures in order to avoid litigation risk,” says Loeper. He added that “a key step is that attempting to outperform by not being fully diversified is going to be Exhibit 1 in future cases that exploit the LaRue ruling for any lone participant that underperformed or bore excessive expenses.” Advisors and sponsors will need to abandon their value proposition of their past services born from the defined benefit plan era, because those services were fundamentally based on the notion of the advisor providing selection and monitoring guidance in an attempt to out perform the investment policy benchmark. But, with those services, such bets against the investment policy benchmark had no impact on the plan participant in a defined benefit plan. The plan sponsor bore the risk and the reward of investment bets against the investment policy benchmarks. Loeper said that those same antiquated defined benefit processes are frequently the standard services being provided to participant directed defined contribution plans today, completely ignoring the impact of the risk such bets introduce to any one participant of potentially under performing at an inopportune time for the participant.

The new proposed regulations even go so far as making the point that, “The Department (of Labor) is taking this opportunity to reiterate its long held position that the relief afforded by section 404(c) and the regulation thereunder does not extend to a fiduciary’s duty to prudently select and monitor designated investment managers and designated investment alternatives under the plan.” Loeper contends that betting against policy benchmarks by not being completely diversified will frequently fail the basic ERISA test of the “clearly prudent” diversification standard and subject sponsors and advisors to large settlements.

In addition to proper diversification, fiduciaries and plan providers need to insure that fees are reasonable, as required under ERISA. Loeper shared with us a striking illustration of the potential repercussions of excessive fees. Consider an example where a married couple each contributes $3,500 (including matching funds, adjusted annually for inflation) to a 401(k) plan, starting at age 25. At age 65, they will have accumulated a combined portfolio of nearly $2.5 million, assuming a return of 7.5% each year. However, a plan provider charging 1.5% in *excess* fees will have netted over $1 million over the same time frame. The couple, investing modestly over a 40 year period, will have sacrificed returns sufficient to make a millionaire out of the investment provider through excess fees.

Loeper notes that 401(k) advisory services have evolved from its roots in the defined benefit era. In defined benefit plans, the company bore the risk of underperformance or excess fees in active bets against investment policy

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benchmarks. If pension funds failed to meet their targets, the cost was a greater contribution on the part of the company. In the 401(k) world the cost of underperformance is passed to the plan participant, and the remedy, as established by LaRue, may be legal actions against the fiduciaries.

"The retirement plan consulting community has been slow to react to the change from a defined benefit to the participant directed era," says Loeper. He added, "the DOL rules represent an important step forward, which should translate to improved retirement savings for millions of plan participants." If advisors and sponsors do not change their procedural processes recognizing these realities, *they* will become a significant provider of retirement income to participants through lawsuits. Loeper has written a new book (The Four Pillars of Retirement Plans©- expected to be released this winter) on the steps sponsors and advisors need to take to avoid what he calls, "the litany of litigation coming from ambulance chasing attorneys converting to ERISA fee and underperformance trial lawyers."

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