

401ks: America's Biggest Investment Fraud Was Foreseen and Preventable

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By EDWARD SIEDLE

Calling these workplace mainstays a “retirement plan” ought to be a crime.

On September 10, 2008 my brokerage firm issued a satirical voluntary recall of most of the nation's 401k plans. Our firm had not sold any 401k products but the intent was to draw attention to the inherent flaws in these investment products. It was simple enough to draft the recall. We used a U.S. Consumer Product Safety Commission recall press release as our model and we asked consumers to immediately take the recalled 401k plan products to their employers or the manufacturers of these products for full refund.

While humorous, our recall was not intended as a joke.

Why did we issue [the recall](#)? Because at that point in time (in 2008), it was apparent to even the most die-hard supporters of defined contribution plans that the great 401k experiment commencing in the early 1980s, had catastrophically failed. While the market recovered significantly since then, with average account balances hovering at perhaps \$50,000 for older workers it is still apparent that 401ks will not provide for anyone's retirement security.

Over the past decade, my firm had issued a series of increasingly stern warnings regarding the nation's failed 401k system. See, for example, at [benchmarkalert.com](#): 401ks: Far More Dangerous Than IRAs (March 2001); An End To 401ks (February 2002); 401k Abuses: The Mutual Fund Industry's Next Nightmare (July 2004); Explaining Poorly Designed 401ks (January 2005); An Extreme Makeover Due for Defined Contribution Plans (June 2007); and Challenges to 401ks Continue (February 2008).

As a former attorney with the SEC regulating mutual funds and later in-house counsel to one of the largest mutual fund complexes, it had long been clear to me (and frankly many other industry insiders) that 401k investors were doomed.

Why were they doomed? Regulators and employers were unconcerned about pervasive conflicts of interest; excessive, hidden fees and wrongdoing that resulted in billions being skimmed from 401k accounts. Lack of adequate employer contributions further ensured that there was simply no way there would be enough in 401ks to fund participants' retirement goals. But that didn't stop regulators, employers and the mutual fund industry from touting 401ks as "retirement plans" to unsuspecting workers. Fraud of this magnitude, involving trillions, makes Madoff look like chicken feed.

What is less apparent even today is that the failure of 401ks was foreseeable decades ago and well-known to both employers and investment industry insiders.

For example, a 2008 Annual Survey of 401k Plan Sponsors by Deloitte Consulting (conducted before the market meltdown) found that 80% of employers believed that 401ks were effective in recruiting employees but only 13% believed that the 401k plans they offered would provide retirement security for their workers. In other words, employers understood that offering a plan that purported to provide for workers' retirement security, without obligating the employer to pay retirement benefits, was helpful in building their businesses. However, employers privately acknowledged that these 401k plans were not sufficient to provide for workers' retirement. For 30 years employers chose not to share this little secret with the workers.

Two profound features of the 2008 market meltdown, both of which continue to plague the nation, were the housing bubble and the failure of 401ks. Remarkably, unlike the housing bubble which has been discussed exhaustively, the dismal failure of 401ks as a retirement vehicle has received little attention. No meaningful regulatory reforms have been enacted. There have been no investigative panels or committees convened and no one has been held accountable. Nothing has changed—except that now it is clear that many older Americans will sink into poverty once they are unable to work.

In my opinion, which I have shared with the SEC, it ought to be illegal to call a 401k plan a "retirement plan" and those parties who promoted them as retirement plans should be held accountable.

Most of the blame for this foreseeable disaster lies with the Department of Labor for failing to implement a regulatory scheme that was appropriate for 401ks and instead choosing to defer to the mutual fund and other financial services industries. For example, the DOL could have decades ago held that retail mutual funds failed to meet the higher standards applicable to 401ks under ERISA, the federal statute governing these plans. Had the DOL required the mutual fund industry to create special “fiduciary class shares” with lower fees (to reflect the lower expenses related to marketing to such plans) and had the DOL prohibited other harmful industry practices within 401ks, such as soft dollar trading and revenue sharing, then the nation’s 401k investors would have accumulated at least an additional 1% per year for the past 30 years.

I estimate appropriate regulation would have resulted in workers having approximately 50% more in their 401ks – money that is sorely needed today. Instead, billions were skimmed for decades from workers retirement accounts by the financial services industry while the watchdogs slept.

Given that over 92% of defined contribution plans have less than \$5 million in assets and have no full-time employee with investment expertise responsible solely for the plan, the DOL has long known that an overwhelming majority of sponsors rely exclusively upon providers for turnkey solutions to plan needs. Since it is impossible to educate all these small plan sponsors regarding the nuances of plan design, costs, etc., the only way the 401k system could have worked was to prohibit the financial services industry from selling retail garbage to 401k sponsors and investors.

The DOL should have focused upon effective regulation of the parties perpetrating and profiting from the abuses, as opposed to educating the victims. The notion that smaller employers and workers will become skilled in plan design, asset allocation and portfolio management was always preposterous. Yet that was the DOL plan. Now that DOL’s regulatory approach has failed, will it change? Doubtful. Judge the DOL on “results,” and the agency gets an “F.”

Worse still over the years as it became increasingly apparent that 401ks were failing to live up to their promise DOL assured employers that their plan

“results” did not matter. All that mattered to DOL was that employers followed the agency’s byzantine policies and procedures regarding “process” (largely drafted by industry) even if the financial outcome to workers was horrendous.

What did it matter if employees loaded up on employer stock, as long as the employer could show that other (better) alternatives were offered within the plan that the employee neglected to select (due to a misguided sense of loyalty)? A vigilant regulator would have prohibited or limited employer stock from 401k plans since employees are already dependent upon the employer company for their current incomes and, as a result, company stock does not offer adequate diversification. Instead the DOL concluded that company stock presumptively is permissible in a 401k, despite the obvious conflict of interest present.

There are countless other examples of how the DOL and other regulators failed to protect participants in the nation’s 401k plans. In early 2009 my firm issued a definitive research report, [Secrets of the 401k Industry: How Employers and Mutual Fund Advisers Prospered as Workers’ Dreams of Retirement Security Evaporated](#) which documented that industry practices have played a significant role in creating the defined contribution retirement plan crisis the nation faces today.

We are on the precipice of the greatest retirement crisis in the history of the world. In the decade to come, we will witness millions of elderly Americans slipping into poverty. Too frail to work, too poor to retire will become the “new normal” for elderly Americans.

The catastrophic failure of 401k defined contribution plans and the resulting crisis was foreseen and preventable, resulting from inadequate regulatory oversight and unchecked industry greed. There is still time to help the Baby Boomers recover and save younger workers from this nightmare. However unless we acknowledge the mistakes of the past and make appropriate changes we cannot restore the dream of a secure retirement for America’s workers. Join with me in calling for an investigation into the causes of the spectacular failure of 401ks, the cruelest hoax ever played upon the nation’s workers.

http://blogs.forbes.com/edwardsiedle/2010/10/07/401ks-americas-biggest-investment-fraud-was-foreseen-and-preventable/#post_comments

