Statement for the Record

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"Solutions to ensure that Americans can enjoy a safe and secure retirement after a lifetime of hard work."

Five Steps to Restoring Trust in the 401(k) System

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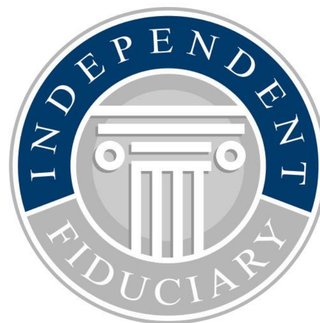

Five Steps to Restoring Trust in the 401(k) system

INTRODUCTION

It is widely accepted that 401(k) and similar arrangements are the way most Americans will invest for retirement. Therefore, it is incumbent upon us all to be absolutely certain there are no unnecessary obstacles (whether intentional or unintentional) to its long-term success.

The 401(k) concept is excellent. It has always had great potential, but that potential was sacrificed on Wall Street's altar of greed, corruption, and the 401(k) industry's harmful business model. It is not too late for the 401(k), but that will require a complete and unequivocal shift in public thinking. In other words, the public—including elected representatives, and regulators—must cast off the marketing-induced stupor that has befallen them.

It is with a deeply felt commitment to the success of our private retirement system that this statement is shared with the Committee. There are reasons the 401(k) is failing. If those reasons are understood and acted upon, the 401(k) can be saved. This statement will explain those reasons and what is required to correct and restore the viability of the 401(k) for generations to come. If all five of the steps described herein are not implemented, the 401(k) system will be doomed to mediocrity – and, more likely, continuing failure.

Step 1: Elevate stature of 401(k) to the original level contemplated by statute

"Give a dog a good name and he'll live up to it."[1]

While the 401(k) as a concept is excellent, the way the plan has been interpreted, marketed, delivered, implemented and operated is not. The 401(k) is suffering because many people inside and outside of the 401(k) and financial services industry view its purpose incorrectly. It is seen as a financial product, not a delicate retirement-income-generating system deserving of fiduciary protections and care.

Many believe that 401(k) plans are nothing more than financial planning or simple savings tools. That is incorrect. 401(k) plans are ***true retirement plans***, with all the attendant obligations and implications. They must be viewed and operated as such for the system to begin to restore the public trust.

From a statutory perspective, a 401(k) plan is as much a retirement plan as a traditional pension plan. Until the 401(k) plan, and the system that it operates within is elevated to the intended stature of a "pension benefit plan" under ERISA section 3(3) (which is why 401(k) plans are reported as a pension benefit plan on form 5500), society and the 401(k) and financial services industry will continue to view the 401(k) as being of "lesser" importance and stature. Behavior and attitudes toward the 401(k) will follow accordingly.

The 401(k) needs a fine reputation to live up to, and that can only happen if all Americans begin viewing it not as just another financial product, more like E*Trade than ERISA, but as an income-producing mechanism, as correctly stated under ERISA, with the ability to financially undergird society as it ages.

Step 2: Create the right types of safe harbors and incentives

> *"Faced with this statutory and regulatory riddle, the Department of Labor ("DOL") and now, Congress, support various investment advice schemes that allow plan sponsors to seek fiduciary relief under ERISA section 404(c). Although these schemes have the potential to resolve the ERISA section 404(c) dilemma, their structural flaws only create more problems—for example, they allow investment advisors to self-deal and operate despite conflicts of interest. And so the riddle of ERISA section 404(c) continues."*[2]

The conventional 401(k) system is not founded solely upon principles that will yield favorable results for participants and beneficiaries. Ironically, there are regulatory incentives to produce mediocre or poor results. Nothing has produced more chaos and confusion in the 401(k) system than Department of Labor section 2550.404c-1, commonly referred to as "404(c)."

404(c) is not just one of many problems with the 401(k) system. It's *the* problem.

We wouldn't let our loved ones get on an airplane that does not strictly adhere to principles of aeronautical science and physics. And we certainly wouldn't knowingly let our loved ones ride in an airplane with a missing wing or a visibly cracked fuselage. That airplane will surely fall short of its destination; and that fact would be obvious long before takeoff. Yet we have a system that permits our loved ones to do just that with 401(k) plans operating within the meaning of Department of Labor regulation 404(c). In many cases, participants merely guess about which funds to invest in, and they often guess wrong. It is commonplace for incomplete or sub-optimal portfolios to be randomly selected. Without even realizing it, participants choose the wrong funds, or the wrong combination of funds, or the most expensive funds–thereby unnecessarily sacrificing years of potential retirement income. To continue the analogy, they choose a portfolio that is not "flight-worthy." Sadly, they will discover that reality far too late in life, and find that their only option is to work harder and longer – perhaps well into their 70's or even beyond.

Section 404(c) was not originally meant for 401(k) plans anyway. It was intended for Defined Benefit Plans with after-tax mandatory employee contribution requirements or the precursor to the 401(k) – the Thrift Savings plans that some employers sponsored in addition to a traditional Defined Benefit Plan. Since the benefits provided under a traditional Defined Benefit Plan were protected by employer funding and the PBGC, it mattered far less if a participant made poor decisions with their after-tax mandatory or Thrift Savings account. The number of participants affected by 404(c) prior to the creation of the 401(k) is not known – but likely insignificant. Perhaps most 401(k)

participants today participate in a plan with a section 404(c) provision. The drafters of ERISA could not have foreseen how 404(c) would damage a system that did not yet exist. ERISA section 404(c) existed prior to the 401(k), and its corrosive effects could not have been known.

In 1991, final regulations under 404(c) were issued by the Department of Labor as a provision that 401(k) plans could utilize. That regulation was ill-conceived. By issuing those regulations, the Department of Labor consigned the 401(k) to mediocrity or worse. It should have been clear that 404(c) should be the exception, not the rule – as there were pre-existing laws in place that gave participants the right to a well diversified, prudent portfolio.

The application of 404(c) to 401(k) plans opened the floodgates to the chaos in speculation and deviation from sound economic and financial principles – placing the burden of "flight-worthiness" on the passenger and taking it away from trained professionals at the airline or the FAA, as it were.

If trust in the 401(k) system is to be restored, the strangle-hold of 404(c) must be broken. That will prevent participants from making incorrect decisions based on emotion, ignorance, greed, or all of the above. It will place investment decision-making back where it belongs – with prudent fiduciaries.

If 404(c) is allowed to remain, it should require a beneficiary waiver before a participant may choose to disregard the portfolios put in place by professional fiduciaries because the result will almost certainly be less favorable for both the participant and the beneficiary. If both agree, so be it. However, a prudent portfolio constructed by an investment fiduciary should be the standard established by law, and it should be accompanied by a safe harbor.

Congress should consider clarifying for the courts that complying with 404(c) requires affirmative proof that all of its requirements have been satisfied. That of course is impossible, because there is no way to determine whether plan participants are "informed." It is the "informed" requirement that gives 404(c) legitimacy, not the offering of a broad selection of funds. The Courts have missed that point entirely. Since it is impossible to know who is truly informed and who is not, even after extensive efforts to provide investor education, 404(c) is simply not viable in a system where the overwhelming population of American workers persists in its failure to grasp the elementary differences between a stock and a bond.[3] Again, 404(c) could perhaps be the exception, but it is a mistake of massive proportions to have permitted it to become the rule.

> *"Many Americans, alas, know little about stocks, bonds, and retirement. This is the conclusion reached by none other than the companies and organizations that would benefit most from a system of private accounts. The Vanguard Group, the National Association of Securities Dealers, the Securities Industry Association, the Investment Protection Trust, Merrill Lynch, Money magazine, and the Securities and Exchange Commission have all done studies or issued reports that reach the same general*

> *conclusion. To make matters worse, much of the research over the past five years has focused on the knowledge of individuals who already own stock and are thus presumably more familiar with the workings of financial markets; the research has still found* ***severe financial illiteracy****."*[4]

Beyond the requirement that participants be "informed," virtually everyone in the 401(k) industry knows that only a tiny fraction of any plan actually complies with the long list of requirements. Section 404(c) is a waste of time, money, and it is also the cause of many billions of dollars wasted each year that otherwise would have been legitimately earned by professionally constructed and managed portfolios. When employers see a safer route (less fiduciary risk) that also has the promise of better results, the system will begin to heal and public trust will be restored.

An employer that sponsors a 401(k) plan should be assured by a clear, unequivocal statutory safe harbor for appointing a professional independent fiduciary, acting pursuant to sections 3(21) or 3(38) of ERISA, or both. That will do more to protect the plan sponsor from fiduciary risk than anything else, and it is consistent with the duty of loyalty in a way that participants do not currently enjoy. Such a safe harbor would reduce or eliminate conflicts of interest. Results would improve through professional application of sound economic and financial principles. No longer would America's employers have to wear two hats and grapple with divided loyalties to their shareholders and their 401(k) plan participants. Such a safe harbor would restore order to the system.

Creating better safe harbors and other incentives that give plan sponsors confidence and a sense of security for having done the right thing the right way will wean the 401(k) from concepts that have only confused and frustrated an otherwise excellent program with potential for long-term success.

Step 3: Participants have a right to know the *expected return* of their portfolio

> *"If [investment] returns could not be expected from the investment of scarce capital, all investment would immediately cease, and corporations would no longer be able to produce their sellable goods and services. The truth is that we invest, not with an eye to making speculative gains, but because we have an expectation of a specific return over time."*[5]

Every week, thousands of enrollment meetings are held in the lunch-rooms of corporate America. Those enrollment meetings seek to explain to participants why they should enroll in their company's 401(k), and which investment options are available to them.

That is fine, with one exception. Most of the paperwork and enrollment materials will provide participants with useless information about the type of investor they are. Participants will take a 5 minute quiz, and that quiz will tell the participant that they are a "conservative" investor, or a "moderate" investor, or perhaps an "aggressive" investor. Perhaps a particular list of funds with suggested ratios for which to allocate new contribution dollars will be associated with each investor type.

There are two fundamental flaws with that approach.

First, whether a participant has a conservative or an aggressive investor profile is dependent on emotion; how much market volatility they can stomach. A participant's tolerance for market turbulence is not static. It can change day-to-day. For example, if a participant with an aggressive profile gets in a car accident, their profile may immediately switch to conservative. That is an emotional profile that does not tie well to the economics of prudent, long-term investing.

Second, the emotion of identifying an investor profile does not help the participant understand the interplay between new funding (ongoing contributions/deposits to the plan) and future retirement income streams that can be ***expected*** (not to be misunderstood as "guaranteed.")

Therefore, the most important thing a participant needs to know is not their emotionally determined ability to endure market turbulence, but rather the long-term economic output of the participant's portfolio. This is called the "***expected return***." Knowing that, a participant cannot truly understand how much money they should be contributing to the plan, when coupled with any employer generosity, if any, to achieve a future income-replacement goal.

The expected return is the most fundamental concept of investing because if those with capital to invest could not expect a return, that capital would be invested elsewhere – or not at all. The concept of expected return is perplexingly absent in the current 401(k) system and is not understood by participants or fiduciaries. That misunderstanding can easily be corrected.

It should be mandated by law that all participants be told what the expected return is for the actual portfolio they are in. That way, the one thing that participants can control – the amount they contribute to the plan – is a decision made in light of the expected return of the portfolio they will invest in so their decision is both informed and founded upon a process that is likely to yield favorable results.

Participants may not be able to afford what they wish they could contribute based on the expected return of their portfolio. For example their portfolio may have an expected return of 5%, and to comfortably retire they may learn that they will need to contribute twice as much as they can afford in order to get there. That is an understood reality of life that many face each day when purchasing goods and services. However, participants should at a minimum know the economic characteristics of their portfolio so they can choose to get more education in order to earn more, work longer, spend less on other things, or a combination thereof.

Consider how different things would be if we stopped inducing emotional decisions in participants and began given them solid, reliable information based on modern principles of economics and finance.

Step 4: Transparency

Our retirement savings system and its participants deserve protection. The bedrock of any mechanism as delicate as the 401(k) should be clarity and transparency.

The debate over whether the cost of a 401(k) plan is reasonable is pointless without standardized transparency. Can something be determined reasonable if it cannot first be seen and understood in a comparative context?

In the case of plans with known economic impact to participants, perhaps all fees and costs are deemed reasonable when compared to the industry as a whole, yet simultaneously excessive in light of the quality or value of services rendered to a specific plan. In other words, all 401(k) plans could eventually have fees that someone deems reasonable, but those same fees may be genuinely excessive at the same time – therefore it is not an either-or scenario.[6] That conundrum cannot be resolved in an environment of opacity.

Given the seriousness of the crisis we face, where an estimated $1 trillion in 401(k) assets has been lost in the past few months, we cannot accept anything less than full and absolute transparency – even if fees and other charges become very low by today's standard. In other words, there may come a time when fees are reasonable, non-excessive, and absolutely transparent. It is in times such as those, transparency will be no less important or necessary for the purpose of protecting trust in the system.

Passage of HR 3185 or a fundamentally similar Bill will begin the process of restoring broken trust. Distilling disclosure of expenses into an understandable format will deliver value to participants, beneficiaries, and employers. The gross-to-net methodology, which means clearly showing gross returns on the investments in a 401(k) account and also showing the net returns that the participant gets to keep, makes the most sense. It reveals total investment returns, the net return to each participant, and by simple subtraction, the actual costs of delivering those net returns to each participant.[7] Any other method obscures both returns and costs from the view of the participants, plan sponsors, and regulators alike. Gross-to-net disclosure establishes true transparency, a pre-requisite to restoring trust in the 401(k).

Transparency should also be required for new financial products that are developed in the future, such as fund-of-funds, lifestyle, and target date funds. Some of those may be well constructed. Some of them are not. Transparency is required to ensure fiduciaries and plan participants understand the difference.

Step 5: Retire-ability measurements

As stated earlier, the 401(k) has not been managed to produce future retirement income. Rather, it has been managed like merely another of an array of ordinary financial products. Thus, the ability of conventional 401(k) plans to produce financially secure

retirees is not a primary discussion item of fiduciaries and committee members in their meetings.

Many factors go into creating a successful program, each having differing importance and weight at different stages of a participant's progression from entry into the workforce to retirement. Also, participants at different ages are affected differently by plan provisions or economic conditions.

For example, younger participants with smaller account balances are most affected by matching or other employer contributions. Older participants with larger account balances are most impacted by fees and other charges. Employers and fiduciaries must understand what helps participants, what hurts them, and when those effects are most likely.

If 401(k) plans are to thrive, employers and fiduciary committees must engage in regular proactive and thoughtful assessments of the "retire-ability" qualities of their plan, while taking into account the demographics of the plan participants as a whole.

Society requires more that ever a more astute body of fiduciaries who understand that improved future retirement income for individuals also enables an improved future economy for all. Higher retirement incomes can help stabilize the economy, sustain tax revenues necessary to deliver essential government services and provide economic opportunity for the rising generation.

Employers must not fear the question, and then answer honestly, "Will our employees be able to retire at their chosen time? If not, what can we do to improve their chances?"

SUMMARY

1. **Return to Roots** – Congress can make it unequivocally clear that plan sponsors need to understand 401(k) plans must not as mere financial planning tools, but rather the a pension benefit mechanism that produces retirement income that will be the financial undergirding mechanism of society.

2. **Safe Harbors & Incentives** – Congress can create meaningful safe harbors and incentives that give employers confidence to proceed in managing their 401(k) plans in accordance with modern principles of economics and finance – thus improving results. Congress can remove or suppress harmful elements of the conventional system, such as Department of Labor regulation 404(c). That regulation, 404(c), is the lead in the paint, the salmonella in the peanuts, the goose in the jet engine of the retirement system. Fix it, and you will fix the root cause of the problems that plague the 401(k).

3. **Expected Returns** – Congress can require that participants be given the expected return (economic characteristic) of the portfolio in which their funds are invested. Unlike knowing the expected return of a portfolio, the emotional risk profile most 401(k) participants are given to help them choose investments is not useful in calculating future retirement income nor is it helpful in making appropriate portfolio changes. The expected return is already required by case law to be known and understood by fiduciaries. That same information should also be made known to participants.

4. **Pass HR 3185** – Congress can pass HR 3185 or its fundamental equivalent to clarify plan expenses by a simple gross-to-net calculation in order to help employers and plan participants make better decisions, and also to restore trust and confidence in the system. No system as important as the 401(k) should have any lingering questions about fee or expense transparency. Thus, the passage of HR 3185 or its equivalent is at a minimum, urgent.

5. **Retire-Ability Measures** – Congress can encourage employers to look beyond the robotic fund selecting process that has become synonymous with being a 401(k) committee member and to look more deeply at how their plans are designed to produce financially secure retirees. And participants can be provided tools to assess their projected retirement dates and expected income levels.

CONCLUSION

There are problems with how the 401(k) has been delivered; that goes without saying. That does not mean we need to accept what has not worked and protect the status quo. No one is suggesting that employers guarantee benefits. It is proposed, rather, that 401(k) plans be managed like the retirement-income-producing mechanism they were always intended to be. It is because the benefits delivered by a 401(k) are not guaranteed that we should demonstrate particular care and compassion. Participants are entirely vulnerable, and deserve better protections. Protecting the interests of participants will require a sweeping shift in thinking toward a system that enables (1) A fiduciary level of care; (2) Improved safe harbors and incentives; (3) Disclosure of expected investment returns; (4) Transparency via actual gross-to-net disclosure; and (5) Measurements of each participant's ability to retire at targeted dates and income levels. The benefits of these five reforms to the 401(k) system will reach more than fifty million working Americans. Without this shift in thinking and behavior, including abandoning the misused 404(c) provisions, the 401(k) will fail to deliver on its original promise. There is hope for the 401(k) to rebuild savings and regain the trust of American workers, but it must be operated as ERISA originally contemplated; like a "pension benefit" plan.

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[1] Attributed to Dale Carnegie

[2] Chicago-Kent Law Review. ERISA Section 404(c) and investment advice: What is an Employer or Plan Sponsor to do? Stefanie Kastrinsky. Page 3 May 16, 2005.

[3] Dave Mastio, "Lessons our 401(k)s Taught us. How much do Americans know about investing for retirement? What investors don't know." http://www.hoover.org/publications/policyreview/3552047.html

[4] Ibid

[5] "Investment Risk vs. Unprincipled Speculation" Journal of Pension Benefits ©Wolters Kluwer Law and Business. Volume 16, Number 2, Winter 2009. Page 76.

[6] See 9th Meigs question for further explanation about the relationship between "reasonable" and "excessive" fees and expenses. http://www.401khelpcenter.com/401k/meigs_mdh_interview.html

[7] See "Gross-to-Net" proposed fee and expense disclosure reporting grid. http://www.dol.gov/ebsa/pdf/IF408b2.pdf. See also http://advisor.morningstar.com/articles/article.asp?s=0&docId=15714&pgNo=2