

## **Caveat Emptor for 401k Plan Sponsors**

**By  
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Mark Twain said, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Twain didn't have a 401k, but his words reflect the understanding most 401k plan sponsors have of their fiduciary responsibility.

Recently I had the opportunity to meet with a cantankerous CEO who exclaimed "we have people handling all this fiduciary stuff...they told me we're bullet-proof!" I'm not looking forward to highlighting the mouse-print in his service providers' contracts indicating "that just ain't so." Unbeknownst to him, he is in breach of his fiduciary duty for allowing his plan participants to pay more than \$100,000 in excessive fees. He also admitted that he chose his current 401k service provider because that service provider would refer business to his company. He was unaware that a fiduciary receiving consideration in connection with plan assets is known as self-dealing. Under the Employee Retirement Income Security Act (ERISA) self dealing is a prohibited transaction for which this CEO could face significant fines and penalties - so much for bullet-proof, let the buyer beware!

Why are we talking about fiduciary responsibility now? It's only been since the Enron & WorldCom debacle's that the Department of Labor has been stepping up its efforts to enforce the fiduciary requirements of ERISA, and the rate of fiduciary breach lawsuits has been increasing significantly over the past few years. Unfortunately, most plan sponsors are unaware of their fiduciary duties, or in many cases that they are fiduciaries. While a CEO might be the named fiduciary, many other employees are usually functional fiduciaries. Anyone within a company that has any responsibility or influence regarding their 401k is probably a fiduciary - and fiduciary responsibility carries potential personal liability!

A large part of fulfilling one's fiduciary responsibility, and the focus of many of the current fiduciary breach lawsuits, involves the reasonableness of the fees and compensation paid to 401k service providers. This can be a challenging task since much of the fees and compensation are not easily identified hard dollar line item on an invoice. Furthermore, these fees and compensation are often hidden or hard to find within contracts and prospectuses which can amount to hundreds of pages.

What's the big deal about fees? Ben Franklin's old adage, "A penny saved is a penny earned" applies here, and those pennies really add up. According to the Department of Labor a 1% difference in fees and expenses over an average 35 year working career could reduce a participant's account balance at retirement by 28%!

While ERISA requires plan sponsors who do not have the fiduciary knowledge to seek the assistance of independent experts, most plan sponsors, including the cantankerous CEO, unknowingly seek expertise from non-fiduciary service providers. Many plan sponsors believe that

the person who sold them their plan has an obligation to fulfill these responsibilities, but this is rarely the case.

This misperception is not surprising given a 2010 survey by ORC/Infogroup which found that 76% of US investors wrongly believed that “financial advisors” are held to a fiduciary standard. In fact, financial advisors and most 401k service providers have no fiduciary obligation, usually deny any fiduciary status in the fine print of their contracts, and aren’t even obligated to put their client’s interest ahead of their own. In other words, let the buyer beware!

Given the Department of Labor’s increasing focus, the Plaintiff’s Bar sensing blood in the water, and the fact that there is no corporate veil of protection for a fiduciary breach, this misperception could prove costly for plan sponsors. Never has the phrase Caveat Emptor been of greater importance! There are many fiduciary traps about which plan sponsors ought to be aware, but here are just two that I find often; Mouse-print & Name-dropping.

**Buyers ought to beware the mouse-print!** Mouse-print is the smaller print rarely found on the first page of a marketing piece which is often times quite different than the “large print” found on the first page. For example, the CEO mentioned above held up his “fiduciary warranty” certificate, complete with gold seal, as evidence of why he was “bullet-proof.”

A number of 401k service providers offer some sort of “fiduciary warranty.” I’ve met several plan sponsors who were confident that they were fulfilling their fiduciary duties because their advisor said XYX Company would protect them in the event of a fiduciary breach lawsuit. Any reasonable person reading the large-print in a fiduciary warranty marketing piece would probably come to a similar conclusion when they read:

*“This unprecedented program offers plan sponsors and fiduciaries greater confidence, security and peace of mind by providing specific assurance for their fund selection. We’re so confident, we promise to restore any losses to the plan and pay litigation costs related to the suitability of our investment process and Fund lineup for 401(k) plans.*

*We recognize that fund selection and monitoring is an important part of the due diligence process for plan fiduciaries, and we are confident that our investment selection and monitoring process meets the highest standards. We are willing to put our name behind the Funds selected from our investment lineup and promise that our Funds....”<sup>1</sup>*

A reasonable person would most likely be even more confident when, in a separate document referenced in the marketing piece, they start to read the mouse-print that states their fiduciary warranty: *Will satisfy the prudence requirement of section 404(a)(1)(B) of ERISA that the investment options be selected according to prevailing investment industry practices and generally accepted investment theories (the “prudence requirement”),....”*

A reasonable person might even review ERISA 404(a)(1)(B) which “requires that a fiduciary shall discharge his duties with respect to a plan 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 in the conduct of an enterprise of a like character and with like aims.”

The reasonable person intuitively would think that the reasonableness of fees is an inherent part of prudence, right? And besides, the large print stated, “...we are committed to helping you meet the highest fiduciary standards in the investment selection and monitoring process and commit to restore losses and pay litigation costs in the event that legal action is brought against qualifying plans. Now that’s security for your plan!”

So what is a reasonable person likely to infer from his fiduciary warranty at this point? A big name company is providing me with greater confidence, security and peace of mind in the selection and monitoring of my 401k fund menu. They are putting their big name behind their funds, their funds are prudent under ERISA, and they’re even putting their money where their mouth is! Maybe it’s not unreasonable to believe he’s bullet-proof?

Unfortunately, “that just ain’t so.” Deeper in the mouse-print we find a caveat (as in caveat emptor) that contradicts everything the reasonable person read so far; the Fiduciary Warranty does not “extend to claims that any expenses paid directly or indirectly by the Plan are reasonable.” Sadly, these fiduciary warranties are usually offered in group annuity 401k products which a recent Forbes article described as “Retirement Plans from Hell.”<sup>2</sup> This type of 401k product typically has the highest expenses which are often hard to find in hundreds of pages of disclosure. So much for bullet-proof, let the buyer beware!

**Buyers ought to beware name-dropping!** Name-dropping is akin to mouse-print, but involves a well-known brand. For example, when asked about their 401k fees, several plan sponsors have responded with “we have Vanguard funds” implying that they pay little in fees.

Vanguard has a well-respected reputation for low-cost, quality mutual funds, and generally, expenses aren’t an issue with Vanguard funds or a Vanguard 401k product. However, in some 401k products you might find, for example, the “XYZ/Vanguard S&P 500 fund.” While the average participant might think he has invested in the Vanguard S&P 500 mutual fund, in the mouse-print he might discover he has actually invested in a “sub-advised account” or “collective investment trust” and not the well-respected named fund he thought.

Collective Investment Trusts or CITs are typically private label versions of publically available mutual funds. CITs are often utilized by large plans and, ideally, are cheaper than the publically available version. The Vanguard S&P 500 fund (VFINX) has an expense ratio of 0.18%. However, in one plan I’ve reviewed, the expense ratio of the “XYZ/Vanguard S&P 500 fund” was 0.53% - almost 200% over retail. On top of this the participants were paying an additional 0.50% wrap fee making the total cost nearly 500% over retail.

Sub-advised accounts are similar but often found in group annuity 401k products like the one mentioned above. The Vanguard 2030 fund (VTHRXX) has an expense ratio of 0.19%. In a recent review of a group annuity 401k, I found the “XYZ/Vanguard 2030 fund” with an expense ratio of 0.94%. Additionally there were two separate wrap fees of 0.37% and 0.25% for a total expense of 1.56% to the participant. That’s 721% over retail and this plan sponsor had a fiduciary warranty! <sup>3</sup>

In the examples above, both plans had assets of approximately \$8,000,000. The plan fiduciaries heard “Vanguard,” and didn’t pay attention to the mouse-print so they mistakenly thought they had chosen low-cost mutual funds. While there might be some situations where these fees are deemed reasonable relative to the services being provided, it’s challenging to make that argument here where neither plan sponsor was aware of these fees.

There has been much debate since the passage of Dodd-Frank on whether all financial service providers ought to be held to a fiduciary standard and necessarily put the interests of their clients ahead of their own. There has also been much discussion on the effectiveness of the amended fee disclosure Rule 408(b)(2). <sup>4</sup> Here is one thing that isn’t debatable, when it comes to plan sponsors choosing a 401k service provider: “Let the buyer beware!”

## NOTES

1. Although the language found in the various marketing pieces of most fiduciary warranties is similar, the italicized portions above are all quoted from the marketing material and fiduciary warranty certificate of one service provider.

An example of the caveat can be found at:

<http://www.docstoc.com/docs/70935394/Fiduciary-Warranty-Certificate>

2. Forbes, Scott Wooley, 07/13/09
3. Thanks to Joe Mensack for correcting my calculations.
4. See “[Rule 408\(b\)\(2\): The New Fiduciary Paradox](#)”

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