404[c]

A Worm in Your Retirement Apple

Matthew D. Hutcheson, CPC
Independent Pension Fiduciary

January 2008

Table of Contents

PART 1

Introduction

My name is Matthew Hutcheson. By training I am a Certified Pension Consultant. I am also an independent researcher of economics, law, finance, actuarial science, investments, fiduciary prudence and process. My research has been published in academic and legal journals.

By trade, I am an Independent Fiduciary.[1] That means that I make independent decisions for Retirement Plans[2] and serve on behalf of the Participants and Beneficiaries of the Plans to which I am appointed. A fiduciary bears the highest duty known to the law.[3]

I have testified before Congress on matters affecting the retirement income security of tens of millions of American workers and have provided statements for the record to the Department of Labor to assist them in their efforts to develop helpful retirement plan regulations.[4]

Statement of Independence

I have no affiliations or ties with any financial institution, other than ordinary working relations as are necessary for the proper operation and administration of the Retirement Plans for which I am responsible. My loyalties are to Plan Participants and their Beneficiaries, and I seek their best interests.

The comments, observations, and statements made here by me are consistent with those fundamental loyalties, expected fiduciary behaviors, and standards of care.

Hopes and Dreams

Like you, I have a family; a wife and children. My mother is a retired high school teacher, and my father is a retired computer security analyst. My five sisters are all accomplished professionals in law, medicine, and academia.

We, like you, have dreams and hopes for the future. And like most of you, we believe that if we play by the rules, work long and hard, we can enjoy the American Dream of earning a college degree, owning a home, enjoying a secure retirement, and having the chance to get ahead in a growing economy.

The sad reality is "For this generation of American workers, the American Dream has the potential to become a nightmare."[5]

Realizing the impending problems, hundreds of people, including myself, have joined the fight to protect the security of your retirement, and exert our best efforts to assist in making the dreams of millions a reality. Many of us are doing so at great personal sacrifice, without pay or promise of reward.

My Objective: To Protect the Retirement of America's Workforce

My purpose in sharing these practical realities is to help American workers retire with dignity and security. The 401(k) in its basic form is one of the great success stories of America's employee benefit system. Therefore, it must be protected from inappropriate practices that undermine its success, including some practices that are generally accepted at the current time or even authorized by law.

"The law that governs virtually all private employer-provided pension and retirement plans, known as ERISA,[6] probably wins the prize for the "Most Difficult to Understand by a Normal Human Being."[7]

ERISA stands for the Employee Retirement Income Security Act. It was signed into law on Labor Day, 1974, by Gerald R. Ford. It is a very complex law, but by and large it has been an effective protection for American workers.

However, because ERISA is so difficult to understand, certain elements within ERISA have been exploited by the 401(k) industry for unfair money-making purposes, at the expense of the worker. In other words, workers pay, but receive no benefit. That is not what ERISA is all about, and it is why I have chosen to convey this message to you. It is high time the general public understand what is happening within their 401(k) plans.

I have made every effort to convey an important, objective, and comprehensible message pertaining to an otherwise extremely complex topic, as well as some thoughts on how the current system might be reformed in the interests of America's future retirees.

PART 2

404(c): A Worm in Your Retirement Apple

A Short Story About Apples and Worms

I'd like to share a simple illustration about the current state of our 401(k) system.

Imagine yourself at the grocery store examining fruit to purchase. You decide on two apples. Both are beautiful, polished, and by all appearances, will be sweet and delicious. Both weigh the exactly the same amount, and you pay the same price for each.

When you get home, to your surprise and disappointment, one of the apples is full of worms! And upon further examination, you realize that the worms have consumed 30% of your apple…the apple you paid for! You shake your head in disbelief. If 30% of your apple has been eaten by worms, you have 30% less to consume for yourself. Yet, since the apple weighed the same as the good apple – the difference in weight must be the worms themselves!

I'm sorry, but I don't appreciate paying for worms, especially when I think I'm only buying an apple.[8]

Worms in the Retirement Industry

The apple is your 401(k) account – what you will eventually consume. The worms are elements or components (services provided) of a particular business model in the 401(k) industry called "bundling," (which I will explain in greater detail shortly) coupled with a Federal regulation called "404(c)."[9] The portion of the apple consumed by the worms is the impact that fees and costs associated with supporting 404(c) have had on your future benefits. After all, the 401(k) industry insists that the worms have to eat too!

Analysis & Action

You paid for an apple that had 30% less consumable fruit than you believed.

Although the both apples weighed the same amount, 30% of the weight of one apple is attributed to worms; parasites that add no value to you, but ounce for ounce cost the same as the apple!

Despite having paid full price for the apple, you have less fruit to eat.

- You take the apple back to the store and demand a refund.
- The store tells you that you should have done a better job of choosing your fruit, and shows you an obscure sign that says, "No returns of fruit with worms…we don't want 'em back either."
- There was no way for you to identify apples with worms, and you are told the law does not require the store to disclose which apples have worms – even though everyone in the produce department knows exactly which apples have worms, and which ones don't. If you don't ask, they won't tell. Sometimes they won't even tell if you do ask!

Bad Fruit

A bundled service provider is a company, such as a financial institution, that performs all of the functions necessary to operate your 401(k) account – soup to nuts. In other words, the financial service provider bundles the entire 401(k) services into a presumably neat package; a one-stop-shop. The "apple" is your account, and they're responsible for polishing it.

Bundled service providers invest your funds, account for them, and provide relevant reports to your employer, you, and the government.

There is nothing inherently wrong with the general bundled 401(k) business model, per se. It is the worms and the "no return policy" within the bundled 401(k) model that creates the problem. The worms are non-valuable components of a 401(k) plan that eat away at your account, year after year. The worms represent fees for non-essential services (excess services), inefficiency, poor external oversight, lack of transparency, and so forth.

To add insult to injury, when you finally discover you have bought a wormy apple, you can't return it for a good one. The store simply says you are out of luck. The bad return policy is called "Department of Labor Regulation 404(c)."

Here's how 404(c) works. Your employer chooses a menu of funds. You then choose individual funds from that menu. If you make mistakes in selecting the funds resulting in poor performance or losses[10] within your account, you are out of luck. The industry tells you there is nothing you can do about it, and it's all because of regulation 404(c). That is the "no-return" policy.

A requirement of 404(c) states that individual 401(k) participants must be "informed" before 404(c) is valid. When I ask regular folks what "informed" means to them, they tell me it means being in possession of all relevant information necessary to make sound investment decisions, and also having an understanding of that information so an intelligent investment decision can be made.

If an investor is truly informed, why would they make mistakes? As you think about that paradox, you may conclude something is seriously wrong with that picture, and you are correct. There is.

Most people don't really know whether they are making good investment choices or not. That's quite the norm. After all, most people don't have specialized investment training. How are people supposed to know whether they are making mistakes or not? Unfortunately, only time will tell. Such uncertainty isn't right. Fiduciaries have an obligation to be loyal to you; to protect you. Not leave you high and dry. You should simply be given worm-free apples from the beginning.

The combination of the worms and a no-return policy make a toxic combination for millions of American workers, and epitomize bad behavior by the presumed pillars of the financial world. Not only should they know better; they do!

Like History Repeating

Can you hear the song "History Repeating" by Shirley Bassey[11] in your head?

> .. and I've seen it before
> .. and I'll see it again
> .. yes I've seen it before
> .. just little bits of history repeating

Something quite unfortunate has happened, right under our noses. We have let history repeat itself, albeit in a more subtle and sophisticated form. This time, it has happened within our retirement system.

We have repeated the financial errors enumerated by a controversial political figure of the early twentieth century, John T. Flynn (1882 – 1964).

While just the sound of his name makes the hair on some people's necks stand on end, he taught many truths that have stood the test of time. I do not necessarily advocate any of his specific political views; however, I do believe that he loved our country and his countrymen. His concerns in the 1930's are the very concerns that burden those of us concerned for the future welfare of American workers today.

"Now we have banks owning not only brokerage firms and New York Stock Exchange specialists. We have brokerage firms bowing to the demands of mutual funds."

John T. Flynn (1882 – 1964)

With permission from Jack Willoughby, a senior editor at Barron's, I quote excerpts from a speech he gave to The Committee for Monetary Research & Education[12] on November 20th, 2002.

"John Thomas Flynn was born in Maryland and educated to be a lawyer but settled upon journalism as a career coming to New York in the Twenties to become managing editor of the New York Globe. He specialized in writing about finance, real estate, and stock market scams.

Flynn wrote about financial excesses of all sorts throughout the Thirties in a way almost no journalist did. He painstakingly took apart major collapses at a time the public was reeling—grasping for answers. Flynn believed that the roles of broker, floor trader, and specialist should have been separated by legislation.

He opposed all forms of financial devices designed to concentrate power in an inside group[13]…(which) should be permanently banned.

Flynn believed sound stewardship[14] would be prompted by transparency.[15] He believed that stock ownership, all management side-deals, and director transactions should be made public.

In one of Flynn's early books entitled 'Graft In Business' Flynn outlined how the mechanics of finance could be used for mischief.

Ladies and Gentlemen, [Flynn's][16] statement could well have been written today even though it was written in the Thirties. In fact our position is worse now than back then because of two things – the intense participation of the public in this gamesmanship through mutual funds and savings plans, and the imposition of government guaranteed deposit insurance providing a government guarantee backing the game.

Flynn aimed his criticisms at the methods in an attempt to reintroduce a sense of public stewardship[17] to the process and to limit speculative ventures.[18]

The result is our current system rife with conflicts far deeper than anything Elliot Spitzer can ever address in his email campaign. Now we have banks owning not only brokerage firms and New York Stock Exchange specialists. We have brokerage firms bowing to the demands of mutual funds.

What were reformers like Flynn trying to do when they set about lobbying for specific changes? They were trying to return a semblance of sanity and stewardship to depository institutions by restricting the various activities all to ensure that the rampant speculation of the Twenties never happened again.

Flynn despaired back in 1933: 'I have very little faith in the country learning a spiritual lesson out of this crisis. Somehow we will struggle out of it. We will have a momentary gushing up of cheap evangelism and then everyone will settle down to get the old National City shares up to $575 again. This course is too deeply embedded in our nature. Our civilization got off on the wrong foot forty or fifty years ago. It is not going to be turned in another direction by just a little depression.'

When you read Flynn's writings you get the sense of deja vu."[19]

What do the views of John T. Flynn have to do with your retirement plan? It's simple, well. . . kind of. The financial games of yester-year, played with "other people's money," have been the generally accepted practice in the 401(k) industry since 1992. As of this writing, sixteen years of "history repeating" have passed without as much as an eyebrow raised by anyone, except for a few courageous lawyers, fiduciaries, and Congressmen.

Way back in the 1930's, Flynn was trying to warn us that financial excesses, financial devices (tools, stratagems) designed to concentrate power within an inside group ("bundling" services into a centralized power center), lack of fiduciary oversight (lack of public stewardship), lack of transparency (poor disclosure), and the encouragement of speculative investing all led to financial disaster in the first half of the twentieth century. All of these conditions (and more) exist simultaneously once again, in particular, within our retirement system, the very system on which you are relying to make your dreams come true.

Hidden Fees and Hidden Purposes

You make choices within your 401(k). The most important of those choices is selecting investments. Regulation 404(c) is a strange provision within ERISA. It presumes that you are likely to make mistakes, and that those mistakes will lead to losses to your future benefits. Those losses will be in the form of either an immediate loss caused by a particular transaction or event, or an equally dreadful "slow bleed" loss, which is a grinding, eroding loss incurred over time caused by poor funds, poor diversification, hidden excessive fees, or a combination of all three.

What makes 404(c) so strange is that, counter to what "ERISA" implies[20], it creates an environment where those who should be loyally protecting your portfolio leave you to your own devices – to guess how to invest your funds. That leads to easily avoidable mistakes and portfolio losses. Yet 404(c) protects the Plan fiduciaries that should be loyally protecting you simply by having them jump through a few hoops.

You know that chronically "frustrated" feeling you have with your 401(k)? That frustration is caused by 404(c). You don't receive the help or assurances you need because of that provision, even though you are supposed to. Yet, when things go wrong, "they"[21] claim no one is responsible but you. Oh, did I mention that you pay to protect the fiduciary, but you don't receive any benefit by so doing?

Strange, wouldn't you say?

Before a fiduciary can be protected from mistakes you might make in your 401(k), an employer/fiduciary must demonstrate that he or she meet all of the requirements of 404(c). In other words, protection from fiduciary liability is dependent upon satisfying the requirements of 404(c). To comply with 404(c), a substantial amount of work must be performed.[22] Complying with so many complicated requirements costs a lot of money, even though some service providers have been known to deceive their clients by saying 404(c) services are "free."[23] Even my ten year old son understands there is no such thing as a free lunch.

In a bundled plan, the service provider does not want you to know that you are paying for the protection of the plan fiduciaries when you yourself receive no benefit of any kind for so doing. Therefore, bundled services providers have endeavored to hide both the purpose of 404(c) from you, and also to hide the way it is financed as well.

The 404(c) services in a bundled Plan are paid for by you, but you don't know that. The reason you don't know it is because the way the dollars change hands is hidden. The current terminology for this technique of hiding the payment for 404(c) services is called "Revenue Sharing."

"There is another type of cost that eats away at your apple, year after year. It is transaction costs – Revenue Sharing's "evil twin." Transaction costs represent a substantial percentage of the overall cost in a conventional bundled 401(k) plan. Transaction costs are truly secret, and most often serve the interests of the financial service firm far more than those of the participant."

Revenue Sharing – A Deception

In its simplest terms, a mutual fund may charge 20% to 100% more than it actually costs to manage the fund itself. The "excess" revenue is fed to the worms to keep them alive. It is that excess revenue that subsidizes 404(c) in a bundled plan.

Without revenue sharing, your employer would have to pay for 404(c) services out of his own pocket. Those employer fiduciaries that truly understand how this works, yet still choose a bundled plan model, reveal that revenue sharing is an ***unreasonable*** cost. In other words, they don't pay for it themselves because they do not feel it is reasonable for them to do so. However, they're happy if you pay. It's not right.

Again, in fairness, some employers with an understanding of fiduciary prudence, opt for an unbundled plan model, and in reality pay for 404(c) services (if they want those services) out of their own pocket. Such employers exemplify loyalty to you and adherence to core fiduciary duties.

Yes, it's shameful. But the bundled industry finds a way to defend itself.

Bundled service providers say that "Revenue Sharing" is part of the fund's management fee (or "expense ratio") which is disclosed in a prospectus and is therefore transparent and disclosed. Some reasonable people might accept that argument, but not prudent fiduciaries.

None of us appreciate paying for worms, especially when we think we're only buying an apple. If the management fee consisted of only what was being charged for managing the fund; that is one thing. But that is not the reality. The fact is, the management fee pays for part apple and part worm. Regular people cannot determine what portion of the fee is going to pay for the edible portion of the fruit.

A few types of Revenue Sharing are out in the open for everyone to see but are hidden because people don't understand what they're looking at.

There is another type of cost that eats away at your apple, year after year. It is transaction costs – Revenue Sharing's "evil twin." Transaction costs represent a substantial percentage of the overall cost in a conventional bundled 401(k) plan. Transaction costs are truly secret, and most often serve the interests of the financial service firm far more than those of the participant.

Every time the manager of the funds in your portfolio executes a trade in pursuit of a higher return, a brokerage firm charges that manager a fee to make that trade. Do you know who pays that fee? You pay it, only you don't know it. You don't know it because the mutual fund company doesn't bill you for it. You never write a check. The mutual fund deducts the money directly from your return. Revenue Sharing, Brokerage Commissions, and other transaction costs can, over time, take half your retirement savings, or more.

Because 404(c) gives you the opportunity to control your own account, you may inadvertently be your own worst enemy, creating more transaction costs than you would ever be willing to pay for out of your own checking account. Why? You would deem them to be unreasonable. You simply would not agree to pay those. Only by hiding those costs from you is the firm running your 401(k) plan able to get you to act in a way that causes you to incur transaction costs that are highly profitable to them, but which generally do not benefit you.

You pay for 404(c), yet receive no benefit

Do Plan Fiduciaries Benefit from 404(c)?

Yes.

Is that bad? Not if they pay for it themselves.

How do they benefit? In essence, 404(c) says that if your 401(k) Plan permits you to exercise control over your 401(k), your employer (fiduciaries) will be protected from liability caused from losses that may occur due to mistakes or your ignorance. So, if you make a mistake, there's a "no return" policy.

Do Bundled Service Providers Benefit from 404(c)?

Yes.

Is that bad? Yes, because a bundled plan, by its nature, makes it impossible for your fiduciaries to protect and remain loyal to you. Your plan fiduciaries cannot monitor what they can't see. In a bundled plan, all services are concentrated into a central source of influence and power over the operation of the plan. (Remember John T. Flynn's warning about that?)

Also, bundled service providers benefit in other ways at your expense. They sell their "package" of goods with 404(c) added on. It gives an employer fiduciary some peace of mind that they won't be held liable for the missing "30%" eaten by "worms," and thereby benefits the bundled provider by making the sale and retention of clients easier.

Do You Benefit from 404(c)?

No.

You just pay for it – dearly.

Modern Day Taxation without Representation

In the 401(k) world, there exists an equivalent of "taxation without representation." It again is 404(c). In a bundled plan, money is withdrawn from your account to pay for 404(c) services. Did you know that 404(c) does not benefit you? It is a strange, counter-intuitive Department of Labor regulation that in essence says an employer can authorize the use of your account to pay for his or her protection from fiduciary liability. In fact, its mere existence in a bundled 401(k) plan guarantees you will have less money in your account when you retire, even if you are properly diversified. The funds extracted from your account to pay for 404(c) do not increase the returns you will earn, nor do they decrease the risks of your portfolio. Those 404(c) fees are simply pure costs that reduce the value of your portfolio and then prevent you from "returning your wormy apple."

In a bundled plan, 404(c) creates an environment in which other important fiduciary obligations cannot be fulfilled, such as proper monitoring of services, costs, etc., thereby creating the likelihood that your 401(k) plan's fiduciary will breach their duty of loyalty to you. No reasonable fiduciary who truly understands their fundamental duties of loyalty and care could possibly argue that the existence of 404(c) in a bundled plan is consistent with those duties.

In fairness to 404(c), however, in a non-bundled plan, where those services are paid by the employer, 404(c) is certainly a fine regulation whereby fiduciaries can honorably benefit.

"No reasonable fiduciary who truly understands their fundamental duties of loyalty and care could possibly argue that the existence of 404(c) in a bundled plan is consistent with those duties."

What can you do?

The place to start is to request the following information from your employer:

1. Whether your plan is a bundled 401(k).
2. Whether 404(c) is an element within your plan.
3. If it is, request information about how much it costs.
4. If your employer doesn't know, you might ask him if he is aware of his fiduciary duty to understand how funds are being expended, and to ensure no funds are expended for purposes that don't secure your future benefits. If the 404(c) component is important to your employer, then try to work constructively and proactively with your employer to have it carved out of your bundled plan so your employer can pay for it separately.
5. Alternatively, you can encourage your employer to switch to an unbundled plan model where 404(c) is not a component. Or, if it is something your employer wants for themselves, request that they pay for it themselves.
6. You can encourage your family and friends to write your Congressmen to pass pending legislation that would improve fee transparency. You can also ask that they consider legislation requiring 404(c) to be paid by the employer only, not from your account.
7. Fee and cost transparency will help employers determine whether or not making you pay for 404(c) is prudent (which it is not), and it will help you know how much you are paying in 404(c) fees to protect someone else without providing benefit to you.
8. Fiduciaries have a duty to protect you. If you believe your employer or fiduciary is only acting on his or her own behalf, you may need legal assistance. However, you will likely find your employer or fiduciary to be more than willing to help you – including paying for 404(c) themselves if it is really that important to them. If it is important to them, they'll deem the associated expense reasonable.

Conclusion

You have worked hard for what you have. You don't deserve to find out you don't have enough money to last during retirement because your retirement "apple" was infested with worms. Fortunately, most people have time to do something to remedy the situation.

Your emails and comments are welcome.

Matthew D. Hutcheson, CPC
Independent Pension Fiduciary
matt@erisa-fiduciary.com

End Notes

1. Pursuant to Employee Retirement Income Security Act of 1974, section 3(21). See also http://en.wikipedia.org/wiki/Fiduciary
2. Such as a 401(k), traditional pension, Employee Stock Ownership Plan, etc.
3. [Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cit. 1982)]
4. http://edworkforce.house.gov/testimony/030607MatthewHutchesontestimony.pdf; http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6667; http://www.dol.gov/ebsa/pdf/Hutcheson070807.pdf;
5. http://www.dol.gov/ebsa/pdf/Hutcheson072407.pdf
6. Dan Houston, September 7, 2005 http://www.harrisinteractive.com/news/newsletters/clientnews/PFG_2005.pdf
7. Employee Retirement Income Security Act of 1974
8. Mauer, Michael., Complete Guide; UCS, Inc. ©2001. Page 100.
9. People think the expense ratio consists of only "apple" when in fact, it pays for both apple and worms.
10. 29 CFR 2550.404c-1; ERISA section 404(c) regulations, or "404(c)". Those losses will be in the form of either an immediate loss caused by a particular transaction or event, or a "slow bleed" loss, which is a grinding, eroding loss incurred over time.
11. http://en.wikipedia.org/wiki/Shirley_Bassey
12. The Committee for Monetary Research & Education is a non-profit educational organization, seeks to promote greater public understanding of the nature of monetary processes and of the central role a healthy monetary system plays in the well-being, indeed, in the very survival of a free society. www.cmre.org
13. An important concept that we will be frequently discuss here. The modern term for concentrating "power" in the 401(k) industry is "bundling" services. Thus, a "bundled plan" is a plan that seeks to concentrate power through one entity performing all related tasks associated with plan operation, including investing, custody, brokerage trades, etc., accounting, reporting, etc.
14. Fiduciary duty and responsibility
15. Meaningful disclosure of fees, economic influences, conflicts of interest, etc. There is a Bill in the House of Representatives right now (HR 3185) that would address poor disclosure and conflicts.
16. Generalization added by author
17. Fiduciary duty and responsibility
18. Speculation encouraged by Governmental regulation 404(c).
19. Mr. Willoughby's full speech can be read at http://www.cmre.org/willoughby.htm
20. One would conclude that ERISA requires all fiduciary actions to "secure" retirement in one way or another. 404(c) does just the opposite. In fact, it creates an environment of retirement "insecurity."
21. The 401(k) industry or whoever might be defending 404(c), such as lawyers, brokers, etc.
22. The following link will direct you to the website of the Snell & Wilmer law firm. The 404(c) compliance checklist was created by Attorney Tom Hoecker http://www.swlaw.com/files/Publication/2831a8c8-750c-4755-8008-21c2cfcae4eb/Presentation/PublicationAttachment/a89601b2-56a4-4797-af66-9b157bb5d8de/404(c)_Compliance_Audit_Checklist.pdf
23. Hutcheson, Matthew D., "Uncovering and Understanding Hidden Fees in Qualified Retirement Plans" (Fall 2007). Available at SSRN: http://ssrn.com/abstract=961996; page 23, third paragraph on page.
24. "Some important 401(k) costs are turnover-related transaction costs from the portfolio manager's trading. This poorly understood "invisible" cost can be several times higher than more "visible" asset management fees or 12b-1 fees. Because such costs are virtually never included in the prospectus, nor in the fund's published expense ratio, most plan sponsors, plan advisers, and the vast majority of participants are unaware of the significant cost impact high portfolio turnover has on their future retirement benefit." *Gregory W. Kasten*, MD, MBA, CFP®, CPC, AIFA®, *is president and* CEO *of Unified Trust Company*, NA, *in Lexington*, KY. *Quote taken from the Journal of Pension Benefits, Spring* 2007.