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401(k) Plan Sponsors Moving Toward Fiduciary Help

Abstract:

Many HR directors have little idea that when it comes to selecting 401(k) advisors, they can choose from two entirely separate industries: the sales industry and the fiduciary advice industry. Those industries play by two completely different sets of rules, and those different rules can affect almost everything related to a plan including the plan participants' retirement lifestyles, the fees paid, communications and the legal risks plan fiduciaries face.

In 2010, a 401(k) plan sponsor sued Paychex, a 401(k) service provider, for breach of fiduciary duty. In that case, the plan sponsor approved a fund menu suggested by Paychex. The plan sponsor later discovered that Paychex suggested high-cost, low performance funds in Paychex's best interests and not in the best interests of the plan participants. The plan sponsor sued Paychex alleging Paychex breached its fiduciary duty to plan participants. The federal court, however, found that Paychex had no fiduciary duty to anyone. Accordingly, the plan sponsor was 100 percent responsible and liable for selecting each fund, even though Paychex recommended those funds. Oddly, in its zeal to do right by the plan participants, by bringing the suit, the plan sponsor unwittingly admitted that it breached its own fiduciary duties by selecting funds that were not in the best interests of plan participants. As in every 401(k) plan, someone was responsible for what was in that plan. To the plan sponsor's surprise, it was not Paychex.

Introduction

Like the plan sponsor in the Paychex case, many HR directors have little idea that when it comes to selecting 401(k) advisors, they can choose from two entirely separate industries: the sales industry and the fiduciary advice industry. Those industries play by two completely different sets of rules, and those different rules can affect almost everything related to a plan including the plan participants' retirement lifestyles, the fees paid, communications and the legal risks plan fiduciaries face.

The Sales and Fiduciary Advice Industries

The differences between the sales and the fiduciary advice industries make it apparent why plan sponsors are shifting toward fiduciary advice. Fiduciary "investment advisors" are held to a fiduciary standard—the highest duty known in the law. They always must act in the best interest of the plan participants. They must select funds in the best interest of plan participants. They must analyze fees and confirm they are all reasonable.

A "financial advisor" in the sales industry, on the other hand, is held merely to a "suitability" standard. As Barbara Roper, director of investor protection for the Consumer Federation of America (CFA), pointed out, a financial advisor can sell you the least suitable of all suitable investments. Financial advisors are often incentivized to sell certain products, so allowing them to place their own monetary interests above those of plan participants can certainly harm retirement accounts. For example, numerous fee disclosures we have reviewed state the financial advisor could earn a trip worth up to $20,000 if he or she sold enough of a certain 401(k) product. It's not hard to guess which product will end up in the plan—quality and value have no place in that decision.

Which leads to conflicts of interest. A fiduciary investment advisor should avoid, whenever possible, conflicts of interest. If conflicts are unavoidable, a true fiduciary should resolve those conflicts in the best interest of the plan sponsor. As noted above, financial advisors who aren't held in check can exploit conflicts of interest, placing their own interests before the plan participants' for personal gain. One way of combating incentives to sell poor products is to require a financial advisor receive only "level compensation." Level compensation means that compensation to the advisor does not vary depending on what investments are selected.

The Cause of the Confusion

Let's start at the time, not so long ago, when Wall Street, bank and insurance company salespeople had normal names, like stock broker, sales representative, insurance agent or insurance salesperson. When someone cold-called you at 7:00 at night pitching a stock, you knew what you were in for. When someone handed a card with "sales representative" on it, you knew you weren't hiring that person as a trusted advisor. The roles were clear: The salesperson had a product to sell, and you made the (hopefully) educated decision to buy it or not.

At some point, the sales reps' firms got fed up with having to identify themselves as such and petitioned the U.S. Securities and Exchange Commission (SEC) to call themselves "financial advisors."

Not-so-coincidentally, the term "financial advisor" sounds (to most ears) just like "investment advisor," which is the legal term for a fiduciary investment advisor. It is a stupid system, according to Roper in a Sept. 15, 2010, letter to Mary Schapiro, then-chairman of the SEC (as submitted by consumer advocacy groups such as the CFA, the AARP and the Certified Financial Planner Board, among others): "[T]he policy itself is stupid. No one in their right mind would create a system in which individuals who call themselves by titles and offer services that are indistinguishable to the average investor are subject to two different standards when they do so. But this is precisely the world that SEC policy over the past two decades has helped to create."

Roper went on to highlight the confusion by reciting recent (2010) survey results. "Nearly all investors (97 percent) agree 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 or commissions they earn and any conflicts of interest that potentially could influence that advice.' "

Roper continued: "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."

The strong views that Roper professes and these consumer advocacy groups promote are increasingly becoming a bigger part of the talk in Washington. The higher profile the discussion, the more HR professionals pick up on the confusion that Wall Street, banks and insurance companies have worked hard to promote.

The SEC Input

One large part of the trend toward fiduciary services comes from the SEC. Mary Jo White, the chairman of the SEC, is seeking input for a uniform fiduciary standard for brokers as well as fiduciaries. This fiduciary standard may end up applying only to retirement plans or not at all. It is clear, however, that the government agencies are well aware of the consumer confusion and are looking at improving the current situation. Bypassing education and disclosure and imposing a fiduciary duty would benefit plan participants' retirement accounts immensely.

Investment Industry Study

In April 2014, a group of consumer advocates including the CFA and the AARP wrote to the SEC commissioners regarding "Section 913 Fiduciary Rulemaking–Evidence of Investor Harm." The group pointed to data that supports that "there is already a strong brokerage industry trend toward providing investment advice on a fiduciary basis and that the costs of such a transition will not be significant." Letter p. 13 (citing the Financial Planning Coalition letter to the SEC, Cerulli Associates, Cerulli Quantitative Update: Advisor Metrics, Exhibit 1.02 (2012).)

Investment Firms Trending Toward Fiduciary Support

Less than two years ago, behemoth investment company Fidelity had one platform. That platform was its "direct" platform, which catered directly and only to plan sponsors. While that platform provides access to hundreds of fund families and thousands of non-Fidelity funds, many portfolios were (and still are) heavily laden with Fidelity-brand funds. When Fidelity has no fiduciary duty to select funds in the best interests of plan participants, Fidelity is free to sell its products (as is its job). The plan fiduciaries, however, who *do* have a fiduciary duty to offer the best funds to plan participants, may be unknowingly put into jeopardy with such a relationship.

Fidelity's recent move to offer a new open-architecture platform for advisors (including fiduciary advisors) reflects the trend toward fiduciary services. Fidelity is actively courting fiduciary advisors to use Fidelity's new advisor platform, and allows the fiduciary advisor to receive level compensation based on a percentage of assets managed. Like Fidelity, Vanguard also offers an open-architecture platform for fiduciary and other advisors. These companies recognize the trend away from sales commissions and toward fiduciary advice, which aligns with their plain fiduciaries' duties.

Also consumer advocates including the CFA and AARP have concluded, based on mounds of evidence, that education and disclosure would not adequately address the confusing issue. Those advocates stress that government rules are necessary to protect investors from non-fiduciaries who can place their own interests before their clients. The issue is too complex, and the sales industry too confounding–investors need governmental rules for their own protection.

Add to that the complexity of the hundreds of pages of 401(k) law, and we see similar reactions in the 401(k) space. HR departments and other administrators and plan fiduciaries often have little time to decipher their own plan's fees and services, much less ERISA (the Employee Retirement Income Security Act of 1974, which governs 401(k) plans). It is understandable why those professionals often rely on someone they trust without even learning the difference between a sales service and fiduciary advice.

This trend is moving toward fiduciary help, the SEC is concerned, and the consumer advocates all praise fiduciary advice. But the confusion and time it takes to do the right thing for plan participants is often a big hurdle that takes too much time to overcome.

A Fiduciary Caveat

While the move toward fiduciaries will, by nearly every account, benefit plan participants, blindly relying on a fiduciary can lead to poor results as well. Among the risks are dealing with those who believe disclosing a conflict allows one to exploit it.

We see this type of "fiduciary" service too frequently from those who pledge to always act in their clients' best interests. For example, a bank taking over a 401(k) plan and keeping 40 percent of the funds in a "stable value" fund because that fund pays the bank an extra $20,000 a year. And the bank "earned" an extra $10,000 a year by rebranding a poor fund and doubling the cost to the plan participants. Or burying a disclosure in a brochure that the "fiduciary" earns commissions as well as assets under a management fee. Or an advisor that owns and uses its own broker dealer. Or indemnification clauses that shift an advisor's fiduciary responsibility to the plan sponsor. Unfortunately, even hiring a fiduciary requires a base level of sophistication to protect oneself.

Conclusion

Plan fiduciaries have a duty to act in the best interest of plan participants. Hiring someone without that same duty to help select investments makes little sense. Despite the complexity, the confusion, the time and the other hurdles, more and more 401(k) plan sponsors (often lead by educated, dedicated HR departments) are recognizing the benefits of fiduciary help and making that move.

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