

ADVISER REPORT

A NEWSLETTER FOR RETIREMENT PLAN ADVISERS

Message From The Firm

Change is coming... and it is fast and furious!

The White House issued a White Paper calling for a fiduciary standard for all advisers—both broker-dealers and RIAs—who give investment advice to any retail investors, which would include most retirement plans. Then, the Administration followed up with proposed legislation to accomplish that purpose. Congressman Barney Frank and the Committee on Financial Services, which he chairs, are at work on that legislation.

At the same time, the House Education and Labor Committee approved an updated version of the investment advice bill which would restrict investment advice—to both plans and participants—to one of two arrangements. The first is the level-fee arrangement and, in a significant change, only RIAs would qualify to be level-fee advisers. That effectively cuts out broker-dealers and benefits brokers. The second alternative is computer model advice, which could be used by RIAs, broker-dealers and insurance companies. However, even for the computer model alternative, benefits brokers and banks and trust companies are excluded.

That bill has been assigned to the House Ways and Means Committee for its review. It is possible—perhaps even likely—that the Ways and Means Committee will expand the bill from just ERISA plans to include non-ERISA 403(b)s, IRAs and 457 plans.

At the same time, the DOL and SEC have held joint hearings on target date funds—largely because of the remarkable losses suffered by 2010 funds in the market meltdown of 2008. It was shocking to many politicians and regulators that a mutual fund that was represented as being appropriate for investors and participants approaching their retirement could lose

Continued on page 2

Benchmarking as a Part of a Prudent Process



By Fred Reish (FredReish@Reish.com)

<http://www.linkedin.com/in/fredreish>

It is commonly accepted that 401(k) fiduciaries must prudently select and monitor both investments and service providers. It is also understood that, in order to fulfill their selection and monitoring responsibilities, 401(k) fiduciaries must engage in a prudent process. However, in my experience, many plan fiduciaries and advisers do not understand the specific requirements for a prudent process. This article focuses on those requirements.

Basically stated, there are several steps to a prudent process, which are:

1. Identify the particular issue to be considered. In some cases, it is obvious. For example, fiduciaries must decide which asset classes should be used by the plan and which mutual funds should be selected to represent those asset classes. However, in other cases, the fiduciaries, like the committee members, have the flexibility to decide whether or not to address an issue, for example, should the plan offer participant-level investment advice or investment management?
2. Determine the information that is *relevant* to making an informed decision about that issue. Keep in mind that all of these steps are subject to the prudent man rule, which measures fiduciaries by the standard of a hypothetical knowledgeable person. Thus, fiduciaries need to identify the information that a

knowledgeable person would need in order to make a prudent decision.

3. Gather and evaluate the information. The output of a prudent process is an informed and reasoned decision. As a result, the fiduciaries should start by gathering the appropriate information. Then, they need to analyze the information to make a decision that is a reasonable result of the evaluation of the information.
4. Implement the decision.
5. At reasonable intervals thereafter, monitor the decision.

When evaluating the relevant data, the fiduciaries should compare it to comparable information from the marketplace. In other words, fiduciaries have to “benchmark” the investments and services in order to evaluate their quality, cost, effectiveness and other attributes. This requirement applies to all fiduciary decisions, regardless of whether they are about recordkeepers, investments, investment advice, participation, and so on. In other words, benchmarking is an inherent part of a prudent process—and fiduciaries must engage in a prudent process for every decision they make.

Here is what the DOL says about the process for selecting a service provider (which applies to all fiduciary decisions): “...the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess

Continued on page 7

Fiduciary Advice: New Perspectives



By Fred Reish (FredReish@Reish.com)
<http://www.linkedin.com/in/fredreish>

The White House has called for a fiduciary standard under the securities laws for investment advice given by broker-dealers and their representatives.

If that proposal is adopted, what will it mean for investment advice for 401(k) plans and participants?

In theory, it would be meaningless. However, in practice, the change would probably be significant.

First, as to the theory, there should not be any legal impact because ERISA already imposes fiduciary status on broker-dealers who provide individualized investment advice to plans and participants. And, while we do not know the details of how the proposed changes will be developed, it is doubtful that the new fiduciary standard would be any higher than the existing ERISA rules.

Before discussing the practical implications, let's look at the major differences between fiduciary and non-fiduciary advice by broker-dealers—using general fiduciary concepts.

- Fiduciary advice is governed by the prudent man rule. That means that the advice will be measured by the standard of a hypothetical knowledgeable investor or adviser, be based on the objectives of the investor (for example, the terms of a personal trust or a retirement plan), and must be consistent with generally accepted investment theories.
- A fiduciary has a duty of loyalty to the investor . . . which means a fiduciary adviser must place the interests of the investor ahead of those of the adviser. That requires, among other things, that the adviser disclose, before investment decisions are made, all material conflicts of interest.

With that background, the most likely consequences on 401(k) plans will be:

- Since broker-dealers will, if the proposal is implemented, be fiduciaries under the securities laws when they give advice, one change may be that more broker-dealers will permit their advisers to serve as fiduciaries for ERISA-governed retirement plans. Since it is likely that the fiduciary responsibilities under the two laws will be similar, the training programs for the advisers for fiduciary compliance under both sets of laws should be similar, the internal procedures and practices for compliance with both sets of laws should be similar, and so on. Since much of the effort and cost of fiduciary compliance would be incurred to comply with the new securities law standard, it is likely that many, and perhaps most, broker-dealers would develop fiduciary programs or expand their existing fiduciary programs for retirement plans.
- The securities laws related to fiduciary standards (for example, the RIA requirements) require disclosures of material conflicts of interest. While ERISA has not required non-fiduciary advisers to disclose conflicts, it has required that the primary plan fiduciaries (*i.e.*, plan sponsors) be aware of conflicts. Further, while the law is not entirely clear, there is an argument that fiduciary advisers are already obligated by ERISA to disclose material conflicts. Furthermore, there are proposals on the table (for example, the 408(b)(2) regulation and legislation that is working its way through Congress) that would require disclosures of certain conflicts of interest by non-fiduciary service providers.

Assuming that the newly proposed fiduciary rules would require disclosures

of material conflicts, one of the burdens of ERISA fiduciary compliance will be largely eliminated by the securities laws imposing the same, or substantially similar, requirements.

For these reasons, my belief is that the proposed fiduciary standards under the securities laws will accelerate the move by broker-dealers to fiduciary status under ERISA.

Of course, there will continue to be significant differences between the fiduciary and conflicts standards under the securities laws and under ERISA. As the White House proposal is developed and works its way through Congress, those differences will be the subject of analysis and debate. Assuming that the proposal is enacted into law, broker-dealers will want to focus on the differences in order to develop their internal compliance practices and to avoid risk management and legal problems. ❖

Message from the Firm *continued from page 1*

25% to 30% in one year. The hearing was held jointly by the agencies on June 18th. Testimony was given and comments were submitted, but the outcome is still unknown. (Our comments are posted on our website at <http://www.reish.com/publications/pdf/testimonybyBRA061809.pdf>)

The moral of the story to advisers is that target date funds are no longer immune from the requirement for a rigorous selection and monitoring process. In other words, target date funds no longer are entitled to a "free pass" just because the provider requires that its target date funds be used in connection with its recordkeeping system.

Some people are speculating that we are reaching a tipping point with target date funds where providers will be required, by the competitive marketplace, to include more than one on their recordkeeping platforms.

We believe that, for focused 401(k) advisers, there has never been a better—or more challenging—time to be in the 401(k) business.

*-Fred Reish
 FredReish@Reish.com*

Investment Manager



By Jason Roberts (JasonRoberts@Reish.com)
<http://www.linkedin.com/in/jasonchristopherroberts>

Introduction

Recent trends in regulatory enforcement and ERISA litigation are leading plan sponsors to examine ways to shift or “outsource” fiduciary risk. The market losses of 2008 have served to underscore this risk, particularly as it relates to investment-related losses in participant accounts. As a result, increasing numbers of sophisticated plan sponsors are asking their advisors to serve as an ERISA 3(38) investment manager and/or conducting searches for those who do. Significant opportunities are emerging for advisors that are equipped to serve in this capacity, but it is a decision that must be carefully evaluated and prudently implemented.

Background and Legal Discussion

ERISA provides plan sponsors with four primary tools to shift or mitigate risk for investment-related losses in participant accounts: 1) qualified default investment alternatives (QDIAs); 2) participant investment advice; 3) 404(c) compliance; and 4) delegating authority to a Section 3(38) investment manager. The first two options only provide protection to plan sponsors if utilized by participants, and the plan fiduciaries remain liable for the selection and monitoring of the plan’s investment options. And while compliance with Section 404(c) may provide additional protection, the plan fiduciaries remain responsible for selecting core investment options that meet the requirements of 404(c) and for providing exhaustive disclosures and notifications.

Section 3(38) makes it possible for plan fiduciaries to delegate primary authority for plan investments to an “investment manager” who: (1) has the power to manage, acquire, or dispose of any asset of a plan; (2) is a registered investment adviser (RIA), bank or insurance

company; and (3) has acknowledged in writing that he is a fiduciary with respect to the plan. The plan fiduciaries are relieved from their obligation to invest or otherwise manage any assets of the plan which are subject to the management of the 3(38) manager, but they must show that a prudent process was followed relative to selecting and monitoring the performance of that manager.

Emerging Service Arrangements

In working with our adviser clients, we are seeing three primary business models emerge: plan-level only; participant-level only; and both plan and participant investment management services. Plan level investment managers take on discretionary responsibility for the selection and monitoring of the “core” investment and may or may not allocate among those options to create model portfolios or managed accounts. Advisors serving as investment managers at the participant level generally limit their activities to creating and managing accounts that are allocated among core investment options selected by an unrelated fiduciary. Depending upon the resources and the expertise of the adviser, it may be advisable to partner with another adviser to fulfill one or more of these functions. Some clients are providing turnkey, comprehensive services by coupling investment manager functions with participant-level investment advice, thereby providing protection for their plan sponsor clients at all levels of service.

Important Considerations

There are three primary factors an adviser should consider before becoming a 3(38) manager. First, advisers should evaluate their respective resources and expertise to determine whether and in what capacity they are comfortable assuming discretion over plan assets. Advisers that are experienced in selecting and monitoring

Continued on page 7

Discussion of CIFs

Another noteworthy trend among our adviser clients is the proliferation of collective investment funds (CIFs) as investment options for employer-sponsored retirement plans. A CIF is a bank or trust company-administered trust that holds commingled assets that meet specific certain criteria. With pressure mounting from legislators and regulators to provide low cost, transparent investments for plan participants, many advisers are turning to CIFs to construct well-diversified model portfolios or managed accounts. CIFs are not subject to the onerous requirements related to registration under the Investment Company Act of 1940, and the operational, administrative and management fees associated with CIFs are generally much lower than their mutual fund counterparts. We are working with our adviser clients to develop and integrate CIF-related strategies into their existing service models. Some advisers are using “off the shelf” CIFs that are managed by a bank or trust company, while others are entering into sub-advisory arrangements whereby the adviser is responsible for selecting, allocating and rebalancing the underlying investments in each CIF. If the adviser acts as a sub-adviser, the adviser will be subject to regulatory oversight by the SEC and must comply with the fiduciary standards of ERISA. We recommend that advisers carefully consider the pros and cons of using CIFs and undertake a review of their service agreements and disclosure documents to ensure that such services are properly authorized and explained.❖

- Jason Roberts
JasonRoberts@Reish.com

Reporting 12b-1 Fees



By Fred Reish (FredReish@Reish.com)
<http://www.linkedin.com/in/fredreish>

The current government activity on service provider compensation includes a Form 5500 reporting requirement.

The reporting requirement is imposed on plan sponsors, but disclosure of that information by advisers is necessary for plan sponsors to complete the Form. We have been advising plan providers, RIA firms and broker-dealers on these issues.

This article focuses on 12b-1 fees paid to broker-dealers in connection with mutual fund investments made by 401(k) plans. The only ERISA requirement for reporting and disclosure of 12b-1 fees by broker-dealers is for plan sponsors to report the fees paid by the plan (through its investments). This is a reporting requirement on Schedule C to the 2009 Form 5500. Note that Schedule C needs to be filed for plans with more than 100 participants and requires reporting of compensation of \$5,000 or more. Thus, this requirement does not apply to small plans. However, it applies to more plans than might be expected, because the number of participants includes all of the employees who are eligible to defer, and not just on those that are deferring.

Beginning this year, covered plans will need to report certain information about “indirect” payments, which include 12b-1 fees. (Indirect payments are those which are made by anyone other than the plan or the plan sponsor. Since 12b-1 fees are paid from a mutual fund to a broker-dealer, they are “indirect.”)

Indirect fees are divided into two subcategories. The first is “eligible indirect” and the second is “other indirect.” Eligible indirect payments are subject to minimal reporting; it is a check-the-box reporting requirement. Other indirect payments must be reported in more detail.

What’s the difference between “eligible” and “other” indirect fees?

Because the rules are complex, I will discuss only the most important one... generally speaking, an indirect payment is eligible if it is a 12b-1 fee and if the broker-dealer provides the plan sponsor with written disclosures of:

- a) *The existence of the indirect compensation;*
- b) *The services provided for the indirect compensation or the purpose of the payment of the compensation;*
- c) *The amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation; and*
- d) *The identity of the party or parties paying and receiving the compensation.*

If that information is provided in writing to the plan sponsor, the check-the-box format may be used for reporting 12b-1 fees paid to the broker-dealer for 2009.

What if those disclosures are not provided?

The plan sponsor still has the obligation to report the indirect payments to the broker-dealer on the Schedule C. However, absent those disclosures, the fees are considered other indirect payments and additional information must be reported. As a practical matter, the plan sponsor or the preparer of the 5500 will need to contact the broker-dealer to request the additional information.

If the information is not provided, Schedule C has a new section which requires plan sponsors to report any service provider (which would include a broker-dealer) that fails, upon request, to supply the information necessary to complete the Schedule C. As a practical

matter, it is likely that the DOL will follow up on at least some of those failures.

However, there is a proposal that the new Schedule C requirement be delayed for a year to allow service providers to update their systems.

Our advice to our broker-dealer clients is that they should look at their existing procedures and their relationships with 401(k) providers to determine the best way to provide the disclosures for eligible indirect reporting. While it is possible that the requirement could be delayed, it is not certain. And, even if it is delayed, it is likely to be effective for 2010. ❖

Target Date Hearings

On June 18th, the DOL and SEC held a joint hearing on target date funds (TDFs). The hearings were precipitated by the surprisingly large investment losses in target date funds (and particularly for 2010 funds) in 2008. Senator Kohl of Wisconsin (who is Chair of the Senate Special Committee on Aging) held hearings on the subject earlier this year and then urged the SEC and DOL to follow up on those hearings.

On May 22nd, the Agencies published a notice concerning the hearings. In that notice, the Agencies focused on the following four issues:

- *How TDF managers determine asset allocations and changes to asset allocations (including glide paths) over the course of a TDF’s operation;*
- *How they select and monitor underlying investments;*
- *How the foregoing, and related risks, are disclosed to investors; and*
- *The approaches or factors for comparing and evaluating TDFs.*

If the government is interested in knowing the answers to those questions, then plan sponsors and their advisers should know the answers. The role of the adviser is to obtain the answers from the provider of the target date investments and to explain those answers, and their significance, to plan sponsors.

Forewarned is forearmed.

DOL Sues Advisers for Participation in Improper Transactions



By Fred Reish (FredReish@Reish.com)
<http://www.linkedin.com/in/fredreish>

In March, the Department of Labor (DOL) filed two lawsuits against former NFL player, Michael Vick, for taking illegal withdrawals from a pension plan of one of his companies—and for which he served as trustee. The DOL complaints allege that Vick withdrew more than \$1.35 million dollars from the pension plan in violation of his fiduciary duties.

In one of the cases—Michael Vick’s personal bankruptcy proceeding—the DOL took the position that the withdrawal of the pension funds constituted a “fraud, defalcation or embezzlement” under the bankruptcy code. The liability for that type of conduct is not dischargeable and, if the court agrees with the DOL, Vick

will continue to be personally liable after the bankruptcy.

While this case is interesting because of the celebrity status of the defendant, I am writing about it because the DOL also alleged that two of Vick’s former financial advisers helped with the withdrawals from the pension plan and, because of that participation, they were personally liable as co-fiduciaries.

The moral of this story is fairly obvious . . . don’t help plan sponsors or other fiduciaries improperly use plan money. If an adviser participates in that kind of a transaction, the adviser can be personally liable, even though he did not receive any personal benefit from the transaction.

But, there is also another, more subtle, point. That is, when an adviser serves as a

fiduciary to a plan—either acknowledged or functional, the adviser has a duty of loyalty to the participants. The adviser can be meeting and working with the plan sponsor, but the adviser’s primary duty of loyalty and care is to the participants. As a result, there may be times where the adviser will need to refuse to participate in a transaction, and even run the risk of being fired, because the duty of loyalty to the participants conflicts with the request of the plan sponsor. In fact, it can be worse than that. We have been involved in cases where advisers have been put in the position of reporting their clients to the DOL in order to avoid exposure to co-fiduciary liability. I can tell you from experience that these are difficult situations. When and if you get involved in a situation like that, make sure to seek expert legal advice. The answers are not always obvious.

Resigning may not be a solution. That is because an adviser is ordinarily required to take affirmative steps to protect the participants. ❖

Asset Allocation Models as QDIAs

There is a little known provision in the QDIA (or qualified default investment alternative) regulation which requires that every QDIA either (i) be a mutual fund or (ii) be “managed” by an acknowledged fiduciary.

This article focuses on the latter alternative, that is, where an asset allocation model is used as the QDIA.

Large plans often use asset allocation models—both risk-based and age-based—as their QDIAs, because their primary investment options are either institutional class mutual fund shares, collective trusts or separate accounts. In other words, by using asset allocation models, those large plans can dramatically reduce the cost of their QDIAs . . . as compared to the expense ratios of retail target date funds. In our experience, the committees of large plan sponsors are willing to sign on as the fiduciaries for managing the asset allocation models, both

because of their use of outside consultants and because of their internal expertise.

However, the situation is different for small- and mid-sized plans. Most often those plan sponsors, and their committees, are not comfortable serving as the fiduciary for managing the QDIA. They usually lack the in-depth understanding of asset allocation concepts, including asset classes, non-correlated investments, and so on. Because of that, they would rather have the consultant serve as the fiduciary to manage the asset allocation models.

The point of this article is that, where an asset allocation model is used as the QDIA, someone needs to be an acknowledged fiduciary for that specific purpose, or the investment will not be eligible for the fiduciary safe harbor for qualified default investment alternatives (under the DOL’s 404(c)(5) regulation). If an adviser serves as the fiduciary (that is, as an

investment manager), the adviser will be subject to ERISA’s fiduciary standards and to the prohibited transaction rules that apply to fiduciaries. For example, if the adviser uses its authority to cause itself to be paid higher compensation, that will be a prohibited transaction.

This is not an issue that affects most plans, because target date mutual funds are far and away the most popular choice as the QDIA. Similarly, lifestyle funds, balanced funds and managed accounts (with an independent investment manager) are also common QDIAs.

However, we are concerned that, in some cases, plans may be using their asset allocation models as QDIAs without a formal acknowledgment of fiduciary status by the plan sponsor or the adviser—for QDIA purposes. In that case, the asset allocation model will not be eligible for QDIA treatment and the fiduciary safe harbor for default investments will be lost.

Academic Studies on Participant Behavior

As a part of our support for academic research concerning participant investment behavior (including our support of research by Professor Shlomo Benartzi of UCLA), we regularly post important academic and industry studies on our website.

We have recently posted a study entitled “Winners and Losers: 401(k) Trading and Portfolio Performances” by Takeshi Yamaguchi and Olivia S. Mitchell of the Wharton School and Gary R. Mottola and Stephen P. Utkus of Vanguard Center for Retirement Research.

The paper examines the impact of trading on investment performance

in defined contribution (DC) plans. It evaluates in detail the impact of workers’ trading decisions on the performance of their DC portfolios using unique new data set of about one million active 401(k) participants in some 1,500 DC plans. The research concludes several findings that should interest fiduciaries responsible for designing DC pensions and regulators of the retirement saving environment.

To view or print a copy of the study, visit our web site at http://www.reish.com/practice_areas/EmpBenefits/wp2007-154.cfm.

Target Date Misunderstanding

On June 18th, the DOL and SEC held a joint hearing concerning target dated funds. Testimony was given at the hearing by a large number of industry experts, including mutual fund managers, industry associations, and behavioral researchers.

One of the most interesting subjects dealt with participant understanding—or misunderstanding—of target date funds. That testimony was based on participant interviews and was provided by Jodi DiCenzo and Michael Liersch of Behavioral Research Associates. Their testimony accompanies this newsletter.

Their surprising discoveries included:

- Over 60% of the surveyed employees said that, by investing in target date funds, they will be able to retire on the targeted date.
- 38% think that target date funds offer a guaranteed return.
- 70% think that target date funds are no more risky than money market accounts.

The attached testimony discusses those points, as well as others. We think that you will be interested in their research results.

Participant Advice, Agreements and Other Issues

In recent months, we have seen an expansion of services by RIA firms that provide advisory and educational services to plans.

While those firms have traditionally provided non-discretionary investment advice to plan sponsors and non-fiduciary investment education to participants, we have been hired by a number of firms to provide our advice and documentation about additional services for:

- Discretionary investment management for 401(k) plans; and
- Non-discretionary investment advice for participants.

Jason Roberts has written an article for this newsletter that discusses the ERISA section 3(38) investment management services. This article focuses on the participant investment advice services.

First, let me explain one thing. These RIA firms are not interested in providing discretionary investment management services to participants. They have decided that their business model is not appropriate for managing a large number of small accounts at a low price. Instead, they are acknowledging, as a matter of fact, that they have been providing individualized investment advice—that is, ERISA fiduciary advice—to participants for many years . . . and they are formalizing that arrangement.

As a part of that, we are preparing (i) agreements for plan sponsors to hire the RIA firms specifically for that purpose, (ii) participant disclosure statements that document the advice arrangement, (iii) descriptions of the process for formulating and delivering the non-discretionary advice, and (iv) language modifying the provisions

of the ADV Part II to accurately reflect the arrangement. In addition, we are consulting with the RIA firms about the delivery of the ADV Part II or a similar brochure to the participants who receive advice.

The point of this article is that investment advisers who provide individualized advice to participants—regardless of whether they use model portfolios or other techniques—should formalize the arrangement, properly document it, and provide appropriate disclosures to participants. Unfortunately, in our experience, many advisory firms are going beyond investment education in their services for participants without properly handling those issues. That creates risk management considerations for the advisory firms.

-Fred Reish
FredReish@Reish.com

Investment Manager

continued from page 3

plan-level investments should consider the degree to which they are comfortable exercising discretion over participant accounts. Conversely, advisers who are experienced in developing and managing model portfolios or managed accounts may be more inclined to provide only participant-level services and leave the selection and monitoring of the core funds to an adviser with more experience servicing ERISA clients at the plan level.

Next, advisers should evaluate any compliance-related concerns. Many broker-dealers, for example, do not permit their affiliated investment adviser representatives (including independent RIAs) to exercise discretion over investments that are subject to ERISA. If the adviser is truly independent and/or has obtained approval to serve as a 3(38), he/she should undertake a review of the relevant service agreements and disclosure documents to ensure that the responsibilities and limitations on the proffered services are fully-disclosed and that the documents are compliant with ERISA and Department of Labor regulations. Lastly, the adviser must determine whether such services are covered under their existing errors and omissions policy or whether they need to obtain additional coverage.

Conclusion

Serving as an ERISA 3(38) manager may provide significant opportunities for advisers seeking to retain and/or grow their assets under management. It may also provide advisers with opportunities to partner with other advisers to offer complementary and/or supplementary services. Given the number and complexity of compliance-related concerns, however, advisers that are seeking to become 3(38) managers are advised to proceed cautiously and to keep abreast of the ever-changing legislative and regulatory landscape. ❖

Benchmarking

continued from page 1

the qualification of the service provider, the quality of the work product, and the reasonableness of fees charged in light of the services provided.”

The DOL goes on to say: “What constitutes an appropriate method of selecting a service provider, however, will depend on the particular facts and circumstances. Soliciting bids among service providers at the outset is a means by which the fiduciary can obtain the necessary information relevant to the decision-making process.”

In this case, the DOL is saying that, by soliciting bids, the fiduciary can obtain information about the individual provider... and can also obtain comparative, or benchmarking, information about other providers of these services.

The DOL continues: “Whether such a process is appropriate in subsequent years may depend, among other things, upon... the fiduciary’s knowledge of prevailing rates for the services...Regardless of the method used, however, the fiduciary must be able to demonstrate compliance with ERISA’s fiduciary standards.”

In other words, regardless of how the fiduciary obtains the comparative information, the fiduciary must be able to demonstrate that he engaged in a process to evaluate both micro information (related to a single service provider) and macro information (comparative data from the industry).

The point of this article is that, in order to engage in a prudent process, fiduciaries must do more than analyze a particular service provider or a particular investment. Instead, they must also compare that information to comparable data about other similar plans, services or investments.

While 401(k) advisers commonly benchmark investments and sometimes benchmark plan costs, my experience is that they often do not use benchmarking data for other fiduciary decisions, such as the services that are offered by a plan (like in investment education,

enrollment meetings, investment advice and management, and so on). However, as more and more 401(k) advisers are positioning themselves as consultants for successful plans, they will need to become more proactive in assisting plan sponsors benchmark the other services and features of plans. ❖

PLANSPONSOR’s 15 Legends of the Retirement Industry

This is our 7th installation of the 15 “Legends.” In our future newsletters and bulletins, we will be featuring the other Legends that were selected by PLANSPONSOR. Fred Reish was selected as one of the 15 “Legends of the Retirement Industry.” These “Legends” are individuals who have, in the past decade and a half, made a lasting contribution to the nation’s retirement security.

During a time where there were no officials in either party who demonstrated interest in pension policy, two congressmen from opposing parties managed to forge a consensus in Congress that produced an intelligent and proactive pensions reform.

Rob Portman, then a Republican Congressman of Ohio, and Ben Cardin, a Maryland Democrat, played a significant role in virtually every piece of pension legislation.

Congratulations to Cardin and Portman, through “their leadership; their willingness to first understand, and then craft practical solutions; and their commitment to setting party difference aside, not only provided an extraordinary example of how government can work but, in the process, have made inestimable contribution to the retirement security of the nation.”

Around the Firm

Speeches: In September, **Jason Roberts** presented “Washington Update” to the Triad Advisors National Sales Meeting in San Diego and at the QA3 Financial National Sales Meeting in Indianapolis. Jason was also a panelist on the topic “The Great Default,” at the Planadvisor National Conference in Orlando. At the SunGard Advanced Pension Conference on September 2nd-4th, held at Chicago, **Bruce Ashton** presented the topics “Making Peace with the DOL” and “Correcting Qualification Failures,” and co-presented “Plan Issues in a Troubled Economy – Mid-Year Safe Harbor 401(k) Changes, Terminations, and Interim Valuations.” Also in September, **Fred Reish** presented “The Top 401(k) Issues for Today... and Tomorrow” for the John Hancock Roadshows, held on September 8th-10th and 22nd-24th.

Quotes: In the September 20th issue of *InvestmentNews*, **Jason** was quoted in the article “Congress to Tackle Rule on Retirement Advice.” He was also interviewed by Kristen McNamara of DowJones Newswire on the topic “Investment Advice and Retirement Plan Participants.”

Articles: In the September issue of the *Plan Sponsor* magazine, **Fred** wrote a column entitled “Reasonable Approaches: Are Your Fees Reasonable?” In the September issue of *LIMRA Regulatory Review*, **Jason** wrote the article “Pitfalls for Registered Representatives Under ERISA.”

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

©2009 Reish & Reicher, A Professional Corporation. All rights reserved. *THE ADVISER REPORT* is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish & Reicher does not warrant and is not responsible for errors or omissions in the content of this report.

Testimony by Behavioral Research Associates at June 18th SEC/DOL Hearing on Target-Date Funds

Presented by
Jodi DiCenzo and Michael Liersch
Behavioral Research Associates, LLC
June 18, 2009

Introduction

Hello. My name is Jodi DiCenzo. My colleague, Michael Liersch and I, represent Behavioral Research Associates, an applied behavioral research firm that specializes in savings and investing decision-making behaviors.

We are pleased to having the opportunity to be here today to discuss three things:

1. Workers' misperceptions about target-date funds from our survey of 250 American workers. Behavioral Research Associates is one of the only organizations to have conducted research that explores how well American workers understand target-date funds.
2. Potential psychological explanations for what might be causing the observed misperceptions.
3. The importance of these perceptual problems, particularly in an environment of automatic enrollment, and suggest that empirical behavioral research inform future regulatory efforts, should there be any.

Our comments should not be construed as a criticism of target-date funds. In fact, they go a long way in overcoming behavioral obstacles such as inertia and irrational asset allocation.

Workers' Misperceptions

In March of this year, we conducted an online survey of 250 American workers to better understand their perceptions of target-date funds. Our respondent group is representative of the U.S. population and our methodology was based on standard research protocols.

Prior to asking workers specific questions about target-date funds, we provided them with typical descriptions of target-date funds compiled from actual marketing materials of the top three target-date fund providers.

The survey results include:

61% of people say that target-date funds make some type of promise, which at a 95% confidence level is a statistical majority.

When asked to describe the promise that target-date funds make, nearly 70% of respondents perceive a promise that does not in fact exist. Here's a sample of what some American workers think the funds promise:

- "Funds at the time of retirement."
- "Secure investment with minimal risk."
- "It's like a guaranteed return on investment even when the market bottoms out."
- "A comfortable retirement."

Alarminglly,

- Over 60% of employees say that investing in target-date funds means they will be able to retire on the target date.
- 38% think target-date funds offer a guaranteed return.
- 30% of workers think they can save less money and still meet their retirement goals if they invest in a target-date fund.

Worse yet, when workers ranked five tasks based on their importance to their overall retirement planning, selecting a savings rate, arguably the most critical determinant of retirement success, was ranked first by the fewest number of people. Only 8% of people say it is the most important aspect of their overall retirement planning.

And what about how workers perceive the risk of target-date funds?

- Over 23% of workers believe that there is little to no chance that they will lose money either before or after the target date.
- 41% think there is little to no chance of losing money in any one-year period, and
- 70% think they are equally as likely or less likely to lose money in any one-year period, as compared to investing in money market funds.

These results are consistent with another survey conducted by Janus. Their survey found that 19% of target-date fund investors believe that the fund guarantees them a certain level of income once they retire. This percentage skyrocketed for investors whose primary source of advice was their employer (56%) and those who relied on friends, family and co-workers (39%).

What Might Explain These Findings?

Although more research is necessary to determine probable psychological explanations, we offer three potential ones. Michael will be happy to further discuss each of these during the question and answer period.

Excessive Optimism. Humans tend to be tirelessly optimistic. Examples abound. It's why more than a majority of people think they will be better than typical.

Framing Effects. How these funds are framed may fit into a particular schema or mental framework, of investors. For example, the framing may set expectations that the fund will somehow solve general retirement planning issues, rather than just asset allocation issues. These mental frameworks may be so powerful that people will remember what they expect, not what they are told. For example, researchers have found that when people expected books to be in a graduate research office, about a third recalled seeing books in that office, even when there were none. Similarly, how target-date funds are framed may create expectations that the funds make various promises related to retirement readiness on the target date— even when no such promises exist – which will cause people recall those non-existent promises as having been made.

Attention, Salience, and Focusing Illusions. The focus on the investment simplicity of target-date funds and the target date itself may cause people to misperceive them as a superior retirement solution along many dimensions. Psychological research shows that attention to particular features matter, and influences how people will feel. For example, research has found that Midwesterners think they will have more life satisfaction in California because they focus too heavily on the California climate, which exaggerates their perceptions of how much good weather will impact their happiness. In fact, the good weather has far less impact than people think, and, as it turns out, Californians and Midwesterners have similar levels of life satisfaction. Similarly, increased attention to and salience of the target date may cause people to overweight the funds' ability to address their overall retirement planning needs.

What Might the Future Hold If This Problem is Not Addressed?

When do these working Americans find out that target-date funds do not promise retirement readiness? The day they retire?

How can we drive home the message that how much you save is of critical importance?

Until we can answer these questions, many American workers are investing in false hope. Absent change, we are knowingly accepting that a significant percentage of American workers believe in some sort of target-date fund magic: They believe that the funds offer retirement readiness on the target date and a guaranteed return. These beliefs are not simply naïve and harmless, they are detrimental to the financial well being of hundreds thousands of Americans.

How Can It Be Addressed?

Regulation offers at least two alternatives: disclosure and product restrictions. Let me be clear that we are not suggesting one over the other or even either, for that matter. We are merely suggesting that as you move forward, continued behavioral research may offer valuable insight on what may be effective.

Understanding perceptions is just the first step of this work. Empirical research must illuminate effective methods to improve understanding and behavior. We can hear smart people weigh in all day on what might work, but until we empirically test these ideas to evaluate their behavioral impact, it is all just conjecture. Our actions must be based on rigorous empirical evidence.

A Growing Number of Passive Investors

As you consider ways to address the issue, remember that many target-date fund investors have not been actively engaged in the decision to invest in them; they have been automatically enrolled into them. There are a growing number of passive target-date fund investors as a result of the increasing popularity of automatic enrollment.

Many workers believe in target-date fund magic, and we have a growing number of passive target-date fund investors. As you move forward, consider the research finding that people view default choices as implicit advice. Implicit advice.

In every decision context, there is a default choice. What implicit advice will you provide the American worker and what behavioral evidence will it be based on?

Thank you.