Fulfilling the 401(k) Promise

Why independent fiduciary advisors are in the best position to fulfill the promise of the 401(k) plan for America's workers.

ERISA allows for the Delegation of Fiduciary Responsibility to independent investment professionals.

Executive Summary

- Many owners/executives of businesses that sponsor 401(k) plans don't have the faintest idea of their fiduciary responsibilities and liabilities under the Employee Retirement Income Security Act of 1974 ("ERISA").

- This lack of knowledge is especially troubling in light of the fact that a breach of these responsibilities can result in **personal liability.** However, it is unlikely that the drafters of ERISA ever imagined that owners/executives of plan sponsors would place their personal net worth in jeopardy by retaining responsibility for the investment of plan assets.

- **ERISA specifically allows for the delegation of fiduciary responsibilities to independent investment professionals**.

- The growth of the 401(k) plan has resulted in a shifting of investment risk and many of the obligations for retirement savings to plan participants, however, contrary to popular belief these changes have not resulted in changes in the legal responsibility for plan investments.

- The financial services industry has rigged the game in their favor with **high and hidden costs**.

- Hiring an independent investment fiduciary for a participant-directed 401(k) plan offers both the fiduciary protection for owners/executives intended by ERISA and the unbiased advice needed by America's workers to maximize their standard of living in retirement.

Fiduciaries have a duty to minimize plan expenses.

Fiduciary Mandate

- In crafting ERISA, Congress looked to the traditional or common law of trusts – simply put, trusts are arrangements where property is managed by one person (or persons, or organizations) for the benefit of another.

- ERISA requires that all plan assets (except insurance contracts) be held in trust and, as under trust law, those responsible for investing and managing retirement plans must live up to high fiduciary standards including:

  - **Duty of Loyalty (Exclusive Purpose Rule)** – a duty to act **solely in the interest of plan participants** and beneficiaries and for the exclusive purpose of providing benefits ***and minimizing expenses***.

  - **Duty to Act Prudently (Prudent Expert Standard)** – a duty to act with the care, skill, prudence and diligence under the circumstances then prevailing that a ***prudent man acting in a like capacity and familiar with such matters*** would use the conduct of an enterprise of a like charter and with like aims.

  - **Duty of Diversification** – a duty to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. UPIA encourages Modern Portfolio Theory.

  - **Duty to Follow Plan Documents** – a duty to act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are not inconsistent with the provisions of ERISA including the plan's investment management agreements and investment policy statement.

Fiduciaries' personal wealth is at risk.

Liability for Breach of Fiduciary Duties

- ERISA Section 409(a) imposes personal liability on fiduciaries that breach their fiduciary duties. In other words, plan fiduciaries put their personal net worth at risk, if their conduct is deemed imprudent.
- "Fiduciaries of an employee benefit plan [such as a 401(k) plan] are charged with carrying out their duties prudently and solely in the interests of the participants and beneficiaries of the plan, and are subject to personal liability to, among other things, make good any losses to the plan resulting from a breach of their fiduciary responsibilities" ERISA Interpretive Bulletin 96-1
    - *In the Enron settlement outside members of the Board of Directors and the chair of the plan committee contributed to a settlement from their personal assets.*
    - *The Department of Labor website reports that penalties in excess of $1 billion annually have been common for much of the past decade.*

The Shift in Retirement Savings Obligations

- In the 35 years since the passage of ERISA there has been a dramatic migration from traditional pension plans to 401(k) plans and the pace of that transition is only accelerating
- This move to defined contribution plans has resulted in both a ***shift of investment risk*** to plan participants, but also a transition of the following retirement savings obligations:
  - Management of investments – the vast majority of 401(k) plans are participant-directed
  - Retirement funding – the 401(k) plan was created to facilitate and encourage retirement savings by employees
    - in the case of matching contributions, employer funding is wholly dependent on employee contributions
  - Payment of plan expenses – fees paid from the trust now directly reduce a participant's nest egg rather than increase an employer's funding obligation

The shift in retirement savings obligations to participants has not resulted in a change in legal responsibility…

- **Even in a participant-directed plan, it remains the plan's fiduciaries and not the participants that have the ultimate legal responsibility for investing plan accounts.**
- Indeed, courts have held that plan fiduciaries receive the protection offered by ERISA 404c only where the investment options offered to participants are suitable and prudent for the plan and remain so on an ongoing basis.
- Therefore, in a participant-directed 401(k) plan, the critical and inescapable issue for the plan fiduciaries is fundamentally the same as in a traditional defined benefit plan, the appropriate selection and monitoring of the investment alternatives (or, in the case of a 401(k) plan, the menu offered for participant-direction).

Indeed, shifting the burden to participants may magnify certain fiduciary obligations

- The payment of plan fees from participant accounts has resulted in a heightened level of scrutiny from both
  - Regulators
    - **2004 – ERISA Advisory Council Report** concludes that the shift to asset-based fees makes it difficult for plan sponsors to understand fees paid.
    - **2005 – SEC Report** based on industry-wide investigation of mutual fund practices raises concerns about disclosure of potential conflicts of interest.
    - **2006 – GAO Report** states 401(k) participants may be losing thousands of dollars in retirement savings because of fees charged.
  - And plaintiff's attorneys – a series of class action lawsuits have been filed challenging service provider and investment-related fees charged to 401(k) plans
    - Firms impacted include International Paper, Deere & Company, Lockheed Martin, Boeing, Kraft, Caterpillar, General Dynamics, and United Technologies Corporation.
    - While these lawsuits have focused on larger plans an excessive fee lawsuit was recently filed in connection with a $2 million plan with approximately 30 participants.

ERISA encourages delegation to an independent investment fiduciary

- ERISA has always provided a “safe harbor” which limits fiduciary liability where a qualified “investment manager” is appointed.
    - A qualified investment manager is a bank, registered investment advisor, etc. **who accepts fiduciary status and discretion over the assets to be managed – <u>in writing</u>**.
- If investment responsibility is properly delegated, the plan sponsor will not be under any obligation to invest or manage any assets of the plan that the investment manager is responsible for investing.
- If an independent investment manager is not retained, even a plan sponsor that meets the requirements of Section 404c remains fully responsible and liable for the prudent selection of the investment options that are offered to plan participants.

The dangers of a non-fiduciary model

Rather than accept delegation, the financial services industry has rigged the game in their favor

- The major players in the 401(k) industry (mutual fund companies, insurance companies and brokerage firms) have encouraged a non-fiduciary (suitability) model where advisors are:
    - not required to act in the best interests of plan participants; and
    - free to earn variable compensation and other forms of commissions which results in ***high and hidden costs*** for participants
- In response to fiduciary concerns, the 401(k) industry has promoted
    - reliance on the safe harbor contained in ERISA section 404c and encouraged education where plan fiduciaries are told that they can receive complete legal immunity for the consequences of investment decisions made by plan participants;
    - fiduciary education and monitoring services; and
    - the so-called "fiduciary warranty" – ***isn't the best warranty that a provider can offer the acceptance of fiduciary responsibility in writing?***

A Win/Win Solution

Hiring an independent investment fiduciary for a participant-directed 401(k) plan offers both the fiduciary protection for owners/executives intended by ERISA and the unbiased advice needed by America's workers to maximize their standard of living in retirement.

"It is safe, easy and eminently prudent for executives to delegate their fiduciary responsibilities as well as the liabilities that go along with them…a plan sponsor appointing a professional named fiduciary can help maximize wealth for plan participants by offering investments options that are lower in cost and broader in diversification of risk…"

-W. Scott Simon, Morningstar Advisor 2009

The AdvisorPlan Program – the 401(k) platform specifically designed for independent investment advisors acting as fiduciaries of ERISA-covered retirement plans

- **Independent Platform – with no hidden agenda – a true unbiased investment approach**
- **"True open-architecture" and availability of funds offered through custodial platform**
    - **No investment restrictions – i.e., no mutual fund revenue sharing requirements for inclusion on the platform**
- **Full Fee Disclosure and dollar for dollar offset of any mutual fund revenue sharing received to reduce plan and participant expenses**

  Cost savings typically 20%-40% compared to current plan
- **Global Portfolio Management – rebalance or reallocate all managed accounts at once**
- **Availability of exchange traded funds (ETFs)**

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About Mark B. Klein

Mark Klein is the Chair of the Employee Benefits Group at Dilworth Paxson, LLP and the president of Professional Capital Services, LLC. Mark is a graduate of Georgetown University Law School and concentrates his practice on overseeing the design, drafting, and implementing qualified and non-qualified retirement plans and welfare arrangements. He also counsels clients on ERISA issues in mergers and acquisitions; fiduciary issues; prohibitive transactions; COBRA and HIPPA issues; and plan terminations. In addition: Mr. Klein's executive compensation work includes drafting and advising on qualified and non-qualified 457 plans, employee stock purchase plans, incentive stock options, non-qualified stock options, stock appreciation rights, split-dollar plans, and non qualified deferred compensation plans (SERPS, 'pure' deferred compensation and mirror plans).

About Lawain McNeil

Lawain McNeil is one of the founders of The Advisor Lab and Efficient Advisors and oversees advisor training and development. As former Executive Vice President of Sales & Marketing for one of the largest independent registered investment advisory firms in the United States, Lawain brings a vast amount of experience in advisor training, education and marketing. Through his leadership, Lawain was instrumental in transitioning over $1 billion of assets from a commission, transactional model to a fee-only fiduciary model. Lawain's tireless advocacy for investors has taken him all over the U.S. speaking at industry and investor events. His passion for individual investors is illustrated in his continued development of investment tools and processes designed to educate investors.

A Closing Thought….

"ERISA holds plan fiduciaries to a high legal standard…the responsibilities of fiduciaries have been described as the highest known to the law"[Donovan v. Bierwirth, 680 F .2d 263, 272 (2d Cit. 1982)] Obviously, not all fiduciaries have the skills needed to satisfy these high standards. Fortunately, ERISA permits fiduciaries, and in fact requires them, to get help when they need it."

–Fred Reish/Joe Faucher