A Conversation with a Fiduciary

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Receptionist: Bob, Mr. Fiduciary is here to see you. He says he's a few minutes early.

Bob: Thank you. Please have him come to my office. (*Thinking to himself: I'm relieved to finally put this matter behind me. I'm confident this guy will help me solve this problem once and for all.*)

Fiduciary: Bob, thank you for asking me to visit with you. How can I help?

Bob: Well, one of my employees thinks they are not being treated fairly by our 401(k) program, and because this employee happens to be my nephew, I thought I should get the opinion of an objective third party--out of respect for my sister, of course. *Smiles and winks.*

Fiduciary: *Smiles and lightly chuckles.* I understand.

Bob: We have about 120 employees. All of them, except "the one" are very happy with our 401(k). We have one of the best 401(k) plans available anywhere, and it's free to our company.

Fiduciary: Tell me more about it.

Bob: It permits employees to join after 90 days of employment. It has 12 funds, all "5 star" ones I might add. We also make a matching contribution.

Fiduciary: Has your nephew shared a specific concern with you?

Bob: A specific concern? How about a dozen specific concerns? He graduated from college two years ago and came to work for me at that time and sometimes comes across as a know-it-all. He even went so far as to accuse me of breaching my fiduciary duty to him and saying I am guilty of fiduciary misfeasance. Kate and I decided to stop having him over for dinner for several months after that last accusation. *Smiles and light laughter.*

Fiduciary: Okay, let's start at the beginning. What is his first concern?

Bob: Gee, where do I start? Oh, I know. He says that I have a legal obligation to invest his 401(k) money for him. Can you believe it? That's his responsibility! I'd never make decisions affecting his or anyone else's 401(k) investments.

Fiduciary: Why not?

Bob: It's a no-win scenario. He would point the finger at me when his investment returns aren't high enough.

Fiduciary: Are you saying that you believe you would get lower returns for him by making those decisions on his behalf than he would if he invested his own account?

Bob: Um, I don't.

Fiduciary: Would you let your nephew make the investment decisions in your 401(k)?

Bob: Of course not! What kind of question is that?

Fiduciary: You expressed a concern that you think he would point his finger at you for getting investment returns that were lower than he himself could have gotten on his own. If that argument is true, then why wouldn't you want him to invest your account?

Bob: Huh? That's not what I meant. Is that a trick question?

Fiduciary: No, it's not a trick question. Let's think about this together for a minute. First, do you really believe he could get higher returns making all investment decisions for himself than you could investing on his behalf, all things being equal?

Bob: Um.

Fiduciary: In other words, each of you has access to the same 12 funds. You each have a time horizon of more than 15 years to invest. Isn't it true that theoretically you could have identical returns over that 15-year period if you were investing funds on the exact same day in the exact same funds?

Bob: I'm not sure.

Fiduciary: Let me make this a bit easier. Do your 12 mutual funds automatically produce better results for you as CEO than they do for, say the new hire in the mail room?

Bob: No, certainly not. I don't see your point.

Fiduciary: Do you expect lower returns than your nephew?

Bob: Of course not. I know we've just met, but I'm starting to wonder if we should table this discussion for now. It's not going where I thought it would.

Fiduciary: Bear with me a little longer, will you?

Bob: I guess, but get to your point.

Fiduciary: All right. Is it safe to say that those 12 funds, when properly utilized in aggregate and in the correct ratios, could produce identical returns for both of you?

Bob: Sure, that seems obvious.

Fiduciary: So, what is good enough for the CEO, is also good enough for the CEO's nephew?

Bob: *Sighs.* Of course.

Fiduciary: Since your nephew has been participating in your plan, have you earned identical returns?

Bob: How am I supposed to know? His 401(k) is his business. That is his responsibility, not mine.

Fiduciary: We'll come back to the responsibility issue later. For now, let's explore why your nephew might be concerned. What do you do as the Plans' fiduciary to ensure all participants get the highest return possible, given identified constraints such as the appropriate levels of risk, time frames, income replacement objectives, etc?

Bob: I don't ever think about those things. That is the responsibility of each individual employee. We have a couple folks come in and do a dog and pony show several times a year to help our employees fulfill their responsibility to themselves. The plan pays them to do it, because the employees get the benefit.

Fiduciary: You selected the underlying funds, didn't you?

Bob: Well, kind of. My investment advisor selected them, and I basically rubber stamped them.

Fiduciary: Did your employees have any say in which fund were made available?

Bob: No.

Fiduciary: So, it's actually not your employees' responsibility to select the funds themselves, but you believe it is their responsibility to choose from the funds you selected.

Bob: Uh, yes, I suppose that would be correct.

Fiduciary: Okay.

Bob: Why are you looking at me that way?

Fiduciary: Tell me again why it's your responsibility to select the funds, but not your responsibility to do anything else? In other words, why is it your employees' responsibility to make investment decisions within a trust? You are placing the most difficult aspect of investing--how to utilize the given 12 funds in the right ratios--on those who understand the least, i.e., the employees.

Bob: Because my 401(k) provider, my CPA, and my lawyer all tell me it is the employees' responsibility. It's the law. Why do you ask that question? It's their money and it's their responsibility to invest it. Everyone understands that.

Fiduciary: Did you personally perform an appropriate level of due diligence on the funds you selected?

Bob: I relied on my investment person to do that for me.

Fiduciary: Could you do it yourself, right now?

Bob: Uh.

Fiduciary: In other words, could you right now select 12 funds to replace your current funds while maintaining the same overall characteristics and objectives in each investment class and category?

Bob: No, of course not.

Fiduciary: I see. And you think your employees could?

Bob: Well.maybe.

Fiduciary: Are you the smartest person in your company?

Bob: Well. *nervously smiles and chuckles.*

Fiduciary: Let's take it a step further. You are a participant in the plan, just like everyone else, right?

Bob: Right.

Fiduciary: Is it fair to say you have made the better investment decisions for your individual 401(k) account than everyone else in your plan?

Bob: Sure, I guess.

Fiduciary: If you are capable of making such decisions for yourself, are you also capable of making the best possible decisions for your employees?

Bob: Yes, but that's not my responsibility!

Fiduciary: Let's say for a moment that you are correct. Let's say that all employees, including your nephew, are substantially "dumber" than you.

Bob: That's an understatement, speaking of my nephew, of course. Smiles.

Fiduciary: Okay, since they're "dumber," is it safe to say that their accounts will not perform as well as yours, primarily because you make better decisions and simply know more?

Bob: Maybe.

Fiduciary: At what point in time do you, as the smarter and more informed person, who is also their fiduciary--meaning their protector, overseer, etc.,--step in and help the less-informed group enjoy the same returns that you have been enjoying? Remember, at no extra cost, the exact same funds you have as the smartest employee could be working for the dumbest employee. Isn't that part of being a good fiduciary?

Bob: I don't agree that I have any obligation to do that. Besides, if I did, and if I made a mistake, I'd be liable for that mistake. I'm not willing to assume that liability.

Fiduciary: What if I told you your 401(k) provider, your CPA, and your attorney may have all misunderstood the laws that govern 401(k) plans?

Bob: I wouldn't believe you. That's ridiculous. My team of professionals is as sharp as they come.

Fiduciary: There's no doubt they are sharp. But what if they are victims to the same marketing and cultural conditioning you are? What if your employees are not responsible for making investment decisions within their own 401(k) accounts and that there is no legal basis for that belief? What if a plan can permit employees to make those decisions, but not legally require them to?

Bob: That's a ludicrous assertion.

Fiduciary: Is it?

Bob: It is.

Fiduciary: Are 401(k) plan investments held in a trust?

Bob: Yes, our plan is named, "Space Sprocket Solutions, Inc. 401(k) Plan and Trust."

Fiduciary: Do you happen to have a family or estate trust?

Bob: Yes, we in fact do.

Fiduciary: Are there identified beneficiaries within that trust?

Bob: Of course.

Fiduciary: Do you let those beneficiaries make decisions within the trust? For example, do they get to decide how things are managed within the trust, today?

Bob: No, I make those decisions.

Fiduciary: Why don't you let the beneficiaries make those decisions instead? Isn't it their responsibility?

Bob: No, it is not. But this is different.

Fiduciary: How is it different?

Bob: The beneficiaries of our family trust didn't put their own money in for the privilege of letting me manage it for them so they can take out their own money after I die.

Fiduciary: What if your sister, for example, contributed $100,000 of her own money to your family trust? Would you make her a trustee so she could manage her own money?

Bob: That seems a little silly. She should just keep her money out of our family trust and invest it on her own.

Fiduciary: But what if there are important reasons for making the contribution, such as tax benefits?

Bob: I supposed I would make her a trustee then.

Fiduciary: And you would define her limited role as being a trustee over the assets she contributed, right?

Bob: Right.

Fiduciary: Would you be okay with what ever decisions she made affecting her $100,000?

Bob: It's her money; she can make any decisions she pleases. After all, she is also a trustee.

Fiduciary: Have you made all of your employee's trustees over their own accounts held in the Space Sprocket, Inc. 401(k) Plan and Trust?

Bob: What?

Fiduciary: Have you made every employee who has contributed his or her own money into the Space Sprocket, Inc. 401(k) Plan and Trust a trustee for his or her own account?

Bob: No, of course not. That would be utter chaos.

Fiduciary: Very true. Could there also be another reason you haven't named your employees as trustees?

Bob: I suppose there could be, but I don't know...

Fiduciary: What if the law simply states that it is the fiduciary's duty to invest trust assets on behalf of participants in the plan? What if trusts are managed by fiduciaries who act on behalf of others who will receive benefits in the future? In other words, what if the law says that participants and beneficiaries are not fiduciaries to themselves? Further, what if a fiduciary must be in place to make decisions on their behalf; in their best interests? Can a participant in a 401(k) plan be a fiduciary to himself in this context?

Bob: Well, that's another thing. If the law was clear in that regard, and if actually said that, then that is exactly what I would do.

Fiduciary: It does say that. It always has.

Bob: This is the first time I've ever heard that, and I'm not sure you are correct. What you are saying is that 600,000 businesses have bought into an approach that is all wrong. Everyone I know thinks it is our employees' legal responsibility to make their own investment decisions regarding their 401(k) accounts within the plan. If it is actually the fiduciary's responsibility, and if it always has been, then we're all making the same big mistake.

Fiduciary: Do you believe that could be a possibility?

Bob: Well, uh, I.here's the thing that bothers me. If the other 599,999 business owners are like me, they would have opted to not set up a 401(k) had they known it was their legal responsibility to take care of their employee's financial future. That's not something I want to deal with. I have too much on my plate. Besides, when are people going to step up and start being responsible for themselves? And what about the employees who demand to invest their own money? They wouldn't participate in the plan if they couldn't make those decisions themselves.

Fiduciary: We'll come back to why every employer is the fiduciary of their plan in a few minutes. For now, let's presume that all 600,000 employers have embraced an improper approach to managing their 401(k) plans. Could you objectively have that discussion?

Bob: Sure. Actually, I'm somewhat intrigued now. This is a mystery that needs to be solved.

Fiduciary: If you were to guess, how would you say this happened?

Bob: Hmm. . . I'm not sure. Let me think. The first thought that comes to mind is that employers may not have set up 401(k) plans unless they could justify passing certain responsibilities off on employees.

Fiduciary: Okay, good. That's a very good observation. Therefore, what?

Bob: Maybe the financial services industry understood this dynamic ahead of time, and constructed a marketing plan around that reality? Or, maybe they tried to sell 401 (k) plans and encountered resistance and then made adjustments as they went along?

Maybe they overlooked established fiduciary requirements when developing ways to sell 401(k) services? Then, once they tasted success, they focused on what worked. How's that for a from-the-hip analysis?

Fiduciary: You've identified an important element. We both agree that most people think it is an employee's responsibility to invest his or her 401(k). You are correct; this common belief is the result of clever marketing, and it is not founded upon law or correct fiduciary principles.

Bob: But since 401(k) plans have been such a huge success, why does it matter?

Fiduciary: Because the financial markets have delivered far better returns than the employees have actually gotten to keep. Billions of dollars each year slip out of participant accounts into the hands of others because employees do not understand how to properly manage their accounts. They can't understand the economics, the fees, the risks, the markets, and many other elements that experts need to know to construct an effective portfolio. Do you suppose this is one of the reasons the law contemplated that one or more fiduciaries would make those decisions in order to prevent unnecessary mistakes, excessive fees and services, and economic slippage?

Bob: Interesting. What happened to the returns the participants didn't receive?

Fiduciary: Those returns end up in the pockets of shrewd business people who understand individual 401(k) investors are prone to making mistakes and lie-in-wait for it to happen.

Bob: If that is true, it infuriates me.

Fiduciary: It should. All participants, with very little effort, could realize market returns in their 401(k) accounts.

Bob: How?

Fiduciary: Simply construct a low cost, efficient portfolio that operates on what we call the "efficient frontier." Let all employees enjoy the benefits of such a portfolio equally. In fact, it is every participant's right to enjoy the results of such a fiduciary-governed portfolio under current retirement plan law. It's been the law since 1974.

Bob: Ah, I got you on something! What about 404(c)?! Why would I do what you are suggesting? I'd have too much liability? 404(c) protects me from legal risk associated with poor investment results.

Fiduciary: How much do you know about 404(c)?

Bob: Enough to know I like the idea.

Fiduciary: Have you ever heard, "There's no such thing as a free lunch?"

Bob: Of course. I'm not an idiot, despite what my nephew thinks!

Fiduciary: I know you're not, which is why I am puzzled that you think 404(c) is something it's not. Why do you think 404(c) is a free lunch?

Bob: I don't follow.

Fiduciary: Tell me how you believe 404(c) works.

Bob: We let employees choose from a menu of funds, and we have no liability for the mistakes they make.

Fiduciary: Is that it?

Bob: I think I remember a few others requirements. My investment sales person told me that we have to offer at least three funds, provide investment education meetings, provide information about the funds, fees, and permit employees to switch funds at least quarterly. If I remember, that's it.

Fiduciary: So, it's your understanding that if you do these things, you get off the

hook if a participant's account performs poorly. Is that correct?

Bob: Yes, isn't it true?

Fiduciary: No, it's not true. There's much more to 404(c) than you think.

Bob: Like what?

Fiduciary: First, let me ask you a question. If you were to guess, what type of 401(k) plan costs more. One that seeks to comply with 404(c), or one that doesn't? All other things being equal, of course.

Bob: The 404(c) plan would cost more because there is more work involved.

Fiduciary: Is that how 404(c) was sold to you?

Bob: I don't follow.

Fiduciary: When the 404(c) concept was initially presented to you, didn't you immediately conclude you would have less work to do, fewer responsibilities, and that is why you bought into it? Isn't that why most employers also bought into it?

Bob: Yes, that was initially true. But I understand that is not the case now.

Fiduciary: Do you agree then that more work equates into more fees?

Bob: Of course. It works that way in every business. Like you said, there's no such thing as a free lunch. It's economics 101.

Fiduciary: What is the purpose of the additional work required to comply with 404(c)?

Bob: It so I can be protected from.

Fiduciary: So you can be protected?

Bob: Let me finish. It shows I have been prudent by letting my employees choose their own funds. (*Pauses for a moment and thinks about the fundamental contradiction in his statement.*) I've done all of the due diligence required and I have fulfilled all of the other requirements, and therefore I should be protected from liability.I think.right?

Fiduciary: Do you fully comply with 404(c)?

Bob: My professional team says I don't actually comply. They tell me that no one does, in reality, but they tell me to keep trying.

Fiduciary: If 404(c) gave no assurance of possible protection from fiduciary risk, would you still keep trying to comply?

Bob: No, it would be a waste of my time and the trust's money.

Fiduciary: What is your sole motivation for trying to comply then?

Bob: Again, so I am protected from fiduciary liability.

Fiduciary: Think like a fiduciary instead of a businessman for a moment. You are spending your employee's retirement assets on services that protect you, not their future.

Bob: What?

Fiduciary: You agree that 404(c) plans cost more, right?

Bob: Yes.

Fiduciary: Do you pay for the additional 404(c) services?

Bob: No, the participants in the plan pay for it.

Fiduciary: Is 404(c) mandatory? In other words, is 404(c) a legal requirement?

Bob: No, I think compliance with 404(c) is a voluntary add on.

Fiduciary: Do you know exactly how much those additional services cost in relation to all other services?

Bob: No.

Fiduciary: Could that be part of the reason your nephew is concerned? He is paying for your protection. You have a fiduciary duty to know how much each aspect of your plan costs so you can evaluate whether those services are in your employees' best interests. At a minimum you are possibly breaching your fiduciary duty by not understanding and managing the costs within your plan. But that's only part of the problem.

Bob: *Pauses.*

Fiduciary: You see, you, as the fiduciary, have the authority to spend the assets of your employee's retirement accounts on plan services. But in the case of 404(c), you are spending it for your benefit, not theirs. And because it's probable you do not comply, you are wasting their money trying. You are actually decreasing their future retirement benefits for the privilege of protecting you from fiduciary risk. Ironically, 404(c) encourages fiduciaries to do the exact opposite of what fundamental fiduciary principles require.

Bob: *Thinking.*

Fiduciary: Also, being a good fiduciary means protecting plan assets. When expenses are required to be paid from plan assets, they should only be paid for services absolutely necessary for delivering the maximum future benefits to your employees. You should not spend a dime more than is necessary to deliver maximum future benefits. This especially means avoiding funds with bloated expense ratios that subsidize the existence of 404(c) practices while giving the false impression that those plan services are "free."

Bob: Interesting.I see.

Fiduciary: By using plan assets to pay for something that is not necessary for the protection or security of future benefits, you are actually hurting participants, not helping them. You admitted you are spending someone else's future money to protect yourself from fiduciary liability.

Bob: But some of my employees will demand to invest their own money, even if they do make mistakes.

Fiduciary: And the long-term results will be unfortunate for them. The problem for you is that you cannot turn a blind eye to it. Especially now that you understand.

Bob: But how would I explain all of this to them?

Fiduciary: They all have one thing in common.

Bob: Which is.?

Fiduciary: Every single one of them, yourself included, does not want anything less than 100% of the potential return available through the available investment choices in his or her 401(k) account. Do you agree?

Bob: Of course! All of us want to get everything we can out of our investments.

Fiduciary: That's how you explain it then. A leading investment expert and researcher named Roger Ibbotson made this point, "For the long-term individual investor who maintains a consistent asset allocation and leans toward index funds, asset allocation determines about 100% of performance." Isn't that what we are talking about? Why not help all employees get 100% of the possible performance less only necessary overhead year in and year out?

Bob: Brilliant.

Fiduciary: Aren't the bulk of your employees, in spite of all of the money spent on education, basically guessing about how to invest their accounts?

Bob: Yes, they sure are. For the first time I think I actually understand why my nephew might be concerned. If what you are saying is true, 404(c) is a really twisted element of our 401(k) system. How did that happen?

Fiduciary: There are many different theories, the most prevalent being the "make it legal" theory.

Bob: What is that?

Fiduciary: Have you ever heard the story of the business owner who asked her CPA what 2+2 equaled? And the CPA answered, "What do you want it to equal?"

Bob: Sure, I've heard that many times.

Fiduciary: Many people feel the financial industry took the 404(c) ideas to clever lawyers who made it equal what the industry wanted it to. It turned out to be the single greatest marketing gimmick in retirement plan history.

Bob: So, basically the 401(k) industry took a non-fiduciary concept--a fundamental violation of fiduciary principles at that - and marketed it in such a way that most business owners thought it was okay?

Fiduciary: Exactly. The marketing message was so crafty, even the regulators were unable to discern the subtle nuance of what was happening.

Bob: Interesting--and troubling at the same time.

Fiduciary: You previously mentioned that you would not have adopted a 401(k) plan without 404(c) protection. You are not alone. Regulators could have been more in tune with pre-existing fiduciary principles, and they could have tied fiduciary protection to something results based, such as helping participants enjoy the benefits of a low cost market-tracking portfolio. For example, they could have made the safe harbor available to all plans where 90% of all participants' historical return was within 1.5% of a historical broad market index. This is one of many possible alternatives that would have been a positive solution for employers and employees alike.

Bob: Because that way the participants could see that they are getting positive results. If they get positive long term results, and with that approach, plan economics would be transparent by design, then the fiduciary would have no liability.

Fiduciary: Exactly! But instead, we have a system that on average delivers returns of 2% to 5% or more below the market over an extended period of time and hides the true economics from all parties--employers, regulators, and employees alike. The 401 (k) industry tells employers all they have to have is a prudent process, but if that process is based upon a flawed concept, then the results will reveal it. A prudent process is only as good as the fiduciary principles upon which it is founded.

Bob: And we all think we get to shrug our shoulders and say, "Sorry, I'm protected from your poor returns and unintelligent investment choices because of 404(c)!" It's unconscionable!

Fiduciary: That's right. Think about what we are doing to society by permitting 404(c) to exist? There are other ways to protect fiduciaries that put participants' interests first.

Bob: It isn't right! I'm embarrassed to say I bought into the gimmick. I thought I was smarter than that, but I admit I've made a mistake. My nephew might not be so dumb after all. All I had to do to be protected from liability was to help all of my employees earn at least as good a return as I receive in my 401(k) account--a return that closely tracks the broad market. I understand now that it is the right of every participant in my 401(k) to get the best possible risk-adjusted return, and since I have always had the power to make that happen, that's exactly what I should have been doing all along.

Fiduciary: I like the analogy of the surgeon and a patient.

Imagine yourself in a discussion with a surgeon you just met at a local hospital. Maybe you have spent an hour at most with him. After sharing some basic information, he says, "Here's what you need to do. Lie down on this table. I'm going to draw five horizontal lines on your chest and abdomen. Each will be slightly different lengths and spaced evenly, and at least one of them marks the point of incision needed to accomplish your objectives." Once the lines are drawn, the physician hands you a scalpel and says, "Okay, you are ready. Cut away!"

"Wait a minute.which one do I cut?"

"Oh, I can't tell you that. I'm giving you more power over your own surgeries than you have ever had in the past. It's your own responsibility to cut. Besides, if I cut, I could have liability if I make a mistake."

"What makes you think I won't make a mistake?" you reply

"Oh you will. We expect something will go wrong."

"How do you figure?"

"Well, first, we haven't told you where or how deep to cut. We're also withholding information about how to manage your anesthetic. Plus, you won't know whether you've performed the surgery correctly for another 25 years or so. You wouldn't be able to figure out how to perform this procedure properly in any event, so there is no need to burden you with lots of information. However, we do have this nice colorful brochure you can use. It has a few cartoons and graphics on it. It should help."

"But what if I die?"

"Nobody has ever actually died from this procedure, though some have had uncomfortable futures. If this procedure doesn't go well, we'll always be here to recommend another surgery you might perform on yourself. We are professionals; we provide guidance, and we don't ask you to pay us a thing. Plus, we clean up when things go wrong; actually, the worse they go, the more we clean up."

"I'm not sure I understand how you can do this and not get paid. . . but I guess that's your problem. What I don't know, can't hurt me, right?"

"Right! Thanks for your concern, but we do quite well for ourselves. We have relationships with hospitals, insurers, surgical equipment firms, medical supplies companies, and others, but you don't need to know about all of that. We know how we get paid, and that's enough. We save money on reports and disclosure this way; besides, most people consider it rather rude to ask professionals like us about our fees."

"But, if things don't go well, who is responsible? Who takes the blame?"

"It's not you, of course, since nobody expects you to know how to perform a procedure like this. And it can't be me, since I'm not going to actually do anything but stand back, watch, and clean up if there is an error. So, it has to be your employer, who sponsors this wonderful employee benefit for you and is obligated to make sure that you're kept healthy and productive."

"Okay. I don't understand much about any of this, it, but I'll go ahead and start to cut. Wish me luck."

You wake up after several days, still sore and bleeding, but alive. Several months later you are released from the hospital. You never do get a bill from the physician--or from anyone else for that matter--but discover that while you were in the hospital, your life savings somehow were cut by 30%, though there is no paper trail showing where your money went. You complain to your employer, but he tells you that he's not responsible for

your pain & suffering, since he took some of your money and bought himself an insurance policy in case you made a mistake. He tells you that, although he knew a real doctor could have performed the procedure professionally, he didn't want to take that sort of risk, and simply says, "You should have done a better job with your own surgery."

You sense in your gut that something is wrong with this picture and contact an attorney to sue your employer for putting you in this ridiculous bind.

Bob: Great analogy! So, I, as the employer, actually have more liability now, because of 404(c)?

Fiduciary: You absolutely do. When the public understands, as you do now, there will be outrage. Duping the general public is never a good thing.

Bob: Shouldn't the government do something?

Fiduciary: I think government understands this problem, and I believe they will eventually fix it, but not before the federal courts deal with it.

Bob: Litigation?

Fiduciary: Right. Once 404(c) has been properly explained to a jury, I think we are going to see sweeping changes, billions in monetary awards, and a national reawakening to appropriate fiduciary behaviors. Straying from fiduciary principles of care and loyalty through rules such as 404(c) is an experiment America should not try again. Corporations could end up paying far more in the end for this mistake. In short, it isn't right or fair to spend someone else's money for your own protection.

Bob: Clearly. However, the federal government says 404(c) is okay, and it is a provision in my 401(k) plan documents. We just can't ignore the fact that 404(c) is part of nearly every 401(k) in the country.

Fiduciary: There are two other issues about 404(c) that will also be tested in the courts.

Bob: Such as.

Fiduciary: The first is the false understanding that 404(c) requires participant education. It doesn't, and thousands of plans use plan assets to pay for participant education. What's worse is that few employees take advantage of it, but they bear a portion of the excess costs built into the overall economics of the plan.

Bob: I've always understood investment education it was a requirement of 404(c).

Fiduciary: It's not. This is where things get tricky. Because participant education is not required by law, nor is it part of 404(c), then it's also not a qualification requirement in the plan document, nor is it necessary to secure future retirement benefits. In fact, there is evidence that it has not helped, but rather hurt, millions of American workers. No amount of education can help participants get better investment returns than the general market over the long haul. A person with zero investment knowledge could easily earn nearly general market returns with a little help from a knowledgeable fiduciary. Returns substantially less than market can really mount up over time. Any transaction involving plan assets that is not required for delivering future benefits and that is also not specifically authorized in the plan document as necessary to fulfill the purpose of the plan are by definition a prohibited transaction. In other words, just because 404(c) is a provision in a plan does not automatically mean the plan must pay for participant education services.

Bob: A prohibited transaction? That doesn't sound good. I also see how excess services such unnecessary education can actually end up hurting participants. There are other things I can now see in my plan that could also potentially fall into that category.

Fiduciary: The tax consequences of a prohibited transaction are frightening. They compound in a geometric fashion. For example, the prohibited transaction tax is 15% of the amount of plan assets in question. Thus, if $35,000 is spent out of trust assets

for participant education services, the prohibited transaction tax is $5,250. If it happens again the next year, the tax is again $5,250, plus $5,250 x 2 from the prior year's prohibited transaction. By the second year the compounding prohibited transaction tax is $5,250 x 4. The third year it would be $5,250 x 8, and so on.

Bob: And the employer has to pay this tax?

Fiduciary: Right. And there's yet another problem. Because 404(c) is a plan design feature, a plan must comply with it if it's in the plan document. It's a widely accepted fact that most plans do not comply with 404(c).

Bob: So, most 401(k) plans are out of compliance in that regard?

Fiduciary: Right. It will be interesting to see how the IRS deals with it. They require full compliance on matters of far less significance, so I doubt they will turn a blind eye to it.

Bob: What about the new law? Doesn't it protect guys like me, who just want a simple way to provide some sort of pension benefit for our employees, from these kinds of things? I think it it's called the Pension Protection Act of 2006? Didn't it create something like a ready-made portfolio; a default portfolio?

Fiduciary: You are referring to something called the Qualified Default Investment Alternative, or QDIA. The Pension Protection Act of 2006 created a safe harbor for fiduciaries that make decisions for employees who fail or refuse to make investment decisions for their 401(k) account. Approaches that are acceptable include life-cycle or targeted-retirement-date funds, balanced funds, or professionally managed accounts.

Bob: Isn't that just coming full circle to what you have said fiduciary should have been doing all along?

Fiduciary: In many ways, yes. QDIAs are good thing, and they could even be a fantastic thing depending on the QDIA's fundamental make up. For example, a basic 60/40 balanced low-cost portfolio of index funds makes a lot of sense. An insurance-product-based QDIA probably doesn't. In any event, QDIAs are step in the right direction toward more prudent and fundamentally sound fiduciary behaviors. My concern is that QDIAs end up being convenient, but loaded with fat.

Bob: What do you mean?

Fiduciary: My concern is that the financial industry will turn a QDIA in a type of financial "fast food." For example, there is a risk of QDIAs costing much more than necessary. The QDIA approach has not only been available in its most efficient form, it's been required by law since 1974. The industry conveniently steered employers away from that approach to make room for 404(c).

Bob: When you say "fast food," you mean something quick and easy, but more expensive than a home cooked meal and less nutritious?

Fiduciary: Bingo. The QDIA has appeal because it is a ready-made "TV dinner" if you will for 401(k) plans. So, while a low cost and efficient QDIA concept is a fine, it is really just an echo of pre-existing law nicely re-packaged in a new type of financial product; a potential boon to the financial services industry, but quite unnecessary. The law already requires fiduciaries to create a well-diversified, low cost, efficient portfolio within the trust. The mere existence of the QDIA confirms what we have been discussing.

Bob: My eyes have really been opened. What should I do? I suppose I should start with having a heart-to-heart chat with my nephew. He may gloat that he was right all along.

Fiduciary: Don't approach it from the standpoint of him being right and you being wrong. Rather, approach the issue generally. Explain to all of your employees that they have a pre-existing right under the law to enjoy the results of a prudent, low-cost portfolio, constructed by a professional. Explain that you have no intention of extracting resources from their accounts to pay for your own protection.

Bob: With all due respect, I'd be insane to make such an admission.

Fiduciary: I understand, but you'll find an honorable and truthful way to handle it. Your employees will respect you for being forthright. Do whatever you can to protect their financial futures and everything will be okay.

Bob: I have to run a business, you know. I don't think I can run the business and be a good fiduciary.

Fiduciary: There are those who could step in assume your responsibilities. They are independent fiduciaries. That's what I do for a living.

Bob: I see.

Fiduciary: Remember early on in our discussion, we talked about whose responsibility it is to invest plan assets?

Bob: Yes. I understand now. It's mine, as the fiduciary, and it always has been.

Fiduciary: You can delegate this responsibility to others who then become fiduciaries to your employees. Fiduciaries bear the highest responsibility known to the law, yet the law permits you to delegate and assign responsibility. You don't have to do this alone--but you do have to do things the right way. Running from and hiding behind gimmick plan provisions such as 404(c) isn't the answer. There are better ways to get what you want while focusing on what's best for your employees first.

Bob: What do we do about the employees who insist on making their own investment decisions? They won't want to lose that control.

Fiduciary: Do you really think they are in control now?

Bob: Not in the pure sense, no. Many of them are out of control because they are in control. That makes my head spin thinking about it! I suppose any control they think they have is partly an illusion. They are playing by the "house's" rules, and the house usually wins.

Fiduciary: You can feel confident that by taking an "employee first" approach, both you and your employees will be just fine in the long run, which is what really matters.

Bob: I agree. If we first seek to do no harm, we have to really mean it. My newest intern's puny little 401(k) isn't worthy of less protection than mine. My account gets protected by the CEO--me. My intern's gets protected by the intern. That just isn't right. If my intern doesn't know enough to protect my account, he certainly doesn't know enough to protect his own. We both can get 100% of the potential return at much lower cost. It's only fair.

Fiduciary: Bob, you've got it!

Bob: Our 401(k) deserves to be delivered in a more dignified and results based way. This discussion has been invaluable, and my nephew was right after all. I'll pay your bill right away, out of company assets of course!

Fiduciary: You can pay me from the plan, just be certain it's in the participants' best interests before you do. If you are not sure, then the corporation should pay the bill.

Bob: Got it. I hear you loud and clear. Smiles, handshake.

Bob: (S*peaking to receptionist.*) Will you get my nephew on the phone? I want to invite him over for dinner this weekend.

Matthew D. Hutcheson is an independent pension fiduciary well known for his work in developing practical methodologies that help fiduciaries uphold duties of care and loyalty to the participants in their retirement plans. He helps dozens of plan sponsors every year develop simple and practical fiduciary solutions. He has testified before Congress on matters relating to fiduciary prudence and retirement plan economics. He may be reached by e-mail at matt@erisa-fiduciary.com.

Questions and comments about this article should be directed to site manager Jerry Kerns.