Plan Sponsor Should Avoid These Retirement Plan Provider "Con Games"

By Ary Rosenbaum, Esq.

The George Clooney-Brad Pitt trilogy of heist films known as Ocean's Eleven, Ocean's Twelve, and Ocean's Thirteen were remembered for their twist endings, stylish pacing, and lightheartedness. Since the Ocean gang were con-men, it did introduce us to the con game jargon like using a Boesky (a wealthy bankroller with insider info); a Jim Brown (confrontation between two people, to distract lifting info); an Ella Fitzgerald (tape looped back to look like a live recording); a Bundle of Joy (pregnant woman) and a Billy Martin (a second chance). A con game is a confidence trick, which is an attempt to defraud a person or group by gaining their confidence. In the retirement plan industry, there is jargon that acts like a confidence trick because it tricks plan sponsors into using a service based on what is a con game without the criminal intent because retirement plan providers eliminate the criminal intent by having plan sponsors sign off on disclosures that plan sponsors won't read. So this article is an introduction to terms and services in the retirement plan industry that plan providers may try to trick you into using that either does not provide what you believe it promises or it's a little short on detail on what it really is.

Using Only Life Insurance As An Investment in Retirement Plans: Life insurance in a retirement plan is like eating a hot dog. There is nothing wrong with eating a hot dog every now and then, but studies show that eating a hot dog a day will raise your chances of colon cancer by about 20%. Life insurance is certainly an important savings vehicle and an estate-planning tool, but it shouldn't be the only savings vehicle especially when it comes to retirement savings. There are a few unscrupulous plan providers (some who both sell insurance and serve as a plan's third party administrator (TPA)) who design defined benefit plans where the plan's funding requirements are used only to fund the insurance premiums in the plan and nothing else. The problem? Well, when times are tough, plan sponsors have a tough time in making ends meet, and defined benefit plan sponsors have it worse. Unlike the discretionary feature of 401(k) plans, defined benefit plan contributions are tied to meeting the defined benefit of a participant at normal retirement age. Well if a plan sponsor can't fund the defined benefit plan's contributions, they will pay a penalty and they will likely have to decrease or freeze the defined benefit plan on a prospective basis. Well the problem here is that the plan was designed to pay the premiums of a whole life policy, a plan sponsor could lose a lot of money by surrendering the policy for its cash value. Too many defined benefit plan sponsors taken in by some of these unscrupulous TPAs learn the hard way that their plans were not designed to provide a benefit, but designed to sell life insurance policies. So if a plan provider suggests a plan that is used to only fund a life insurance policy, take a pass.

The Inflated Plan Custody Fee: In the world of daily 401(k) plans, plan custodians such as Fidelity, TD Ameritrade, Schwab, Matrix and other providers, charge a custody fee for using their trading platform. The charge is usually between 5 and 10 basis points (0.05% to 0.10%) of plan assets. Typically, a TPA will pass on that charge directly to the plan sponsor. The problem is that many plan sponsors don't know what a typical custody charge should be unless they shop the plan around. The problem? In the good old days before fee disclosure, some TPAs (some who also had their own financial advisory practices) would steer plans towards mutual funds that paid revenue sharing without disclosing those amounts they received from the mutual fund companies to the plan sponsors. So a TPA may have been making more money on the plan that the plan sponsor thought (and should have known as a plan fiduciary). Thanks to fee disclosure, these TPAs have had to ditch the hidden revenue sharing gimmick, only to change course by fully disclosing it by burying it in a "custody fee" that is 15 basis points to 25 basis points, instead of the 5 to 10 basis points that the other TPAs charge. Of course, these revenue hungry TPAs will claim that they are doing nothing wrong because they are disclosing their fees, but charging a markup of 250 % to 400% on a custody fee is outrageous because most plan sponsors don't know what a reasonable custody fee is. So if you find a plan provider charging an exceptionally high custody fee, compare that fee with what other providers using that same custodian charge for a plan that is similar in size to your own. If more people are aware of this inflated fee, then the sentinel is watching.

No Fee Administration from Your Payroll Provider: There is no such thing as a free lunch or free plan administration. Many plan sponsors have been reading that lately in their disclosures from their plan providers. Many plan sponsors assumed that administration was free because expenses were embedded in the plan's investment, what are called wrap fees. So while we all assumed that the myth of free administration would end with fee disclosure, some cynics like me assumed that the myth would remain in some shape. Well, I understand that some payroll providers are advertising that if you use their TPA services, administration is free. How they can charge nothing for plan administration? Well, they can certainly hide that fee in the payroll services they provide because disclosure under ERISA won't extend to fee charges for non-ERISA services. Let's face it, how is the Department of Labor or a competing provider going to prove that a payroll provider is hiding plan administration expenses with the payroll expenses? Even if the payroll provider is really charging absolutely nothing for administration and not hiding the fee, is plan administration something you really want to pay nothing for? Plan administration is a highly technical and specialized service, would you trust a provider that claims that their services are worth nothing because they are giving it away?

The Fiduciary Warranty: Since plan sponsors have been inundated with articles and retirement plan providers talking about increased fiduciary liability and the hiring of independent ERISA fiduciaries such as a §3(38) fiduciary, a number of bundled plan providers have decided to cash in on this hoopla by offering what they call a "fiduciary warranty." When they hear the words "fiduciary warranty", I assume most plan sponsors think that these plan providers will either serve in some sort of a fiduciary capacity or indemnify the plan sponsor in any lawsuits brought by plan participants for any claim for a breach of fiduciary duty. Of course, these providers go out of their way to make sure that they are not identified as serving in any fiduciary capacity and the fine print in these warranties indicate that the providers will only defend plan sponsors in only in rare instances. The warranty only states that the investment options that this provider selected were prudent, satisfied the Section 404(c) requirement of offering a "broad range of investment alternatives", and that the investment strategies provide a suitable basis for plan participants to construct well diversified portfolios. Sounds like a great warranty? Actually, I don't think that the warranty is worth the paper that it's written on. That whole broad range requirement is rather broad; I am unaware of any plan fiduciaries ever being sued on that requirement. To comply with the simple broad range requirement, the plan fiduciaries must first decide on the asset classes (e.g., stocks and bonds) and styles (e.g., large cap U.S. equity growth fund, small cap U.S. equity value) for the "core" investments of the plan. So plan sponsors need to offer a diverse group of investments A fiduciary warranty is almost absolutely no protection for plan fiduciaries, it's like buying car insurance that only covers you in a head on collision or a life insurance policy that only pays on accidental death. It's a warranty that warranties very little. The fiduciary warranty is no substitute for an ERISA §3(21) or ERISA §3(38) fiduciary or a co-fiduciary. Unless a bundled provider assumes some sort of fiduciary capacity, the plan sponsor as a plan fiduciary is not being protected. The fiduciary warranty is a deceptive practice. Sure, the plan providers will claim that the limits on their warranty are fully disclosed and they are correct. However, most plan sponsors who do not use the services of an independent ERISA attorney will not understand that the protection of liability for the broad range of investments requirements under ERISA §404(c) is such a small part of fiduciary liability and very few cases against plan fiduciaries are ever litigated on that requirement because it is such an easy task.

So if a plan provider is playing a three card Monte with some of these gimmicks, you'll know were the money card is. The best bet is to never play their game.

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