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The Yale Professor Letters: Tempest or Teapot?
By Bruce Ashton

A recent tremor in the 401(k) world may lead to aftershocks in 403(b) and 457 plans.

First, the background: earlier this summer, a Yale law professor sent letters to about 6,000 401(k) plan sponsors. He sent several different versions, but the message in each was basically the same…the plan sponsor had breached its fiduciary duty to its employees by offering too-expensive investments. He said this conclusion was based on a study of 401(k) investment fees that he had prepared (along with another professor) and intended to publicize in early 2014. In some of the letters, he went so far as to tell the plan sponsor that he would release his conclusions about their plan via Twitter.

The letters generated considerable comment. Most were critical of the study, pointing out that it relied on outdated and incomplete information and focused on a very limited segment of the 401(k) market. As a result, many responders concluded that the study was not a valid basis on which to conclude that a plan's investment costs were too high or that a plan sponsor had breached its fiduciary duty. (For a more detailed analysis, see a memorandum prepared by me and two of my colleagues at http://www.drinkerbiddle.com/resources/publications/2013/401k-controversial-yale-letters.)

If you've read this far, you may be wondering, "What does this have to do with me?" The study relates only to 401(k) plans and is flawed. So why should you care?

The answer is simple: Regardless of its flaws, the Yale professor's study raises an important issue that plan sponsors need to consider. Plan costs, especially the costs of the investments—which inherently are borne by the participants—have gained increasing attention from regulators, class action plaintiff's lawyers and law-makers in recent years. And the professor's study adds some academic weight, especially to a non-critical reader. More importantly, though, at a fundamental level, it simply highlights the importance of looking at the cost of the investment alternatives made available to the participants in a participant-directed plan. This includes 403(b) and 457 plans as well as 401(k) plans. And, in light of the desire of employers to do right by their participants—and the fiduciary requirements under some state laws—it includes non-ERISA plans as well as those governed by the federal law.

So what should the sponsor of a 403(b) or 457 plan do about this tempest? In cases where the sponsor (or a group acting on behalf of the sponsor) exercises some discretion or control over what investment alternatives are made available to the employees, we suggest the following:

- First, understand the costs of the investments, whether annuities or custodial accounts. This includes the expense of managing the investment, the fees being paid to the person selling the

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investment and any expense related to getting out of the investment (surrender fees and the like).

- Second, compare the costs over various alternatives as a way of testing the reasonableness of the costs. Alternatively, the sponsor may be able to obtain an independent report—generally referred to as a benchmarking report—that compares costs.
- Third, consider the costs relative to the benefit being received by the participants, such as the return on investment and/or services being offered by the provider or the broker.
- Fourth, if the costs appear to be out of line, especially in relation to the benefits, consider negotiating, for the benefit of the participants, a reduction in the expenses or an increase in services; and if that is not possible, consider changing to a different investment. (While you may not be in a position to require the participants to make a change, at least you can affect the alternatives being offered going forward.)

At one level, given its deficiencies, the Yale professor's study may turn out to be a minor footnote in 401(k) lore. At another level, however, it reminds us of the importance of examining investment costs and being proactive in seeking to make them reasonable.

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