The Smaller The 401(k) Plan, The Bigger The Problems

By Ary Rosenbaum, Esq.

401(k) plans are a world of contradictions. It's one of the few employer provided benefits that an employee usually pays for through their account balance. It's a retirement plan that an employer offers that the employee has to mostly fund. Most 401(k) plans offer participant directed investments and participants are usually the least equipped to make financial investment decisions. 401(k) plan sponsors are on the hook for liability for inefficient work performed by their retirement plan providers. One of the biggest contradictions out there is that the smaller the 401(k) plan, the bigger the problems. So this article is why smaller 401(k) plans have more issues than larger plans and why small 401(k) plan sponsors must be more vigilant in their role as plan fiduciaries.

Daily 401(k) plans are not created equally

It is natural to assume that larger 401(k) plans that have more participants and more assets than smaller plans that should have more problems than smaller plans. However, it's the larger plan's size that makes it easier to manage and avoid some of the administration, headaches compliance problems, and fee issues that smaller plans have. This contradiction is based on the fact that in the daily valued 401(k) plan, world all plans are not created equal. Asset size dictates pricing, level of care, and level of service for 401(k) plans so a larger plan will be at an advantage over a smaller one. It has been my experience that smaller 401(k) plans are more likely to have issues concerning plan compliance, hidden administration fees, and increased fiduciary liability as it pertains to participant directed investments than their larger counterparts.

One major difference is the human resources staff

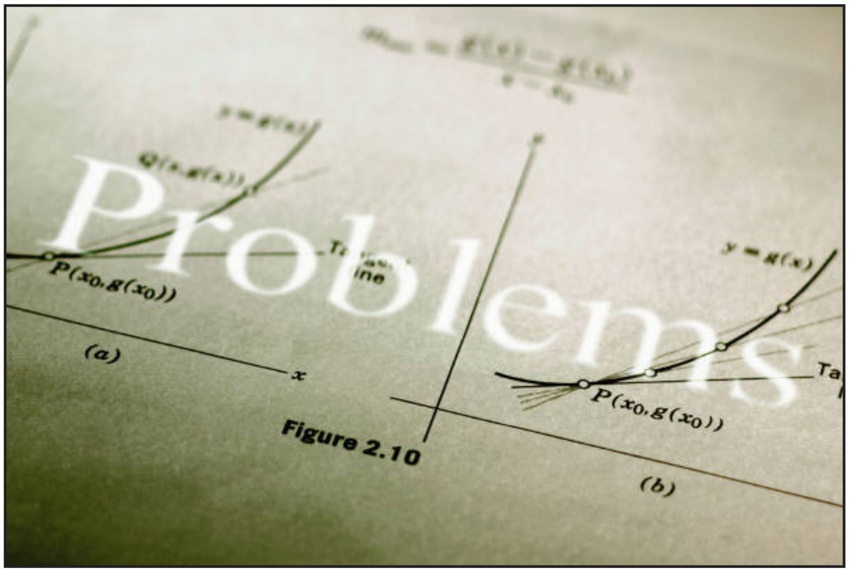
Large companies sponsor large 401(k) plans and small companies sponsor small 401(k) plans. One of the major differences between a larger and smaller company is the experience of the human resources staff that will handle most of the 401(k) issues. Larger companies have a human re-

sources director with a background in employee benefits or they may even actually employ their very own certified employees benefits specialist. A smaller company that sponsors a 401(k) plan will have a less experienced human resources staff with almost no retirement plan experience or if there is no HR manager, this function may actually be handled by own of the owners of the company. The difference between the two is that a larger company with a staff that is well versed in retirement benefits will have an easier time to act as a check and balance on plan providers to ensure that they are doing their jobs, as well as picking up the slack when the providers drop the ball. The human resources staff of a smaller company may have a difficult time in identifying retirement plan issues, often relying too much on the plan providers to their detriment because it's often he plan providers that cause errors that cause huge 401(k) problems.

Smaller plans have limited choices for the TPA

When it comes to selecting a third party administration (TPA) firm for their plan, larger 401(k) plans have a wider variety of providers to choose from because thanks to economies of scale and larger revenue sharing payments received because of increased asset size, they pay less in fees as a percentage amount when compared to plan assets. Larger 401(k) plans will likely choose unbundled TPAs or deal directly with one of the mutual fund companies who offer their services as TPA. Smaller 401(k) plans choose bundled providers or insurance company based platforms because of the low base fees, unaware of some of the wrap fees layered into the specific plan investments. Some small plans make the mistake of hiring their payroll provider as a TPA without realizing that their no frills services expects the plan sponsors (who have the least amount of experience) to have a bigger role in the day-to-day administration of the plan. That is why so many smaller 401(k) plans are insistent that they pay nothing for plan administration when they do, at a larger percentage in fees as compared to plan assets.

Larger plans have an edge over smaller plans because the larger size of the plan gives the plan sponsor more competitive pricing as many competent providers vie to land such a huge account.



Smaller plans have more administration problems

Whether it's plan design errors, bad census preparation by the employer, or mistakes in compliance, smaller plans have more administrative headaches than larger plans. The TPAs working on smaller plans tend to make more errors than medium or larger sized plans. Usually it's because of the TPA's level of services. TPAs that cater to the small plan market may be overburdened with work, lack experience, or don't provide training to their staff. Whatever it may be, larger plans have more checks and balances either with TPA or their retirement plan errors to nip plan errors in the bud while smaller plan errors tend to fester until they become larger errors.

Sophistication of the Plan's financial advisor

Smaller 401(k) plans are more likely to hire financial advisors with less of a background in retirement plans than larger 401(k) plans. Many small plans employ financial advisors who have very few retirement plan under management, which means they are less likely to be familiar with some of the requirements that retirement plans must meet to ensure continued qualification under the Internal Revenue Code and ERISA. Larger 401(k) plans are more likely to hire financial advisors that have more experience in the most important roles that a 401(k) plans financial advisor has, such as the development of an investment policy statements (IPS), constant review of plan investments to see if it still meets the requirements of the IPS, as well as providing education to plan participants to meet the requirements of ERISA §404(c). I call financial advisors who have a very small book of retirement plan assets, small potato financial advisors because of their lack of experience when it comes to the fulfillment of their duties. These advisors are less likely to fulfill their duties in helping plan sponsor through the fiduciary process and some may also hold the same belief of the free 401(k) administration myth discussed above.

Larger plans have the audit check

One of the biggest advantages that larger 401(k) plans have over smaller plans is a legal requirement that most plans would like to avoid because of the expense. Retirement plans with more than 100 participants generally are required to procure an independent audit from a CPA firm to accompany their Form 5500. While the audit is there to check the financial status of the plan, it is often a check and balance against other plan providers to ensure that the plan operates according to their plan document and the law. From experience, I have seen audits root out unnecessary fees charged by a TPA as well as finding compliance issues dealing with lack of repayments on participant loans. While no audit is fool proof, it is an effective mechanism to oversee that the TPA and financial advisor are doing their jobs correctly. I had one client who discovered that their TPA was pocketing revenue sharing payments received from mutual funds companies instead offsetting their fees as promised and it was the auditor that caught the fraud. A plan which didn't require an audit would never have recovered those pilfered amounts.

Small plans can avoid the problems if they are diligent

While I do believe that smaller 401(k) plans are more likely to have larger problems than larger plans when it comes to compliance, limiting fiduciary liability, and minimizing administrative cost, it doesn't have to be that way. Smaller plans have larger compliances issues because they don't implement a system of checks and balances in place to ensure that plan providers are doing their jobs in a correct manner. A system of checks and balances is a situation where a plan sponsor can simply hire independent, professional plan providers that ensure that the other providers are doing their job. So a smaller 401(k) plan should utilize the services of an independent TPA, an independent financial advisor (which means not linked to the TPA), and an independent ERISA attorney. From experience, the best retirement plans are where all plan providers are well versed in the retirement plan business, so they understand their duties and the duties of the other providers.

Bigger doesn't have to be better as long as smaller 401(k) plan sponsors start taking their fiduciary liability more seriously. The first step is assembling a top-notch team of independent plan providers. The second step is keeping tabs on these providers. These two easy steps will go a long way in ensuring that a small plan doesn't have a large problem.

THE ROSENBAUM LAW FIRM P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw