Beware Of The Dark Side Of The 401(k) Business

By Ary Rosenbaum, Esq.

I grew up in New York City and the City of today isn't like it was when I grew up. They called it Fun City and not because it was fun unless you thought crime was fun. I remember going to take a Washington D.C. bus (because NYC Buses built by Grumman broke down) around Times Square and there was an adult movie theater every 100 feet or it looked that way. Like Gotham in the Batman comics, there is an ugly underbelly to New York City. Less so today, but it's there. The same can be said of the retirement plan business, there is a dark side and this article will highlight some of the bad in the business to avoid if you are a plan sponsor.

Revenue Sharing is like payola, the alphabet soup of share classes

The payola scandal in the 1950's was when in the music industry, there was an illegal practice of payment by record companies for the broadcast of recordings on commercial radio in which the song was presented as being part of the normal day's broadcast. Payola was basically paid to play. Revenue sharing in the 401(k) plan business is the practice where certain mutual funds make a payment to a plan's third-party administrator (TPA) if the Plan uses that fund in its investment lineup. What's the difference between revenue sharing and payola? One practice is legal and the other practice was made illegal. While revenue sharing is legal, concerns over the last 15 years have severely curtailed the practice. The reason why is mandatory fee disclosure. So many plan sponsors in the past assumed they were paying nothing for administration and part of that was because of revenue sharing payments. The problem is that mutual funds that pay revenue sharing are more expensive than funds that don't, so plan participants were paying for that revenue sharing through these funds with higher expense ratios. In addition, many plan sponsors selected mutual funds just because they paid revenue sharing and recent ERISA litigation indicates that it's a bad idea because it's a breach of a fiduciary duty to select funds just because they pay revenue sharing. There is nothing illegal about using revenue sharing funds, but it gives the impression of impropriety. The last thing any retirement plan sponsor wants is any suggestion of impropriety. 15 years ago, people thought I was crazy when I suggested that revenue sharing was a questionable practice. Now people have advocated the use of only using non-revenue-sharing paying funds. Another part of the dark side of business is share classes. Both actively and passively managed mutual funds have different share classes. Actively managed funds have more share classes with each class designated by a letter. The problem is when larger plans are paying high share class expense ratios when cheaper share classes are available. Plan sponsors need to make sure their mutual fund classes are correct, so they're not paying more than they should, since overpaying is a breach of the fiduciary duty of paying reasonable plan expenses.

Some referrals are paid advertising

I have been involved in the retirement plan business and I know a thing or two about what other plan providers are good in the marketplace. When asked by a plan sponsor about referrals for a plan provider, I always suggest 2-3 providers so that the plan sponsor can make a decision on which they think is the best fit. The reason I always pick more than one provider to prefer is because I like giving people options and I don't want to give the impression that I'm pushing just one provider for a specific reason. On a handful of occasions, I have been approached by brokers who have advertised to me that they have referral programs for accountants and attorneys. As soon as I hear that, I stop them in their tracks. I have absolutely no interest in literally selling my referrals for money and I think it is disingenuous for an ERISA attorney to collect a legal fee and then collect a fee based on plan assets just for making a referral. I remember working at my first TPA job and a well-known ERISA attorney was upset that the financial advisor who was affiliated with the firm didn't offer

him a finder's fee. The ERISA attorney later joined a very prestigious law firm and actually set up a dummy corporation just so that his law firm partners didn't know and couldn't share the sale of his referrals and in my mind, his soul. I recently was called by a potential client complaining about a tax attorney who referred a broker who referred a TPA. The TPA did a poor job and the tax attorney isn't returning phone calls, so maybe money changed hands for multiple referrals? Referrals should be based on the competence of a plan provider instead of being based on the almighty dollar.

It's all about assets

For participant-directed 401(k) plans, what it really boils down to is plan assets. When people say it's not about the money, it's about the money. Who a retirement plan sponsor can hire as a plan provider is based on the size of plan assets. Even for someone like me, the fact is that my business is working with small to medium-sized plans. While I'd like to work on a large Fortune 100 401(k) plan, that's not going to be in the cards. While larger 401(k) plans can work with a plethora of potential plan providers, smaller plans have fewer choices. The problem with fewer choices is that pricing isn't as competitive and the fixed costs of administering a retirement plan go down when there are more participants and plan assets to spread the costs. Larger plans may be far less in fees as a percentage of assets as compared to smaller plans. Men and women are supposed to be created equally, but daily valued 401(k) plans are not because larger plans have farther pull in getting better providers and usually better service. Those are the breaks, kids.

A bad TPA will hurt you

There are so many reasons that a retirement plan can land into compliance trouble. Retirement plans have so many working parts like a piece of machinery. The problem is that most errors occur in the day-to-day plan administration, so choosing the right or wrong TPA can certainly help or hurt a plan and the plan sponsor. While there are plan errors resulting from ERISA attorneys, financial advisors, and plan sponsors, the bulk of issues usually can be traced to errors made by the TPA. That is why as always with all due respect to other plan providers, the TPA is the most important provider to choose.

You might get promises that they contractually won't deliver

Many plan providers have this practice where they promise you something and then contractually limit themselves from actually delivering that promise. I once knew a TPA that had its own registered investment advisory (RIA) business which means that they advised plan sponsors on retirement plans. Being an RIA means that they were automatically a fiduciary, but their contract insisted that they were not fiduciaries. I have also seen this contractual hocus pocus with what is known as a fiduciary warranty that many insurance company plan providers offer. While it's a warranty that offers very, very, very, very, very little protection in defending claims against a pan sponsor for breach of fiduciary duty, many plan sponsors assume that the plan provider offering it is a fiduciary. The insurance companies clearly don't and as some wise person said once: "If an insurance company insures risk for money, what does it say about fiduciary warranties when they give it to a plan sponsor for free?" Any type of contract for plan services needs to be fully read to make sure that the plan sponsors get the services and protection they were promised.

Despite it all, it's always the plan sponsor's fault

When a retirement plan sponsor installs a retirement plan, they forget to realize the gigantic duty they have. By being a plan sponsor, they are also a fiduciary. Being a fiduciary requires the highest duty of care because that means being responsible for other people's money just like a bank or registered investment advisor. So when a plan delves into the murky dark side of the retirement plan business by hiring a bad TPA or selecting funds just based on revenue sharing, they are ultimately the ones to play. Sure, they may have causes of action against a bad plan provider, but they are ultimately still on the hook for hiring that bad provider. The catch-22 of being a retirement plan sponsor is not having the knowledge of retirement plans, but being responsible for all decisions regarding the retirement plan.

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