The Future of the Qualified Plan: Solving employers' fiduciary dilemmas while responding to the call for advice

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Abstract:

Plan sponsors need help meeting their fiduciary obligations, while participants crave advice. Clients are demanding investment flexibility and full disclosure of fees and expenses. Financial Planners can—and should—solve all of these problems as the advisors of choice for qualified plans. Successful planners will change the way they serve qualified plan clients:

- They will become fiduciary consultants to the plan sponsor.
- They will deliver superior service to participants and meet the demand for financial advice.
- They will change the role of products by delivering their services through open architecture platforms with full disclosure.

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Four trends are shaping the next generation of qualified retirement plans for small to mid-sized businesses:

1. Business owner concerns over fiduciary responsibility and liability
2. An unmet demand by participants for financial advice
3. Client demand for greater investment flexibility
4. Demand for full disclosure and revenue sharing.

Like trends in any industry, trends in the retirement plan industry begin with client problems: how we solve those problems determines the next step in the evolution of the profession.

Solving the four problems above will lead advisors who wish to succeed in the pension marketplace to change the way they do business:

- They will become fiduciary consultants to the plan sponsor.
- They will deliver superior service to participants and meet the demand for financial advice.
- They will change the role of products by delivering their services through platforms that minimize conflicts of interest by offering:
  - Open architecture (access to a full range of investments)
  - Full disclosure of fees, expenses, and relationships
  - 100% pass-through of revenue sharing payments to the plan.

The greatest indicator that this future will occur is that ***it has already happened***. Some consultants in the large plan marketplace have operated this way for years, and advisors who bring this level of service to smaller plans are simply taking the next step in a logical progression.

<u>The Role of Financial Planners in the Qualified Plan Marketplace</u>

In the world of plan sales, nothing is more powerful than a seasoned financial planner with a sub-specialty in retirement plans. A qualified plan is an investment, and people want help with their investments from sophisticated financial professionals. It stands to reason that they will prefer an experienced CFP to a 27-year-old insurance agent, and a local professional to a toll-free number. A business owner with a $500,000 account balance is just as interested in that $500,000 as he is in the same amount in an IRA, and will take a keen interest in the quality of advisor willing to service the plan.

Should all planners become specialists in qualified plans? No. In fact, most financial planners should stay away from qualified plans or defer to specialist colleagues. Yet the small business market is one that attracts many planners, and those who commit to building qualified plans into a significant part of their practice (at least 10 plans, to give an arbitrary number) need a blueprint for service worthy of the profession. The purpose of this article is to paint a picture of the qualified plan of the future. The role of financial planners is to help create that future for their clients.

Problem #1: The Business Owner's Fiduciary Dilemma

Larger companies virtually never make a decision regarding their qualified retirement plans without consulting professional advisors. The reason is simple: they do not want to be sued. Imagine a corporate executive charged with the responsibility for making decisions regarding a $500 million retirement plan. As a decision-maker, he is *de facto* a fiduciary, meaning he is personally liable for the prudent management of someone else's money. How will this executive feel about being personally liable for $500 million?

Look at the following year 2000 case citations from the 10th and 11th federal circuit courts: *Hurd v. Ross; Herman v. Schwent; Rhoades v. Casey; Bowles v. Reade.* Those names are the names of people, not corporations. Those individuals are the fiduciaries of their companies' retirement plans, and they were sued as individuals for breaches of fiduciary duty. "Breach" in this context means "error"—these individuals were sued by their employees for making mistakes.

When an individual loses a case, it is the individual who is held accountable for paying the damages. Naturally the plaintiff's attorneys go after the deepest pockets, so the companies are invariably named in the suits, but one point of law is clear to the judge, the attorneys, and the retirement plan consultants they call as expert witnesses: ***fiduciaries are personally responsible for the retirement plans they oversee***. The foremost question on the mind of a business owner who sponsors a retirement plan, therefore, should be "How can I best satisfy my legal obligations as a fiduciary?"

The problem for many business owners is that they ask the wrong question. They do not ask, "What do I need to do as a fiduciary?" Instead they say, "I want a retirement plan," call a broker or agent, and buy whatever that broker or agent is selling. Perhaps they shop, but they let the salespeople control the information that is presented. Certainly they follow no checklist, consult no specialists, review no due diligence "how-to" manual. Fiduciary due diligence requires "procedural prudence," but most plan sponsors follow no set procedure and would not know what such a procedure should include in order for the courts to view it as "prudent."

In court, it is logical to assume a plan fiduciary would be asked certain questions:

- Do you have an investment policy statement?
- Can you document the process you followed in reviewing your investment options?
- Can you show the court your records for the past five years showing the monitoring you conducted on plan investments and co-fiduciaries?

- When investments under-performed as measured against the criteria in your investment policy, did you replace them?
- How did you choose your current provider? Show your documentation of the process you followed.

Many plan sponsors could only stand mute if asked such questions.

Solution #1: Advisors as Fiduciary Consultants

Large plan sponsors (loosely defined as plans with over 10,000 participants) get help because they know they need it. Sponsors of small to mid-size plans typically have no idea of the legal responsibilities and liabilities they face and view the retirement plan as a purchase decision. Larger plan sponsors hire consultants and advisors to guide them through the process, document the process, and ensure all fiduciary duties are prudently executed. Smaller plan sponsors make an appointment with a salesperson, listen to what is said, and make a decision based on personal preference and undocumented criteria.

Small to mid-size plan sponsors need advice. They need the help of competent consultants or advisors who can bring them a version of large-plan fiduciary consulting suitably adapted to smaller plans. They need this help partly because of risk, but there is a better reason: it is the right thing to do. Pose the question to a business owner like this: "Knowing the law and what is required of you as a fiduciary, would you deliberately choose *not* to meet those obligations?"

A financial planner's services to plan sponsors might include the following:

- Helping draft an Investment Policy Statement
- Conducting vendor searches
- Establishing criteria for due diligence
- Implementing a program of fiduciary monitoring
- Ensuring that investments are promptly replaced when they fail to meet the established criteria
- Ensuring that the plan complies with applicable laws and regulations
- Ensuring that the process is documented
- Ensuring compliance with ERISA §404(c).

Some of these services fall solely to the advisor while others are contracted out to providers who are selected and monitored with the assistance of the advisor.

Beyond Consulting: Taking Responsibility

Giving advice on how to meet fiduciary obligations is important and necessary to plan sponsors, but from the sponsor's perspective an even more desirable service is to hire a firm that will take over some of the liability. Keith Clark of MWC Consultants describes the "successful service providers of the future" in the September-October 2001 *Pension Actuary*: "The winners may be those who take on a formal fiduciary role, as well as provide direct advice to the participant."

Most providers strenuously avoid being categorized as fiduciaries, and make this point plain in their literature, communications, and contracts. The vast majority of institutional trustees, for example, are "directed" trustees who act only on the directions of plan

fiduciaries, and are fiduciaries themselves only with respect to asset custody. Similarly, most investment advisors do not accept fiduciary status in writing and most Registered Investment Advisors do not accept ERISA Investment Manager status in writing.

But a handful of providers are breaking new ground in the fiduciary arena, accepting fiduciary responsibility in varying degrees. At one end of the spectrum are providers who accept "co-fiduciary" status but limit their liability through sharing of responsibility with the plan sponsor and exculpatory clauses in their agreements. These advisors acknowledge their duty to participants under ERISA 404(a) but accept no discretion, and therefore limit their liability. At the other extreme are Discretionary Trustees—institutional trustees who are willing to take sole responsibility as Trustee for all the functions of that office. These new fiduciary firms may be showing the way to a new benchmark for superior service.

Problem #2: Participants' Hunger for Financial advice

The simplicity of an enrollment presentation does not change participants' ultimate question. Walk them through the asset allocation process step-by-step, give them a simple risk questionnaire, and they still ask the same thing when you are done: "So what should I do with my money?" The industry's answer to this question has been education—worksheets, pamphlets, booklets, websites, slide shows. The problem is that, after over twenty years since the introduction of the first 401(k), we know with reasonable certainty that education alone does not work.

Poor Decisions

Most individuals stink at investing. Dalbar observes in annual studies, begun in 1996, that the average investor in a mutual fund experienced actual performance close to half the performance of the funds themselves. One possible reason Dalbar offers for the disparity is that investors jump in after the fund has had a great year, then out after bad years.

In addition to the Dalbar studies, a recent study by Bernartzi et al. (UCLA 2001) shows that investors consistently commit basic errors such as failing to diversify properly and chasing the highest returns. Thus several studies confirm the notion that most private investors stink at investing. Now consider a purely anecdotal view of the problem:

What Investors are Supposed to Do	What They Actually Do
Buy low, sell high	Buy high, sell low
Buy and hold	Buy and sell (or hold too long)
Diversify	Buy what appears "hot"
Allocate among asset classes	Overweight recently hot categories
Review and rebalance	Ignore and knee-jerk

This chart makes light of a serious topic—our clients' life savings—but is it wrong? Based purely on the anecdotal experiences of one advisor—the author—this is a reasonabe description of the behavior of a large portion of qualified plan participants.

Consider a typical participant during an enrollment meeting. Mrs. Smith is an intelligent 40-year-old making $30,000 per year. She has little interest in investments beyond being concerned that she make the right decisions. She is given an enrollment book, which she flips through quickly and vows to read later (she never does). She listens to the enrollment presentation then takes the book home, postponing the decision as to how she should invest until later. When the HR department sends an email to all employees that "today is the final day to turn in enrollment forms," Mrs. Smith quickly fills out the form by allocating her assets among four funds, each with what she perceives to be attractive track records. "Attractive track records" turns out to mean Mrs. Smith has chosen four funds with recent top performance, all of them large cap growth funds.

Now go forward in time: one year later Mrs. Smith is at another enrollment meeting and is reviewing her investment options. She realizes that all four of the choices she made turned out to be "bad." She therefore moves out of all but one, and allocates the remaining assets to a bond fund.

Is Mrs. Smith an unrealistic example? Not for advisors who service qualified plan participants. While many participants understand basic investment principles, many others have little understanding of portfolio management and no interest in learning. Even "educated" participants are often guilty of basic errors, such as shifting from "losing" asset classes to "winning" asset classes with classically bad timing.

Education is Not Enough: Participants Need Advice

Another study shows a clear correlation between advice and improved outcomes for participants. The Institute of Management and Administration (IOMA) published a study on Managing 401(k) Plans in 2002. The study noted that participants who received investment advice outperformed nonadvised participant portfolios 86% of the time, with an average outperformance of 1.48%. During the recent bear market the outperformance was over 3.00%.

Education requires that participants study, learn, and implement prudent investment principles, and it simply never happens for the vast majority of Americans. "Advice" can take many forms, including printed information or online advice services, but in the end the advice that participants will actually implement is a simple, single decision—a "check the box" election—to have a professional manage their money for them.

Solution #2: Portfolio Models and Consistent, On-Site Education

Jon Chambers, a Principal with Shultz Collins Lawson Chambers, an investment advisory firm in San Francisco, offers the following insight, "Our experience working with a cross-section of plan sponsors for whom we provide investment education and model portfolios is that 50% to 70% of assets end up in the models that we design." In other words, given a professional money management solution and education that leads them to trust that solution, people use it. That still leaves participants managing 30% to 50% of their own assets, but this is America. People are allowed to choose for themselves, even if they make bad choices.

Chambers' firm consults primarily with larger plan sponsors but points the way to a model for participant education that may—perhaps should—become the future standard for plans of all sizes: models plus education. Online advice services such as Financial Engines, Mpower, and Morningstar ClearFuture have grabbed attention recently as a solution. Though growing quickly, nationwide usage according to Morningstar and Hewitt remains at perhaps 15% of plan sponsors. While clearly a positive addition to the lineup of education options, online advice is at best only part of the answer.

Models coupled with consistent, credible education should yield the best possible result. The SunAmerica letter (DOL Advisory Opinion 2001-9A) describes in detail how such a service might work:

- Portfolio models are available as core options of the plan alongside other mutual fund choices. For example, Conservative, Moderate, and Aggressive models are available among a menu of perhaps fifteen total fund choices. The model consists of a professionally managed portfolio of funds made up of the other core options in the plan.
- A credible financial professional delivers the advice in a group workshop or enrollment meeting, repeatedly, quarter after quarter and year after year.
- The participants can make a simple election on the spot that enables them to follow the advice, or get help by phone (from a human being) in implementing the advice, or they may choose their own allocation.

The Qualified Plan as Wealth Manager

Advice is not necessarily the best description of what participants want. A better insight is that clients want the very best money management available, and they hire financial professionals to give it to them. Perhaps the secret to helping participants succeed lies in making the retirement plan resemble—or become—a custom wealth management solution. The elements of such a solution should duplicate as closely as possible the investment management solutions offered by planners to individual clients:

- An "open field" of investment choices from which the financial expert chooses the "best of the best"
- An asset allocation strategy
- Implementation: the financial professional makes everything happen
- Active review and management: once chosen, the investments and allocation are not left to deteriorate, but are constantly monitored and updated
- Personal attention.

This is a list of things that financial planners routinely do for their clients. There is a reason planners do these things and a reason clients are willing to pay for them. Of the points on the list, all can be delivered in a retirement plan using models and education with one exception: personal attention. One-on-one meetings are expensive and generally not priced into a retirement plan service agreement. Virtually all other aspects of a professional management solution can be delivered within the plan. Even personal attention can be made available—optionally—as an added service for an added fee.

Portfolio Models vs. Lifestyle Funds

Lifestyle funds serve as a good illustration of why it is important for the plan to resemble, as much as possible, a custom wealth management solution. A proponent of lifestyle funds reading the previous few paragraphs might properly exclaim, "What's so different about models?" The answer is "nothing, and everything." Lifestyle funds serve exactly the same function as models, and while there are legitimate criticisms of lifestyle funds, such as hidden fees and potential conflicts of interest, for the most part they are a perfectly appropriate way to accomplish the objective of providing a simplified management solution.

The problem with lifestyle funds is that people do not use them. According to Hewitt Associates, 35% of large plans have lifestyle funds, in which 32.8% of participants use them. The percentage of assets this reflects is not mentioned, but can reasonably be supposed to be less than 32.8% since many participants place only a portion of their assets into a lifestyle option.

How many financial planners sell clients on the notion that sophisticated advice consists of placing 100% of their assets in a single mutual fund with seemingly mediocre returns? Perception is reality. If planners are not recommending such a strategy, it should not surprise us that few plan participants buy it. Managed portfolios are what most financial professionals offer; models more closely resemble that solution. Perhaps the difference is cosmetic, but we should not dismiss participant preference as a valid determinant of education and advice strategy.

Financial planners and investment advisors work hard to deliver sophisticated advice and solutions, and clients buy their services. These paying customers are also participants in their companies' retirement plans, and when those plans resemble private investment management solutions, it stands to reason that participants might respond favorably.

The debate over how best to provide advice—and a managed solution as the ultimate expression of that advice—is just beginning. Models sound like an excellent solution, but the technology to make them work seamlessly is relatively new and potentially problematic. Without a doubt, however, the next few years will see a surge in qualified plan services offering both advice and managed portfolio options for participants.

Problem #3: The Demand for Investment Flexibility

Ted Benna, dubbed "Father of the 401(k)" for his filing for a determination letter on the first 401(k) in 1981, illustrates perfectly the quandary in which many plan advisors find themselves. On one hand, participants clamor for advice and, by extension, investment solutions. On the other hand, participants and plan sponsors clamor for ever more flexibility in plan investments. In the July 2000 issue of *Financial Planning*, Benna was featured in an article where he revealed his work to develop an "open architecture" solution for a "major" provider.

In the article, Benna described the future of the 401(k) in terms of portable brokerage accounts, in which participants could invest in a huge array of securities and carry the

account with them from one employer to another. Fast forward one year: in 2001 Benna was lobbying Congress for pension reforms mandating, in essence, that participants be given simplified choices in the form of portfolio models.

Why the dichotomy? Most advisors would probably agree that the majority of plan participants are not likely to make good investment choices without help. The proliferation of fund choices does not help these participants, and may hurt them, yet how can an advisor serve the best interests of those who require simplicity while satisfying the minority that insists on self-direction? "Open architecture" can provide the answer.

Solution #3: Open Architecture

An "open architecture" plan is one in which virtually any mutual fund is available at the ***plan level***, and in some cases may include private money managers. At the plan level, in designing the core fund menu, there would be very few limitations on the investments available. This flexibility alone is generally sufficient to satisfy most plan sponsors and the key people who drive the decision-making.

While different sources apply terms differently, open architecture is here distinguished from an "open option" or self-directed plan in which each participant can pursue the investment of his or her choice, often from separate vendors. Doctor groups are notorious for such arrangements, in which every doctor has his or her retirement plan assets with a favorite stockbroker. Attorney Thomas Hoecker of Snell & Wilmer, L.L.P., an employee benefits law firm in Arizona, uses unequivocal language in describing open option plans: "This common, prevailing practice does not comply with the regulations and is ill-advised." Open architecture, therefore, refers to open access to investment choices at the plan level, not the participant level.

Problem #4: Revenue Sharing Practices

"Under the table" payments have been in the press a great deal as of late. McHenry Consulting Group published a white paper entitled *Whose Money is it Anyway: Revenue Sharing in the Qualified Plan Marketplace*. *Plan Sponsor* magazine has published several articles describing the practice of revenue sharing, in which mutual funds send "kickbacks" in the form of 12(b)1's, sub-transfer agency fees ("Sub-T/A's"), finders' fees, and shareholder servicing fees. The payments are made to whoever places the business—broker/dealers, insurance companies, and other investment platforms. The practice has historically been viewed as perfectly legal, but there are questions as to its propriety in qualified plans due to the stringent fiduciary requirements.

In 1997 the Department of Labor issued several Advisory Opinions, the Frost letter and two Aetna letters, in which it delivered guidance on the practice, saying in essence that

- Fiduciaries could only accept such payments if 100% of the payments were passed through to the plan, or offset dollar-for-dollar by fee reductions;
- Non-fiduciary vendors could keep the fees but must disclose them.

A lawsuit filed against Nationwide last fall alleges that Nationwide acted improperly in receiving these fees. Whether Nationwide acted improperly or not, the lawsuit raised a

critical issue for plan sponsors: on what basis are the funds selected that are offered to the participants?

The problem with revenue sharing as it is commonly practiced is the potential for conflict of interest. Insurance companies and other non-fiduciary providers have a clear financial incentive to form "Alliances" with fund families based in large part on the size of the revenue sharing payments offered. For a fiduciary to make such a selection would be a clear breach of fiduciary duty, yet any fiduciary purchasing a product from a nonfiduciary vendor must consider this potential conflict of interest and wonder how the menu of available funds is selected and monitored.

Solution #4: 100% Revenue Sharing and Full Disclosure

Vendors should offer full disclosure of all fees and expenses and pass through 100% of all revenue sharing payments. This represents a radical departure from common practice, but many firms exist already that follow the new model: full disclosure, full revenue sharing, revenue neutrality. To be "revenue neutral" simply means that there is no financial incentive for or against a particular investment selection, and the selection and monitoring can proceed as required by ERISA—in the sole interests of participants and beneficiaries.

Full disclosure applies not just to providers but to financial salespeople as well. Financial planners as a group are generally quite comfortable with the notion of full disclosure and can easily transition to this model. In a market where fees are often "buried" and disclosure is opaque, planners offering an objective approach with transparent fees have a clear competitive advantage.

Conclusion

Planners who share an excitement for the qualified plan marketplace can follow this action plan to create a profitable and rewarding niche:

- Commit to qualified plans as a significant component of your business.
- Learn what it means to be a fiduciary and how to solve your clients' fiduciary dilemmas through workshops, online presentations, and focused study (the *Resource* list below is a good start).
- Become an advisor and service provider for participants.
- Form relationships with vendors who fit your vision:
    - Open architecture
    - Full disclosure and revenue sharing
    - Professional fiduciary management and protection
- Focus on ***superior service*** as your primary goal, and your practice will thrive.

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