The Mistakes Employers Should Avoid Starting A 401(k) Plan

By Ary Rosenbaum, Esq.

I'm a firm believer that you need to get off on the right foot if you start something new. Otherwise, you have a tough time recovering. When I talk about getting off on the wrong foot, I always remember wanting to get involved with Hillel, the Jewish student organization at college. They had a welcoming barbecue the first weekend of school and after I arrived 15 minutes after it started, they ran out of food. The students who had no intention of joining Hillel because they weren't Jewish had hamburgers and hot dogs and all I got was a stale bagel. Needless to say, I never joined Hillel. Being a retirement plan sponsor is a bigger deal than joining Hillel especially when you factor in the responsibility of being a plan fiduciary, so it's important that the employer gets on the right foot and avoids making the mistake of starting a 401(k) plan.

Not understanding why they are setting up the Plan in the first place

Yes, employers start-up 401(k) plans for a variety of reasons. While there are many reasons why they want to start up one, they must figure out why they did. The reason why they need to know why they set it up in the first place is that it could certainly help out when it comes to designing all aspects of the plan and the options it offers.

Not understanding the demographics of their employees

When it comes to 401(k) plan designs for both salary deferrals and employer contributions, an employer needs to understand the demographics of their employee base because different demographics can certainly impact whether deferrals and employer contributions can be maximized. For example, the demographics of a law firm are different than the demographics of a fast-food restaurant. Why does it matter? Thanks to 401(k) plan discrimination testing, it does because the demographics of an employer where the lower-paid employee aren't going to defer is going to impact on whether the employees who make more than $135,000 and the owners can defer. Demographics will also impact whether the plan sponsor can afford to make greater contributions to their highly compensated employees and owner-employees as well. Too many employers don't factor in their demographics when they set their plan up and that leaves possible compliance headaches down the road and possibly missed opportunities to make employer contributions.

Forgetting that a plan sponsor wears two hats

Employers who want to set up a new 401(k) plan for their employees need to understand the roles and responsibilities of being a retirement plan sponsor. Being a plan sponsor also means being a plan fiduciary. A fiduciary is a person or organization that owes to another the duties of good faith and trust. Being a fiduciary is the highest legal duty of one party to another, it also means being bound ethically to act in the other's best interests. So as a 401(k) plan sponsor, an employer is also a fiduciary because they are responsible for the retirement plan assets of their employees. If an employer wants to be reckless with their own money, that's their business. An employer can't be irresponsible with the retirement plan assets of their employees because they are a fiduciary. They have to act in the plan's best interest and not their own. They have to select plan providers that are in the plan's best interest and not their own, such as hiring a bank as a plan provider that provides them a line of credit or hiring a relative as a plan provider. Plan sponsors also need to make sure that the fees that the plan is paying are reasonable since that's a duty of a fiduciary. So plan sponsors need to understand that they wear two hats when they start a 401(k) plan: plan sponsor and plan fiduciary.

Not understanding what plan providers do

Employers need to understand what plan providers do. The reason they need to know is that they ultimately are responsible for any errors made by their plan providers. As a plan sponsor and plan fiduciary, employers are on the hook for any errors and/or omissions that plan providers make. So an employer needs to understand what a third-party administrator (TPA) does when it comes to day-to-day plan administration. They need to find out whether with a specific TPA, they may also need a recordkeeper or whether the TPA wears both hats. As a plan sponsor, they need to understand what a financial advisor does. They need to understand that they can't handle the fiduciary process on their own if they have no training and education in investments. A 401(k) plan is like a machine, it has many moving parts and a plan sponsor needs to understand how those plan providers work with these "moving parts."

Not understanding if plan providers serve in a fiduciary role

I hear from so many financial advisors and plan sponsors who claim that the TPA they are complaining about is breaching their fiduciary responsibility. The only problem is that unless the TPA serves as the ERISA §3(16) administrator or does something that makes them a fiduciary, they usually aren't. Employers as plan sponsors need to know what fiduciary role if any that their plan providers are serving. For example, a financial advisor can serve in a limited role as a co-fiduciary or they can assume the bulk of the liability if they serve as an ERISA §3(38) fiduciary. It's not important just for the new plan sponsor to identify what plan providers do, they need to know what kind of fiduciary role they serve because plan providers serving in a fiduciary capacity can lessen their liability as a plan sponsor.

Dealing with a bundled provider directly and alone

Many employers who want to start a 401(k) plan put the cart before the horse by trying to deal directly with a bundled plan provider without hiring a financial advisor and/or ERISA attorney first. What's a bundled plan provider? A bundled plan provider is a mutual fund company or insurance company that offers plan administration services because it's an effective way to distribute their investments in 401(k) plans. Understandably, employers who want to start a 401(k) plan know who Fidelity or Vanguard is and there is nothing wrong with considering mutual fund companies such as those as a bundled provider. The problem is that these new 401(k) plan sponsors don't understand the role of these bundled providers, the costs involved, and some of their drawbacks especially in a time of increased litigation against plan sponsors. These employers don't understand that they may not even have the option of dealing directly with these bundled providers since many of them wouldn't accept a plan with zero assets. Seeking out a bundled provider should be based on guidance provided by a financial advisor or ERISA attorney who knows whether a bundled or unbundled TPA is the best choice for the plan sponsor.

Not understanding the limited liability of a participant-directed plan

Employers interested in starting a 401(k) plan are advised about the merits of a plan where the participants direct their investments. They are led to believe that they won't be held liable for any losses incurred by participants when they select their investments, as delineated in ERISA §404(c). The problem is that isn't necessarily true if the plan sponsor fails to handle their part of the responsibility of ERISA §404(c). Even if a participant directs their investment, a plan sponsor needs to review the investment options they offer and provide investment education so that participants can make informed investment decisions. Too many plan sponsors think that if they offer investments and hand out a prospectus, they're off the hook for any losses. It's not that easy, plan sponsors with the help of their financial advisor can create a fiduciary process that can help get that liability protection under ERISA §404(c).

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