THE 401K ETHICIST

The Moral Hazard of Too Big to Jail

*Mark Mensack**

Building upon the notion of moral hazard in the March/April 401k Ethicist, The Moral Hazard of Too Big to Jail examines risk asymmetry and information asymmetry in light of some recent developments; namely the Government's failure to indict HSBC or its leadership for money-laundering, and a new FINRA rule classifying retirement plan sponsors as institutional investors. In this column, the author argues that Wall Street and FINRA, the regulator responsible for overseeing Wall Street, are deepening the moral hazard for retirement plan sponsors and making it that much more difficult for plan sponsors to fulfill their fiduciary and ethical responsibilities.

In my last column, I discussed the notion of moral hazard on Wall Street and particularly in the 401k marketplace. Given several related developments since submitting that column in December, I'd like to delve a bit further into this topic beginning with a more thorough explanation of moral hazard and a closer look at the effect of risk and information asymmetry.

Economist Paul Krugman described moral hazard as "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly."[1] For our purposes, risk asymmetry is where the risk faced by the parties involved is significantly lop-sided. For example, since the 2008 financial crisis, the notion of moral hazard has often been used to describe the actions of some large American banks. Banks have traditionally been very judicious or risk-adverse in their lending decisions because if they lend money to an unworthy borrower, the bank faces the risk of losing the money lent.

A moral hazard arises when the government relieves the banks of this risk by bailing them out such that the banks face no consequences for imprudent lending decisions. Imagine someone taking their life savings to Las Vegas and betting it all on red. Obviously not a prudent decision, but what

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Mark welcomes comments and criticisms, and suggestions for future topics. He also welcomes examples of ethical issues in the retirement plan space, and especially misleading 401k marketing materials at 401kEthicist@PrudentChampion.com Some of Mark's articles and presentations regarding the topics mentioned here can be found at www.PrudentChampion.com.

if the policy was that if you win, you double your money, or if you lose, the government will make you whole. Simply put, asymmetric risk in this scenario is that one's upside potential is unlimited, while one's downside risk is nil.

Another aspect of moral hazard is sometimes described as the principal-agent problem or information asymmetry. Information asymmetry occurs when one party to a transaction, typically the buyer, has less information upon which to base a decision than the other party, typically the seller. Consider the sub-prime mortgage mess where most homebuyers were ignorant of the risk inherent in these mortgages, while the companies that sold them were very well aware. In this scenario the overlap of asymmetric risk and asymmetric information is apparent. Based upon too little information, homebuyers took these mortgages and the result in many cases has been the loss of their homes. Some mortgage companies knowingly sold these mortgages, yet I am not aware of a single executive from the mortgage industry being indicted.

ASYMMETRY OF RISK: 401K PLAN SPONSORS

A topic I often address is the issue of information asymmetry in the 401k industry, in which brokerage firms typically have more knowledge regarding the 401k product and a plan sponsor's fiduciary duties than the plan sponsor. While everyone understands the risk of losing money, most fiduciaries, including plan sponsors, do not understand fiduciary risk. Fiduciary responsibility carries personal liability, and there is no "corporate veil" to protect a fiduciary. ERISA 409(a) states, "any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed by this sub-chapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach. . . ." One of the most common fiduciary challenges is ensuring that the plan is not paying excessive or unreasonable fees from plan assets, but more on this shortly.

Fiduciary obligations are among the "highest known to the law."[2] A fiduciary must discharge his or her duties with the care, skill, prudence, and diligence that a prudent person 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. A fiduciary must act for the exclusive purpose of providing retirement benefits, and all decisions regarding the plan must be made with the best interests of the participants and beneficiaries in mind. Many believe that a breach of fiduciary duty is necessarily a malicious or criminal act. However, most fiduciary breaches result from the omission, not the commission, of an act. According to Fred Reish, a nationally recognized ERISA attorney, "Fiduciaries are not sued for what they do; instead they are sued for what they do not do."[3]

It's not just the CEO or HR Director who is a fiduciary. Anyone, regardless of title or position, who has influence over decisions regarding the plan or plan assets may be deemed a fiduciary, and therefore has potential personal liability! While fiduciary breach lawsuits are a threat to plan fiduciaries, so is the Department of Labor. In 2011 the Employee Benefit Security Administration (EBSA), the agency that enforces ERISA, closed 3,472 civil investigations. 75% of those resulted in monetary results and 255 were referred for litigation. The EBSA also closed 302 criminal investigations, 75 of which closed with guilty pleas or convictions, and 129 individuals were indicted. In 2011 alone, the EBSA achieved $1.38 billion in total monetary results.[4]

Many of the current fiduciary breach lawsuits are based upon fiduciaries failing to do one or more of the following: a) being cognizant of all the fees being charged to the plan; b) being cognizant of all of the compensation being received by any interested party to the plan; c) ensuring that the fees and compensation paid to service providers are reasonable relative to the services being provided; and d) conducting due diligence and monitoring the performance of the investment options in the plan.

EXCESS FEES: HOW MUCH ARE WE REALLY TALKING ABOUT?

The Department of Labor, the Plaintiff's Bar, and the recent 408(b)(2) amendment have all focused on excessive fees found in many retirement plan products, but how much are we really talking about? According to Edward Siedle, a 401k industry critic and former attorney with the SEC, "Regulators and employers were unconcerned about pervasive conflicts of interest; excessive, hidden fees and wrongdoing that resulted in billions being skimmed from 401k accounts. . . . Fraud of this magnitude, involving trillions, makes Madoff look like chicken feed." Siedle estimates that these issues have cost American workers "approximately 50%" of their retirement assets.[5]

Siedle is not alone, 401k industry expert Dan Solin writes, "The existing 401(k) system is a scam far greater than anything Bernie Madoff could have conceived." Solin suggests that "excessive fees have dramatically reduced employees account balances. By some accounts, the combination of poor investment options, high expenses and poor planning have caused many plan participants to have a zero return on their 401(k) investments."[6]

W. Devin Wolfe, a Registered Investment Advisor with Financial Plan, Inc. in Bellingham Washington, provides a detailed observation: "In one instance we were reviewing the 401(k) options of a client and found an excellent fund; however, when we examined the annual expense ratio it was a whopping 2.81%. The catch is when you remove the insurance company's "wrapper" we could invest in the same fund for an expense ratio of 0.56% annually. Although the client didn't think they were paying anything they were losing 2.25% of their investment return each year to expenses above and beyond that of the actual investment."[7]

While it is not uncommon to find 2.25% in hidden excessive 401k fees, the Department of Labor notes that just a 1% difference in fees over the average American's 35-year working career could reduce that person's retirement nest egg by as much as 28%.[8]

THE MORAL HAZARD OF RULE 408(B)(2)

Plan sponsors have always had a fiduciary duty to understand all fees paid by the plan, to discover all compensation received by 401k service providers, and to ensure these amounts were reasonable given the services provided. In other words, there ought to be symmetry of information regarding fees in order for the plan sponsor to fulfill this obligation. Without this symmetry of information, plan sponsors are faced with a moral hazard. This is not a new problem. Prior to July 2012 service providers were under no legal obligation to disclose this information. In fact a 2011 AARP study found that 71% of the 72 million Americans currently invested in a 401(k) plan don't know that they are paying any 401(k) fees.[9]

The intent of Rule 408(b)(2), which took effect in July 2012, is to legally mandate the symmetry of fee information so that plan sponsors can make well-informed decisions regarding 401k service providers. Unfortunately, so far, Rule 408(b)(2) is not the panacea that was intended. While I go into greater detail in *Rule 408(b)(2): The New Fiduciary Paradox*, Craig Freedman, Managing Director of the Retirement Readiness Institute in Boca Raton Florida has found that 408(b)(2) is far from the cure-all that was intended. Freedman has conducted dozens of 408(b)(2) fee assessments and comments "many vendors are going to go down kicking and screaming before succumbing to full transparency."[10] Full transparency ought to equate to symmetry of information; however, Freedman observes "it is amazing how much effort and creativity has been put into the creation of many fee disclosures making it extremely difficult and in some cases impossible to understand what the fees are, even for someone like myself who knows what to look for."[11]

Apparently the efforts of some 401k vendors to fight fee transparency are working. Freedman has observed that the "frustration levels have risen to the extent that some plan sponsors have relied on their service providers to comply with the regulations rather than conducting their own independent evaluation as required by the regulations and many have abandon any real effort to comply altogether." So much for eliminating the moral hazard![12]

Freedman's experience isn't unique. Carlos Panksep, Managing Director of CEFEX, the Center for Fiduciary Excellence, notes "The form and transparency of disclosures can range from extremely simple to dizzyingly complex; and in some cases, completely absent." Panksep's advice for plan sponsors, "Unless they conduct RFP's, all plan sponsors should hire an independent expert to review fees and disclosures."[13] It's noteworthy that the panacea for eliminating the moral hazard of hidden fees is described as *dizzyingly complex* and that plan sponsors are advised to *hire an independent expert*. In an article entitled ". . . But Beware of Moral Hazards" Richard Lindsey, former SEC Director of the Division of Market Regulation, seems to be in agreement regarding the moral hazard facing 401k plan sponsors when he notes, "Moral hazard may exist anytime there is *difficulty or cost* associated with monitoring and enforcing the behavior of a party with interests that are in conflict with our own."[14]

HAVE NO FEAR FINRA IS HERE!

While it sounds as if plan sponsors are between a rock and a hard-place with this challenge of information asymmetry, they can always look to the Financial Industry Regulatory Authority (FINRA) which claims "investors need to know someone is looking out for them." FINRA's alleged mission is "to protect America's investors by making sure the securities industry operates fairly and honestly." FINRA claims to be "every investor's advocate" and that "every investor deserves fundamental protections when investing in the stock market."[15] FINRA explicitly includes those invested in 401(k) plans and other thrift, savings or employee benefit plans in these claims.

Referring to the 408(b)(2) disclosures, the description *dizzyingly complex* compounds the information asymmetry problem and contradicts FINRA's concern for Wall Street firms to act *fair and honestly*. This brings me to the other recent development I mentioned in my first paragraph; the new FINRA rules which took effect in February, particularly FINRA Rule 2210, Communications with the Public. This rule governs, among other things, the marketing materials broker dealers use to market their services. FINRA claims that it's "Advertising Regulation Department reviews broker-dealers' advertisements and other communications with the public to ensure that they are fair, balanced and not misleading."[16] While I've often criticized 401k marketing materials for being unfair, imbalanced and misleading, what surprised me about the updated rule is that retirement plan sponsors are classified as institutional investors.[17]

Institutional Investors have traditionally been defined under Rule 4512 which does not include retirement plan sponsors, but rather banks, insurance companies, registered investment companies, registered investment advisors; and also "any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million."[18] The critical distinction between retail and institutional investors is that an institutional investor has the knowledge and sophistication of a professional investor, in other words, information asymmetry is not an issue. As such, "Institutional investors face fewer protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves."[19]

Aside from the unique risk of being held personally liable for hidden plan fees, studies indicate that plan sponsors are typically far from knowledgeable or sophisticated when it comes to understanding their obligations under ERISA. For example, an April 2012 report by the Government Accounting Agency found that "48 percent of plans did not know if their service providers had revenue sharing arrangements with other providers."[20] Furthermore, 51 respondents that reported being aware of revenue sharing also reported that they did not consider the revenue sharing arrangements when selecting service providers, or that they did not have enough information to do so.

FINRA'S MESSAGE TO 401K PLAN SPONSORS: CAVEAT EMPTOR

By classifying plan sponsors as institutional investors, FINRA enables those who sell expensive 401k products with excessive hidden fees to maintain information asymmetry, but there's another aspect that adds to the moral hazard. As Alison Frankel notes in her article, *Goldman Sachs and the Sophisticated Investor: Who's duping whom?*, "Courts expect that so-called sophisticated investors engage in their own due diligence and don't rely entirely on what sellers tell them. Sophisticated investors have a higher bar for claims of fraud and negligent misrepresentation than ordinary people who buy and sell securities."[21]

By classifying plan sponsors as institutional investors who ought to know better, instead of eliminating the problem of information asymmetry, FINRA is providing Wall Street with a defense should the plan sponsor ever decide to sue its 401k vendor. Co-inventor of the 401(k) Plan Richard Flynn explains: "The suitability standards when dealing with institutional clients are lower than when dealing with retail clients . . . If a plan sponsor is sued for a fiduciary breach, it will be in a state or federal court where the plan sponsor will be painted as a sophisticated expert relative to the plan participants. While this might be an accurate relative portrayal, we all know and the GAO substantiates that most plan sponsors are far from being sophisticated experts regarding 401k plans or their fiduciary duties."[22] If Flynn's explanation sounds unreasonable, please remember Nationwide's counter-suit against the Haddock 401k Trustees. Dan Solin summarizes Nationwide's argument: "If our conduct caused harm to the plan participants, it was our clients' fault for not being smart enough to put a stop to it."[23]

ASYMMETRY OF RISK: WALL STREET

In my earlier column I summarized Plato's Ring of Gyges in which Plato holds that people only do the right thing because they fear the consequences of doing the wrong thing. Although Plato didn't use the term, his story describes the notion of moral hazard in that someone is likely to take greater risk, if they don't have to suffer the consequences of taking that risk. In that column I note that, given the absence of criminal prosecution of Wall Street executives involved with the mortgage crisis, it's not a stretch to realize that the SEC and FINRA have given Wall Street or at least the big players on Wall Street, the Ring of Gyges. Shortly after I submitted the last column, news broke that HSBC was paying a $1.9 billion settlement for money-laundering. However, authorities were not going to indict HSBC or any of its employees. If money-laundering billions of dollars in and of itself isn't worthy of a criminal indictment, realize that HSBC was laundering money for Iran and the Mexican drug cartels.

While $1.9 billion isn't necessarily pocket change, it's less than 12% of HSBC's 2011 profit of $16.8 billion. I suggest that a 12% penalty with no criminal indictment is no penalty at all; rather it's merely the cost of doing business. The logic of this decision, according to a recent New York Times editorial, was due to "fear that criminal prosecution would topple the bank and, in the process, endanger the financial system." The editorial goes on to say, "Clearly, the government has bought into the notion that too big to fail is too big to jail."[24] If Plato were writing his story today, he might have called it the Ring of HSBC, and the moral of the story could have been *if Wall Street has no reason to fear the risk of punishment for violating the law, then Wall Street is likely to violate the law.*

Getting off the hook with just a fine is not uncommon; in fact, in many cases Wall Street firms don't even have to admit wrongdoing so long as they pay a fine. For example, the SEC and Citigroup settled a case involving the sale of misleading mortgage-backed securities for $285 million without having to admit guilt. In other words, so long as they pay the fine, Wall Street firms and their executives can do as they please without ever having to take any personal responsibility for their actions.

Am I taking this too far? Jimmy Gurulé, a Notre Dame law professor and former assistant attorney general recently observed, "There appears to be an exception for employees of large banks that have engaged in particularly serious and egregious violations of the law . . ." Regarding HSBC, Gurule said that the settlement "makes a mockery of the criminal justice system."[25]

MORAL HAZARD = CAVEAT EMPTOR

In my inaugural column we examined how a 401k plan sponsor's fiduciary obligations are also ethical obligations to the plan participants. While there are many outstanding 401k vendors, there are also many that "are going to go down kicking and screaming" before making it easier for plan sponsors to fulfill their fiduciary and ethical obligations. I suggest that every day of kicking and screaming enables certain 401k vendors to extend the moral hazard facing 401k plan sponsors. It's also one more day for those 401k vendors to pilfer assets away from American 401k participants. I also suggest that every day that FINRA fails to enforce its own rules requiring Wall Street firms to act fair and honestly, FINRA is complicit. So what is a plan sponsor to do?

My first piece of advice is caveat emptor! I've addressed deceptive 401k sales practices such as fiduciary warranties in the past, and as Dan Solin writes in *The 401(k) Sucker Punch*, many brokers and insurance companies "throw around the "fiduciary" word with abandon and mislead employers into believing they will share legal responsibility in the event of a lawsuit concerning plan choices."[26]

My second piece of advice is to engage a truly independent fiduciary willing to unequivocally assume ERISA 402(a) Named Fiduciary status, and/or ERISA 3(38) Investment Manager status. For more on fiduciary delegation read Scott Simon's *How to Properly Mitigate Risk for Plan Fiduciaries.*[27]

NOTES:

[1]Krugman, Paul (2009). *The Re-*

turn of Depression Economics and the Crisis of 2008.

[2]Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir. 1982).

[3]2006 ASPPA Annual Conference, Key Fiduciary Issues for 401(k) Plans.

[4] http://www.dol.gov/ebsa/newsroom/fsFYagencyresults.html.

[5] http://www.forbes.com/sites/edwardsiedle/2010/10/07/401ks-americas-biggest-investment-fraud-was-foreseen-and-preventable/.

[6] http://www.huffingtonpost.com/dan-solin/shining-a-bright-light-on_b_162767.html solin scam.

[7] http://financialplaninc.com/401k/is-the-fleecing-of-401k-plans-over.

[8] http://www.dol.gov/ebsa/publications/401k_employee.html.

[9] http://assets.aarp.org/rgcenter/econ/401(k)-fees-awareness-11.pdf.

[10]Rule 408(b)(2):The New Fiduciary Paradox http:/www.prudentchampion.com/wp-content/uploads/2012/08/Rule408b2-The-New-Fiduciary-Paradox-7-30-12.pdf.

[11]Craig Freedman Quote: Email exchange, 1/31/2013.

[12]Ibid.

[13]Carlos Panksep, Email exchange, 2/01/2013.

[14] http://www.asensio.com/Commentary/DOJ/WSJ91495.pdf.

[15] http://www.asensio.com/Commentary/DOJ/WSJ91495.pdf. https://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf.

[16] http://www.asensio.com/Commentary/DOJ/WSJ91495.pdf. https://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf.

[17] http://www.prudentchampion.com/wp-content/uploads/2012/12/Caveat-Emptor-for-401k-Plan-Sponsors-12-19-12.pdf.

[18] http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9958&print=1.

[19] http://www.investopedia.com/terms/i/institutionalinvestor.asp#axzz2KRuaU3wy.

[20] http://www.gao.gov/products/GAO-12-325.

[21] http://newsandinsight.thomsonreuters.com/Legal/News/2012/10_-_October/Goldman_Sachs_and_the_sophisticated_investor_Who_s_duping_whom_/.

[22]E-mail exchange 1/23/2013 Flynn co-invented the 401k: Using a prototype plan document from Ted Benna as a point of departure, Rich Flynn led the development of one of the first complete 401(k) plan packages in 1982. This package included individually designed plan documents, submission packages, recordkeeping, trustee/custodian services, and the development of the window GIC to provide risk-free funding of benefits at the old American Bank and Trust.

[23] http://www.huffingtonpost.com/dan-solin/nationwide-tosses-its-401_b_666934.html.

[24] http://www.nytimes.com/2012/12/12/opinion/hsbc-too-big-to-indict.html?_r=2&.

[25] http://money.cnn.com/2012/12/12/news/companies/hsbc-money-laundering/index.html.

[26] http://www.dailyfinance.com/2010/01/09/the-401-k-sucker-punch/.

[27] http://www.morningstar.com/advisor/t/60401484/how-to-properly-mitigate-risk-for-plan-fiduciaries.htm?&single=true.