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The Gathering Storm – Who is Paying For Your Retirement Plan, And How?

(The April and May newsletters are adapted from a speech given by Bill Berg, Sigma's president, at the April 16 Spring Seminar of the Western Pension & Benefits Conference in Portland, Oregon)

Imagine that you have an aging uncle and, at a family meeting, a decision is made that one of your cousins will take charge of the uncle's health care. You later find that, of the two available local health plans, your cousin enrolled the uncle in the plan that is generally thought to be the lesser of the two, allowing the cousin's family to reach a critical mass so that the cousin gets a discounted rate for his children. How would you feel about your cousin's choice?

***There are the rules we know
without being told, and the rules
we don't know no matter
how many times we're told.***

With respect to both care of family members and fiduciary duties in retirement plans under the Employment Retirement Income Security Act of 1974 ("ERISA"), the good news is that we tend to know what reasonable duties are and which actions are appropriate. The bad news is that many retirement plan fiduciaries are not fulfilling their duties. How can this be the case? In the retirement plan world, I do not believe it is a matter of fiduciaries knowing too little, but rather a case of them knowing too much. The situation would improve by stripping away what fiduciaries are struggling to understand and get them to apply what they already know, what they have always known.

The source of the problem is confusion between two types of law. One, the common law, is the set of common sense rules developed from the time of the caveman (e.g., do not steal from the neighbor's cave) and passed down to us in law, religion and the likes of Plato, Aristotle and Cicero. The other, statutory/regulatory law, involves legislators or regulators inventing rules to take care of what they perceive as a crisis. Being an expedient solution to a pressing problem, statutory and regulatory law may ignore history and human nature. The common law is the set of rules everyone knows even if they are not written down, while nobody knows what the rules are under statutory and regulatory law despite their being written down. Think of the tax code, always in flux, always being reinterpreted.

Under the common law, fiduciaries are expected to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ERISA

incorporates this “prudent person” standard, but other parts of the statute and regulations attempt to further define or even limit this duty. When common sense law and regulatory law seem to contradict each other, I believe there is a natural tendency for the issue to be resolved in the direction of common sense that everyone understands.

Current practice in the world of retirement plans varies from common sense notions of duty and fairness in how service providers are paid through “revenue sharing.” Revenue sharing is where providers of services to, say, a 401(k) plan are paid in a manner other than them submitting a bill and someone, either the plan participants (the employees) or the plan sponsor (the employer), writing a check to pay the bill. A simple example would be if money that participants think of as an investment expense is used to pay for record keeping services.

***Money was invented for a reason.
The only reason not to use money
in a financial transaction is to hide
something from somebody.***

There are all kinds of revenue sharing methods with arcane names like 12b-1 fees, shareholder service fees, pay for play fees and the like. It would be too depressing, and time is too short, to detail them all here. The common feature, however, is that the service provider is paid without the plan sponsor or plan participants writing a check. This is a form of barter, where services or goods are traded without an explicit money cost being allocated to them. I have a particular blind spot here because I have never understood barter. Money was invented for a reason, and the only reason to not use money is to hide something from somebody. This becomes a problem if there are more than two parties involved in a transaction.

For example, a local tire retailer has an annual promotion in which they give away “free beef” to tire purchasers – you buy your tires during the promotion, and you get steaks. Everyone understands that the beef is not really free, that the retailer is temporarily cutting their profit margin to garner the attention of potential customers. Now add a third party and imagine that you receive the beef only if you refer a friend who buys tires. You show up with your friend, you both buy tires, but only you get the “free” beef, presumably at a moment when your friend is not looking. How will your friend feel about this if he finds out? My guess is that most of us believe the fair way to handle this transaction is for you to explain it to your friend ahead of time and the two of you agree to share the beef.

I used to share a ride to work with my wife, with her dropping me off in the morning and picking me up later. Frustrated at my chronic lateness at the end of the day, she would park and run into a local shop to buy cookies. Every day when I came down, she would be waiting with three cookies. We would each eat one and split the third. One day, after years of this routine, I finished early and surprised her by buying the cookies. When I ordered three cookies, the guy behind the counter said, “If you buy three, you get a fourth for free.” That had always been the deal. My wife likes cookies more than I do, and I would

willingly give her the fourth cookie if she asked (something she disputes to this day), but the lack of disclosure made a difference psychologically. When she arrived to pick me up that day, we had what diplomats might call “a frank and candid exchange of viewpoints.”

In the retirement plan world, the two party case could be a traditional, defined benefit pension plan in which the plan pays a fixed, monthly benefit to retirees. The employer pays money to the service provider (e.g. an actuary) in exchange for services at a competitive, negotiated price. There is no reason not to use money for the purpose for which it was intended; to define the specific cost of the service provided, with everyone understanding the benefits received and the cost paid.

Unless there is a service that is billed for, doesn't money flowing from a retirement plan belong to the plan itself?

But now let us add a third party, participants of a 401(k) plan. Many of these plans have a “bundled” provider, where the investments and other services are provided by the same firm. Participants pay “investment fees” from their retirement account balances, and the bundled service provider gives the plan sponsor “free” services (e.g. record keeping) that have no explicit cost attached to them. There’s nothing inherently sinister in this if the services could be appropriately paid for by the plan instead of the plan sponsor anyway, assuming the overall costs are reasonable. As in our tire and cookie purchasing examples, however, the perception of an unknowing party, in this case the plan participants, can make all the difference.

This type of revenue sharing is pervasive, almost impossible to escape. Shortly after we began advising 401(k) plans, we received a check in the mail for \$46.16 from an investment manager we had recently hired for a few clients. Not wanting to be involved in revenue sharing, we unsuccessfully tried to get the investment manager to take the check back. It then occurred to us that, as fiduciaries to our clients’ plans, we had a duty to pass that money on to our clients instead of refusing it to maintain our sense of purity. We asked the sender of the check for a detailed accounting of how the \$46.16 was determined, so we could allocate it among the applicable clients. They were surprised at the request, but we now go through that kind of accounting each month to make sure each retirement plan client receives their correct share of the revenue sharing that we would prefer to not have to deal with in the first place. Of course, once the matter was settled, we couldn’t help wondering if we were the first people who hadn’t just cashed the check. We were left with the impression that the notion that money flowing from a retirement plan belongs to the plan’s participants was something of a novel concept.

At least shareholder service fees (the source of the \$46.16) are specified in a mutual fund prospectus, but there are various other flora and fauna of revenue sharing that are not so explicit, particularly in bundled plans and pooled accounts. Without a dedication to disclose by honest service providers, even experience and diligence may not be enough to understand the true cost. We tried, working with

other experienced and savvy veterans of the 401(k) world, to understand the true costs paid by clients of a bundled service provider and thought we had clear understanding of expenses from the disclosure provided. We were mistaken, though, finding out from an acquaintance working for the bundled service provider that we had missed an entire layer of expenses. This is the world of revenue sharing at its worst, where, akin to *The Sopranos*, you only find the truth if “you know a guy who knows a guy....”

The result is that bundled service providers, those that provide not just investments but other plan services, have a tremendous marketing advantage -- they claim to include services for “free” that appear as a specific expense in the proposals of *a la carte* service providers. The “beef” is not really free, but it is an enormous psychological advantage to get paid without the client having to cut a check. This psychological advantage provides an incentive for fiduciaries to select service providers for reasons other than the superiority of investment options, lower overall costs or other factors that would be in the best interests of the plan participants.

In revenue sharing, like on The Sopranos, you may only be able to find the truth by “knowing a guy who knows a guy....”

In the case law and administrative decisions under ERISA, arcana abound about which expenses can be justifiably paid out of plan assets and which cannot. Since this is part of regulatory law, there is inherent uncertainty, with gray areas around the edges. The larger issue, however may be that a huge percentage of 401(k) plans have little or no idea of the true costs of the component services involved in plan administration, and they are not prodded by curiosity to find out. On the other hand, the Department of Labor, the primary regulator of the plans, has a spreadsheet on its website indicating that plans and their fiduciaries ought to be able to apply a specific dollar cost to each component service (e.g. record keeping, custodianship of funds, acting as plan trustee, investment management, etc.).

Such a chasm between the assumptions of the regulators and the assumptions of the regulated creates substantial uncertainty about the ultimate course of plan regulation and fiduciary liability. In addition to the legal and regulatory issues, however, is the important issue of the trust of the participants in the plans. Don’t the participants deserve to know what plan expenses are coming out of their pockets, even if it is seemingly legal under the regulations? Do the plan fiduciaries even know enough about the true plan costs to tell them?

Thus, there are three types of plan sponsors and plan fiduciaries: (1) **The Unknowing**, those that are ignorant, lazy or just not interested enough to investigate the true costs of their plan, or with service providers failing to disclose the costs; (2) **The Knowing but Dishonest**, those that have the participants pick up the costs of the plan while pretending they do not; and (3) **The Knowing but Honest**, those who adequately disclose the plan costs and sources of payment to employees. Despite the description, we do not want to be too hard on the “unknowing,” since in many cases clear, understandable and correct information

on plan costs is hard to obtain due to cloudy or misleading disclosure by some service providers.

Imagine you are a fiduciary of a 401(k) plan with 850 employees, 14 investment options with daily valuation of participant accounts and daily switching of investments allowed, and 147 outstanding participant loans of varying duration. The plan is being sued, you testify at the lawsuit and the plaintiff's attorney asks you how much the plan pays for record keeping. How comfortable are you going to be replying "Why, that was free"?

Consider the political and regulatory environment that could exist if 401(k) participants are surprised, reasonably or unreasonably, to find out that they have been picking up the tab for a variety of retirement plan expenses that they assumed were being paid for by their employers. Employers may claim that they budget the expenses of the retirement plan and any money flows from revenue sharing are just passed through to the participants in the form of higher benefits. In this potential class-warfare environment, however, the participants will be told by attorneys, politicians and the media that they were being taken advantage of by their employers. Which side is likely to prove more convincing? Your cousin may have been passing on the savings derived from adding your uncle to his health plan for the benefit of the uncle, but would that be your first assumption when you find out what he has done?

An employer sponsoring a retirement plan may be honest without disclosing plan costs to employees, but without disclosure, they'll never be able to prove it.

The current environment with respect to revenue sharing is one of considerable uncertainty. Many employer/plan sponsors are astonished to find out that anyone would think that they should know the specific costs for services involved in

their plans. We have informed prospective clients of the simple trailing sales commissions paid to their current broker-consultant (approaching six figures on an annual basis and coming out of the investment returns of the participants) and seen the shock in their faces. We have made the same disclosure to the trustee of another prospect, and his reply was that he knew the amounts, but did not want to disclose them to the participants because they would be disturbed by their magnitude. We have also spoken with prospects that were knowledgeable about true plan expenses and happy with their level expressed as a percentage, but who were unhappy when the expenses were put in dollar terms. The reasonableness of plan expenses is not dependent upon the manner of mathematical expression.

Our primary recommendation to plan fiduciaries is to try to fall within the "knowing and honest" category. This means making every attempt to know the true costs of the retirement plan, including costs that may not be obvious. Once they know the true costs, certainly not a trivial matter with the prevalence of sloppy and/or disingenuous disclosure by some service providers, we encourage them to fully disclose both the level of costs and who is picking up the tab to their participants. You can be honest without disclosure, but you will never be able to prove it.

If you are an employer, can you look your employees in the eyes and tell them that you have adequately disclosed, in a manner they understand, what the costs of the retirement plan are and who is paying those costs? Can you tell them you chose the best and most cost-effective plan service providers, not just those that had a psychologically easy way of paying the costs? If you are a participant in a plan, do you fully understand the costs you are paying for your retirement plan, starting with those disclosed in the prospectus for the different investments? If you are a service provider to a 401(k) plan, can you look your clients in the eyes and tell them that you have fully disclosed and fully accounted for any revenue sharing you receive in connection with your services?

To reiterate what I said earlier, I have a particular bias against barter-like transactions such as revenue sharing. While there may be some psychological advantage for the chief financial officer to not have to cut a check for plan expenses, the whole apparatus of revenue sharing would not exist if there were two parties involved (plan sponsors and service providers) as opposed to three (sponsors, service providers and plan participants). The result of revenue sharing is to pass costs through to plan participants who are unlikely to focus on such costs and who, if they knew the costs, might negotiate for having the employer pick up a larger share of the tab. The passive silence of an unknowing and therefore compliant employee base should not be a primary goal for the employer, and employers seeking that goal are likely to wind up actually getting the opposite once the truth is known.

One who tells lies merely hides the truth, while one who tells half lies has forgotten where he put it.

The ultimate purposes of a retirement plan are to provide retirement income to participants, to attract new employees and to improve employee morale. Even if having participants pay all the expenses falls within the current interpretation of what regulatory law allows, if disclosure of plan costs and who pays them would affect any of these ends, there is a problem, just like with your cousin taking care of your uncle's health plan. The perception of hiding something or of a conflict of interest is likely to be harmful to the attractiveness of the employer and the morale of the employees.

I am not claiming that most or even many employer/plan sponsors are intentionally dishonest, just that the prevalent system of paying for plan services can be misleading and encourages inattention. It is alluring to believe that you are getting valuable services for free but, to paraphrase a line from my favorite movie, "Lawrence of Arabia," one who lies merely hides the truth, but one who tells half-lies has forgotten where he put it. Plan fiduciaries and service providers would serve themselves, and plan participants, better by not worrying so much about the strict legality of various types of revenue sharing under the regulations and start worrying more about more general issues of fairness and disclosure. My hunch is that the need for revenue sharing will disappear with full disclosure, and we can once again return to actually using money for the purpose for which it was intended.