Fiduciary Focus: Fleecing 403(b) Plan Participants (Part 8)

W. Scott Simon | 06-05-08

In my November column, I gave fair warning that it would "be the last (for now) of my seven-part series on 403(b) plans." But "for now" was then; this month's column is, well, now.

School districts and nonprofit entities such as hospitals are now attempting to come to grips with regulations promulgated by the Internal Revenue Service that will govern 403(b) plans as of Jan. 1, 2009. Administrators at some school districts have taken my seven-part series on 403(b) plans to heart and are now seeking to emulate the model 403(b) plan that I set forth in those columns.

These administrators are to be commended for a number of reasons. First, their actions in implementing the model show that they are truly dedicated to the well-being of participants (and their beneficiaries) in their respective 403(b) plans. These actions indicate that they have assumed the mindset of fiduciaries. Second, they are exhibiting great courage in bucking the old, established 403(b) system which is dominated by insurance companies and their costly and poorly diversified investment products which, largely for those very reasons, often generate lousy returns. This system is, fundamentally, a goofy one and for that reason will slowly die out.

I've seen requests for proposal issued by some of these courageous and leading-edge school administrators seeking to implement 403(b) plans that emulate the model 403(b) plan that I set forth in the aforementioned seven-part series. These requests, on the whole, are excellent but they reveal some misunderstanding about three crucial issues which I believe requires some correction. These issues include fiduciary duties, deceptive cost structures and irrelevant requirements in request for proposal templates.

How to Avoid Becoming an Ostrich about Fiduciary Duties

All retirement plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) are governed by fiduciaries with distinct responsibilities (and corresponding liabilities) to plan participants (and their beneficiaries). The new IRS 403(b) regulations make clear that school districts aren't subject to ERISA. School administrators in some states, however, will find, post-Jan. 1, that they've become fiduciaries under their respective state fiduciary laws with respect to the 403(b) plans they administer.

In some other states, though, school administrators are told by legal counsel that there are no state fiduciary laws to govern their conduct with respect to the 403(b) plans they administer. As a result, administrators in these states state confidently that they will not assume any fiduciary responsibilities for their respective 403(b) plans. This reaction, it seems to me, is a bit like an ostrich that sticks its head in the sand, thinking it has avoided all danger.

No doubt the advice rendered in such situations by legal counsel is correct - as far as it goes. Yet, I fear that it verges on the kind of legal advice that my little brother used to jokingly accuse me of giving him at times: "I have no doubt that your advice is 100% correct (if, on the one hand, then.but, if, on the other hand, then.) and 100% useless (if, on the one hand, then.but, if, on the other hand, then.)." Given the creativity of the plaintiff's bar in raising exotic legal theories against defendants (including school administrators) on statutory, case law, common law or even constitutional bases, the ostrich defense may not be such a good one.

What to do then? Try to ensure as much as possible that the legal advice rendered in these situations is not only 100% correct, but also 100% useful. And what would be the nature of that "useful" legal advice? Simple: recommend to school administrators (even where they aren't fiduciaries under either ERISA or state fiduciary laws) that they act like fiduciaries and implement best fiduciary practices.

This recommendation fits hand-in-glove with the thrust of the new 403(b) regulations which are designed to mirror the fiduciary duties and principles of ERISA-governed 401(k) plans. It's also in accord with the fiduciary-like language used by many school districts (whether expressed in an RFP or elsewhere) to "protect" "our" employees from, for example, the erosion of their retirement savings by the rapacious fee structures that exist in most current 403(b) plans.

The best way that I know of for school administrators to act like fiduciaries and implement best fiduciary practices is to retain, at modest cost, the services of a professional independent fiduciary. The fundamental, underlying duty of an independent fiduciary--the duty of loyalty--is owed solely to plan participants (and their beneficiaries) in a 403(b) plan.

It also seems to me that school administrators refusing to accept any fiduciary responsibility on advice of their legal counsel have, at the very least, a moral obligation to hire a qualified entity that will. Otherwise, a school district seeking to emulate my model 403(b) plan won't be a model for anything; it will simply be just another 403(b) plan that fails to protect its participants (and their beneficiaries) from the beasts that have roamed the 403(b) landscape unchecked for far too long, devouring far too many. In fact, the complete lack of fiduciary governance in the K-12 403(b) plan market has contributed mightily to creating a prime hunting ground for salespeople that have maximized their own personal gain at the expense of teachers and other school employees.

How to Avoid Getting Bamboozled about Costs

I once had a fiduciary of a multibillion-dollar 401(k) plan assure me that the plan incurred no administrative costs at all; it was "free." When I heard that, I immediately thought of the thousands of participants in the plan whose retirement would be impacted so negatively - and so unnecessarily--by that untutored mind.

Proposals set forth by many investment advisors in response to requests for proposals-- whether involving 403(b) plans, 401(k) plans or others--contain outright deceptions, pure and simple, and they can have devastating impacts on the account balances of plan participants for years and years. It's often easy for those assessing these proposals - including school administrators - to get bamboozled by some of their terms. I'll provide a brief example to show how those charged with the solemn responsibility to implement a truly model 403(b) plan can avoid this.

Consider a proposal in response to a request for proposals that shows zero fees for administrative services to ensure that a 403(b) plan is set up and operating appropriately from the get-go; the implication is that such fees are "free" to the 403(b) plan. Since this work must always be done and given certain realities of the marketplace--there's no such thing as a free lunch, no one works for free, etc.--the firm submitting this proposal must, in order to cover the costs of doing this required, up-front work, increase the investment expenses (borne by plan participants naturally) of its proposed 403(b) plan by, say, three (3) basis points to amortize the cost of such work over the period that the firm expects to retain the contract for the plan. In other words, this firm recoups its initial setup costs by essentially amortizing those costs over the life of such contract.

Compare this approach of amortizing never-ending costs (charged against plan participants) to that of a firm that sets forth a proposal with an explicit, flat dollar fee that's spelled out clearly and charged only once (to plan participants). The former approach shows a (deceptive) zero number while the latter shows an (honest) actual dollar number.

From a simple spreadsheet perspective, "free" upfront administrative costs look enticing to a school district but the real impact on the account balances of plan participants can be devastating - even in cases where the recurring basis point fee--resulting in never-ending, increasingly growing administrative costs--is only slight. Every participant will pay for a limited, one-time scope of work years and years after that work has long since been completed. From a fiduciary, fiduciary-like or even moral perspective, it's simply not fair to charge plan participants (a lot more) into perpetuity for what clearly should be a one-time (and a lot less), flat dollar fee.

Many firms that respond to requests for proposals (whether issued for 403(b) or 401(k) plans) have helped create this kind of Rube Goldberg-like system that hides high fees from plan sponsors to ensure that they get to keep them with impunity, and present cost data in such a way as to mislead plan sponsors. These firms are the same ones that are now actively resisting current legislative and regulatory proposals to disclose their fees fully. Their reasoning: there's no way for plan sponsors or participants to understand all these fees, given the complexity of the system set up to extract them. This sounds a lot like the guy who landed on death row for murdering his parents and is now crying that he's an orphan. School administrators who are truly looking to create a revolutionary model 403(b) plan on behalf of eligible participants should not fall for this line.

How to Avoid Getting Stuck with the Same Old Stuff

Many requests for proposals, by their very terms, ensure that school districts will end up choosing from the same awful cast of characters that have helped create the disaster that now passes for the K-12 403(b) plan market. The gatekeeper/consultants that help facilitate the request process by providing school districts with templates for their requests for proposals are a primary cause of this. Such requests for proposals typically require that a firm have, say, $5 billion worth of 403(b) business and experience in administering, say, three large public 403(b) plans.

The end result of these mindless requirements is to eliminate many of the best providers in the country that service the defined contribution plan market. By requiring a provider to have billions of dollars worth of 403 (b) business means that a school district is limiting its search to those providers that have sold the most 403(b) product under the current system that many would agree has been an abomination for participants (and their beneficiaries). Talk about laying down a red carpet so that the fox can stroll into the chicken coop to guard the chickens.

In reality, a 403(b) plan in the K-12 market isn't even a plan; it's simply an arrangement whereby a school district agrees to remit money on behalf of its employees who have opened an account with a 403(b) vendor. (Many school districts have somewhere between twenty and one-hundred vendor firms associated with their 403(b) plans; the Los Angeles Unified School District in my home state of California has 122 vendors.) Such non-plan arrangements are precisely why a firm's dollar volume experience as required by many requests for proposals has nothing whatever to do with actually administering 403(b) plans in the K-12 market.

The idea that a firm's dollar volume experience has had any value in the K-12 403(b) market or will have any value in the brave new world of 403(b) plans come January 1 is patent nonsense and constitutes yet another form of bamboozlement that's inflicted on school administrators. A firm's dollar volume experience as required by many requests for proposals is an irrelevant marker by which to measure implementation of the model 403(b) plan set forth in these columns. A more useful marker would be to require firms to have x dollars of defined contribution administration experience. After all, 403(b) plans will be just another subset in the world of defined contribution plans once Jan. 1 rolls around.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner, and an Accredited Investment Fiduciary Analyst. Simon's certification as an AIFA qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

For more information about Simon, please visit Prudent Investor Advisors, or you can e-mail him at wssimon@prudentllc.com