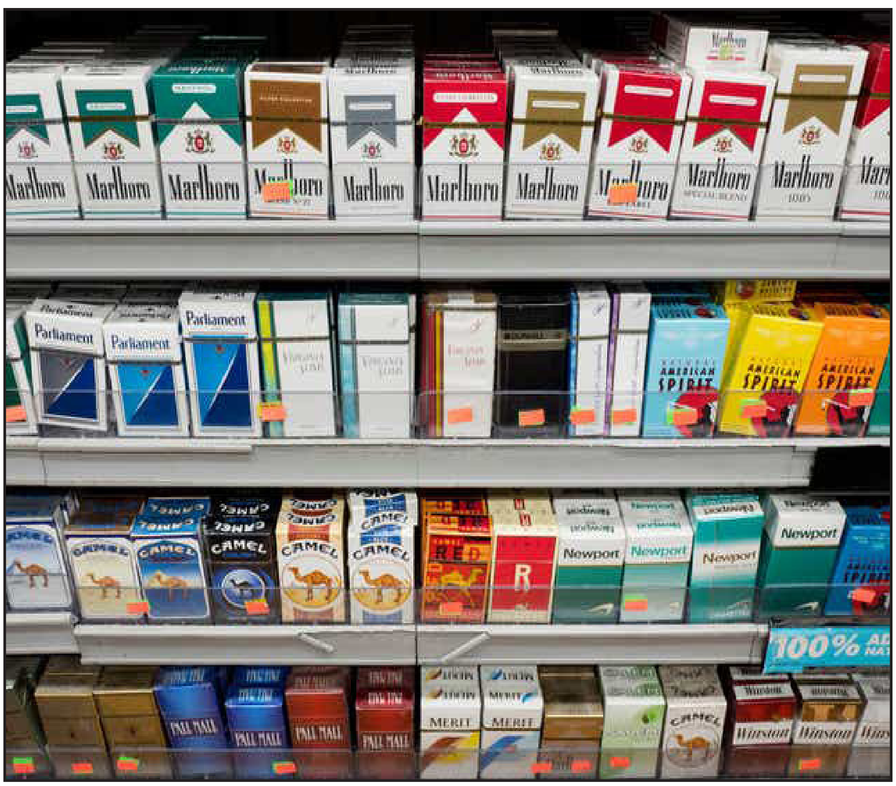
“Absurd” 401(k) Plan Sponsor Facts That Are 100% True

By Ary Rosenbaum, Esq.

We drive on parkways and park on driveways. Cigarettes are sold in gas stations even though smoking is prohibited there. Fat chance and slim chance mean the same thing. Phonetic isn’t spelled the way it sounds. When it comes to retirement plans, there are absurd things that make no sense but are actually true. The problem is that plan sponsors don’t know about these things before it’s too late. So this article is about absurd things about 401(k) plans that are actually true.



No matter what a plan sponsor does, they are always on the hook

Plan sponsors are plan fiduciaries, which means they have the highest duty of care in law and equity. Being a fiduciary is about being responsible for the retirement plan assets of plan participants, so they also have more responsibility in holding someone else’s money than in holding their own. As part of running a retirement plan, a plan sponsor needs to hire qualified and experienced plan providers that will handle the bulk of the work in the day-to-day running of the plan. The problem is that while a plan sponsor will delegate work to their plan providers, they are still on the hook for liability. So a plan sponsor will be responsible for any mistakes or transgressions of the plan providers they hire including theft of assets by these providers. Even hiring plan providers who proclaim they will assume all liability by being an ERISA §3(38) financial advisor or an ERISA §3(16) administrator will still keep a plan sponsor on the hook. While these ERISA fiduciaries have been delegated the responsibility and the liability that goes with it, the plan sponsor is still responsible for hiring these providers which means that they are liable for anything these ERISA fiduciaries do wrong. In Revenge of the Sith, Obi-Wan Kenobi said that only the Sith speaks in absolutes, and anyone who says that a plan sponsor can eliminate all of their liability is just plain wrong. A plan sponsor can always minimize their liability; there is no mechanism to completely eliminate it. So don’t let a retirement plan provider salesperson tell you otherwise.

If higher-paid people defer more, you have a problem

All qualified retirement plans including 401(k) plans must go through compliance/discrimination testing in order to maintain their qualification under the Internal Revenue Code. One of the problems is the actual deferral percentage (ADP) test which tests for discrimination of salary deferrals in favor of highly compensated employees. When you think of it, the idea of the ADP test is absurd just based on the fact that an HCE is only someone who makes more than $120,000 which isn’t that wealthy if you live in a metropolitan area. Secondly, discrimination doesn’t mean that the plan sponsor didn’t allow lower-paid employees to contribute. It just could mean that highly compensated employees deferred salary as a group at a rate higher than 2% than the group of lower-paid employees. Common sense dictates that higher-paid employees will have more money to defer than lower-paid employees, so that really isn’t discrimination and doesn’t seem fair. The Internal Revenue Code isn’t about fairness, it’s about rules and plans that fail this ADP test need to correct it or adopt a safe harbor plan design in future years to avoid the test. Life is not fair and neither is the ADP test.

Mutual fund costs are a big consideration

When a plan sponsor meets with potential plan providers such as a financial advisor or a third party administrator (TPA), they are presented with the fees that these providers charge. In addition, providers than getting hired by the plan sponsor will have to provide the plan sponsor with annual fee disclosures. The problem is many TPAs and financial advisors don’t emphasize the cost of the investment options in the Plan. Mutual fund expenses eat up the rate of return that plan participants can make in their investment gains and these expenses are part of the cost of running a retirement plan. The problem is that too many plan sponsors don't know the costs of the investments offered under their Plan and it's one of their important duties as a plan fiduciary. Mutual funds cut into plan participant gains and plan sponsors have been sued for keeping too many expensive funds on their lineup when there are less expensive options including a different share class of the very same fund being offered. So mutual fund costs need to be understood and reviewed to avoid pecuniary harm to the plan sponsor.

Participant direction of investments doesn't shield Plan sponsor from liability completely

One of the reasons that 401(k) plans where investments are directed by plan participants are the most dominant plan in the market is because of great marketing and a mischaracterization of an important rule under ERISA (Employee Retirement Income Security Act of 1974). ERISA §404(c) does provide a plan sponsor with liability protections on participant-directed retirement plans, such as a 401(k). The problem is there is an actual catch. The plan sponsor gets that protection if the plan satisfies the conditions in the 404(c) regulations. The plan has to offer a broad range of investment alternatives. The plan sponsor must provide plan participants with an opportunity to exercise control over assets in their accounts, subject to reasonable restrictions. Participants must also be allowed to exercise independent control over their plan investment decisions. The Plan must also supply plan participants with certain information regarding the plan and its investment options. So if the plan sponsor doesn't satisfy the requirements of the regulations, then the plan sponsor will lose some of that liability protection under 404(c). So the liability protection for participant direction of investments is a sliding scale, a plan sponsor will have liability protection based on how much they comply with the regulations. So a plan sponsor that doesn't provide participants with information or hasn't reviewed plan investments isn't going to get much protection under 404(c). So ERISA §404(c) isn't a blank contract of protection or a suicide pact for plan sponsors. A plan sponsor needs to understand their duties and potential liability if they offer the direction of investments to plan participants.

Fiduciary is marketed in a way that it may not mean what you think it might mean

Plan sponsors are fiduciaries, so are financial advisors that take on that role because they have to (registered investment advisors) or they volunteer (a few brokers). The problem with using the word fiduciary is that it implies that someone will undertake a fiduciary role, but sometimes they aren't. For example, many insurance companies that serve as TPAs offer something called a fiduciary warranty. It claims that it will indemnify plan sponsors if they are sued for a breach of their fiduciary duty in very narrow circumstances that plan sponsors rarely get sued for and offers no coverage for any other fiduciary breach. Plan sponsors have a better chance of being struck by lightning than being sued where the terms of the warranty will kick in. The meaningless of this fiduciary warranty can be explained by this: an insurance company makes money by insuring work, so how much is it worth if insurance companies are giving it away for free? The use of the word fiduciary in fiduciary warranty may give some plan sponsors the silly idea that these insurance companies will serve as fiduciary, but they don't. The use of the word fiduciary is great for marketing, but it might be a game of bait and switch if plan sponsors assume their provider is serving in a fiduciary capacity when they're not. So that's why plan sponsors need to make sure contracts with their providers delineate whether they are serving in the capacity they are promising or implying. Otherwise, plan sponsors may be in for a rude surprise.

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