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From the Editor:

I happened to see an article in Worth magazine earlier this year about a fellow in Texas who gathers statistics on 401(k) plans. Of course, this is an easy way to get my attention. Anyway, the article was about a pension attorney and consultant named Brooks Hamilton. Hamilton compiled statistics on the returns that plan participants have historically received on their chosen investments. The bottom line is that there is significant disparity between the "haves" and the "have-nots," as I call them. The spread between the returns of the top quartile of investors and the bottom quartile is astonishing, at least to me. Be sure to read Brooks' letter to the editor (A Fork in the Road) at the end of this issue to find out his solution to this critical problem that affects the retirement adequacy of 401(k) participants.

Joan Gucciardi
August 1999

A FORK IN THE ROAD

by Brooks Hamilton

Good intentions can have disastrous results, as the author illustrates here in discussing the application of the 404(c) ERISA section of the 401(k) plan, which basically forces participants to make investment elections that may do more harm than good.

To the Editor:

Yogi Berra once said, "*When you come to a fork in the road, . . . take it!* Well, that is just what the 401(k) industry indeed did a few years ago regarding Section 404(c). And now there is evidence that a number of gurus are becoming ever more concerned that a cancer is growing on what is otherwise a beautiful social and economic development. Causing this concern is not just the startling growth of a totally new 401(k) plan feature - participant directed investment options - but an emerging view of the ramifications. Was the turn taken earlier this decade a mere coincidence? . . . probably not. But some background is needed to judge whether the fork taken by so many plan sponsors will lead their employees to dignity or despair.

Final 404(c) regulations became effective January 1, 1994 for calendar-year plans. While compliance with 404(c) is voluntary, fiduciaries who successfully comply with a maze of complex rules are generally relieved of any fiduciary responsibility for investment losses, provided (repeat, provided) <u>all plan participants exercise independent control over their accounts</u>

Many pundits argue that complete compliance with the final 404(c) regulations is probably not legally feasible or practical. As is often the case, the words written by regulators to guide us seem straight forward enough at first reading. We are told that to be a successful 404(c) plan sponsor one must (i) give participants the opportunity to choose from a broad range of investment alternatives, (ii) allow them to make elections with appropriate frequency, (iii) assure that investment options are diversified, and finally (iv) provide participants with sufficient information to enable them to make informed investment decisions. According to the Commerce Clearing House Pension Plan Guide, fiduciaries are <u>never</u> relieved of their <u>constant</u> duty to consider the prudence of the investment alternatives made available to participants under the plan, and maintain oversight over the investment options [see CCH-EXP, PEN-PLAN-GUIDE, ¶4485, **Participant-Directed Accounts,** <u>ERISA Reg. §2550.404c-1(b)(2)</u> (i).]

As Shakespeare might have said: Ah, there's the rub. Just what do we imagine the regulators meant by indicating that an ERISA fiduciary (even where all requirements of 404(c) are fully met) is not relieved of the constant duty to *<u>maintain oversight over the investment options</u>*. What do we think the United States Supreme Court might some day say these words have always meant? That is, do they mean that constant attention and care must be given to the initial and continuing propriety of the investment choices offered to participants? And/or do these words include the correctness of the actual investment choices made by participants? And just what else might, should, will they (and all of the other words) be deemed to have always meant, in the years to come?

Experience teaches that predicting the future meaning of seemingly simple words written long ago is far from simple. To illustrate, a 1972 federal law states that no person "*shall, on the basis of sex, be excluded from participation in . . . or subjected to discrimination under"* any educational program receiving federal funds. For a generation most have felt secure that Congress intended to ban discriminatory admission standards, denial of access to programs, et cetera, by a school district. But in a 5-4 decision written by Judge Sandra Day O'Connor, the Justices have just ruled that a student can sue a school district under this law if "*subjected to discrimination*" by another student! The always vital facts and circumstances in this case include both "*actual knowledge*" and "*deliberate indifference*" by the defendant to offensive sexual harassment committed by one student against another. We will resist further comment, but it may serve the reader well to make an indelible mental note that where the Justices note a fundamental (i.e., common sense) wrong involving a defendant with *actual knowledge* of odious facts and circumstances who then manifests a *deliberate indifference,* a judicial *s-t-r-e-t-c-h* may occur.

We should all remember, there is universal agreement that there is no protection afforded by Section 404(c) if a participant does not exercise <u>control</u> over his or her account. And there is also universal agreement that failure to provide participants with adequate investment information will effectively deny such participants control over their accounts. In short, for 404(c) to apply, a participant must have actually exercised control with respect to whatever transaction is at issue, and the burden of proof (that 404(c) applies and thus affords protection) is on the plan sponsor. Finally, as our guide continues, it is also written that the information provided to participants <u>(i) may not be too general, but (ii) still must be sufficient for the **average participant to both understand and assess all** of the available plan investment alternatives</u>.

The view expressed by some is that when reduced to its pure essence, all that these particular words mean is that a plan sponsor must <u>furnish</u> the information specified by 404(c) to all participants. That is, what participants do with the information is of no concern.

Can we assume that the mere fact that a plan sponsor and all ERISA fiduciaries have *actual knowledge* that most participants:

- ✓ apparently do not know (nor care to learn) the difference between a stock and a bond, as reported in a recent editorial in USA TODAY (and numerous other media sources and

Internet web cites),
- ✓ are making dismal and often emotional investment decisions (or none at all), and
- ✓ are growing old and poor . . .

is simply that: a mere fact, with no legal consequences: i.e., that *deliberate indifference* to participant plight by fiduciaries with *actual knowledge* will be tolerated? It may pay to note that we live in a culture that increasingly demands victory for any victim. Recalling the lady who spilled hot coffee on herself driving out of Mc Donald's, a new legal sales pitch may arrive much sooner than we think:

> *Friends, are you **forced** to make investment decisions regarding your retirement nest-egg by your employer, when he knows full well that you don't know a stock from a bond? And further, that you really don't care to go back to school to learn how to become your own investment manager/expert? And is this being done to you in a conniving attempt by your employer to avoid his responsibility to you under the pension laws of America? Finally, and as a result, are you now growing old, and poor, destined to be a burden to your children and an embarrassment to yourself? Even though you have sacrificed and saved enough to assume you have assured your well being in your golden years, will you only be reaping fool's gold because of your employer's treachery and his deliberate indifference to the despair he has selfishly inflicted on you? Well, relax my friends. Just call the following 800 phone number and you too can become rich.*

Those who laugh now at the thought of such a legal marketing program may be among the first to laugh, but those laughing last will be on the way to their bank. For if the protection seemingly promised by

404(c) is the illusion we believe it to be in most cases, ERISA fiduciaries will be liable (and personally liable) for the dismal investment results achieved by participants directing their own investments.

Disparity in the results achieved in our nation's 401(k) plans has two faces: while we hope and plan for dignity, decency, decorum, and distinction, too often the results lead to despair, degradation, disgrace, and dishonor. The clear promise inherent in the social contract that 401(k) plans are fast becoming is that a working career characterized by prudent financial forbearance, expressed in the form of an orderly personal savings habit, will be rewarded in the end by an opportunity to live out one's golden years in dignity and distinction - as opposed to despair and disgrace. Yield disparity is the fever caused by a financial cancer that will, unchecked, destroy this dream for millions of citizens.

Our firm, BH&A, first became concerned about what we have now come to call "yield disparity" in the early-to-mid-nineties. Taking the wrong fork, for reasons of interest perhaps only to historians, the industry has now sown the seeds for a huge and inevitable yield disparity among participants in most 401(k) plans. These plans pretend to *allow*, but in fact *force*, participants to make investment elections. Why do so many 401(k) plans force participants to make investment elections? Have public opinion polls revealed a hue and cry from workers that they be afforded the opportunity to personally invest their pension nest-egg? Hardly. The reason is simple: if this feature was not forced on all, it would be used by only a few. And if it was only used by a few, it would not survive as a feature.

Once you "follow the money" and identify just who benefits (both how and how much) from the platform that these type plans rest on, you will also begin to understand how an ingenious *push marketing* campaign, astride 404(c), caused the 401(k) industry to take the wrong fork.

The ultimate effect of yield disparity would be hard to overstate. The following four tables are actual cases that bear a remarkable similarity. They were chosen to indicate the scope of the problem. They are widely separated geographically and span the last three years. In all cases, analysis of the demographics revealed no "smoking gun" correlation - except one: the higher a group's pay (all cases were divided into quintiles) the higher the group's investment return. On reflection, this could have been predicted. No other census characteristic seemed correlated to the results (age, service, et cetera).

TABLE A: Plan had 3,000 - 4,000 participants and over $75 million in assets.

Quintile	* * * Average for all Participants in each Quintile * * *			
	Age	Pay	All Contributions	1997 Yield
First	41	$47,701	10.81%	**24.06%**
Second	44	$45,199	11.91%	**20.36%**
Third	43	$43,803	11.10%	**16.60%**
Fourth	40	$39,788	10.67%	**11.96%**
Fifth	40	$33,795	7.76%	**4.14%**

TABLE B: Plan had 2,000 - 2,500 participants and over $55 million in assets.

Quintile	* * * Average for all Participants in each Quintile * * *			
	Age	Pay	All Contributions	1996 Yield
1	41	$79,869	10.56%	**17.41%**
2	40	$71,607	11.04%	**14.75%**
3	39	$65,999	11.13%	**12.94%**
4	39	$59,076	10.90%	**10.89%**
5	38	$53,895	7.60%	**7.12%**

TABLE C: Plan had 5,000 - 6,500 participants and over $75 million in assets.

Quintile	* * * Average for all Participants in each Quintile * * *			
	Age	Pay	Contributions	1997 Yield
1	40	$52,123	6.90%	**28.27%**
2	39	$43,188	6.97%	**24.09%**
3	37	$39,079	6.76%	**19.99%**
4	38	$34,254	6.17%	**15.28%**
5	35	$30,883	5.57%	**6.48%**

TABLE D: Plan had 3,500 - 4,000 participants and over $125 million in assets.

Quintile	* * * Average for all Participants in each Quintile * * *		
	Average Pay	Annual Contributions	1998 Yield
First	$45,323	10.81%	**26.14%**
Second	$43,744	10.47%	**20.34%**
Third	$43,016	10.93%	**16.11%**
Fourth	$40,058	10.23%	**12.40%**
Fifth	$32,523	6.74%	**5.44%**

The nineties have been spectacular. Using data found at www.forecasts.org, the following table indicates the annual percentage change in three economic indicators for the past five decades: the prime lending rate, CPI, and S&P 500. Clearly, the seventies were a bummer, as the prime rate soared from 8.5% to 15.3% at the same time that the S&P limped along from 85.02 to 107.94. The cost of a consumer's basket of goods doubled. By comparison, the nineties have been terrific, with the prime rate falling from 10.11% to 7.75% at the same time that the S&P has rocketed from 329.08 to 1,335.18 (April, 1999). A consumer's basket of goods has increased only about 30%. Greenspan for President!

		Average Annual Percentage Increase		
Period		**Prime Rate**	**CPI**	**S&P 500**
Fifties		**9.20%**	**2.24%**	**12.63%**
Sixties		**5.32%**	**2.52%**	**5.05%**
Seventies		**5.89%**	**7.10%**	**2.39%**
Eighties		**-3.73%**	**4.84%**	**11.35%**
Ninties		**-2.84%**	**2.85%**	**15.10%**

The 15.1% annualized increase in the S&P has been accomplished, from 1990 to date, by annual investment returns of 0%, 21%, 7%,6%,-5%,31%,16%, 8%, and 25% last year. As we have accumulated yield disparity data starting in 1996 (see above four tables), we note that the S&P averaged 16.3% during these three years while the yield disparity cancer has averaged 18.2%. That is, a simple averaging of these tables shows that those in the top quintile had average pay of $56,254, were age 41, had total contributions of 9.8%, and earned 24% on their account. Those at the bottom had average pay of $37,774, were age 38, had total contributions of 6.9%, and earned 5.8% on their account.

To normalize these unprecedented investment returns to be more in line with historical performance, we simply divided by two and rounded to the near integer. Accordingly, and in order to rationally project future replacement income, we assumed that the top quintile would earn 12% long term, while the bottom quintile would earn 3%, and that pay overall would increase around 5% annually.

Including average current accounts, the bottom quintile participants (some 6 million citizens) would retire at age 65 on around 17% of pay (before Social Security); the top quintile is projected to retire at just over 100% of pay (before Social Security).

A generation spent enduring this wretched financial cancer will trigger a social upheaval unsurpassed in our nation's history. As America grays, one of our greatest bed rocks would suffer an irreversible calamity. The great American middle class, suffering losses in the Trillions, would be severely downsized, spiraling America itself down, down into a book-end society composed largely of the rich and the poor. Students of history will weep at the thought.

We are all taught at an early age that *you can't turn back the clock. Well, actually you can - just think: Daylight Savings Time*. But that said, we probably should not sit back and wait for participant directed 401(k) plans to reverse course, and disgorge this feature.

Please do not misunderstand. It is not the participant directed investment feature, alone and by itself, that we have come to view as a tragic blunder. Force is the villain. When you think about it, as the Supreme Court will surely be asked to do, can those planning to make themselves ERISA fiduciaries conceive and impose a plan structure that forces employees, most of whom possess neither investment expertise nor experience, to make investment choices they do not comprehend, and thus involuntarily to become ignorantly responsible for perhaps the most significant asset they possess? All in the name of a self-indulgent desire by the soon-to-be fiduciaries to protect themselves, once fiduciaries. Well! Is that not the very essence of the common sense meaning given to the phrase - *breaching one's fiduciary duty*! After all, does anybody really believe that employee directed investment features are embedded in 401(k) plans for the *exclusive benefit* of employees and their beneficiaries? And haven't we read somewhere that a plan must be established and operated pursuant to this standard? Something like:

> *A qualified plan must be for the <u>exclusive</u> benefit of employees and their beneficiaries* (See Code Sec. 401(a); IRS Reg. §§1.401-1(a)(3) (ii); 1.401-2(a)(1); 1.401-2(a)(3)).
>
> And also: *This is not only a requirement for qualification, but, since enactment of ERISA, <u>a substantive requirement of the law</u>, applying to qualified and non-qualified plans alike* (See ERISA Sec. 403(c)(1)).

Now, we all know that beauty is in the eye of the beholder, but how in the wide world have we come to entertain the proposition that a person

> established by law to be an ERISA fiduciary,
>
> thus owing the highest duty and standard of care and loyalty to beneficiaries yet defined by Western Civilization,
>
> and who, finally, is specifically mandated by law to assure that a 401(k) plan is *for the exclusive benefit of employees and their beneficiaries*,

can somehow delegate, or directly cause to be delegated, without recourse, probably the single most important fiduciary function, asset management, to a non-professional layman with no qualification or experience - that is, to the very same beneficiary to whom is owed history's highest fiduciary duty and standard of care and loyalty? If one plans to undertake and continue on this course of forcing beneficiaries to manage their investments, they had better be certain that they can prove in court that

404(c) applies. But even if it does, don't forget that fiduciaries will still be responsible insofar as their constant duty to *maintain oversight over the investment options,* whatever that may someday mean.

While pondering that, ponder this as well. Does anyone believe that there is even one CEO in America who would allow this very same non-professional lay person to direct the investment of the CEO's 401(k) account? See the legal enigma? How can an ERISA fiduciary who would not abide John Doe even touching the fiduciary's own personal 401(k) account with the proverbial ten foot pole, nevertheless, in exercising the highest fiduciary duty and standard of care and loyalty known to mankind, be party to a 401(k) plan that literally forces the same John Doe to manage his very own personal account!

It is an obscene legal fiction to think for even a minute that forcing employees to direct investments is a feature embedded inside a plan by fiduciaries solely to benefit all of the John Doe participants. It is embedded in a plan because the plan sponsor (and other fiduciaries) have swallowed hook, line, and sinker the too clever sales pitch of masterful push marketers. And you can bet your last dollar that these push marketers have made certain that they are not ERISA fiduciaries!

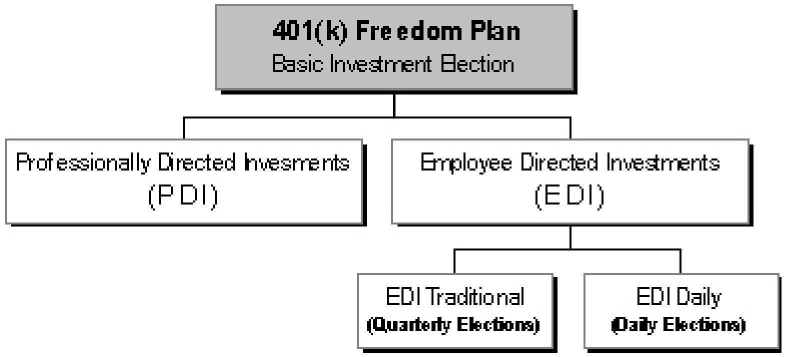
So, what is to be done? What have Americans always done when force is wrongfully imposed on them? We choose to fight for freedom, and freedom is the solution. Imagine a 401(k) Freedom Plan. Why Freedom Plan? Because this new plan, unlike any we know of, would offer each and every participant total freedom of choice regarding the manner in which his/her accounts would be invested. That is, every participant could either (i) choose to choose, or (ii) choose to not choose! This total flexibility and unrestricted freedom of choice is, we believe, a new innovation that could become an industry standard within a few years, if, that is, enough participants choose to direct their own investments once they are not forced to do so. Otherwise, participant directed investment account plans may simply fade away (like old soldiers and defined benefit pension plans).

How would a Freedom Plan work? Each participant would be free to choose to either (i) direct his/her 401(k) plan investments, or to (ii) not direct investments. An associate choosing to not direct plan investments would choose what we call the PDI election - **P**rofessionally **D**irected **I**nvestment account. Assume participants with total plan assets of $20 million choose PDI. These PDI assets would be invested as determined by professionals selected and monitored by the plan sponsor (much akin to the way current defined benefit pension funds are managed).

A participant choosing to direct his/her plan investments would choose what we call the EDI election - **E**mployee **D**irected **I**nvestment account. We anticipate that some 401(k) plans will provide two types of EDI accounts: an EDI Quarterly account, and an EDI Daily account.

The EDI Quarterly account would operate basically in the same manner as many plans have operated heretofore, with the participant initially able to select from six or so investment funds, making changes on a quarterly basis.

The EDI Daily account would operate much the same as a brokerage account. The following chart illustrates the Freedom Plan.



We believe that PDI could *spark a revolution* in the 401(k) industry. For reasons we understand, practically all have viewed any *daily* type plan feature as a feature that a 401(k) plan either (i) did not allow, or (ii) forced all to accept. In short, daily plans marketed by advocates (primarily the retail mutual fund industry) are invariably structured so that all plan participants have a daily account, whether they want one or not. Plans marketed by opponents are structured so that no plan participants have a daily account. Thus, the market's response to a feature that nearly all acknowledge only a few actually use, are plans that either impose the feature on all, or deny the feature to all.

Not so with a 401(k) Freedom Plan. Has a nice ring to it, doesn't it.

What else will be done? Well, we believe that two future developments are inevitable. First, class action lawsuits seeking first hundreds of millions of dollars, then billions of dollars, alleging *actual knowledge* and *deliberate indifference* by fiduciaries will proliferate. Expect the total dollars involved to far, far exceed the tobacco litigation. Second, Congress will conduct hearings, and new legislation will attempt to "fix" the politically perceived problems. As an example, start thinking about new statutory tests - like a yield disparity test. To wit, if the yield disparity between highly compensated employees and non-highly compensated employees exceeds two percent (and it tends to be much, much higher), it will have to be "fixed" by means of a re-allocation of investment income!

Maybe you can turn back the clock after all. As a nation of the people, by the people, for the people, the people must try. Let Freedom ring!