Choosing a 401k plan Advisor?

Why is choosing a 401k service provider and/or a 401k plan Advisor a major decision?
Because unlike most day to day work-related decisions these are fiduciary decisions.

A fiduciary is anyone “exercising any authority or control regarding the management or disposition of plan assets…” ERISA §3(21)(A) Fiduciary status is determined either by being named a fiduciary, or by virtue of the function or activities one carries out regarding the plan. Failing to fulfill one’s fiduciary responsibilities carries a personal liability.

Anyone responsible for, or having an effect upon, choosing a 401k service provider or advisor is a fiduciary. The Department of Labor mandates that a fiduciary must “engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. . . such process should be designed to avoid self-dealing, conflicts of interest or other improper influence.”

DOL Field Assistance Bulletin 2002-3 (Nov. 5, 2002)

Self-dealing, conflicts of interest, and improper influence are very serious issues for fiduciaries and “following the money” is the primary method in avoiding these transgressions. Many novice fiduciaries believe that understanding “what they are paying” is limited to the fees or hard-dollars they see. However, the Department of Labor expounds upon the money trail explicitly:

Fiduciaries have an obligation to “assure that the compensation paid directly or indirectly by [a plan to a service provider] is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by [the service provider] in connection with the investment of plan assets. The responsible plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that [the service provider] receives with respect to the plans investments….to make an informed decision whether the [service providers] compensation for services is no more than reasonable.” DOL - Frost (97-15A) and Aetna (97-16A)

A sad situation in the 401k market place is the “Fiduciary Paradox.” The fiduciary paradox is the contradiction between plan sponsors being charged with the duty above (for which, if they fail, they can be held personally liable) and the fact that under ERISA, non-fiduciary 401k service providers have no requirement to clearly disclose their compensation. Some believe that the passing of the updated fee disclosure rules will solve this paradox, but that remains to be seen.

The DOL recognizes the challenge of plan sponsors in fulfilling their fiduciary duties and has stated: “Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.” DOL Reg. § 2509.95-1(c)(6)

The Courts have echoed this point: “…where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors.” Liss v. Smith, 991 F.Supp. 278, 297 (S.D.N.Y. 1998)
Questions to ask a potential 401k service provider or 401k advisor?

Are you a registered representative (aka. financial advisor/consultant, representative, agent, broker, account executives, wealth managers, or full-service investment advisor) or a Registered Investment Advisor?

By law, registered representatives are held to the “Suitability Standard” while Registered Investment Advisors (RIA’s) are held to the “Fiduciary Standard.” The suitability standard is akin to non-malfeasance and might be restated as the “do no harm” standard. A registered representative has no obligation to place your interests above his own. The fiduciary standard is akin to beneficence and might be restated as the “do good” standard. For a registered representative to violate the Suitability Standard, he must proactively harm you. An RIA violates the Fiduciary Standard if he fails to put your best interests ahead of his own!

By virtue of their employment contract, registered representatives have an obligation of loyalty to their broker-dealer. By law, an RIA has an obligation of loyalty to his client.

Given an array of 401k products, a registered representative can choose to sell you just about any product, even if this product will prevent you from fulfilling your fiduciary duty (via fiduciary paradox); for example: the product that makes him a bigger commission; the product his firm is pushing that week; or proprietary products which make his firm more money. Some broker-dealers market themselves as independent and unbiased, while only offering to their clients & prospects those products that “pay to play” or provide “kickbacks,” and do not permit their representatives to sell products that refuse to participate in such schemes.

Under ERISA, fiduciary responsibility carries a personal liability. As a 401k plan sponsor you have a potential personal liability, if you fail to fulfill your fiduciary duties. Is it more prudent to seek advice from a salesperson, whose loyalty is to his broker dealer and whose responsibility to you is limited to the “Suitability Rule”; or is it more prudent to seek advice from an Independent Fiduciary, who either shares or assumes your fiduciary risk as an ERISA Fiduciary, and who by law and by contract, is loyal ONLY to you and your participants?

*This in no way disparages all broker-dealers, nor all registered representatives. Nor does it imply that all RIAs are flawless. However, the fact is that registered representatives and their broker-dealers are in the business of selling products and the law governing them is designed as such. Registered Investment Advisors are in the business of providing advice for a fee, and the laws governing them are designed as such. More importantly, the laws governing fiduciaries, including Independent Fiduciaries who assume ERISA 3(38) status are among the “highest known to the law.” Brussian v. RJR Nabisco, 5th Circuit Court, 2000
In writing, and in clear unequivocal language, do you assume fiduciary responsibility under ERISA as either an ERISA 3(21)(a)(ii) or ERISA 3(38) fiduciary?

ERISA and subsequent case law provide for the use of independent experts as noted above, and while there are several respected professional designations, not all of these designees are independent.

Ensure that your service provider has “skin in the game” and is willing agree in unequivocal language and in writing that he is either sharing fiduciary responsibility with you (3(21)(a)(ii), or alleviating you of some of it (3(38)).

An ERISA 3(21)(a)(ii) fiduciary assumes fiduciary responsibility alongside you. An ERISA 3(38) can assume discretionary authority over the plan’s investment decisions and thereby relieve you of any fiduciary liability regarding investment decisions.

While many nationally recognized insurance and brokerage firms advertise that they have the knowledge, resources and expertise to assist the 401k plan sponsor in fulfilling their fiduciary duties, nearly all, in the fine print, state that they, nor their advisors, act in any fiduciary capacity!

Several nationally recognized 401k service providers offer some sort of “Fiduciary Warranty” and many plan sponsors believe this gimmick protects them from fiduciary liability. However, in the fine print, one typically finds significant qualifications to this warranty. One major provider states, in the fine print, that their warranty only protects the plan sponsor from the “Broad Range” or Diversification Rule. The Broad Range Rule requires that a plan offer participants at least three investment options which have substantially different risk/reward profiles. The fine print specifically states that the warranty does not cover the quality of the investments options, nor the reasonableness of the fees of those investment options. To add to the deception, in many cases the service provider’s own proprietary, often more expensive, investment options must be used for this warranty to apply! (More on this in Caveat Emptor: Two words every 401k plan sponsor must know: http://www.fi360.com/main/pdf/11competition_submission_mensack.pdf)

Are you compliant with ERISA Section 411?

ERISA Section 411 provides 22 eligibility criteria. It is a violation of ERISA for anyone not compliant with these 22 criteria to act as a fiduciary on an ERISA plan. These criteria apply not just to outside or independent advisors, but also to the employees within a company who are fiduciaries.

Consider screening a potential plan advisor or service provider through “e-Luminary.” E-Luminary is a new tool designed at the request of the California Public Employees Retirement System in order to provide its retirees with trustworthy advisors, both RIA and Registered Representatives, who embrace the fiduciary standard. It is also being adopted by the Teachers Retirement Systems in Texas and Utah. The advisors in this database have undergone a thorough background check and have been approved and certified by Matthew D. Hutcheson, one of the foremost Independent Fiduciaries in the Country.
Do you hold either the Accredited Investment Fiduciary (AIF) or Accredited Investment Fiduciary Analyst (AIFA) designations from the Center for Fiduciary Studies. Or the Qualified Plan Financial Consultant (QPFC) from the American Society of Pension Professionals & Actuaries (ASPPA)?

The AIF and AIFA are the only professional designations in the country that certify one’s expertise in fiduciary issues. ASPPA offers several well respected designations, but the Qualified Plan Financial Consultant (QPFC) is the most common and appropriate for a plan advisor.

Beware of all other titles or designations, particularly those created by some of the larger broker-dealers, and held exclusively by their own representatives.

What fees and expenses will my plan be subject to, and what compensation will you and your firm receive, if we work with you?

Insist on 100% transparency regarding all fees and expenses! Fees and expenses generally fall into three categories: Advisory, Administrative, and Investment.

**Advisory fees:** How does this advisor, and his employer, get paid?

**Administrative or plan level fees:** How does the record-keeper, administrator and custodian get paid?

**Investment expense:** What is the expense of the investment options, and is there any Revenue sharing that offsets either the advisory or administrative fees?

“Revenue sharing” is fiduciarily acceptable when the appropriate mutual fund share class is used and all 12b-1 fees and Sub-TA fees are accounted for and used to offset appropriate expenses.

Other fees which raise fiduciary red flags are: Administrative service charge, Sales & Service fee, Separate account expense, M&E or mortality & expense fee, base charge, asset charge, wrap fee, market value adjustment, surrender charge, and contingent deferred sales charge. It's not uncommon for certain types of 401k products to have total expenses exceeding 3% or 4%; however, because some of these fees are buried deep within the fine print, it appears to the plan sponsor that the total expenses are much less. Recently there was an ad in the Newark Star Ledger from a law firm stating 401k participants that had this type of 401k product “may have legal claims…related to fees and charges taken from retirement assets…”

A particularly sharp Advisor might address transaction costs and the value of offering “passively” rather than “actively” managed investment options. Transaction costs include commissions paid by a mutual fund for trading positions within the fund. These costs sometimes exceed the published expense ratio of the mutual fund. Passively managed funds tend to have lower transaction costs than actively managed funds.
What are all the sources of your compensation and your firm’s compensation, relative to our plan?

One caution when asking an advisor about his compensation: The advisor’s employer might have arrangements with 401k product service providers where the employer receives additional compensation above and beyond that which the advisor is aware. A plan sponsor has a fiduciary duty to discover this additional compensation which is indirectly coming from your plan assets. Unfortunately, disclosures are often buried within the prospectus and difficult to find.

Registered Representatives are generally compensated from 12b-1 fees, of which their broker-dealer keeps a percentage. While this in and of itself is not an issue, its fertile ground for conflicts of interest. Some mutual funds have no 12b-1 fees, while others have 12b-1 fees of 1%.

Most mutual funds also pay Sub-Transfer Agency (Sub-TA) fees which are supposed to offset the administration costs of a plan, and these can vary greatly by share class.

In some cases where a firm acts as the Advisor and as a “producing” Third Party Administrator (TPA) it collects both 12b-1’s and Sub-TA’s. (Some TPA’s also might receive an “over-ride” from service providers for placing or maintaining a certain level of assets with that provider.)

Both of these fees are found within the expense ratio of a mutual fund, and certain mutual funds have multiple “share classes” often identified with letters such as A, B, C, I, R, R1 through R6, all of which might have various levels of 12b-1 and Sub-TA fees.

Other sources of compensation might be revenue sharing other than Sub-TA’s and 12b-1’s such as, securities lending fees, and Section 28(e) fees (aka. soft dollars) to name a few.

What conflicts of interest might you, or your firm, have when providing plan level advice to sponsors, or participant level advice to employees?

Many broker-dealers receive various amounts of compensation including “other than 12b-1 & sub-TA” revenue sharing from 401k service providers, including from the individual mutual fund families offered within a 401k product. So long as all of this compensation is properly disclosed and accounted for, it’s not necessarily an issue. However many also “push” providers, or limit their service provider menu to providers that pay for shelf space or some other form of “pay to play” scheme. Any advisor who can offer only a limited number of 401k products, or any 401k product that limits the number of investment options from which the plan sponsor can choose is suspect. (This only applies to the options from which the plan sponsor can choose in order to create the necessarily limited menu from which plan participants can choose. Participants having access to too many investments creates its own issues.)