InvestmentNews
The Leading Information Source for Financial Advisers

DOL fiduciary rule won't help some 403(b) retirement plans

InvestmentNews Reprints

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, click the link below.

- Order a reprint article

The plans in public school districts — often a "laissez-faire" type of arrangement exposing teachers to high-fee products — won't be helped by the new regulation

By Greg Iacurci | *October 21, 2016 - 1:07 pm EST*

Through its fiduciary rule, the Department of Labor is attempting to rein in conflicted investment advice and reduce costs for retirement savers.

However, there's a corner of the retirement market plagued by the sort of high fees and sales practices the DOL is attacking that won't be touched by the regulation: public school districts.

403(b) plans, a type of defined contribution plan for public schools, tax-exempt organizations and ministers, are notorious among advisers and industry practitioners as being a sort of free-for-all environment with multiple vendors, high-fee investment products and brokers who can camp out in a school cafeteria to try to make a sale.

“It's almost laissez-faire,” Marcia Wagner, principal at The Wagner Law Group, said. “The teachers can be marketed by people who are very good providers to the marketplace and people who aren't, and it's a problem.”

Public K-12 plans aren't subject to the Employee Retirement Income Security Act of 1974, and are therefore immune from the DOL rule, which raises investment advice standards in most retirement accounts.

When the rule goes into effect in April, brokers to ERISA retirement plans, such as 401(k)s, will be held to a fiduciary standard of care when providing investment advice for compensation. The same will not be true of brokers to non-ERISA plans, meaning it can be business-as-usual.

“It's kind of like the Wild, Wild West,” according to Jania Stout, practice leader and co-founder of the Fiduciary Plan Advisors group at HighTower Advisors. “Teachers are really at the mercy of whoever's sitting in the cafeteria they're walking into that day. It could be a good representative. Or they're trying to put them in a product that's two or three times more expensive.”

403(b) plans for the public K-12 market aren't the only non-ERISA plans. Plans among public higher-education institutions, government plans such as state and federal DC plans, and some church plans don't fall under ERISA's purview.

Aside from these cataegories, plans can also be structured to skirt ERISA by limiting employer involvement. Such plans, for example, can't have an employer match. That's how some private K-12 school districts are able to avoid adhering to the statute.

However, advisers and other industry practitioners say other types of non-ERISA 403(b) plans and governmental 457 plans don't experience the same issues on a widespread scale.

“It is culturally unique to K-12,” said Joshua Schwartz, president of Retirement Plan Advisors, who works almost exclusively with non-ERISA plans.

Even though these plans are subject to state law, the tort bar hasn't gotten very involved with litigation in this realm, Ms. Wagner said.

Non-ERISA 403(b) plans hold roughly 57% of the $900 billion in the 403(b) market, according to a joint report from the Investment Company Institute and BrightScope Inc.

Of course, not all public-school-district DC plans are plagued by poor investments and potential misconduct. But the way they're set up, often with little employer involvement, creates an environment where abuses can thrive.

“What you have is technically an employer-sponsored retirement plan with no oversight,” Mr. Schwartz said. “As a result you have a range of business practices from the different providers, and you also lose any economies of scale.”

Some school districts have an “open access” arrangement, whereby they allow all interested vendors to offer 403(b) products, provided they meet certain criteria, according to a National Bureau of Economic Research report published in July 2015 that analyzed retirement plans among North Carolina school districts.

Indeed, it's not uncommon to see 10 or more providers, and some districts have over 100, according to Mr. Schwartz. That could yield thousands of potential investment options.

Further, sales representatives sell products directly to employees at school districts, the report says, allowing for providers to enter into individual contracts with teachers. Contrast that with employers sponsoring 401(k) plans, who vet providers, serve as a central conduit controlling access to employees and whittle down a limited investment menu.

Such decentralized investing and record-keeping makes data difficult to come by. However, a 2010 report published by the TIAA-CREF Institute shows the sort of pricing disparity that occurs among “open-access” school districts.

In California and Texas, two “open-access” states, the average asset-based fee was 211 basis points and 171 basis points, respectively. By contrast, the average in Iowa and Arizona, two “controlled access” states that use a competitive bidding process to whittle down providers, was 87 and 80 basis points, respectively.

Variability among fees is greater, too — in California, roughly two-thirds of asset-based fees fall between 89 and 333 basis points. In Iowa, the range is between 50 and 123 basis points.

“What you tend to see is high-fee programs, frequently with surrender periods,” said Mr. Schwartz, who said investments tend to be annuities and mutual funds with sales loads.

In California and Texas districts, average back-end loads are 163 basis points and 233 basis points respectively; average surrender charges are a respective 419 basis points and 877 basis points.

“In any open-vendor environment, you're establishing a competitive environment for selling, and not a cooperative environment” to help save for retirement, Mr. Schwartz said.

Even though the DOL fiduciary rule won't directly affect these DC plans, the regulation could put pressure on employers, even if their plans aren't governed by ERISA, to take them more seriously, Ms. Wagner said.

“This is like an area of pensions that's been left behind, and we're waiting for this inevitable groundswell [from the fiduciary rule],” Ms. Wagner said. “It could take time. And in the meantime, people could be hurt” by poor investments.

Reproductions and distribution of the above news story are strictly prohibited. To order reprints and/or request permission to use the article in full or partial format please contact our Reprint Sales Manager at (732) 723-0569.