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How the Supreme Court Could Stop the 401(k) Rip-Off

A case that might be brought to the Supreme Court would affect 401(k) participants.

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The Supreme Court of the United States has indicated an interest in deciding an important 401(k) case, Tibble v. Edison International. If the Supreme Court decides to hear the Tibble case, and if it decides it in a manner that will benefit investors, the impact could be profound.

Before discussing the issues at play in Tibble, it's necessary to understand that mutual funds frequently offer investors a choice between institutional and retail shares. The underlying investment, regardless of which share class is chosen, is the same. The only difference is institutional shares have lower management fees. In order to qualify to purchase institutional shares, the minimum investment is higher than for retail shares.

The savings in fees to investors between retail and institutional share classes can be considerable, especially when compounded over time. For example, Vanguard offers retail shares of its popular Total Stock Market Index Fund, with an expense ratio (management fee) of 0.17 percent. The minimum investment to purchase the retail shares is $3,000. However, if you can satisfy the increased minimum of $10,000, you can purchase institutional shares of the same fund and incur an expense ratio of only 0.05 percent.

Registered investment advisers have a fiduciary duty to their clients. In my opinion, it would be a breach of that duty to place a client who qualifies for institutional shares in retail shares of the same fund.

Plan sponsors of 401(k) plans also have a fiduciary duty to participants in the plan. These duties are imposed by the Employee Retirement Income Security Act of 1974. If a plan sponsor breaches its fiduciary duty, participants have six years to seek redress in court. The penalties for breaching a fiduciary duty to the plan can be substantial, including an obligation to make good on any losses resulting from the breach.

The plaintiffs in Tibble were participants in the 401(k) plan sponsored by their employer, Edison International. Edison's plan is a large one, managing approximately $3.8 billion in assets, with 20,000 participants.

Plaintiffs allege that Edison added a number of mutual funds to the plan in 1999. Six of those mutual funds had both institutional and retail share classes. Both share classes invested in the same securities and were managed by the same fund managers. The only difference is the retail shares have significantly higher fees that were shared by the fund family with the plan's record-keeper.

This fee-sharing arrangement permitted Edison to lower its administration costs by $8 million. Although this must have been good news for Edison, the participants were not so fortunate. They were the ones subsidizing the reduction in administration costs by paying the higher cost of the retail mutual fund investments. I doubt many were aware of this fact.

The trial court found that Edison breached its fiduciary duty by selecting retail instead of institutional shares of those mutual funds that were first included in the plan within six years before the lawsuit was filed. However, the court threw out identical claims against Edison for selecting retail funds included in the plan more than six years before the action was filed, finding those claims to be time-barred. The trial court was not persuaded by the fact that the high-priced retail mutual funds remained in the plan year after year, even though they were initially selected more than six years before the claim was filed.

The decision of the trial court was subsequently affirmed by the 9th Circuit Court of Appeals. The Supreme Court has an opportunity to change this pro-corporation and anti-investor holding. It is Finance 101 to always use institutional share classes when they are available. It's hardly a high burden on plan sponsors to ask them to continually review investment options in the plan in order to ensure participants are being offered the lowest-fee share classes available. It makes absolutely no sense to immunize plan sponsors from this modest duty.

If a client came to me as a wealth adviser and showed me a portfolio consisting of imprudent investments, I would be obligated to review that portfolio and make prudent recommendations, regardless of when the imprudent investments were initially placed in the portfolio. You would think plan sponsors responsible for the retirement security of tens of thousands of their employees would be held to the same standard.

Let's hope the Supreme Court decides to hear the Tibble case and arrives at a decision that will stop the current rip-off of 401(k) participants.

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