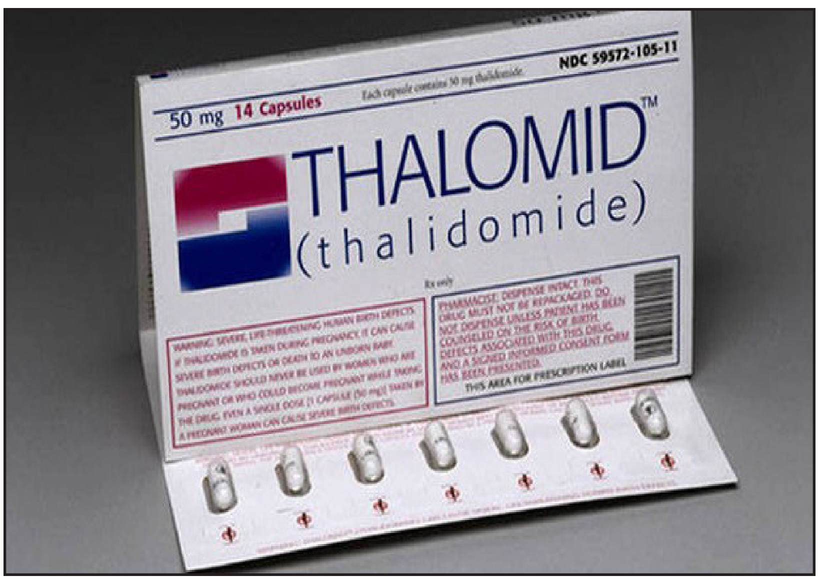
Future Threats That a 401(k) Plan Sponsor Should Be Aware Of

By Ary Rosenbaum, Esq.

What was good yesterday might not be a good today. Asbestos was a great fireproof building material until it was found to cause asbestosis and malignant mesothelioma Thalidomide was a great drug for morning sickness until it was discovered it caused birth defects. Those tax shelters in the early 1980s saves taxpayers a lot of money before the Tax Reform Act of 1996 killed them with limit on passive activity losses. What was good then isn't good now and what is good now may not be good tomorrow. As a retirement plan sponsor you have to understand what isn't good now and you need to be concerned what might not be good later. This article talks about what maybe issues for plan sponsors in the future, as governmental action and litigation may make what is OK today not so good tomorrow.

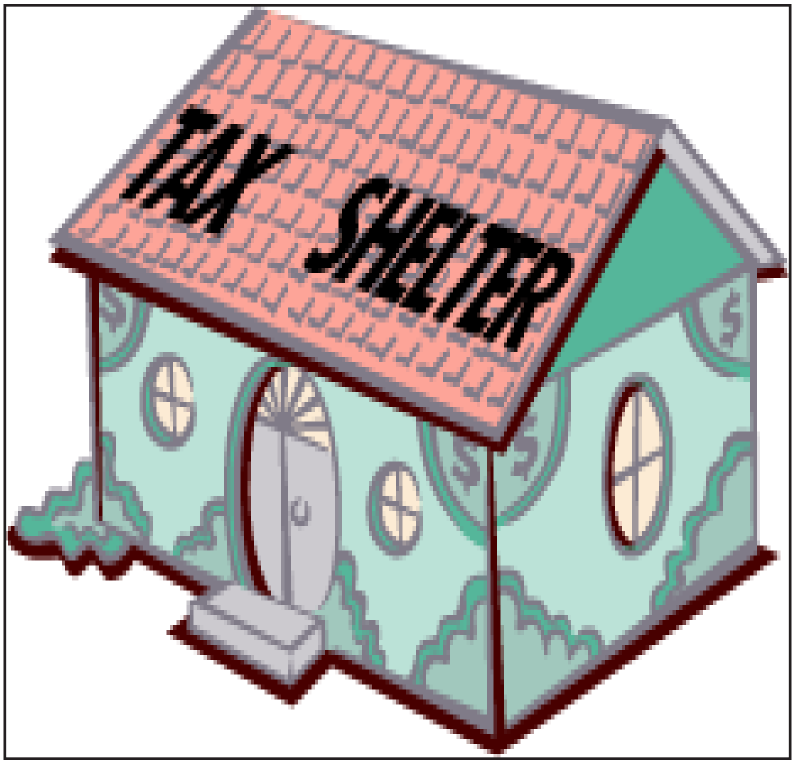
Fee Disclosures will be scrutinized

Fee disclosures have been around for only about a year and a half, which is a blip in the 30+year history of 401(k) plans. As a plan sponsor, you know that your provider that charges $1,000 or more to the plan for expenses must provide a fee disclosure to you and you have the responsibility of providing a fee disclosure to your plan participants. The problem is that the fee disclosure didn't come with a whole set of instructions and too many plan sponsors have taken those fee disclosure forms and have done absolutely nothing with them except maybe making a hat or a brooch or a pterodactyl. The problem is that plan sponsors such as yourself need to review the fee disclosures that your plan providers have provided and take a good look on how much expenses are being charged directly to the plan and what compensation these providers are getting directly or indirectly (such as payments forwarded by a mutual fund company). After taking a good look at these plan expenses, you need to determine whether the fees are reasonable or not. That doesn't mean you need to pay the lowest fees because the lowest fees may mean a low level of service. If you do nothing with your fee disclosure forms or you don't bother to get them; you run the risk that any transaction with a plan provider maybe considered a prohibited transaction. Fee disclosure regulations weren't implemented by the Department of Labor (DOL) for the heck of it, these are rules that were implemented to be followed. So whether it's occurring now or in the future, DOL agents from the Employee Benefit Security Administration will audit plan sponsors to ensure compliance with fee disclosure regulations and will take action against those that haven't done their duty. Just because it hasn't been divulged publicly that plan sponsors have been targeted to comply with the fee disclosure regulations and some have been penalized for not doing their job doesn't mean it isn't happening. Why take a chance that I'm wrong or right in this? Take a chance on the job that you were supposed to do and that is to pay reasonable plan expenses and the only way to do it is review your fee disclosures and benchmark them for reasonableness for the services provided.



The danger of revenue sharing and mutual fund share classes

Whether you are ware or not, revenue sharing is a compensation practice in which money is paid by mutual fund companies directly to third party administrators (TPAs) to offset plan expenses because the plan sponsor used specific funds that these mutual fund companies managed. Many TPA firms and plan advisors champion the use of revenue sharing producing funds because these payments are supposed to be used to offset administrative expenses, which are usually borne by the plan participants. It should be noted that not every mutual fund can pay revenue sharing (because they can't afford it) and there are many share classes of some mutual funds that may or may not pay revenue sharing. This has been a common practice of the industry because plan sponsors didn't want to pay plan expenses out of their pocket and revenue sharing reduces plan expenses. While this has been common practice, what has been the new pattern is litigation against plan sponsors who select mutual funds that pay revenue sharing because funds that pay revenue sharing are usually more expensive that mutual funds that don't. If you use revenue sharing paying funds, odds are that your plan's investment policy statement (IPS) doesn't discuss revenue sharing in fund selection that can question your decision making in fund selections. Even if you have language in the IPS concerning the use of revenue sharing, you can't let your investment decisions be swayed by it. Simply using funds just because they produce revenue sharing is a lawsuit ready to happen. You have to be prudent and careful, having high expense mutual funds with the main consideration that they pay in revenue sharing is going to be a violation of your duty of prudence. You also have a fiduciary duty to decide which share classes of the mutual funds you offer to make sure that the most inexpensive one possible (often depending on plan size) is used. Recent court cases have shown that plan sponsors who picked mutual funds just because they paid revenue sharing or picked funds when less inexpensive share classes of the very same fund were available are liable for breaches of fiduciary duty. While these plan sponsors tend have larger 401(k) plans, this will have a trickling down effect to plan sponsors such as yourself.



Using mutual funds of your plan provider

Many mutual fund companies offer their own TPA service where they are called a bundled provider and the idea behind them being in the TPA business is that it is an effective way of distributing their own funds while not having to give revenue sharing to other TPAs out there. The problem with dealing directly with a mutual fund company provider is that as part of the deal is that it's expected you will offer some or most of their funds on your investment lineup. Obviously, what's the point of dealing with the Fidelity and Vanguards of the world if you're not going to use their funds? What is the danger with dominating a mutual fund lineup with the mutual funds of your bundled provider? The best way to avoid danger is to see it a mile away. Some of the large mutual fund companies such as Fidelity and MassMutual are being sued by their very own employees for stocking their 401(k) plan's fund lineup with their own funds. So while the allegation are that they are self dealing by placing these funds on the plan's investment lineup, it doesn't take a small logical leap to say that plan sponsors who use their bundled provider's mutual funds maybe targeted later down the line. While I'm not suggesting that you forsake a bundled provider, you should be cautious about what funds you select for your plan's lineup and make sure that the underlying consideration about adding funds to a plan's lineup is what's best for plan participants and not what's best for your plan provider. Plan sponsors that can articulate the selection of plan investments based on prudent criteria are in better shape that plan sponsors who only pick plan investments because they think what their bundled provider wants them to do.

Using a broker as a financial advisor

There are two types of people who can call themselves a 401(k) financial advisor. One is a stockbroker and the other is a registered investment advisor (RIA). While an RIA must be a plan fiduciary under current DOL rules, a stockbroker is nor unless they voluntarily assume that role. For a few years now, the DOL has been adamant in changing the definition of plan fiduciary to include stockbrokers and Wall Street and their bidders (some members of Congress) have been fighting this change. I believe the change is inevitable. It maybe watered down, it may change and allow some wiggle room, but brokers will eventually fall under the rule. Many of the larger broker-dealers know this change is inevitable as some of their top brokers are already offering their services in a co-fiduciary capacity. So if the fiduciary rule change happens, what will happen if you have a broker as your financial advisor? Your broker may either assume the role as a fiduciary, partner up with someone who will assume that status (an RIA or a broker in the office that has been designated as the one to work on all retirement plans in the office), or leave the retirement plan business. So if you have a broker now, ask them what their plan is if the rule changes. It's better to know now what the plan is rather than to have a surprise later down the line such as you needing a new financial advisor or whether you have to meet someone else that will be pitching in as a plan fiduciary. There is no reason to panic or change your financial advisor, it's just important you know that there are contingencies in place and what they are when the change does occur. Better to be safe that having to scramble.

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