Conflicts of Interest in 401k Plans

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EBSA(Employee Benefits Security Administration) has proposed amending the regulation under section 408(B)(2) of the Employee Retirement Income Security Act (ERISA) to require disclosure of potential conflicts involving compensation that may affect the objectivity of the provider and conflicts of interest that might affect the provision of services.

A question remains, "Who will determine what conflicts of interest exist and who will define what is a 'conflict of interest' that must be disclosed?" The answer, of course, is "the fiduciary of the plan". The providers of the plan work for their own firms and their responsibility is to themselves and their employers. It is the fiduciary on the plan that has a duty to the participants and their beneficiaries. The discussion that follows outlines some *possible* conflicts of interest that might be present in your retirement plan that you, as a fiduciary of the plan, might want to explore with your plan provider.

1. Does the provider (salesman/firm) receive different compensation on different fund choices? In other words, is their objectivity compromised because one fund choice pays them more than another? Look into the 12b-1 fees charged on all investment options.

2. If a vendor is proposing that a new plan be chosen from several alternatives, are the finder's fees different for the plans proposed?

3. Is your provider using your plan to solicit business from your employees? Do their rollover, transfer, distribution forms encourage your employee to open accounts with your provider? Is there a conflict between attention paid to the retirement success of your employees and attention paid to gathering assets for themselves and/or their firms?

4. Does your provider engage in principal trading? A conflict can arise when a provider offers a proprietary fund that sometimes obtains securities from the firm's own trading portfolio. This does not necessarily mean that the provider is "dumping" securities from its own portfolio into your fund choice, but it would be prudent to ask if there is any interaction between any of your fund choices and the security portfolios of any firm involved in the plan. If so, it might be prudent to look into the particular securities sold to your fund and the amount of trading costs incurred.

5. Does your provider own any significant amount of any funds that are in your plan? If the salesman on the plan owns his company's stock and/or his company owns a significant share of the fund firm that provides one or more of your fund

choices, is there not a danger that the provider's objectivity might be compromised? Is there not a temptation to recommend inclusion or use of investment choices that benefit the stock of the salesman and/or his firm?

6. Is your provider offering passive funds or actively managed funds? "Passive" funds have lower fees and lower trading costs. "Actively managed" funds have higher fees and higher trading costs. Is the extra expense worth it? Considering that only a fraction of funds beat their indexes in any given year and virtually none of these funds make their way into 401k plans, one could argue that no "actively managed" fund that is in a 401k plan is *ever* worth the additional cost. Ask your provider which of the fund choices that are recommended have beaten their respective index on a consistent basis and what their performance has been against their index over the history of the fund.

7. Share class may be something to look at if different fund choices are of different classes. "Retirement Class" sounds vaguely like "something good" but, in most cases, these share classes simply mean that expenses are higher and returns are lower than other available share classes.

8. "Asset Allocation" funds, by whatever name (lifecycle, time horizon, retirement, etc), should also be understood insofar as they may carry higher expenses or pay the provider more is some other way. At the same time, one might ask just what is *in* these funds.

9. "Soft dollar" revenue from 401k plans may-or may not-be a reasonable and valid expense, but differences in the amount of such costs between fund choices can be sources of conflicts of interest. It is doubtful that your representative has any idea how much "soft dollar" revenue is associated with any fund choice, but certainly he should provide such information. After all, these are costs that the plan fiduciary may be asked to justify as "reasonable".

"Conflicts of interest" do not necessarily mean "ripoff". Certainly, the various providers of 401k services deserve to be compensated. However, as in your own business, higher margins are generally most welcome in the product or service called "a 401k plan". It is the responsibility of the customer (that means *you*) to keep these costs reasonable and, more to the point of this discussion, to determine the objectivity present in the recommendation of the various fund choices in your 401k lineup and the advice given regarding investment in those individual fund choices.