JOURNAL *of* COMPENSATION *and* BENEFITS

November/ December 2020 Vol. 36/No. 6

Mat #42583099

The Wizard of Oz, Retirement Plans and You

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Retirement plan sponsors are subject to both legal and ethical obligations. We are all familiar with the basis of the legal obligations such as the Employee Retirement Income Security Act of 1974 (ERISA) and the Uniformed Prudent Investor Act, and many have heard that the courts have described the fiduciary obligations of plan sponsors as the "highest known to the law." Some might be less familiar with why retirement plan sponsors have ethical obligations. Without getting bogged down in ethical theory, it is a simple matter of trust. Plan sponsors have been given the responsibility, or entrusted, to provide their employees with a reasonable opportunity to achieve a secure retirement income. This article reviews the differences between legal and ethical obligations, and provides a path for the ethical plan sponsor.

Not long ago while watching the *Wizard of Oz* I had an epiphany; the Wizard was a 401(k) salesman! Unfortunately, this is not a joke. There really are similarities between the Wizard of Oz and how many 401(k) products are sold in America today. There are two similarities I would like to discuss in this column: Professor Marvel's magic elixir, and the great and powerful Oz.

Just as Professor Marvel claims that his magic elixir cures what ails you, some claims used to sell 401(k) products are just as worthless in providing you fiduciary protection. And, just as Dorothy and friends believed that they could rely on the Wizard to get back home, many retirement plan sponsors believe they can rely on their 401(k) service providers to help them fulfill their fiduciary duties. Like the Wizard who used elaborate props to make himself appear great and powerful, some retirement plan providers would also like you to "Pay no attention to that man behind the curtain."

LEGAL OBLIGATIONS VS. ETHICAL OBLIGATIONS

Retirement plan sponsors are subject to both legal and ethical obligations. We are all familiar with the basis of the legal obligations such as ERISA and the Uniformed Prudent Investor Act. And many have heard that the courts have described the fiduciary obligations of plan sponsors as the "highest known to the law."[1]

Some might be less familiar with why retirement plan sponsors have ethical obligations. Without getting bogged down in ethical theory, it is a simple matter of trust. Plan sponsors

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have been given the responsibility, or entrusted, to provide their employees with a reasonable opportunity to achieve a secure retirement income.

Even brokers or salespeople, who are usually not considered to be fiduciaries, have been subject to ERISA where the "broker knows, or should have known, that trust has been placed in that broker."[2]

Sarah Peck, author of *Investment Ethics*, notes "Because you are dealing with others' money either directly or indirectly, ***you have an obligation not to abuse the trust*** that others have either explicitly or implicitly placed in you to treat them fairly."

You might be thinking "I would never abuse the trust someone has put in me," but let us ensure we are considering the complete meaning of "ethical obligation." Unethical behavior is often described as "doing something wrong;" however, failure to do something right can also be deemed unethical. Consider the West Point Honor Code, or in civilian terms, code of ethics: A Cadet will not lie, cheat, steal, nor tolerate those who do. Most would agree that lying, cheating or stealing are unethical acts. In ethical terms, we call this a "negative obligation."

It is the last clause, "nor tolerate those who do," that generates the most discussion at West Point. In ethical terms this clause is known as an "affirmative obligation." If a cadet fails to take action in a situation where he or she is aware of another cadet lying, cheating or stealing, that cadet has also violated the Honor Code. Some might be familiar with this concept as a "sin of omission."

Ethically speaking, affirmative obligations are much more challenging than negative obligations. With negative obligations I need only control my own actions. Affirmative obligations, however, obligate me to do something regarding the actions of others. This ought to be of particular interest to members of the American Society of Pension Professionals & Actuaries (ASPPA).

Similar to the West Point Honor Code, the ASPPA Code of Conduct contains an affirmative obligation stating, "If the member is aware of any significant conflict between the interests of a principal and the interests of another party, the member should advise the principal of the conflict . . ." We will explore this particular obligation in a future column.

When retirement plan sponsors fail to fulfill their affirmative obligations as fiduciaries they are inhibiting their employee's opportunity for secure retirement income with which they have been entrusted. ERISA attorney Fred Reish echoed these affirmative obligations with "Fiduciaries are not sued for what they do, instead they are sued for what they do not do."[3]

Legal Obligations

The most common cause of fiduciary breach lawsuits is excessive fees and expenses. While we are going to focus on the ethical issues, we need to note a few key parts of ERISA first:

- ERISA § 404(a)(1)(A) mandates that a fiduciary *shall* defray reasonable expenses.
- ERISA § 408(b)(2) mandates that unless a fiduciary complies with the following three criteria he/she has committed a prohibited transaction, a mortal sin for fiduciaries:
    1. The services must be ***necessary*** for the operation of the plan;
    2. The services must be furnished under a ***contract or arrangement which is reasonable*** and;
    3. No more than ***reasonable compensa-***

tion is paid for the service.

- DOL Reg. § 2509.95-1(c)(6) states that if a fiduciary does not possess the necessary expertise to evaluate such factors, he/she would need to obtain the advice of a qualified, independent expert.

In order to appreciate some of the ethical issues ahead there two other important legal points to note. The first is ERISA § 409, which mandates that a fiduciary can be held personally liable for any losses the plan incurs by reason of its breach. To be clear, excessive plan fees or expenses are considered a loss to the plan. In addition to ERISA § 409, plan sponsors ought to know that a prohibited transaction also constitutes a violation of Internal Revenue Code § 4975, and even a criminal violation of U.S. Code, Title 18, § 1954.

Ethical Obligations

While prohibited transactions and fiduciary breaches may carry significant legal penalties, our focus is on ethical issues which are just as harmful. Mary Shapiro, Commissioner of the Securities and Exchange Commission (SEC) has said "ethical misconduct doesn't need to reach criminal levels in order to harm investors. What we often see is a culture of neglect or rationalization, where the pursuit of profit obscures a sense of any moral obligation to the investor."[4]

How do the legal obligations above translate into ethical obligations? 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 (DOL), 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%![5]

No one questions that service providers deserve to get paid for their work, and obviously retirement plans cost money to operate. If the reasonable cost for a given retirement plan considering the services provided is 1%, than the example above presents no legal or ethical issue. However, many retirement plan products charge excess and unnecessary expenses which are not reasonable relative to the services provided.

If a plan sponsor fails to discover and evaluate all of the fees and expenses in the retirement plan product they choose for their employees, then potentially the plan sponsor has abused the trust of those employees by negligently permitting 28% of their retirement nest egg to be pilfered away.

PROFESSOR MARVEL AND THE WIZARD OF OZ

The point of this column is not so much the ethical obligations of plan sponsors, as it is the challenges plan sponsors face in fulfilling these ethical obligations. Most plan sponsors recognize their legal and ethical duties and more often than not they rely on the advice of service providers to fulfill these duties. However, some of these service providers, like the Wizard, represent themselves as qualified, experts capable of assisting the plan sponsor to the land of fiduciary fulfillment—until you look behind the curtain!

While plan sponsors have fiduciary responsibilities, most retirement plan service providers are brokers or registered representatives subject to the much lower suitability standard. To understand the significant difference between a plan sponsor's fiduciary standard and a broker's suitability standard, we can look to Hippocrates who obligated physicians to help the sick, or at least do no harm. Notice both the negative and affirmative obligations here. These two obligations are explained in the ethical principles of non-maleficence and beneficence.

The principle of beneficence is an affirmative obligation and literally means "do good." The ethical maxim of this principle is "One ought to act in ways that promote the well-being of others." This compares to the fiduciary standard which is an affirmative obligation to do what is in the best interest of one's client.

The principle of non-maleficence is a negative obligation and literally means "do no harm." The ethical maxim of this principle is "One ought to act in ways that do not cause harm to others." In bio-medical ethics this principle includes the negative obligation not to do harm inadvertently or by carelessness, or malice or negligence.

According to FINRA's Suitability Rule, a broker must have a reasonable basis to believe that a recommended investment is suitable given the client's objectives. To be clear, suitable equates to "good enough" but certainly not in the client's best interests. As an example, both of the following investment options are suitable: one pays a minimal commission, but will be much more effective in reaching the client's objectives; and another pays a high commission, but is just good enough to reach the client's objectives. The suitability standard is akin to the Lemon Law for cars. Regardless of how expensive, or how protracted or how uncomfortable the trip, so long as the vehicle runs, it is suitable.

The Great and Powerful Oz

If you were under the impression that your service provider's advice was in your best interests because "advisor" or "consultant" was in his or her title, you are not alone. A 2010 survey by ORC/Infogroup found that 76% of U.S. investors wrongly believed that "financial advisors" are held to a fiduciary standard.[6] Financial advisor or financial consultant is typically the title given to the sales force of broker-dealers like Merrill Lynch and Morgan Stanley.

To be clear, investors are not responsible for this misunderstanding; broker-dealers and their employees are governed by the Securities Exchange Act of 1934 which mandates only the suitability standard. It should surprise you that the titles "financial consultant" and "financial advisor" are not found in this Act. In the Act we find the titles stockbroker or registered representative, both of which rightly imply salesperson. In a recent *New York Times* article, Rutgers Professor Arthur Laby commented on these misleading titles with, "The greatest risk the average investor runs is the risk of being misled into thinking that the broker is acting in the best interest of the client, as opposed to acting in the firm's interest."[7] Unfortunately, plan sponsors face the same risk when working with many retirement plan service providers.

Most 401(k) service providers have no fiduciary obligation, and typically deny any fiduciary status in the fine print of their contracts. However, in the larger print of retirement plan marketing materials there is rarely a clear denial of their fiduciary status. For example, you might find language sympathetic to your fiduciary concerns such as "For many plan sponsors, investment and other fiduciary responsibilities can seem overwhelming. That's where we can help."[8] It goes on to say that this service provider "is committed to putting our resources and experience to work for your retirement plan." A second piece entitled "The Fiduciary Duty to get help" essentially says, if you hire us, "you will have gone a long way, and perhaps all of the way, to satisfy ERISA's fiduciary standards . . ."[9]

While we can describe the Wizard's misrepresentations as harmless puffery of a fictional character, misrepresentations of retirement plan salespeople can be quite dangerous to real plan sponsors. Recall ERISA § 409 which mandates that a fiduciary can be held personally liable for excessive fees and expenses. Plan sponsors can be held personally liable because there is no corporate veil when it comes to fiduciary responsibility.

Pay No Attention to that Man Behind the Curtain

What is behind the curtain? In many cases we find what former SEC Chairman Christopher Cox describes as a "witch's brew of hidden fees, conflicts of interest" which are "at odds with investors' best interests."[10] According to Alison Borland, Retirement Strategy Leader at Hewitt Associates, LLC., these fees "are eating up thousands of dollars of employees' retirement savings without them even knowing it."[11]

One of the best examples to understand this witch's brew is to examine Vanguard funds when they are found within certain group annuity 401(k) products which are offered by some insurance companies. Vanguard has a well-respected reputation for low-cost, quality mutual funds, and generally, expenses are not an issue with Vanguard funds or a Vanguard 401(k) product. However, in some 401(k) products you might find, for example, the "XYZ/Vanguard S&P 500 fund." While the plan sponsors might think they have chosen the Vanguard S&P 500 mutual fund for their investment menu, in the mouse-print of their contract they might discover they have actually chosen what is called a "sub-advised account" and not the actual Vanguard S&P 500 mutual fund.

The Vanguard S&P 500 fund (VFINX) has an expense ratio of 0.18%. However, in one plan I have reviewed, the expense ratio of the "XYZ/Vanguard S&P 500 fund" was 0.53%—almost 300% over retail. On top of this the participants were paying an additional 0.50% wrap fee, making the total cost nearly 600% over retail. Unfortunately, the plan sponsor heard "Vanguard," and mistakenly thought he had chosen a low-cost 401(k) product.

Who Is the Man Behind the Curtain?

Let me begin this section by noting that the man I am referring to is nearly always a company, and not the individual advisor you know. Individual advisors are rarely aware of these issues, and it was not until I sought outside fiduciary training did I realize the games being played in the 401(k) arena. Under ERISA, plan sponsors are permitted to delegate nearly all of their fiduciary responsibility, and therefore nearly all of their potential fiduciary liability, to ERISA § 3(21) fiduciaries and/or ERISA § 3(38) investment managers. However, sometimes the man behind the curtain is a phantom fiduciary. The most common phantom fiduciary is an ERISA § 3(21)(a)(ii) fiduciary or a "limited-scope 3(21)." The "(a)(ii)" is critical here! While a "full-scope 3(21)" can truly protect plan sponsors by assuming responsibility and decision-making authority, a limited-scope or 3(21)(a)(ii) assumes no true responsibility, and therefore, provides no protection from fiduciary liability.

Phantom fiduciaries talk like fiduciaries and even walk like fiduciaries, but in the fine print of their contract they eviscerate any true fiduciary responsibility. One of the more insidious examples is a company that provided a warranty in writing stating that it "satisfies the criteria in Section 3(38) of ERISA to be an investment manager." An important note here is that ERISA § 3(38) investment managers are responsible for all of a plan's investment decisions. Reasonable fees are an inherent consideration in making these investment decisions.

However, under additional

conditions and limitations we find verbiage eviscerating any true fiduciary responsibility. It states that the warranty does not "cover any claim or loss resulting from, or in any manner related to, the fees and expenses, direct or indirect, of the investments or of the Program. This includes, for example (but is not limited to), any expenses charged to or by any mutual funds, or plan providers or advisers."

While it is common to find examples of service providers claiming ERISA § 3(21)(a)(ii) status, this was the first time I encountered a phantom 3(38) so I contacted the company asking, "how can you claim to be qualified as an ERISA § 3(38) fiduciary, yet not take fiduciary responsibility regarding reasonable fees?" Their response was essentially that they could limit their warranty anyway they chose. My second question was, "if you are clearly stating that you are qualified as an ERISA § 3(38) investment manager, will the DOL care about the limitations in your warranty?" That ended the conversation; however, according to their website this warranty is still available.

Professor Marvel's Magic Elixir

While I have only investigated one phantom 3(38) fiduciary, a number of 401(k) service providers offer a more general "fiduciary warranty." The Professor with his elixir has been described as a charlatan. A charlatan is someone who knowingly hawks worthless nostrums, such as the magic elixir, that will not deliver on the representations he has made. Professor Marvel's magic elixir is no different than a phantom fiduciary's fiduciary warranty. Imagine the professor as a 401(k) salesman hawking a fiduciary warranty saying:

> *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 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!*[12]

So what is a reasonable person likely to infer from a fiduciary warranty at this point? A big name company is their name behind their funds, their funds are prudent under ERISA, and they're even putting their money where their mouth is!

Unfortunately, in the mouse-print we find a caveat (as in caveat emptor) that contradicts everything the Professor said; this Fiduciary Warranty does not *"extend to claims that any expenses paid directly or indirectly by the Plan are reasonable."*[13] These fiduciary warranties are usually offered in group annuity 401(k) products like the one mentioned earlier where the Vanguard fund cost 600% over retail.

DO WE REALLY WANT TO GO BACK TO KANSAS?

While far from perfect, the 401(k) is the primary means by which most Americans will have some chance to achieve retirement income security, and they are trusting their employers to provide this chance. Although it might seem as if offering a retirement plan to employees is just too much work or creates too much risk, remember the words of ethicist Michael Josephson who wrote, "Ethics is all about how we meet the challenge of doing the right thing when the act will cost more than we want to pay."[14]

NOTES:

[1]Donovan v. Bierwirth, 680 F.2d 263, 272, 3 Employee Benefits Cas. (BNA) 1417, 64 A.L.R. Fed. 580 (2d Cir. 1982).

[2]Gouger v. Bear, Stearns & Co., Inc., 823 F. Supp. 282, 288, Fed. Sec. L. Rep. (CCH) P 97639 (E.D. Pa. 1993).

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

[4]Shapiro, Ethics and Leadership Lecture, "The Road Ahead in Regulation," Dominican University, 10/14/08.

[5] http://www.dol.gov/ebsa/publications/401(k)_employee.html.

[6] http://www.fpanet.org/docs/assets/3FE57198-1D09-67A1-ACB5B3E363E33CB2/091510FiduciarysurveynewsreleaseFINAL4.pdf.

[7] http://www.nytimes.com/2012/07/07/your-money/beware-of-fancy-financial-adviser-titles.html?_r=1.

[8]Page 3 of "The Services Available to Your 401(k) Plan," http://fa.morganstanleyindividual.com/public/facilityfiles/MSSBAAAAAABEX9/94078073-acd6-4eb3-be2a-d102ae7c1c85.pdf.

[9]Page 3 of "The Fiduciary Duty to Get Help," http://fa.smithbarney.com/public/projectfiles/d141fd54-cf0f-43bc-ae17-342d580b1918.pdf.

[10]Quoted in "Over Time, Hidden Fees Snatch Big Percentages From 401(k)s," http://www.washingtonpost.com/wp-dyn/content/article/2008/02/01/AR2008020103900.html.

[11]Quoted in "High 401(k) plan fees continue to deplete retirement savings balances," http://www.accountingweb.com/topic/accounting-auditing/high-401(k)-plan-fees-continue-deplete-retirement-savings-balances.

[12] https://www.ps.jhancockpensions.com/assets/pdfs/PS9615-9615.pdf.

[13] http://www.docstoc.com/docs/70935394/Fiduciary-Warranty-Certificate.

[14] http://charactercounts.org/michael/2011/01/.