

THE 401K ETHICIST

The Moral Hazard of Paltering & Puffery, Part II

Mark Mensack*

In the first part of *The Moral Hazard of Paltering & Puffery* we examined how paltering contributes to the moral hazard facing 401k plan sponsors. To palter is to intentionally deceive or mislead without making a false statement. Palters are half-truths and the vague or ambiguous statements that some think fall into a grey area short of a lie. We examined examples of paltering in 401k marketing materials, which lead to the pilfering of 401k assets the amount of which one critic claims makes “Madoff look like chicken feed.”¹ Part one ended with the question, isn’t there a law against paltering?

LAW AND ETHICS TO THE RESCUE

Isn’t it curious that there are consumer warning labels on so many products from McDonald’s coffee being hot to cigarettes causing cancer? Where are the 401k warning labels stating, *This Retirement Plan Product May be Hazardous to your Retirement Income Security!* Unfortunately the Consumer Product Safety Commission is responsible for these sorts of warnings and its focus is on “protecting the public from unreasonable risks of injury or death” not from paltering or pilfering.²

Some readers have objected to my use of the word pilfering and my pejorative descriptions such as 401k rip-off and world’s largest skimming operation. I would argue that this is the appropriate word and these descriptions are accurate. Russ McAlmond, President of Evergreen Capital Management Inc., expresses the same thought with “But what if I purposely over-billed the client, or put the client in an investment that paid more commission than another with less benefits, or had hidden fees in my 401k program that I did not disclose to my plan sponsors . . . These are also examples of stealing money from clients which may

* MARK MENSACK, AIFA®, GFS® is the Principal of Mark D. Mensack, LLC., an independent fiduciary consulting practice affiliated with Fiduciary Plan Governance, LLC.. His expertise is in the area of fiduciary best practices, 401k hidden fees and ethical issues in the retirement plan marketplace. He has eighteen years of financial services experience; fourteen as a financial advisor with broker-dealers, and four as an RIA. Mark has a Masters in Philosophy from the University of Pennsylvania and is a former US Army Officer. His final active duty assignment was on the faculty of the United States Military Academy at West Point, NY where he taught Philosophy, Ethics & Critical Reasoning.

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.

be less obvious but just as wrong.”³

Some may focus on the clause “that I did not disclose to my plan sponsors” in Russ’s statement and argue, “but if you read the footnotes on page 68 of that report those fees are disclosed.”⁴ Let’s recall that Merriam-Webster defines pilfer as “to steal stealthily in small amounts and often again and again.”⁵ Within this definition the word “steal” has ruffled some feathers; however, what other word applies to a situation in which someone takes my property without my consent? Obviously if I don’t know that someone is taking my property, I have not given my consent. My 401k assets are my property, and while I’ll happily pay a reasonable fee for the services provided, empirical evidence proves that most 401k participants and nearly half of 401k plan sponsors, have little if any knowledge of the fees being taken from their accounts.

Consider the AARP’s 2011 survey, *401(k) Participants’ Awareness and Understanding of Fees*. The AARP found that of the more than 72 million 401k participants in America invested in more than 483,000 plans which contain over \$3 trillion in assets, 71% believed they paid no fees!⁶

The findings of a 2012 Gov-

ernment Accounting Office survey of 401k plan sponsors weren’t much better and found that “plan sponsors were challenged by complex fee arrangements and likely paid more than they realized.”⁷ The most common type of fee arrangement is known as *revenue sharing*. Revenue sharing is where portions of the internal expenses of an investment within a 401k plan are shared with other service providers such as brokers, administrators and record-keepers. When properly accounted for, revenue sharing isn’t necessarily a problem; however, “sponsors of an estimated 48 percent of plans did not know if their service providers had revenue sharing arrangements with other providers.”⁸

The survey specifically noted that “Fees associated with certain 401(k) insurance products—where participants pay for some benefits but which otherwise appear similar to non-insurance 401(k) products—can be difficult for sponsors to identify and therefore evaluate.” An especially disturbing point was “that about 17 percent of sponsors did not know if their plans had group variable annuity contracts.” It was suggested that the reason was because “it is difficult for sponsors to distinguish between group variable annuity contracts and mutual funds, because the insurance

company’s separate or subaccounts often use the same name as the mutual funds . . .”⁹

My personal experience coincides with this suggestion and reminds me of a common example of paltering and pilfering on which I elaborate in *Caveat Emptor for 401k Plan Sponsors*.¹⁰ When asked about their plan, more than one plan sponsor has told me that they had Vanguard, when in fact they had what appeared to be Vanguard funds within a group annuity 401k product. While conducting a fiduciary review of one such plan, sponsored by a law firm with less than 100 participants and \$8 million in assets, I found that although some of their investment options appeared to be Vanguard mutual funds, they were actually accounts sub-advised by Vanguard. One fund appeared to be the Vanguard Target Retirement 2030 fund which directly from Vanguard has an expense ratio of 0.19%; however this investment option had an expense ratio of 0.94%. Additionally this plan had two separate wrap fees of 0.37% and 0.25% for a total expense of 1.56%. That’s 721% over retail and the plan sponsor had no idea!

With this plan we have paltering, specifically equivocation, and pilfering with the unknown expense that is 721% over

retail. The equivocation lies in the name Vanguard being associated with low cost mutual funds, yet in this case it's the name of a sub-advised account within an expensive group annuity 401k product. Vanguard does not offer group annuity 401k products and I would welcome Jack Bogle's thoughts on the brand he built being used in this way.

IS THERE A LAW AGAINST PALTERING?

Of course there are laws against paltering! Of the regulators that one might reasonably believe would have laws against paltering, the Federal Trade Commission (FTC) seems to address paltering most accurately. The FTC is the nation's consumer protection agency whose mission is "to prevent business practices that are anticompetitive, deceptive, or unfair to consumers."¹¹ In its Policy Statement on Deception the FTC states that "The Commission will find an act or practice deceptive if there is a misrepresentation, omission, or other practice, that misleads the consumer acting reasonably in the circumstances, to the consumer's detriment." It goes on to address paltering specifically with "There may be a concern about the way a product or service is marketed, such as where inaccurate or incomplete information is provided."¹²

Within the FTC there's even a Division of Financial Practices which one would think would have taken action regarding the paltering marketing materials noted in the first part of this column. Unfortunately, the Division of Financial Practices only "promotes truthfulness and fairness in the provision of these services by entities within the FTC's jurisdiction" and Wall Street is outside of the FTC's jurisdiction.¹³

There are three other regulators that one might reasonably believe would have laws against paltering on Wall Street although not as specifically as the FTC. The Department of Labor (DOL), the Securities Exchange Commission (SEC), and the Financial Industry Regulatory Authority (FINRA).

The Department of Labor enforces the Employee Retirement Income Security Act (ERISA). ERISA § 408(b)(2) clearly prohibits pilfering retirement plan assets, but is less clear regarding the paltering rampant in the sale of retirement plans. The DOL has initiated the Fiduciary Service Provider Compensation Project. The purpose of this initiative is "to investigate the receipt of improper or undisclosed compensation by employee benefit plan consultants and other investment advisers."¹⁴

The Securities Exchange

Commission (SEC) enforces the Securities Exchange Act of 1933, sometimes known as the "Truth in Securities Act." Part of the Securities Exchange Act seems to address paltering when it prohibits the sales of securities by means "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . ."¹⁵

The Financial Industry Regulatory Authority (FINRA) seems to have the most rules that apply to paltering. FINRA's mission is to ensure that brokerage firms act ethically with their customers which include 401k plan sponsors. Former FINRA CEO and SEC Chairman Mary Shapiro summarizes all of FINRA's rules with "The foundational rule in FINRA's rather large rule book is an ethical one: that brokerage firms must conduct their business in accordance with "high standards of commercial honor and just and equitable principles of trade."¹⁶ Given such high-minded claims by its leadership, let's take a closer look at the Financial Industry Regulatory Authority.

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY

FINRA is the result of the 2006 merger between the National Association of Securities

Dealers and the enforcement arm of the New York Stock Exchange. Surprising to many is that FINRA is a private corporation, not a government agency like the Securities Exchange Commission or the Department of Labor. According to FINRA's website, it is "an independent, not-for-profit organization with a public mission: to protect America's investors by making sure the securities industry operates fairly and honestly." Echoing the words of Schapiro FINRA's Get to Know Us brochure states, "Our independent regulation plays a critical role in America's financial system—by enforcing high ethical standards, bringing the necessary resources and expertise to regulation and enhancing investor safeguards and market integrity—all at no cost to taxpayers."¹⁷ It's important to note that the reason that there is no cost to the tax-payer is that FINRA is paid by the brokerage firms it regulates.

This brochure also seems to address paltering with "Empowered by the federal government, we're here to protect American investors from fraud and bad practices." And unlike the FTC, FINRA explicitly protects 401k participants with: "We help employees save for—and protect—their futures. We work to make sure that investors steer clear of fraud and other problems that stand in the way of

financial security." FINRA describes its roles as "Every investor deserves fundamental protections when investing in the stock market. Whether Americans are investing in a 401(k) or other thrift, savings or employee benefit plan . . . FINRA works every day to ensure that: anyone who sells a securities product has been officially tested, qualified and licensed; every securities product advertisement used is truthful, and not misleading; any securities product promoted or sold to an investor is suitable for that investor's needs; and investors receive complete disclosure about the investment product before purchase."¹⁸

A specific FINRA rule pertinent to paltering is Rule 2210 which addresses communications between brokerage firms and their employees with the investing public. This rule mandates that communications with public must be based upon the principles of fair dealing and good faith, and must be fair and balanced. They must provide sound basis for evaluating the facts, and may not omit any material fact if omission would cause the communication to be misleading.

FINRA further prohibits false statements, promissory statements or claims, exaggerated statements, unwarranted statements, and misleading

statements. Regarding footnotes FINRA explains that they may not inhibit an investor's understanding of the communication. Therefore: information needed to balance benefits must appear prominently (e.g., risks, costs, caveats); and if such information is missed easily, there is a problem.¹⁹

It would certainly seem that this rule addresses all of the paltering found in the 401k marketing materials I've referenced in past columns which begs the question of why has FINRA approved these marketing pieces?

PUFFERY

For the second time in the past year or so the word puffery has been used to describe claims made by Wall Street firms. Puffery is defined by Merriam-Webster as "exaggerated commendation especially for promotional purposes."²⁰ Synonyms for puffery include hype, ballyhoo and publicity; however, in an article "'Puffery' in Advertising" Donald J. Boudreaux describes puffery as "harmless hyperbole" which "consists of promotional claims that no one out of diapers takes literally."²¹ A local restaurant claiming the best burgers in town might be harmless hyperbole, but what if we make important decisions based upon

the claims of a professional or of a professional organization?

In a *Business Week* article, *S&P's Outrageous, Clever Fraud Defense*, Paul M. Barrett notes that S&P has described itself as "the world's leading provider of independent opinions and analysis on the debt and equity markets," as well as "the world's foremost provider of independent credit ratings, indices, risk evaluation and investment research."²²

In a suit against the Standard & Poor's Ratings Services the US Department of Justice alleges that S&P fraudulently inflated ratings on toxic mortgage bonds in contradiction to its claims of independence and objectivity. S&P is defending itself by arguing that their claims of independence and objectivity are "promotional rhetoric" amounting to "classic puffery" which Barrett interprets has "Only a sap would believe the nice things we say about our work."²³

While S&P's puffery argument is a sad reflection on the organization, there is an even more despicable example to be found on Wall Street. Imagine a financial firm arguing that its own code of ethics or its business principles were puffery.

In *Wall Street Ethics Codes Make Me Want to Inhale*, Susan Antilla reports that during a

2010 Senate Permanent Subcommittee on Investigations hearing executives from Goldman Sachs explained that "Ethical standards were very important," and that "We care very much about ethics."²⁴

It appears that these statements about ethics were disingenuous at best. In a class action lawsuit Goldman Sachs is accused of making false claims—the false claims being the Goldman Sachs Business Principles, which include the following statements:

1. "Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow."²⁵

2. "We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard."²⁶

3. "Integrity and honesty are at the heart of our business."²⁷

The lawsuit argued that these claims were fraudulent because of Goldman's "repeated failures to disclose the entire mix of known material information" and "repeated false and misleading statements and omissions concerning its massive and fraudulent conflicts of interest with its clients."²⁸

Goldman Sachs argued "that the statements contained in its own "Business Principles" were "not actionable because they amount to vague statements of corporate mismanagement, puffery, and statements of opinion"²⁹ U.S. District Judge Paul Crotty commented, "If Goldman's claim of 'honesty' and 'integrity' are simple puffery, the world of finance may be in more trouble than we recognize."³⁰

It appears we might be in more trouble than we recognize. Michael Hausfeld is one of the attorneys involved with the Libor interest rate fixing class action and was quoted in *The Biggest Price-fixing Scandal Ever* saying: "It's now evident that there is a ubiquitous culture among the banks to collude and cheat their customers as many times as they can in as many forms as they can conceive," he said. "And that's not just surmising. This is just based upon what they've been caught at."³¹

Wall Street critic and author of the article Matt Taibbi believes that "The only reason this problem has not received the attention it deserves is because the scale of it is so enormous that ordinary people simply cannot see it. It's not just stealing by reaching a hand into your pocket and taking out money, but stealing in which banks can hit a few keystrokes and magi-

cally make whatever's in your pocket worth less. This is corruption at the molecular level of the economy, Space Age stealing—and it's only just coming into view."³²

Chuck Colson in *Why Ethics Matters: The SEC vs. Goldman Sachs* seems to point out our next step when he writes "When ethics fail in the commercial markets, more and more stringent regulations are certain to follow. It's the only way to assure the integrity of financial and commercial transactions."³³ However, what if the representations made by the private corporation that enforces the stringent regulations are puffery as well? This could explain why FINRA approved so many marketing pieces fraught with palters.

ARE FINRA'S CLAIMS PUFFERY?

Dale Ledbetter is an attorney with a 30 year career representing investors and fighting against the seamy underbelly of Wall Street. In his book co-authored with Connie Becker, *How Wall Street Rips You Off*, he provide real-life examples of how Wall Street palters and pilfers from the average investor; from titles used to mislead customers to excess fees in mutual funds and annuities.

Ledbetter implies puffery when he warns, "Do not take

seriously FINRA's claim to protect investors. FINRA is a trade association fueled, primarily, by the contributions of its members. FINRA never forgets its real mission, first and foremost, is to protect the interests of that membership."³⁴ Ledbetter and Becker also provide examples of how FINRA has its own "kangaroo court" for investors that take action against Wall Street firms.

Kangaroo court is not an overreaching description. William Galvin, the secretary of the Commonwealth of Massachusetts, echoes this when he said the mandatory arbitration system is "an industry sponsored damage-containment and control program masquerading as judicial proceeding."³⁵

Few legislators recognize that the fox is guarding the henhouse, in fact, in an August 2012 Wall Street Journal Op-ed Spencer Bachus of the House Financial Services has attempted to garner even more power for FINRA.³⁶ One congressman, Steve Cohen recognizes that "There is inherent conflict of interest in having a self-regulatory group that funds this agency and has always been on the side of broker dealers."³⁷

CONCLUSION

In an earlier column, *The Moral Hazard of Uninformed*

Consent, I concluded the medical community minimized the danger of moral hazard by enforcing a strong code of ethics and maintaining a fiduciary standard of care which puts the patient's interest first. Evidence abounds that Madoff Whistleblower Harry Markopolos was correct in his assessment that FINRA is a "very corrupt self-regulatory organization."³⁸ Furthermore, given the preponderance of paltering in 401k marketing materials, it appears that FINRA's claim that brokerage firms must conduct their business ethically and in accordance with "high standards of commercial honor and just and equitable principles of trade" is mere puffery.

So where does that leave us? Rich Flynn, co-creator of the 401k, observes that "the fact of life in today's deregulated financial services world is 'The more you screw things up, the more opportunities there are to make money behind the curtain!' The management of the investment industry, seeing itself in the role of the Wizard of Oz, repeatedly exclaims, 'Disregard that man behind the curtain!' But Toto keeps on pulling at the curtain."³⁹

So what are we to do? Until such time that our political leadership recognizes the inherent conflict of interest that Congressman Cohen does, I sug-

gest that all of us keep pulling on that curtain just like Toto!

NOTES:

¹ <http://www.forbes.com/sites/edwardsiedle/2010/10/07/401ks-americas-biggest-investment-fraud-was-foreseen-and-preventable/>.

² <http://www.cpsc.gov/en/About-CPSC/>.

³ http://www.401khelpcenter.com/401k/mcalmond_ethics.html#.Ua1C5ezD-P85.

⁴ While this example appears far-fetched, please see slide 28 of *The Wizard of Oz, Retirement Plans & You* presentation from the 2013 FI360 Conference at <http://www.prudentchampion.com/resources/articles-presentations/>.

⁵ <http://www.merriam-webster.com/dictionary/pilfer>.

⁶ <http://assets.aarp.org/rgcenter/econ/401k-fees-awareness-11.pdf>.

⁷ <http://www.gao.gov/products/GAO-12-325>.

⁸ <http://www.gao.gov/products/GAO-12-325>.

⁹ <http://www.gao.gov/products/GAO-12-325>.

¹⁰ <http://www.prudentchampion.com/wp-content/uploads/2012/12/Caveat-Emptor-for-401k-Plan-Sponsors-12-19-12.pdf>.

¹¹ <http://www.ftc.gov/ftc/about.shtm>.

¹² <http://www.ftc.gov/bcp/policystmt/ad-decept.htm>.

¹³ <http://www.ftc.gov/bcp/bcftp.shtm>.

¹⁴ http://www.dol.gov/ebsa/erisa_enforcement.html.

¹⁵ http://en.wikipedia.org/wiki/SEC_Rule_10b-5.

¹⁶ <http://www.finra.org/Newsroom/Speeches/Schapiro/P117298>.

¹⁷ <http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf>.

¹⁸ <http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf>.

¹⁹ Paraphrased from <http://www.finra.org/web/groups/industry/@ip/@edu/@mat/documents/education/p124627.pdf>.

²⁰ <http://www.merriam-webster.com/dictionary/puffery>.

²¹ http://mises.org/freemarket_detail.aspx?control=228.

²² <http://www.businessweek.com/articles/2013-04-23/s-and-ps-out-rageous-clever-fraud-defense>.

²³ <http://www.businessweek.com/articles/2013-04-23/s-and-ps-out-rageous-clever-fraud-defense>.

²⁴ <http://www.bloomberg.com/news/2010-05-04/wall-street-ethics-codes-make-me-want-to-inhale-susan-antilla.html>.

²⁵ <http://www.nylj.com/nylawyer/adgifs/decisions/062512plaintiff.pdf>.

²⁶ <http://www.nylj.com/nylawyer/adgifs/decisions/062512plaintiff.pdf>.

²⁷ <http://www.nylj.com/nylawyer/adgifs/decisions/062512plaintiff.pdf>.

²⁸ <http://www.nylj.com/nylawyer/adgifs/decisions/062512plaintiff.pdf>.

²⁹ <http://www.nylj.com/nylawyer/adgifs/decisions/062512plaintiff.pdf>.

³⁰ <http://nymag.com/daily/intel/>

[2012/06/judge-calls-goldman-sachs-orwellian.html](http://www.rollingstone.com/politics/news/everything-is-rigged-the-biggest-financial-scandal-yet-20130425?page=3).

³¹ <http://www.rollingstone.com/politics/news/everything-is-rigged-the-biggest-financial-scandal-yet-20130425?page=3>.

³² <http://www.rollingstone.com/politics/news/everything-is-rigged-the-biggest-financial-scandal-yet-20130425?page=3>.

³³ <http://www.texasinsider.org/?p=26099>.

³⁴ *How Wall Street Rips You Off* by Dale Ledbetter and Connie Becker, 2012.

³⁵ <http://financialservices.house.gov/media/pdf/031705wfg.pdf>.

³⁶ <http://www.riabiz.com/a/15013280/why-bachus-sro-that-must-not-be-named-would-prove-a-tyrant-to-rias>.

³⁷ <http://www.asensio.com/www/?p=1375>.

³⁸ <http://www.businessinsider.com/2009/2/madoff-whistleblower-markopolos-speaks>.

³⁹ Email exchange between Richard Flynn and the author, 1/08.2013. Flynn co-invented the 401k: Using a prototype plan document from Ted Benna as a point of departure, Richard 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 Company.