May 2014 Vol. 32, No. 3

ILLINOIS STATE BAR ASSOCIATION

EMPLOYEE BENEFITS

The newsletter of the Illinois State Bar Association's Section on Employee Benefits

New rules, continued non-compliance: Protecting business owners and plan participants in the changing 401k plan climate

By Kurt Winiecki

In November 2012, a federal judge awarded $12 million in attorney fees in a civil case in which 401k plan fiduciaries breached their fiduciary duties to the plan participants. *Tussey v. ABB, Inc.*, No. 2:06-cv-04305-NKL (W.D. Mo. Nov. 2, 2012). Those fees were added to the $35 million previously awarded in damages against the 401k plan fiduciaries to replenish the retirement accounts of employees participating in the plan. *Tussey v. ABB, Inc.*, No. 2:06-cv-04305-NKL, 2010 U.S. Dist. LEXIS 45240 (W.D. Mo. Mar. 31, 2012). The responsibility of offering a 401k plan is serious business. Many business owners, law firms, general counsels and employees tasked with administering 401k plans misunderstand their legal duties if they recognize them at all.

Attorneys are in a unique position to help business owners and 401k plan fiduciaries better protect plan participants and themselves. Attorneys can help their clients avoid audits, fines, suits, damage awards, attorney fees and personal liability stemming from noncompliance with 401k plan laws. Many business owners likely expect such advice from their general counsel. Others mistakenly believe that hiring a sales company somehow relieves them of their fiduciary duties. Others simply never understood the extent and complexity of ERISA, including that plan fiduciaries can be *personally liable* for imprudent plan decisions. Attorneys who counsel business owners with 401k plans should be familiar enough with the new 401k rules to spot compliance issues and help business owners and plan fiduciaries reduce their risks.

This article describes common non-compliance issues related to 401k plans, including new fee disclosure rules that are often ignored.

Background

The Employee Retirement Income Security Act of 1974 ("ERISA") is the federal statute that governs 401k plans and its administrators. *See* 29 U.S.C. § 1001 *et seq.* It was originally intended as a consumer protection bill. *Tussey v. ABB, Inc.*, No. 2:06-cv-04305-NKL, 2010 U.S. Dist. LEXIS 45240, p. 6 (W.D. Mo. Mar. 31, 2012). The U.S. Department of Labor ("DOL") is a federal agency tasked with enforcing ERISA. Part of the DOL's mission is to safeguard the welfare of retirees. Office of the Secretary, United States Department of Labor, *Our Mission*, <http://www.dol.gov/opa/aboutdol/mission.htm>.

Contrary to popular belief, employees who participate in a 401k plan typically pay for much, if not all, of a 401k plan's expenses. Accordingly, ERISA forbids the paying of unreasonable fees and thus requires plan sponsors to understand the services rendered and their costs. *See* 29 USC 1104(a)(1)(A)(ii). For years, however, many 401k plan service providers such as third party administrators, recordkeepers, custodians, non-fiduciary "financial advisors" and fiduciary investment advisors provided little helpful information about their services and costs. Confusing and misleading disclosures often hid high fees and poor investment performance. The lack of understandable information made it difficult for 401k plan fiduciaries to assess services and fees, which often harmed employees participating in the plan.

As a result, the DOL recently enacted new rules that help 401k plan sponsors fulfill their duty to assess the reasonableness of fees. *See* 29 C.F.R. § 2550.408b-2. The new DOL rules highlight a trend toward greater scrutiny of 401k plan services, fees and responsibilities. Because plan fiduciaries can be held *personally liable* for breaching their duties (*see* 29 USC § 1109(a)), it is important for plan fiduciaries to understand their responsibilities inside and out. Unfortunately, many business owners know little about how to fulfill their duties and often mistakenly rely on service providers to fulfill those duties. Worse yet, those responsibilities are imposed on unwitting employees with zero knowledge of ERISA or their personal risks.

The 401k Plan Fiduciary Framework

Sometimes referred to as the "highest duty known in the law," a fiduciary has a legal duty to act in someone else's interest at all times. *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982). Because employees pay much (if not all) of a 401k plan's expenses, those who run a 401k plan are held to a fiduciary duty to always act in the best interests of plan participants.

A plan must have at least one named fiduciary, but other important plan decision-makers are fiduciaries, too. "Using discretion in administering and managing a plan or controlling the plan's assets makes that person a fiduciary to the extent of that discretion

or control." Plan fiduciaries typically include the employer trustees, fiduciary investment advisors, individuals exercising discretion in administering the plan, members of the administrative committee and those who choose the committee. *See* Employee Benefits Security Administration, *Meeting Your Fiduciary Responsibilities*, p. 1 (February 2012) <http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html#.UJwIQYbhffo>.

The DOL provides a framework for meeting fiduciary duties. Responsibilities of plan fiduciaries include:

- Acting solely in the best interest of plan participants (*see* 29 U.S.C. § 1104(a)(1)(A)(i));
- Paying only reasonable plan expenses. (*see* 29 U.S.C. § 1104(a)(1)(A)(ii));
- Carrying out their duties prudently (*see* 29 U.S.C. § 1104(a)(1)(B));
- Diversifying plan investments (*see* 29 U.S.C. § 1104(a)(1)(C)); and
- Following the plan documents (*see* 29 U.S.C. § 1104(a)(1)(D)).

Importantly, "[t]he duty to act prudently is one of a fiduciary's central responsibilities under ERISA." *Meeting Your Fiduciary Responsibilities*, p. 2. Because outcomes cannot be predicted, prudent decision-making focuses on a prudent *process* rather than a favorable outcome. "One way fiduciaries can demonstrate that they have carried out their responsibilities properly is by documenting the processes used to carry out their fiduciary responsibilities." *Meeting Your Fiduciary Responsibilities*, p. 2.

Accordingly, the decision-making framework for plan fiduciaries is to:

- *Understand* their fiduciary duties;
- Develop and implement a process for making *prudent* decisions; and
- *Document* the processes used and the decisions made.

Non-Compliance Risks

Despite clear statutory responsibilities, administrative rules and loads of helpful compliance information provided by the DOL, plan fiduciaries often ignore their responsibilities.

First, plan fiduciaries often fail to recognize they are fiduciaries. Business owners, CFOs, Human Resource Directors and even general counsel may understand their jobs, but may not be ERISA scholars. They may unknowingly be fiduciaries. Since unknowing fiduciaries are unlikely to be complying with all of ERISA's requirements, this is a legal gap that puts employees and plan fiduciaries at risk.

A trap often awaits plan fiduciaries who wrongly assume other plan service providers are meeting ERISA's requirements. Despite what the service provider may imply during or after the sales process, upon examination of a service provider's legal relationship to the plan, it often becomes clear that the plan fiduciaries are solely and 100% legally responsible for all plan decisions. This misplaced reliance can result in failure to meet the most straightforward of requirements.

Significantly, law firms are not immune to ERISA's complexities. Many firms delegate ERISA duties to a managing partner or Human Resources director who has little familiarity (if any) with the federal statute. Smaller businesses, including law firms, often fail to understand the difference between using plan funds for investment and a loan to the owner. These situations can lead to prohibited transactions and liability for the decision-makers.

Finally, even when fiduciaries understand they are responsible for complying with ERISA, they often fail to do so for a variety of reasons.

New Fee Disclosure Rules

Many plan fiduciaries may simply be unaware of current rules, especially the new DOL rules regarding fee analysis. July 1, 2012 was the deadline for each plan service provider to provide the plan sponsor a fee disclosure statement pursuant to ERISA (a "Fee Disclosure"). Employee Benefits Security Administration, United States Department of Labor, *Final Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans* (February 2012) <http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html>. Importantly, it is the plan sponsor's duty to obtain Fee Disclosures from each service provider. If the plan sponsor fails to obtain the Fee Disclosure, it must notify the DOL and indicate whether that relationship was terminated or not. Also under the new rules, plan sponsors must provide plan participants certain fee and plan information on a regular basis.

Simply possessing the Fee Disclosures is not enough of course. A plan sponsor must also read, analyze and determine whether the fees for each service provided are reasonable as paying unreasonable fees has always violated ERISA. *See* 29 U.S.C. § 1104(a)(1)(A)(ii)). To help assess whether a fee is reasonable, the DOL suggests that when choosing a service provider, "a fiduciary may want to survey a number of potential providers" and compare them across the same requirements." *Meeting Your Fiduciary Responsibilities*, p. 2. Another way of assessing reasonableness, often suggested by ERISA attorneys and other financial professionals, is to compare the current fees to an industry standard. This is called "benchmarking" the fees. To benchmark fees, the plan sponsor obtains a comparison report of the current services and fees with the services and fees paid in the same industry and with similar plans. Both methods appear to provide an objective way of determining fee reasonableness.

Even with the new rules and suggested Fee Disclosure format, reports and fees remain confusing. Fee Disclosures can be dozens of pages long, include irrelevant information and be buried in other documents (like service contracts). Revenue-sharing remains a source of confusion. Revenue sharing occurs when a mutual fund shares a portion of its expense ratio (the fee the mutual fund collects for participants owning that fund) with other service providers. Accordingly, even with clear and accurate Fee Disclosures, plan sponsors often need help determining what they are getting, how much they are paying and what is reasonable.

Investment Responsibilities and Non-Compliance

When it comes to investment decisions, the DOL recommends that plan sponsors hire help if they aren't investment advisors themselves: "Lacking [investment] expertise, a fiduciary will want to hire someone with that professional knowledge to carry out the investment [function]." *Meeting Your Fiduciary Responsibilities*, p. 2. The first question is whether a plan sponsor should hire a fiduciary or not. While the DOL is silent on this subject as to plan sponsors, it provides some guidance as to possible best practices.

When discussing whether *individuals* themselves should hire fiduciary investment advisors, the DOL answers with a resounding YES. In its Fiduciary Fact Sheet, the DOL states that who you pay for investment advice is a "crucial decision." The DOL then flat out states, "You want to make sure that the advisor you select is working in your best interest . . . ." Employee Benefits Security Administration, United States Department

of Labor, *How to Tell Whether Your Adviser is Working in Your Best Interest: A Fiduciary Guide for Individual Consumers*, <http://www.dol.gov/ebsa/newsroom/fsfiduciaryoutreach-consumers.html>. While this DOL advice is aimed directly at individual investors paying for investment advice, it is likely good advice for fiduciary plan sponsors who hire advisors (or not) for their employees as well.

A recent consumer advocacy survey indicates that individual investors prefer fiduciary advice as well. The survey, conducted by the Consumer Federation of America, AARP and several other non-profit consumer advocacy groups, found that 97 percent of investors believe that "When you receive investment advice from a financial professional, the person providing the advice should put your interests ahead of theirs and should have to tell you upfront about any fees and commissions they earn and any conflicts of interest that potentially could influence that advice." Despite the DOL and investors being virtually unanimous about the "right" way to provide investment advice, "76 percent of investors are wrong in believing that 'financial advisors' – a term used by brokerage firms to describe their salespeople – are held to a fiduciary duty." Letter from Barbara Roper, Director of Investor Protection for the Consumer Federation of America (and others) to Mary Schapiro, Chairman of the Securities and Exchange Commission, first page of support following letter (Sept. 15, 2010). <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CC4QFjAA&url=http%3A%2F%2Fwww.sec.gov%2Fcomments%2F4-606%2F4606-2748.pdf&ei=0UB9UaabOce42QWepIDoBw&usg=AFQjCNF7gkVnhR2NllplUNwaIqAJDyg4wA&bvm=bv.45645796,d.b2I>. This confusion extends beyond individual investors and into the 401k plan "advice" industry. Plan sponsors must understand the difference between salespeople and companies hocking their own product and investment advisors who provide fiduciary investment advice. Without this understanding, an appropriate, "prudent" decision is difficult.

Hiring an advisor with fiduciary duties consistent with what nearly all individual investors want and expect is likely a prudent decision. However, neither the DOL nor ERISA dictates who a 401k plan sponsor must hire. Indeed, a 401k plan sponsor need not hire any advisor at all. What is required, though, is that the choice be prudent. Advisors fall into two main groups: non-fiduciary salespeople and fiduciary investment advisors.

Hiring a "Financial Advisor" salesperson

"Financial advisors" employed by Wall Street firms, banks and insurance companies are typically salespeople who are held to a "suitability" standard rather than a fiduciary standard. In fact, a "financial advisor" can recommend the *least suitable* of all suitable investment options. A Wall Street firm, bank or insurance company "financial advisor" can recommend investments based solely on the amount of compensation the "advisor" receives. Such biased "help" can steer a plan sponsor to choose that firm's own product or other proprietary product.

For example, a 401k plan hires a bank to help with the investment duties. Through expense ratios (the ongoing fees charged by the management teams of mutual funds and other products), the bank can reap heavy profits if plan participants invest in the bank's own products. Accordingly, the bank's "financial advisor" is incentivized to use the bank's products over other company products. Rather than acting as a fiduciary and using a methodology for choosing the "best" product for each investment asset class, the "advisor" chooses the bank's own funds whenever possible. Because the "advisor" is incentivized to sell the bank's own product, choices are made based on the advisor's compensation, not on the quality of the funds. Choosing funds on this basis requires no monitoring and fulfills *no* fiduciary function. If an investment policy exists, the bank's method of constructing an investment menu can violate it. Importantly, through default investment options and education that steers investors toward certain funds, the majority of a plan's assets can end up in the bank's products even if the fund bank places a minority of products in the lineup.

Fund companies suffer the same bias. Not only do fund companies sell their own product, they often do so exclusively. For example, every single fund in a fund company's investment menus can be the company's own product. While this may reduce certain costs, fiduciary plan sponsors must examine factors beyond just cost when choosing the best investment options for plan participants.

Insurance companies are the third type of sales organization on which plan sponsors often rely for investment services. Insurance companies often have a significantly limited product base compared to other platforms. Insurance companies are often more expensive than other providers, and again, the responsibility of investment choices fall squarely and solely on the plan fiduciaries. One Fee Disclosure recently reviewed by our firm stated that if the insurance company "financial advisor" sold enough of a certain insurance product to 401k plans, the advisor could be rewarded with a trip worth up to $20,000.

Finally, Wall Street "financial advisors" are not fiduciaries either. They can use their own products and are often highly incentivized to sell other companies' products.

Because a "financial advisor" at a bank, fund company, insurance company or Wall Street firm are not fiduciaries, plan sponsors remain solely and 100% responsible for each and every investment choice offered to plan participants. Hiring "financial advisors" can result in misplaced reliance on a salesperson, biased investment choices, lack of a prudent process for selecting investments in the best interests of plan participants and heightened legal exposure. Moreover, if a plan sponsor is paying thousands of dollars annually to an advisor it hasn't seen in years, the advisor cannot be adding value to plan participants, and paying such a salesperson is not likely reasonable. Trusted attorneys may be in the best position to initiate a review of an advisor's duty (or lack thereof) to the plan and the value the advisor brings to plan participants.

Hiring a Fiduciary Advisor

On the other hand, a plan sponsor can choose an Investment Advisor to help make investment decisions. "Investment Advisors" are fiduciaries. Fiduciary "investment advisors" can accept one of two levels of fiduciary responsibility: co-fiduciary and full fiduciary.

Some Investment Advisors become *co-fiduciaries* with the plan sponsor, in which case the Investment Advisor and plan fiduciaries share the responsibility for making investment decisions. *See* 29 U.S.C. § 1002(21). In these instances, the plan sponsor retains full responsibility for each of the investment decisions, but the investment advisor is also fully responsible for the investment decisions. A co-fiduciary investment advisor typically develops, uses and documents the investment process and prudent investment choices. Initial investment decisions and monitoring reports would be forwarded

to the plan sponsor for review and approval. Significantly, a plan sponsor not only retains full responsibility for the investment decisions, but must also establish and document a process for regularly evaluating the *investment advisor* as a service provider.

Investment Advisors can also take entire decision-making responsibility off a plan sponsor's table. *See* 29 U.S.C. § 1002(38). When hiring a "full fiduciary," the plan sponsor is relieved of all decision-making pertaining to investments: that responsibility falls 100% on the "full fiduciary" investment advisor's shoulders. Importantly, the only responsibility that is delegated is that of the investment choices. The plan sponsor must always establish and document process for all other fiduciary decisions, including the regular evaluation of the investment advisor as a service provider.

Unfortunately, a situation where a service provider uses the term "fiduciary" can be confusing to a plan sponsor. Plan sponsors often assume many (if not all) of their ERISA duties are transferred to "fiduciary" service providers. Such is not the case, and such misunderstandings are opportunities for corporate counsel to educate and protect their business clients.

One final note on fiduciary advisors: sometimes fiduciaries do not act as fiduciaries. Sometimes, deep in the document called the firm "Brochure" or "ADV Part 2" one may find un-fiduciary practices. For example, an ADV Part 2 may disclose that the advisor may be compensated (and thus be heavily incentivized) to insert certain products (including their own firm's products) in the plan. Disclosing conflicts of interest is significantly different than avoiding conflicts or resolving them in the best interest of the client. Plan sponsors want to examine advisors who work for a company that sells its own product with heightened scrutiny.

Understanding the differences between non-fiduciary and fiduciary advisors is a big step toward hiring the best advisor for the plan participants. What justification exists for choosing a salesperson who can recommend merely suitable products over a fiduciary advisor who is legally required to act in the plan participants' best interests and is accountable and liable for those investment decisions? Whatever justification exists, that decision-making process should be well documented to record its prudence.

Conclusion

Trusted attorneys are in a unique position to help protect their corporate clients by understanding the basics of ERISA. Corporate counsel can teach their clients the difference between non-fiduciary salespeople and fiduciary investment advisors, the perils of relying on companies that sell proprietary products and the need to document every prudent decision and every decision-making process. This information is necessary for plan sponsors and other plan fiduciaries to protect themselves and make the best decisions in their employees' best interests. Being part of the solution starts with understanding the hot-button topics the new DOL rules target and how to spot the deficiencies in service providers, fee disclosures and prudent processes. ■

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THE ILLINOIS STATE BAR ASSOCIATION'S
EMPLOYEE BENEFITS NEWSLETTER, VOL. 32 #3, MAY 2014.
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