Published on *The National Law Review* https://natlawreview.com

The “Yale Professor Letters”: What 401(k) Sponsors Need to Know (and Do) Now

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Over the past two weeks, a Yale Law School professor has sent letters to approximately 6,000 sponsors of 401(k) plans implying that they may have breached their fiduciary duties with respect to plan costs and investments. Many of the letters state that the sponsor’s plan has been identified as a “potentially high-cost plan,” and all of the letters we have reviewed suggest that the sponsors consider improving their fund lineup and eliminating more expensive fund offerings. The letters refer to a study prepared by the professor and a colleague based on data compiled from Forms 5500 for the year ending December 31, 2009.

Given the current focus on plan expenses by the DOL and in class action litigation, plan sponsors who received such a letter have a right to be concerned. But even those who did not need to be aware of this issue and take appropriate action.

In some of the letters, the professor states: “Based on an extensive database of 401(k) plans, your plan ranked XX,XXX out of 46,875 plans in total plan cost. Among plans of comparable size (measured by total net assets), your plan ranked **worse** than XX percent of plans.” [Emphasis added] And in some of the letters, he adds: “We wanted to inform you that we are planning to publicize the results of our study in the Spring of 2014. We will make our results available to newspapers (including the New York Times and Wall Street Journal), **as well as disseminate the results via Twitter with a separate hashtag for your company.**” [Emphasis added]

Publication of the study’s findings will likely garner attention from lawmakers, plaintiff’s attorneys, plan participants and the Department of Labor. In short, this issue should be taken seriously. Plan sponsors need to be aware of this development, and they also need to know that the study’s findings may not be accurate or relevant for their plans.

Key Takeaways for Plan Sponsors

- The study has a number of deficiencies that call into question both its accuracy and the conclusions it draws. Among other things, it fails to consider the quantity, type and quality of services being provided and the differences in the designs of plans.

- As a measure of fiduciary performance, a comparison of plans based solely on cost is at best incomplete and misleading – a fiduciary's duty is to ensure that costs are reasonable in light of the services being provided, not to provide the cheapest plan.

- Many plan sponsors, either following their receipt of the ERISA 408(b)(2) disclosures from "covered service providers" or in anticipation of receiving them, have already taken action to reduce plan costs and provider compensation from 2009 levels (upon which the study's findings are based). For these plan sponsors, the letters (and the study) are moot.

- In our experience, most 401(k) plans are well-managed, and it is inappropriate to suggest that, of a set of well-managed plans, some (*e.g.*, those with "expenses above average") are mismanaged…that is, that the fiduciaries have breached their fiduciary duties.

- If they have not already done so, plan sponsors should evaluate the services, costs and provider compensation of their plans and determine whether they are reasonable, taking into account all relevant factors. There are several ways to accomplish this, including use of a benchmarking service or engaging in a request for proposal (RFP) process.

For example, the professor's analysis is based on dated information from 2009. It uses information from the annual 5500 forms that is likely incomplete and in many instances is not reflective of a plan's true costs.[1] It fails to consider relevant factors about the services being obtained for the indicated costs, the structure of the plans and the extent to which the costs are attributable to plan services that justify the cost because, for example, they help participants to achieve favorable outcomes.

The following are observations about the analysis:

Fiduciary Practices. A report released by the ICI in June 2013, indicates that the majority of 401(k) plan fiduciaries are doing a good job in managing plan fund expenses.[2] This is borne out by our own observation that most 401(k) plans are well-managed and that the fiduciaries are attentive to their responsibilities, especially related to expenses.

For example, we are aware of plans that have either changed providers or renegotiated their fees since their receipt of the ERISA Section 408(b)(2) fee disclosures, which became effective in 2012, and have significantly reduced their plan costs. For those plan sponsors who have taken action to reduce costs as a result of the 408(b)(2) disclosure, the professor's analysis is inapplicable. Further, while it is not entirely clear where the professor draws the line, if the standard he applies for prudent and low cost is at or below the mean, he is not applying the proper legal standard for judging fiduciary conduct. Adopting this view would suggest that out of 1,000 Yale professors, any that are in the bottom 50% should be not be retained.

Focus on Cost. In examining the cost of the investments, the study focuses solely on publicly traded mutual funds (to the exclusion of other types of investments) and also fails to consider other factors, such as:

- to what extent the investment costs (*e.g.,* revenue sharing) are used to pay for plan administration;
- differences in plan design; and
- whether the plan offers investment education, individual investment advice, automatic enrollment or other services or features that can improve participants' retirement readiness but that add expense.

The study favors plans that offer passively-managed index funds (which typically do not pay revenue sharing and thus will not support the cost of participant services). While index funds are often good investments for 401(k) plans, actively managed mutual funds can also be prudent choices.

The analysis does not fully consider compensation paid to providers from fund fees (*i.e*., revenue sharing), a fact the study authors admit in a footnote – noting that "(s)ince compensation paid from fund fees is not currently disclosed, **it is absent from our data**." [Emphasis added] Because recordkeepers and other providers are often compensated, sometimes entirely, from revenue sharing (which is sourced in the mutual funds' expense ratio), this is material. In other words, in determining whether a plan is "high cost," the study looks only at the investment management and operating costs of the plans' mutual funds, but apparently does not give corresponding "credit" for the revenue sharing paid from the fund fees. Based on our observations, in most cases, if the costs of plan services (*e.g.,*recordkeeping) were not paid by revenue sharing, it would have been paid by the plan and charged to participant accounts – resulting in the same net cost to the participants.

The problem with the focus on costs, to the exclusion of all other factors, becomes clear when considering what type of plan would fare best in the study: a simple 401(k) plan offering solely a suite of index funds. However, because there would be no revenue from fund fees, the plan may well not offer robust participant services or the costs of those services would be charged to participant accounts on top of the investment costs. Clearly, eliminating participant services may not be in the best interests of participants. In short, a focus on costs alone does not address whether they are reasonable in light of all circumstances, including the quantity, type and quality of services provided, which is the proper way to benchmark a plan.

***Fund Fee Reductions*.** The analysis ignores industry-wide improvements that have pushed investment fees borne by 401(k) plans consistently lower in recent years. For example, a June 2013 report by the ICI found that 401(k) mutual fund fees have decreased by 15% over the past 15 years for equity funds, by 19% for hybrid funds and 23% for bond funds, and that they are significantly lower than retail mutual fund fees. It also points out that at year-end 2012, 84% of mutual fund assets in 401(k) plans were held in no-load funds and that, of the remaining approximately 15% held in loans funds, they were predominantly in share classes that do not charge participants a front-end load. We mention the front-end load issue because front end loads are one of the factors cited by the professor in suggesting that 401(k) fees are high.

Action Steps

While the study has flaws, and the references to "potentially high cost" and "worse" plans may seem threatening, one of the professor's messages is correct…plan sponsors have a responsibility to make sure that their mutual fund fees, and other investment costs, are reasonable. What should a plan sponsor do?

The first step is to ensure that the plan's services and expenses have been evaluated using market data, a benchmarking service, RFP process or otherwise.

The second is that, if the analysis suggests that the costs for investments or services are excessive, the fiduciaries should contact the service providers and negotiate for reduced costs (which could include less expensive fund share classes or credits to an expense recapture account) or expanded services.

Conclusion

The letters being sent to plan sponsors, as well as the study, do not accurately represent whether the fees and costs for a particular plan are unreasonable in light of the plan services and, therefore, whether a breach has occurred. While the study may be of limited value, the issue it raises is important. Plan sponsors should obtain market data on their plans and determine if the providers' compensation and the investment costs are reasonable… relative to the services being provided.

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[1] *See, e.g.,* findings in the Government Accountability Office report "401(k) Plans: Increased Educational Outreach and Broader Oversight May Help Reduce Plan Fees," April 2012, available at http://www.gao.gov/assets/600/590359.pdf.

[2] Investment Company Institute, "The Economies of Providing 401(k) Plans: Services, Fees, and Expenses, 2012," June 2013, available at http://ici.org/pdf/per19-04.pdf.

National Law Review, Volume III, Number 205