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Supreme Court Ruling Could Curtail High-Cost Retirement Plan Options

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A high court decision upholding a suit against Northwestern University for having 400-plus retirement-plan options, including many high-cost ones, could shake up other retirement plans and encourage them to simplify.
Stefani Reynolds/Bloomberg

Ever go to the supermarket and wonder which of the multitude of flavors of yogurt you should purchase? Yoplait by itself has 87 flavors.

Now imagine, instead of being in the supermarket, you're in your retirement plan's shopping aisle and you've got 400 different investment funds to choose from. You can't taste them to see if they're any good and their ingredients are in fine print. For plan investors, so many choices are overwhelming, and they could lead to poor choices.

That in essence was the logic the Supreme Court used in deciding a case—*Hughes v. Northwestern University*—this January. The decision will likely result in retirement-plan sponsors reducing the number of funds, and particularly high cost-funds, in plans, observers say.

In the case, three university employees claimed that Northwestern failed in its fiduciary duty as a retirement plan sponsor by offering 400-plus investment options, including "needlessly expensive" ones. The excess of choice caused "participant confusion and poor investment decisions." Northwestern had previously argued successfully before the Court of Appeals for the Seventh Circuit that since low-cost investment options were available in the plan, the presence of high-cost ones too was acceptable.

In a unanimous decision, the Supreme Court vacated the Seventh Circuit's judgment to dismiss the Hughes complaint. Delivering the court's opinion, Justice Sonya Sotomayor called the logic that offering a plethora of fund options is acceptable, so long as some are low-cost, "flawed." According to retirement plan rules under the Employee Retirement Income Security Act of 1974 or ERISA, sponsors have a "duty to monitor all plan investments and remove any imprudent ones."

Todd Collins, an ERISA lawyer at Berger Montague PC who represents plaintiffs in similar employee suits, calls the decision a "clarion call." He said the Supreme Court made clear "we're dealing with people failing to discharge their fiduciary duty to protect the interests of plan participants."

Collins says historically plans have offered higher-cost retail share classes of funds because funds engage in "revenue sharing" in which in exchange for employees paying higher expense ratios funds will pick up the tab for the plan's record-keeping. Moreover, "plan fiduciaries often are either not qualified or they don't do their homework," he says because it isn't companies' money at risk: "It is shocking to see a multibillion-dollar plan with members of the committee or the even the chair of the committee, not being aware of the whole notion of revenue sharing, or whether or not the particular target-date funds they're offering are indexed or actively managed."

Others see the high-court decision not as a landmark but part of a continuing trend. John Rekenthaler, Morningstar's vice president of research, says that after the first 401(k) retirement plan was offered in 1980, there was a trend toward increasing investment options: "In the 1990s, people were requesting technology funds and sector funds, and the idea was that a plan sponsor that was responsive to their employees should add more."

But after investors got burned in the dot-com crash in 2000-02 and then the 2007-09 recession, that trend reversed. Notes Rekenthaler: "Northwestern's plan was once modern, but has now become old school, because in the last 20 years, the trend has gone from more to less [options]." He thinks the problem with the old model was that it catered to "wealthier, more active investors" who were requesting niche funds: "They're not typical." Indeed, according to research done by 401(k) custodian Vanguard, 60% of its retirement plan participants held just one fund in their accounts in 2020, generally the plan's default target-date fund selected for them.

Northwestern's plan was confusing, Collins says: "Maybe not to the finance professor, but how is the person who's a groundskeeper or a clerk supposed to know the difference between one fund and another fund?"

Still, the case isn't over. It has been kicked back to the Seventh Circuit court to be resolved. Northwestern spokesperson Jon Yates said to Barron's in an email: "While we are disappointed the U.S. Supreme Court disagreed with the reasoning adopted by the Seventh Circuit, we are pleased that the Court has asked the Seventh Circuit to reconsider whether plaintiffs' allegations fail to state a claim. As Northwestern has explained, the University didn't violate its fiduciary duty with regard to the record-keeping or the investment fees related to its retirement plans, and nothing in the Court's decision prevents the Seventh Circuit from reaching that conclusion in re-examining the allegations on remand."

One ERISA lawyer Marcia Wagner, who represents both plan sponsors and employees at her firm Wagner Law Group, calls the Hughes Supreme Court decision "narrow" in its scope: "It's clearly a win [for employee plaintiffs]. But I don't know if I'd overemphasize the importance." She's not sure it will survive Northwestern's motion to dismiss.

Yet the Supreme Court decision could embolden other plaintiffs. Given how conservative the retirement plan industry has been historically because it fears such litigation, the trend toward fewer funds and lower-cost index and target-date funds in plans will continue.

For sophisticated investors who like many options, that is bad news. But for the average consumer who doesn't check funds' expense ratios or know how much sugar might be in Starburst Cherry flavored Yoplait—16 grams per 8 ounce serving—it could be good for their financial health.

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