

WADE FINANCIAL GROUP



# Why 401(k) Plan Sponsors Are Getting Sued and What You Should Do About It

Why having an independent Fiduciary Audit prepared and unbundling your 401(k) plan are the smartest moves you can make

*Author: Jerry B. Wade, CFP<sup>®</sup>, CFS*

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## The Current Challenge.

The Pension Protection Act of 2006 created a substantial paradigm shift regarding requirements for plan sponsors being required to offer full disclosure of plan costs to plan participants. Many plan sponsors are not fully aware of all the ramifications.

1. The Department of Labor (DOL) has identified no less than 17 separate charges that may be present in the 401(k) delivery food chain.
2. Focusing mainly on plan investment performance and traditional fiduciary issues is no longer sufficient to meet these new DOL regulations.

On December 13, 2007, the (DOL) published new regulations under the Employee Retirement Income Security Act (ERISA) Section 408(b)(2) to require more comprehensive written disclosures by service providers to 401(k) plan fiduciaries in the areas of:

1. Compensation.
2. Potential conflicts of interest.

## The Ramifications

1. ERISA Section 404(a)(1) requires that fiduciaries act prudently and solely in the best interest of the plan's participants and beneficiaries when selecting or monitoring plan service providers.
  - a. This was not a specific requirement previously and greatly increases the liability of all individuals functioning as fiduciaries on behalf of the 401(k) plan.
  - b. This means the Chief Finance Officer and all other individuals at the company who "play a role" with the 401(k) plan now have increased liability for lawsuit risk.
2. New DOL disclosure requirements include:
  - a. An annual description of all investments.
  - b. A communication to plan sponsors providing full knowledge and disclosure of all fees associated with a 401(k) plan to the plan's participants annually.
  - c. A disclosure of any conflicts of interest, such as revenue sharing.
  - d. Providing plan participants with a quarterly rate-of-returns statement on their investments.
3. The U.S. Government has concluded that:
  - a. Plan participation is not at a sufficient level for most Americans to achieve their retirement objectives.

- b. The average plan participant is confused about investing.
  - c. Disclosure is not currently taking place regarding the total amount of plan costs and how plan costs impact current and future participant account balances.
4. Employers need to provide employees access to specific, unbiased investment advice.
- a. This supports employees in making smarter decisions.
  - b. Prudent advice can be provided with minimal risk to the employer.
  - c. An example of “prudent” advice would be the plan sponsor offering the expertise of a Fee-Only, fiduciary financial advisor, with the advice being cost neutral to the plan participant.
  - d. An example of “imprudent” advice would be provided by a registered representative, holding an active securities license, who by legal contract, is obligated to place their employer’s interests ahead of the customer<sup>(1)</sup>.
5. The LaRue Ruling: Participants can sue and are doing so. There are currently 12 class action lawsuits against plan sponsors for high or undisclosed fees. See Appendix for details.
6. Plan sponsors working with insurance company plans face the biggest challenge and highest lawsuit risk due to the confusing nature of multiple and inscrutable fees.
7. Plan sponsors will now need an outside Accredited Investment Fiduciary (AIF).  
AIF’s focus on helping plan sponsors improve their 401(k) plans so that the amount employees are saving for retirement is dramatically increased.
8. Is the plan participant on track for retirement? Each plan participant's progress should be measured and reported to the participant annually. The overall plan needs benchmarks so that the participant and the plan sponsor know if the employee is on track for a successful retirement.

**The good news: The Pension Protection Act of 2006 contained many improvements.**

**The bad news: These new rules didn’t go far enough.**

- The rules require only basic disclosure of investment and other costs impacting a plan participant's account balance. What’s missing are invisible costs such as explicit brokerage commissions and implicit trading costs. On some funds, these costs can meet or exceed the fund’s disclosed Operating Expense Ratio (OER). To analyze these hidden costs requires a review that goes beyond a mutual fund’s prospectus. You need to request the fund’s Statement of Additional Information (SAI). Ferreting out the desired information from the SAI requires the skills of a forensic scientist.
- While the DOL acknowledges that these additional expenses can be significant, the final ruling does not require that these expenses be identified and disclosed.

(1) Source: TD Waterhouse

## The Mystery of Plan Fees - a Rube Goldberg Contraption!



### Example of 401(k) Fees

#### Plan Administration Fees:

1. Plan recordkeeping
2. Accounting
3. Legal
4. Trustee services
5. Telephone voice-response systems
6. Access to a customer service representative
7. Educational seminars
8. Retirement planning software
9. Investment advice
10. Electronic access to plan
11. Information
12. Daily valuation and online transactions.

#### Investment-Related Fees:

1. Management fees
2. Sales charges
3. Surrender charges
4. Internal operating expenses of mutual funds, collective funds and annuities
5. Mortality and Risk expenses
6. Contract charges
7. Implicit trading costs
8. Explicit trading costs
9. 12 b(1) fees
10. Revenue sharing expenses

**Unbundling = Lower Costs, Employee Satisfaction and Reduced Lawsuit Risk**

To achieve all of the potential benefits and assure full DOL compliance, a typical outcome of a Fiduciary Audit is the unbundling of plan service providers.

It is this bundling of services that has created the backlash from the DOL and plan participants requiring full disclosure of all fees and any conflicts of interests. For years, 401(k) service providers have operated in such a way that disclosure was not required and many plans costs obscured.

This is no longer legally acceptable. These bundled situations are rife with conflicts, such as:

1. Revenue sharing
2. Soft dollars
3. A focus on proprietary products
4. A bias against low cost index funds
5. A focus on funds that pay 12b-1 fees

After completing a Fiduciary Audit, many plan sponsors reach the conclusion that existing service providers will need to be replaced in order to achieve the most robust plan improvements as a result of the old system’s inability to meet the requirements of today’s full disclosure, lower fee, higher lawsuit risk-qualified plan environment.

**Bundled**



**Unbundled**



## The Problem With 401(k) Investment Committees

The intentions of 401(k) plan investment committees are noble and worthy in pursuit. Unfortunately, the vast majority of investment committees often do more harm than good. Under new DOL rules, investment committee members are now subjected to a greatly increased lawsuit liability risk from plan participants. Most investment committees and their members are unaware of this new massive increase in risk they now have taken on.

Investment Committees consist of the following attributes that add up to new lawsuit risk:

1. Loosely formed.
2. Often do not operate consistent with Modern Portfolio Theory, which has proven that it is the “asset classes that contributes 90% of the success of investing,” with less than 10% of a plan participant’s return attributable to “fund or security selection.”  
  
If committee members acknowledge this, they would reduce the time they spend “evaluating investments” and at the same time lower the plan’s costs, increase the future account balances for plan participants and drastically reduce their lawsuit risk.
3. Most 401(k) plans have been “sold” not “purchased,” meaning that the plan was typically put in place when a selling representative from a brokerage firm or insurance company offered a nice “bundled plan” that could keep things simple for the employer. The salesperson in most cases is a friend of one of the owners, allowing for form in some cases to trump substance.
4. Few 401(k) plans work with a true fiduciary consultant. Most work with sales reps.
5. Investment committee members are not trained experts in the area of investing and are subject to the same pitfalls that face the majority of individual investors:

- The typical American does not understand both investing and investments.
- Lack of understanding breeds reliance on “people that sound like they know what they are talking about.” Of these people, 95% work for Wall Street brokerage firms and insurance companies.
- Most investors “buy high and sell low” and are particularly successful at shooting themselves in the foot where their 401(k) plan is concerned. Studies of investment committee members have found them no less susceptible to this behavior.
- A belief that more investment options offered in a 401(k) plan make it “better.”
- Many 401(k) plans offer investment choices that are too similar in nature and thus have significant security overlap. Diversifying across similar funds provides both employees and investment committee members a uniformed perception that they are achieving diversification.

- A belief that there is a “magic method” provided by the plan’s service providers that can identify in advance which actively managed mutual funds may “beat the market” moving forward.

Investment committees, like individual investors, are notorious for removing an under-performing “actively managed fund” and replacing with a new “actively managed fund” that has proven to have had better performance over the prior time period measured.

All academic studies <sup>(1)</sup> have shown the following:

- i. Less than 50% of today’s top performing funds will still be in the upper 50% five years from now.
- ii. At least 50% of today’s under performing funds will move to the upper 50% five years from now

<sup>(1)</sup> Source: SEI Investments

## **Lawsuit Risk For Plan Sponsors Has Never Been Higher – And Is Increasing**

“Underlying the current spate of lawsuits over 401(k) fiduciary misconduct (particularly fee levels, revenue sharing, self-dealing and active versus passive management) is a simple question: Are participants getting their money’s worth for the fees they pay? That seemingly simple question gives rise to a multitude of other questions, which are anything but simple.”

Richard D. Glass, Working Paper No. 20, September, 2008

### **Examples of Possible Claims and Their Resulting Damages are:**

1. Plan sponsor is deliberately misleading.

Attorneys will likely argue that sponsors and the fiduciaries they employed deliberately provided participants with misleading communications that omitted material information, which their employees needed to make informed decisions. In fact, such a case is now in the Court of Appeals for the Second Circuit.

2. Active Management resulted in lower returns.

Participants incurred damages equal to fees they paid for active management minus well-selected index funds with a fee schedule appropriate for a plan of that size.

3. Plan sponsor failed to educate employees on benefits of higher contributions.

The fiduciaries did not make participants aware of their insufficient contributions because they put the sponsor’s financial interests (avoiding increased matches) and human resource goals (using the 401(k) plan to attract, motivate, and retain employees) ahead of their duty of loyalty to participants.

4. Lower contribution rates equal less money at retirement.

Participants incurred damages because they contributed less than what they would have had the fiduciaries made them aware that their current contribution levels were too low.

5. Lack of adequate employee communications equals risk for plan sponsor.

A judge could easily decide that if well-designed targeted communications, on average, get 10% of the workforce to increase their contributions by 4% (going from 6% of pay to 10% of pay), the sponsor should contribute that amount (plus match if appropriate) plus growth for the past “X” number of years.

Richard D. Glass, Working Paper No. 20, September, 2008

## **There's No Such Thing as a Free Plan Audit.**

Some companies in the marketplace are offering “free” plan audits. With these free offers, it's obvious that the provider is offering a loss leader service in hope of taking over the plan. This not only steps right into a conflict of interest pothole but also places a spin on the project that should be avoided.

Free advice always comes at an undisclosed price and places the plan sponsor at risk for a lawsuit. If an employee sues, and it's discovered that free services led to changes in the plan that resulted in the best interests of the employee being placed at risk, the sponsor is liable.

Plan sponsors choosing to utilize free services are acting directly in conflict with the spirit of the DOL ruling. The ruling directs 401(k) plan sponsors to seek a source of unbiased advice with full disclosure of where and how various service providers to 401(k) plans are paid, including any conflicts of interest.

## **Positive Results from a Fiduciary Audit**

After the completion of a Fiduciary Audit, the 401(k) plan sponsor needs to determine how the plan can best achieve the potential outcomes that the audit typically reveals. These outcomes may include:

1. Launching of a new participant education program based upon the audit to help the employees accumulate enough assets for retirement. This program should include a personalized report for each participant; including the details and to what degree the participant is on track to achieving retirement success.
2. Reduction of fees including: Investment management (both implicit and explicit), administration, custodial, financial advisor and trustee fees.
3. Elimination of any revenue sharing arrangements that may have been taking place which often result in conflicts of interest.
4. Potential introduction of new tools that can increase plan participation and employee satisfaction.
5. Implementing suggested modifications to the plan's Investment Policy Statement (IPS).
6. Implementing suggested changes with the current investments offered, thus improving the plan for participants. This ranges from the “asset class” driven suggestions in the Fiduciary Stewardship Audit to specific changes that are also needed.
7. Educating the plan sponsor as to why employees do so poorly with managing their 401(k) plan accounts and what changes can result in an improved outcome for participants.
8. Elimination of any false diversification uncovered due to security or fund overlap.
9. Reduction of lawsuit risk for key employees of the company responsible either directly or indirectly as a plan fiduciary.

## The Problems Retirement Plan Fiduciaries Face.

- Fiduciaries of employee retirement plans such as 401(k) plans can place their own personal net worth at risk if they fail to fulfill their duties prudently.
- This personal liability can be assigned to fiduciaries for investment mistakes they make and investment mistakes made by plan participants.
- Fiduciaries would naturally like to eliminate, or at least reduce, their personal exposure to liability.
- In fact, the Employee Retirement Income Security Act (ERISA) allows fiduciaries the opportunity to transfer that liability to the investment advisors for their plans.

## **But many of these advisors, including many investment advisors to 401(k) plans, have no interest in helping fiduciaries reduce their liability.**

- Helping fiduciaries would mean that the advisors themselves would have to assume liability.
- Many advisors avoid a fiduciary standard of conduct when advising plan fiduciaries and substitute an inferior, salesperson-like standard of conduct.
- Investment advisors to retirement plans that adhere to a salesperson standard give plan fiduciaries a false sense of security.
- Fiduciaries are led to believe that the advisors will “take care of everything,” including satisfying the fiduciaries’ own duties to their plan participants.
- Unfortunately, many investment advisors that adhere to a salesperson standard don’t really take care of anything. They aren’t required to since the standard they follow won’t allow them to have a fiduciary relationship with plan participants.
- Investment advisors adhering to a salesperson standard owe no fiduciary duties to participants.

Therefore, when plan participants file lawsuits against plan fiduciaries, the fiduciaries are left to face liability all alone because their advisors (those who adhere to a salesperson standard) aren’t held to the same rigorous standard (a fiduciary standard) as are the fiduciaries.

**When Considering Financial Advice, *Small Print* Reveals Big Differences.**

- Most “investment advisors” are not Registered Investment Advisors.
- 95% of financial advisors do not operate in a true fiduciary fashion.
- Wall Street special exemptions have allowed brokers to skirt the fiduciary issue.
- The market upheaval has put investors into uncharted waters.
- Confusion is rampant.
- Investment jargon and labels serve to further the confusion.



## **This Alphabet Soup Is Hard To Swallow**

CPA, CFP, CLU, CHFC, RFC, RIA. Stockbroker. Financial planner. Private banker. Variable annuity agent. These are just a few of the over 80 names and designations of financial advisors that have popped up over the past decade (Source Fi360). Only one is required by law to place their clients' interests first by providing advice without an inherent conflict of interest.

## **A Registered Investment Advisor**

Fee-Only, Registered Investment Advisors (RIAs) adhere to a fiduciary standard and sell only one thing: Their knowledge. They're not stockbrokers or registered representatives who earn a commission from selling financial products. Placing your interests first is legally defined as acting as a fiduciary.

## **Defining Fiduciary**

- Simply put, a fiduciary is a financial advisor who is held to an exacting, legal standard; one who occupies a position of special trust and confidence when working with a client.
- As a fiduciary, the financial advisor is required to act with undivided loyalty to the client.
- This includes disclosure of how the financial advisor is to be compensated and any possible or corresponding conflicts of interest.
- The author has fine-tuned this definition to mean "one who has the legal duty to act in the best interest of another." An RIA is a special type of financial advisor who functions in a stewardship capacity. Professional fiduciaries are a rarity. A physician who follows the Hippocratic Oath is one. So is a CPA.

Some "financial planners" might be one, too. Advisors who are affiliated with a broker-dealer firm are most likely not fiduciaries.

If the 401(k) plan sponsor signs an NASD (North American Securities Dealers) binding arbitration agreement, which is required by almost every broker-dealer firm, then the firm's advisors would not be held to a fiduciary standard by the North American Securities Dealers.

## Resolving the Problem

Sponsors and fiduciaries of retirement plans, personally responsible for the prudent selection and monitoring of investment options, can transfer their personal exposure and liability to an independent fiduciary.

- A true independent fiduciary will accept this risk by acknowledging in writing and in accordance with ERISA their status as an ERISA-defined investment manager and independent fiduciary to sponsors of the retirement plan.

Transferring the risk for selecting and monitoring plan investment options from the fiduciaries of a 401(k) plan helps align the interests of all parties.

- When an independent fiduciary sits on the same side of the table as the plan fiduciaries, conflicts of interest disappear.
- This increases the chances that plan fiduciaries will prudently discharge their duties solely in the interests of the plan's participants and their beneficiaries, as they are required to do by ERISA.

Among the most important duties of fiduciaries for 401(k) plans are diversifying the risk of the plan investment options, controlling plan costs and helping make sure plan participants are contributing enough to succeed financially at retirement.

- By minimizing the risks and costs of the retirement plans and helping employees invest at higher contribution rates, fiduciaries can significantly reduce their personal exposure to liability.

### Three “Pillars” of a Successful Plan

1. Participation Levels
2. Deferral Rates
3. Quality of Participant Investing

#### Participation Levels

- Needs to be at least 85% in order to have a chance for two-thirds of employees to have enough money to retire.

#### Deferral Rates

- The most critical component of measuring success.
- Employer/employee contributions should average between 15% and 18%.

#### The Quality of Participant Investing

- Most consultants focus on the fiduciary liability surrounding the selection and monitoring of funds when in fact, measuring the quality of participant investing regardless of the investment options offered is far more important when measuring the potential for a successful retirement plan.

### State of the Industry - America is not on Track(\*)

- It is estimated that Americans need to replace 75% of their pre-retirement income during retirement yet Social Security will replace less than 40%.
- The typical American household is on track to replace 58% of their income.
- Average retirement savings rates are 3.5% annually.

### Increasing The “Odds of Success” Is Where The “Puck” Has Moved

The overriding goal of every 401(k) plan sponsor and their Accredited Investment Fiduciary (AIF) should be to help plan sponsors provide a vehicle where their employees have the opportunity to accumulate enough money for a secure retirement.

1. The DOL, GOA, SEC, and Congress have all changed their focus away from Defined Benefit Plans to Defined Contribution Plans.
2. Many in government believe that the average American is ill-equipped to manage their own retirement.

*(\*)Source: Fidelity Research Institute 2007 Retirement Index*

3. Government agencies are focusing on two things:
  - a. Inadequate participant education
  - b. Plan fees
4. Litigators are filing class action lawsuits against Plan Sponsors and Providers.
5. Focusing only on mutual fund performance and Co-Fiduciary Issues is “yesterday’s news!”
6. 401(k) plan sponsors need to work with an (AIF) to focus their efforts on helping provide a plan where employees are saving enough for retirement and continuously benchmarking the plan’s success in meeting this goal.

### **The Upcoming “Retirement Crisis”**

- Only 3 out of every 100 Americans have enough money to retire comfortably.
- Just 23% of Americans age 55 have accumulated at least \$250,000 in retirement assets.
- 49% of employees report having less than \$25,000 in total retirement savings.
- 8% of workers are saving at least 15% of each paycheck for retirement.
- 50% of employees that change jobs cash out rather than transfer their account to an IRA or their new employer’s plan.

### **How Much Money Do You Need to Retire?**

- Studies show that in order to have enough money to retire, the combined employee/employer contributions need to be between 15% and 18%. However, the average combined employee/employer contribution is only 9%.
- For a healthy couple at age 65, there is a 50% probability that one of them will live to age 90 and 25% probability of attaining age 97.
- It is estimated that 401(k) plan participants will need 8 to 10 times their ending annual salary to have enough money to retire comfortably.

### **Does Your 401(k) Plan Pass The “Participant Success Test?”**

- Providers preach that a participant should strive for a 75% income replacement including Social Security, but are they benchmarking their success?
- A successful plan is one where two-thirds of employees will achieve a 75% income replacement.

**Studies of Investor Behavior Offer the Following Information:**

- The typical American does not understand both investing and investments
- Lack of understanding breeds lower participant rates
- Most investors “buy high and sell low” and are particularly successful at shooting themselves in the foot where their 401(k) plan is concerned.
- The more investment options offered in a 401(k) plan, the lower the participation
- Employees are not very good at picking their investments in their 401(k) plan
- Employees do not readily choose Target Date funds for the bulk of their allocation because they have a felt need to diversify further.
- Many 401(k) plans offer investment choices that are too similar in nature and thus have significant security overlap. Diversifying across similar funds provides employees a uniformed perception that they are achieving diversification.

**How Diversified is the Typical 401(k) Line-up of Investments?**

- Most 401(k) plans offer too many choices and too little diversity of asset categories.
- Most 401(k) plans believe in paying higher costs for active management
- All academic studies have proven that paying extra for active management, in most asset categories, results in employees achieving lesser results than they could have with low-cost index funds.
- Most 401(k) plan sponsors, their investment committees and their financial advisors, are susceptible to the same “performance chasing” of actively managed funds as the typical investor is. This creates a huge lawsuit risk liability for those individuals associated with any 401(k) plan.

## **Model Portfolios vs. “Pick Your Own at the Investment Apple Orchard”**

401(k) Plan sponsors and their participants that have adopted model portfolios have seen increases in employee satisfaction and improved true diversification of employee account balances. The majority of 401(k) plans have not yet adopted model portfolios. There are two methods for offering them:

### **1. Hypothetical Strategic Model portfolios – Non Discretionary**

This method provides participants three to four models based upon various asset allocation mixes. These models are typically suggested by the plan consultant/investment provider and approved by the 401(k) plan investment committee, then communicated to employees. There is no active management of these models. If the stock market has gone up or down and rebalancing might make sense, this needs to be done by the employee. If it were suggested that one of the funds in a hypothetical model should be replaced, the process would involve suggestion by the plan consultant/investment provider and approval by the investment committee. Under this arrangement, there is shared fiduciary risk among the plan sponsor and plan consultant/investment provider. As depicted earlier in this document, the investment provider(s) may not be functioning as a fiduciary as a result of their conflicted status if they are a registered representative working for a broker dealer.

### **2. Managed Model portfolios – Discretionary**

This method provides participants three to four models based upon various asset allocation mixes. The plan sponsor delegates the responsibility of constructing the model portfolios and choosing plan investment choices to the AIF.

Under this arrangement, the plan sponsor has reduced their fiduciary risk by hiring the AIF to take care of the investment management of the plan. The plan sponsor is still responsible for monitoring the AIF but is no longer at risk for disgruntled employees who might want to sue them for various breaches of fiduciary conduct that have now been delegated.

The AIF typically builds a set of models with very low-cost index funds as the foundation for the plan, thus lowering plan costs and helping the plan sponsor reduce the risk of lawsuit due to plan costs being too high.

The AIF then provides active management of these models. If the stock market has gone up or down and rebalancing might make sense, the AIF implements this on behalf of all employees assigned to a particular model.

If it is determined that one of the funds in a model should be replaced, the AIF completes this change and communicates this change to both the plan sponsor and the 401(k) plan participants affected by such change.

Under this arrangement, there is reduced fiduciary risk for the plan sponsor and more for the AIF consultant/investment provider. The AIF investment provider is functioning as a fiduciary as a result of their status in meeting ERISA requirements for such status.

### **Actual Client Custom Model Success**

- 39% of active participants converted 100% of their account to a custom model.
- Approximately 85% of newly eligible employees choose a custom model at enrollment.
- Only 18% of participants are single-fund investors.
- 65% of participants own 3 or more funds (includes model portfolio participants).

Source: Associated Benefit Group (ABG)

## About The Author – Jerry B. Wade, CFP®, CFS

**Career Summary:** Mr. Wade is president and CEO of Wade Financial Group, Inc. (WFG), an independent, FEE-ONLY advisory firm in Minneapolis which provides comprehensive financial planning, tax planning, investment management and estate planning for high net worth families located across the U.S. A native of New Castle, Indiana, Wade is a 1981 graduate of Ball State University in Muncie, Indiana, with a Bachelor of Science Degree in Communications. While at BSU, Wade was a collegiate swimmer and worked in radio.



Before founding WFG in 1994, he spent 10 years associated with American Express Financial Advisors. During his tenure with Amex, Mr. Wade functioned as a financial planner, trainer and strategic consultant to IDS/Amex senior management.

**Role at WFG:** Mr. Wade chairs the firm's Investment Committee, supervises the delivery of all services and is integrally involved with the strategic planning to help clients achieve their financial objectives.

**Professional Credentials:** Mr. Wade is a Certified Financial Planner™ practitioner and a Certified Fund Specialist. He is one of only a handful of financial advisors in the U.S. that has gained membership in NAPFA (National Association of Personal Financial Advisors), which advances FEE-ONLY planning. He is also a member of NACFC (National Association of Christian Financial Consultants).

**Accolades:** Mr. Wade has been chosen by Worth Magazine as one of the best 250 Advisors in the U.S. each year from 1998 to 2002 and in 2004, 2006, 2007 and 2008. He was also chosen as one of the top estate planning experts in the U.S. according to J.K. Lasser's book "New Rules for Estate Planning and Tax," 2001 and as one of the best 150 financial advisors for doctors by Medical Economics Magazine in November 2006.

**Consumer Advocate:** Mr. Wade founded and has underwritten a public, comprehensive website [www.fundpolice.com](http://www.fundpolice.com), that has documented numerous scandals affecting mutual funds and other financial institutions..

**Patent Pending Investment Advice:** Mr. Wade has applied for a U.S. patent to recognize WFG's unique and novel ConVal™ investment approach. Mr. Wade has founded "Wade Funds" and in December, 2008 will launch WFG's first mutual fund, the Core Destination fund, in an effort to make WFG's investment advice available to the wider public.

### Media Exposure

Radio & Television Mr. Wade has appeared on the following: CBN's "700 Club", Public Television's "The Financial Advisors," KARE 11, KMSP Channel 9, KCCO and WCCO with Dark Star and Rita Maloney. Jerry Wade was also the host of the financial talk show, "Make Money Now" with Jerry Wade on 1570 AM the Patriot II in Minneapolis.

Print - Published Mr. Wade has been published in MN Business & Opportunities, Minneapolis Star and Tribune, Mutual Fund Magazine, St. Paul Pioneer Press and Financial Planning Practitioner. He is also a contributing author to "Building Your \$1,000,000 Nest Egg" by Aspatore books.

Print – Contributions Mr. Wade has been quoted in, contributed to or featured in: Wall Street Journal, Boston Globe, Bloomberg Financial, Mature Outlook, Black Enterprise, The Robb Report, Mutual Fund News, Financial Planning Magazine, Dow Jones Investment Advisor, "Sound Money" newsletter, Journal of Financial Planning, Smart Money Interactive and Investment News

**Volunteer:** Mr. Wade co-founded with his wife, Remember Our Heroes, a non-profit that connected military veterans to the classroom. Over a period of six years, Mr. and Mrs. Wade organized and made presentations with veterans to thousands of students.

06/15/09

# Addendum

### **Fiduciary Duty According to ERISA**

To exercise the same care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would exercise in the conduct of an enterprise of a like character and with like aims.

*-ERISA, Section 404(a)(1)(B)*

## **Participant Files Excessive 401(k) Fee Suit Against Wal-Mart**

A Missouri Wal-Mart employee and participant in the company's 401(k) plan has filed an excessive fee lawsuit against the giant retailer.

According to a news report on [LawyersandSettlements.com](http://LawyersandSettlements.com), plaintiff Jeremy Braden claims that the company cost participants \$60 million in unnecessary expenses over six years by offering what Braden said were expensive mutual funds and not their less expensive alternatives. The complaint alleges that all plan investment options were retail class shares, which historically carry higher fees than institutional class shares, and that plan trustee Merrill Lynch & Co., Inc. received revenue sharing and other unspecified payments without providing any services.

The news account said the suit, which requests class action certification, seeks to represent current or former employees who participated in, or benefited from the plan since January 31, 2002. It is estimated that more than one million people could be affected.

According to the complaint, Wal-Mart failed to inform employees about the impact that the allegedly excessive fees would have on their savings, why particular investments options were chosen, or that less expensive options were available.

*-Source: Fred Schneyer, 04/21/2008*

## **Wal-Mart Answers Excessive 401(k) Fee Allegations**

In response to participant allegations, Wal-Mart said ERISA doesn't require fiduciaries to select the cheapest option.

In a 35-page retort to a class action lawsuit over excessive fees in its 401(k) plan, Wal-Mart said disclosures about such things as how investments options were selected or revenue sharing arrangements are "demonstrably immaterial to any investment decision faced by participants."

According to a Workforce Management news report, Wal-Mart added that participant Jeremy Braden, who filed the suit, did not suggest that he would have invested his 401(k) assets differently if such disclosures were provided. The retail giant called the employees' allegations little more than "mere speculation," lacking any substance, the news report said.

In addition, Wal-Mart accused the suit of disregarding the relation of the fees to the overall costs of administering the plan and ignoring "the economics of participant directed individual account plans." The company pointed out that (ERISA) does not call for plan fiduciaries to consider only price when selecting investment options or select the least expensive options.

Braden claimed in his suit that the company cost participants \$60 million in unnecessary expenses over six years by offering what he said were expensive mutual funds and not their less expensive alternatives (see [Participant Files Excessive 401\(k\) Fee Suit Against Wal-Mart](#)). The suit also accuses Wal-Mart of failing to inform participants about the impact that the allegedly excessive fees would have on their savings, why particular investments options were chosen, or that less expensive options were available.

*-Source: Rebecca Moore – 07/21/2008*

## **New DOL Rules for 401(k) Plans**

On December 13, 2007, the Department of Labor (DOL) published new regulations under ERISA Section 408(b)(2) to require more comprehensive written disclosure by service providers to 401(k) plan fiduciaries concerning the service providers' compensation and any potential conflicts of interest.

## **Fiduciary Requirement for 401(k) Plan Sponsors**

The company that sponsors a 401(k) plan and those individuals that comprise the "decision-making body" are considered plan fiduciaries. The extent of fiduciary liability varies depending upon how the plan sponsor has chosen to "configure the plan." If the plan sponsor has not retained the services of an outside-of-the-company co-fiduciary or full-fiduciary, the responsibility is much higher than if they have.

Fiduciaries have a duty under ERISA Section 404(a)(1) when selecting or monitoring plan service providers to act prudently and solely in the best interest of the plan's participants and beneficiaries.

According to the DOL, "fundamental to the fiduciary's ability to discharge these obligations is the availability of information sufficient to enable the fiduciary to make informed decisions about the services, the costs, and the service provider."

On November 16, 2007, the DOL published final revisions to Form 5500 that will be fully effective by the 2009 reporting year. The revisions to Schedule C "Service Provider Information" add a requirement for detailed disclosure of fees paid directly or indirectly to plan service providers.

## **Conflict of Interest Disclosures**

In addition to the service and fee disclosures, service providers to 401(k) plans must provide, in writing to the plan sponsor, the following disclosures to help plan fiduciaries understand the relationships and indirect sources of compensation that may create potential conflicts of interest:

- Whether the service provider (or an affiliate) is a fiduciary either under ERISA or the Investment Advisers Act of 1940 (Prop. Reg. § 2550.408b-2(c)(1)(iii)(B));
- Whether the service provider has any material financial, referral, or other relationship or arrangement with a money manager, broker, other client of the service provider, other service provider to the plan, or any other entity that creates or may create a conflict of interest for the service provider (Prop. Reg. § 2550.408b-2(c)(1)(iii)(D));
- Whether the service provider will be able to affect its own compensation or fees without the prior approval of an independent plan fiduciary (Prop. Reg. § 2550.408b-2(c)(1)(iii)(E)); and
- Whether the service provider has any policies or procedures that address actual or potential conflicts of interest (Prop. Reg. § 2550.408b-2(c)(1)(iii)(F)).

## Ongoing Disclosure and Enforcement

Finally, the proposed regulations require the contract to include the following ongoing disclosure obligations:

- The service provider must disclose any material change to the required disclosures within 30 days (Prop. Reg. § 2550.408b-2(c)(1)(iv)); and
- The service provider must disclose all information requested by the plan fiduciary or administrator in order to comply with the reporting requirements of ERISA (*e.g.*, Form 5500 and Schedule C) (Prop. Reg. § 2550.408b-2(c)(1)(v)). With regard to enforcement, the proposed regulations include the following:
  - The service provider must actually comply with its disclosure obligations under the contract (Prop. Reg. § 2550.408b-2(c)(1)(vi)); and
  - As is the standard under the existing regulations, the contract must permit termination by the plan on reasonably short notice if the arrangement becomes disadvantageous to the plan (Prop. Reg. § 2550.408b-2(c)(2)).

## The Anti-Participant Rule.

W. Scott Simon

Any discussion about the regulatory effort (i.e., proposed rule §2550.404a-5 set forth by the Department of Labor) or the legislative effort (i.e., HR 3185) to disclose fees associated with qualified retirement plans such as 401(k) plans must begin with citation to the relevant portion of section 404(a)(1)(A) of the Employee Retirement Income Security Act (ERISA): "[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."

This essential duty of plan sponsor fiduciaries requires them (among other things) to identify and understand plan expenses that are paid to plan service providers so that they can determine whether they're reasonable in light of the level and quality of services offered by the providers. This is basic ERISA law and cannot be in dispute.

Only after a sponsor determines through a conscious, prudent process that the expenses associated with the investment options offered in a retirement plan are reasonable can the sponsor then make such options available to plan participants. The sequence here is important: The plan sponsor must make a determination of the reasonableness of costs before it can be in a position to disclose such costs intelligently to participants in the plan it sponsors.

In promulgating its proposed rule §2550.404a-5, the Department of Labor has failed to require that plan service providers, such as mutual fund families, insurance companies, and other large financial-services firms, make complete and understandable cost disclosures to plan sponsors in a uniform format. This failure means that plan sponsors will continue to have a weak grasp of the total economic impact that the costs in their plans have on the account balances of plan participants. If plan sponsors have a weak grasp of this, plan participants have little chance to get the cogent information they need to make intelligent decisions with respect to their plan accounts.

Certain plan providers with a keen self interest in obfuscating the disclosure of costs associated with retirement plans have had a direct hand in guiding the Department of Labor by the nose toward promulgation of its proposed rule, now commonly known as the "anti-participant rule." Part of this "guidance" has included focusing the Department of Labor on the supposed confusion and added costs of making expense disclosures to plan participants. Such commotion has never been anything other than a red herring. In fact, complete and cogent disclosure of costs by plan providers to plan sponsors in a uniform format would allow plan sponsors to make complete and cogent disclosure of costs to plan participants in a uniform format.

By the way, the bleating by plan service providers about the "added" costs they would incur by having to make cost disclosures to plan participants is pure baloney. In fact, plan record-keepers have this data readily available because it has already been compiled. Are we to believe that service providers don't know, to the penny, what their costs are and therefore what their profits are?

Another wonderful byproduct of the "anti-participant rule" is that costs associated with retirement plans will otherwise remain unnecessarily high because of their obfuscation. The Department of Labor just doesn't seem to understand this. Buried in the 31-page manifesto issued by the Department of Labor in the July 23, 2008, Federal Register titled "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule," is this passage:

"In developing proposed regulation [408(b)(2)], the [Department of Labor] considered why the market alone does not provide transparent fee disclosure to participants comparable to that prescribed by this regulation. The lack of transparent fee disclosure in this market suggests to the [Department of Labor] that individuals may underestimate the impact that fees and expenses can have on their account balances, and thus undervalue transparent fee disclosure. The [Department of Labor] believes that this causes individuals to make uninformed investment decisions that result in inferior outcomes to those that would result from making investment decisions based on full information. If employees undervalue disclosure, plan sponsors might under-provide it. Sub-optimal levels of disclosure translate into inefficiencies in participants choices of investment products and services."

What's disturbing about this series of illogically sequenced sentences (as indicated, some were omitted to make this mish-mash less nonsensical) is that the initial question posed—why the market alone does not provide transparent fee disclosure to participants—is never answered. The focus, instead, is on plan participants that "underestimate the impact that expenses can have on their account balances," thereby causing them to "undervalue transparent fee disclosure," which in turn causes them to "make uninformed investment decisions that result in inferior outcomes."

The next-to-last sentence of this meandering passage is a real corker: "If employees undervalue disclosure, plan sponsors might under-provide it." The Department of Labor has it exactly backward here. Instead, it should read: Plan sponsors under-provide disclosure so naturally participants undervalue disclosure. Or worse, they don't value it at all since they have no idea about the costs of plan investment options. Added to this, of course, should be the obvious notion that sponsors under-provide disclosure to participants because plan providers do not provide them with complete and cogent disclosure of costs.

The only sentence in this passage that makes any sense is the last one: "Sub-optimal levels of disclosure translate into inefficiencies in participants' choices of investment products and services."

Yeah, no kidding. But the Department of Labor merely scratches its head here and doesn't even attempt to answer either its initial question (why doesn't the market provide transparent fee disclosure to plan participants) or this one.

In fact, the root answer to both is the same: plan service providers have no duty under ERISA to disclose to plan sponsors the costs associated with the investment options in retirement plans, despite the GAO's repeated urging that the Congress amend ERISA to fix the "disconnect" that I've described previously in this column. The Department of Labor could have done something to help correct that disconnect, but it punted and failed to do so.

Because the Department of Labor's "anti-participant rule" fails to require plan sponsors to make meaningful cost disclosures to plan participants, participants are still left in the dark about the harmful total economic impact on their account balances made by the Rube Goldberg-like business models followed by many plan providers.

Another aspect of the "anti-participant rule" is that it's being touted as a major "reform" when in fact it's really the opposite: A decided setback for meaningful cost disclosure. Those with a self interest in keeping plan sponsors (not to mention plan participants) in the dark about costs so that they can continue their system of extracting excess compensation from participant accounts get to strut about and assume the mantle of "reformer." Talk about a bizarro universe in which plan participants (and plan sponsors) continue to be harmed and plan service providers continue to thrive at their expense. This is the very antithesis of ERISA and its "sole interest" and "exclusive purpose" rules, which are concerned with no one else other than plan participants (and their beneficiaries).

All this could have been avoided, of course, by having the Department of Labor focus first on the duties that plan sponsors are charged with under ERISA and making it mandatory for plan providers to provide full and complete cost disclosures to plan sponsors in a uniform format. That's really the only way for sponsors to understand costs effectively in order to meet their reasonableness duty so that they can then disclose such costs meaningfully to their participants. Disclosure in this context must mean that all relevant information is conveyed and that it's understandable to the average person.

Alas, this nonsense wasn't avoided for a number of reasons. One is that the plan sponsors that comprise the membership of certain interest groups whose representatives testified before the House Education and Labor Committee and the Department of Labor don't want to have the costs associated with the plans they sponsor to be disclosed clearly to their employees. Clear and complete disclosure would reveal, in many cases, how much these companies are passing on such costs to their participants.

It's easy to understand why such companies would not want to have the hidden--and therefore high costs--associated with the plans they sponsor disclosed to their participants. The answer to that is not to perpetuate this game, which, by the way, is played even by many of the Fortune 500 companies that continue to pack their retirement plans with retail-priced investment options.

The answer, rather, for any plan sponsor is to demand that plan service providers provide them with full and complete disclosure of the costs associated with the investment options offered in their plan while also insisting that such options be institutionally priced (i.e., low cost) and diversified broadly.

It is possible—even in the face of the Department of Labor's "anti-participant rule"—to avoid the high costs and poor diversification inherent in the investment products offered by far too many of the current crop of plan providers.

Another reason why the nonsense of the "anti-participant rule" will become final is that certain interest groups whose representatives testified before the House education and labor committee and the Department of Labor comprise not only plan sponsor employers but also mutual fund companies, insurance companies, and other large financial-services firms. The interest groups whose memberships are dominated by these large firms mirror the views of such firms rather than those of plan participants and the employers that owe fiduciary duties to them in their retirement plans. That explains why these groups are motivated to oppose any proposed regulations or legislation that would harm the interests of their members, such as full and complete disclosure of costs to plan sponsors and plan participants—even if such proposals would be beneficial to sponsors and participants.

Where does all this leave plan participants? Answer: The "anti-participant rule" leaves plan participants out in the cold with no entity—especially not the Department of Labor—having an interest in championing their interests. This is directly contrary to the sole interest and exclusive purpose rules of ERISA section 404(a)(1)(A).

Given the reality of the "anti-participant rule," it would behoove the Congress to pass H.R. 3185 in 2009. Then after its passage by the Senate, either the reform candidate—John McCain—or the change candidate—Barack Obama—should sign it into law.

*-source: W. Scott Simon 09-04-08*

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## The Department of Labor Didn't Say Anything, It Just Talked

W. Scott Simon | 08-07-08

Among the wonderful memories of my childhood were the times when my little brother and I got to cuddle in bed with our father on Saturday mornings. We would run in to our parents' bedroom and, after Mom got up to go fix us all a big breakfast, take turns crawling into bed to be enveloped by Dad's strong embrace. Although he wasn't a large man, his forearms were Popeye-like from the hard physical work he did growing up on his parents' farm.

One morning, when it was my turn to crawl into bed with my father, Mom yelled something from the kitchen which none of us could hear. My dad told my brother to go and see what she wanted. He did so and came trotting back with his report. "What," my father asked, "did your mother say?" My brother's reply, long since immortalized in family lore: "She didn't say anything, she just talked."

The same sentiment struck me as I read through the 31-page manifesto issued by the U.S. Department of Labor in the July 23, 2008, Federal Register titled "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule." More than half of this document is taken up by explanations of the 39(!) tables provided, which detail the costs (\$0.7594 billion) and benefits (\$6.8756 billion) of implementing the proposed rule. The proposed rule (§2550.404a-5) itself takes up less than three pages.

Although the estimated benefits of implementing the rule clearly outweigh the estimated costs, about 66.5% (\$4.5666 billion) of those benefits consist of reduced participant search time while only 33.5% (\$2.3089 billion) of the benefits consist of an actual reduction in fees paid by participants. It remains to be seen how plan participants will be able to transform all those search-time benefits into more dollar benefits for their plan accounts.

According to an accompanying fact sheet released by the Department of Labor, "[a]n estimated 65 million participants are covered by approximately 437,000 participant-directed individual account plans (including 401(k) plans). While workers in these plans are responsible for making retirement savings decisions, there is concern as to whether they have access to basic plan and investment information in a format useful to making informed decisions about management of their own retirement accounts. . The proposed regulation requires that uniform, basic disclosures be given to all participants and beneficiaries who direct the investment of assets in their individual accounts, and that investment related information be presented in a format that makes comparisons [among a plan's investment options] easy." The rule, as proposed, is to take effect for plan years beginning on or after Jan. 1, 2009.

**Basic Plan and Investment Information:** Advisors should understand that the essential problem with the Department of Labor's proposed rule is that it requires only basic (as opposed to complete) disclosure of investment and other costs impacting a plan participant's account balance. What's needed under this rule, instead, is full disclosure of the total economic impact that both "visible" costs (e.g., the annual expense ratio of mutual funds) and "invisible" costs (e.g., the bid-ask spreads of mutual funds) have on the accounts of participants in retirement plans. The reality of all costs, not just some, is what participants need to have disclosed to them in order to make informed decisions about their plan accounts.

The rule, for example, fails to require that plan sponsors disclose to plan participants the trading costs associated with the investment options offered by a plan. Yet the Department of Labor is well aware that the trading costs of, say, a mutual fund can be significant. After stating that a "review of the relevant literature suggests that plan participants on average pay fees that are higher than necessary by 11.3 basis points per year[,]" the Department of Labor makes clear its understanding in the accompanying footnote that "[t]his estimate of excess expense does not take into account less visible expenses such as mutual funds' internal transaction costs (including explicit brokerage commissions and implicit trading costs), which are sometimes [often, more like] larger than funds' expense ratios." (My emphasis.)

What the Department of Labor has done in its proposed rule is to require disclosure of a mutual fund's annual expense ratio with no requirement to disclose, as noted, the fund's internal transaction costs - which are often larger than the expense ratio. In addition, even though the Department of Labor states, as noted, that studies suggest that participants on average pay an unnecessary extra 11.3 basis points in fees per year, it then proceeds to cite five studies concluding that this assumption is conservative. There can be no doubt that disclosing fee information completely so that markets can be free to function efficiently to lower fees through increased competition will result in cost savings to plan participants of many multiples of 11.3 basis points.

**Uniform, Basic Disclosures in a Format Useful to Making Informed Decisions.** The Department of Labor's fact sheet states that "[t]he proposal also requires that investment-related information, including fees and expenses, must be disclosed in a chart or similar format that will help participants easily compare the plan's investment options."

No one could argue that uniform comparative disclosures aren't an excellent idea. But any such disclosures should be complete, not partial. What I mean by "complete" here is not a laundry list of the costs associated with each discreet service provided to a plan such as the \$13,095.08 paid to the law firm of Dewey, Cheatem & Howe (c'mon, you legal beagles, I'm just joking around here in the waning days of summer). Rather, disclosure of costs would be complete in the sense that all broad categories of costs (e.g., investment-related, including trading costs, and administrative/operational-related, etc.) are set forth clearly with a more detailed breakdown of costs available to plan participants upon their individual request.

The problem with the Department of Labor's suggested format is that it's woefully inadequate in actually helping participants get a handle on determining the costs of the investment options offered by their retirement plans. Advisors should consider the case of a plan participant viewing the chart provided by the Department of Labor in the appendix of its proposed rule. The participant sees a format in which a confusing array of percentages and dollars is presented without any real context. This consists of little more than taking partial (not complete) information and repackaging it for delivery to plan participants in the form of a disclosure -- at added cost to them -- which is not much better than that found in any prospectus.

In addition, plan participants are directed to sources other than the chart in front of them such as Web sites that might have more current information about an investment option's performance, and fees and expenses. If this is the best that the Department of Labor can do, why didn't it simply take data from prospectuses and save all of us a lot of time, money and trees? Advisors should understand that the Department of Labor's proposed rule is simply out of touch with the reality of meaningful disclosure of costs.

**Is There Something That They're Not Telling Us Children?** A basic question, yet unanswered, is why it's so bloody difficult to get a complete, understandable, and cogent disclosure of the total economic impact that both "visible" costs and "invisible" costs have on the accounts of participants in retirement plans. (A formula for such disclosure was contained in H.R. 3185 - the 401(k) Fair Disclosure for Retirement Security Act of 2007 -- but the current Congress failed to pass that bill.)

We've all heard, of course, the stock answer to the preceding question which goes something like this: "I'm afraid that disclosure of all these big, old mean costs would just confuse the children; we must protect them from such dangers and keep it simple." In this context, "simple" is just another word for "conceal and keep 'em confused." As I noted in last month's column, this kind of answer makes sense when it comes from entities that profit directly from hiding their high-cost products.

But many of the interest groups that say they represent both companies that offer retirement plans and those participating in them also oppose transparent disclosure of the total economic impact that all costs have on the accounts of participants in retirement plans. As I've asked before, why would these interest groups ever want to make it at all difficult for their plan sponsor membership to be able to precisely identify the nature and amount of the costs associated with the 401(k) plans they offer to their employees so that they can disclose them fully to such employees?

Making such disclosures easy and transparent would be of immense help to employee-participants -- the end-all of ERISA -- and allow the plan sponsor membership in these interest groups to prudently carry out the duties that basic ERISA law prescribes for them. Except for those providing high cost investment options to retirement plans, this helps all concerned: plan participants and plan sponsors, as well as the interest groups that say they represent, both participants and sponsors.

Transparent disclosure of costs will allow markets to function freely and efficiently to lower fees through enhanced competition. The resultant costs savings could very well result in even greater contributions to retirement plans as participants gain greater confidence in the integrity of the cost structures they face. This not only could keep contributions flowing to retirement plans but might even increase them dramatically. It's backward of the interest groups in question to think that maintaining cost opacity will keep the new contribution taps running and that full disclosure of costs will shut them off. In fact, it would be quite the opposite; such groups may therefore want to reverse their thinking, get on board, and truly support necessary cost disclosure reforms.

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## Online Resources

### Fiduciary guidance

Center for Fiduciary Studies – FI360™

[www.fi360.com](http://www.fi360.com)

Focus on Fiduciary (National Association of Personal Financial Advisors)

[www.NAPFA.org](http://www.NAPFA.org)

Department of Labor

[www.dol.gov/ebsa](http://www.dol.gov/ebsa)

### Know your referral partner – Form ADV

[www.advisorinfo.sec.gov/IAPD/content/search/iapd\\_OrgSearch.aspx](http://www.advisorinfo.sec.gov/IAPD/content/search/iapd_OrgSearch.aspx)