The Future Is Now For 401(k) Plan Sponsors

By Ary Rosenbaum, Esq.

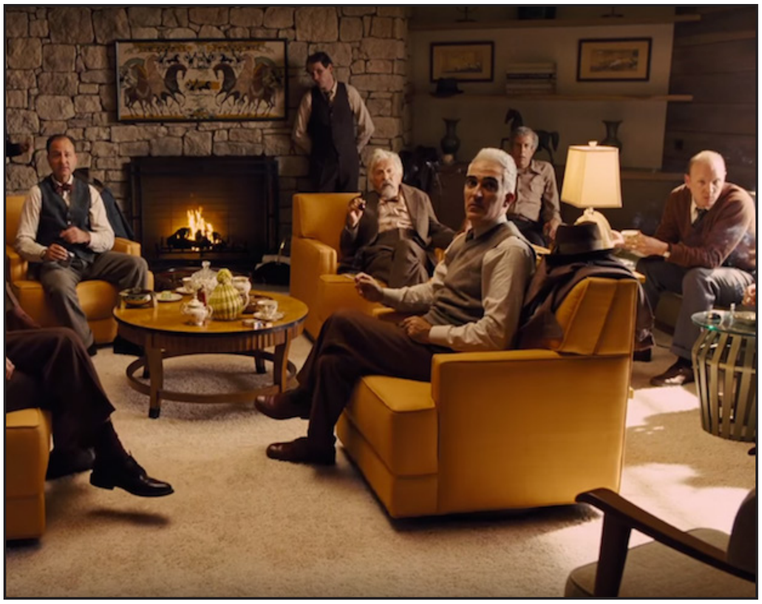
When I was the head ERISA attorney at a New York based third party administrator (TPA), I left because I saw the future of the retirement plan business and I didn't think this TPA was a part of it. I had issues with undisclosed fees, conflicts of interest, and revenue sharing. Several employees of that TPA thought my problems were silly because these issues were actually lawful. I left that TPA in 2007 and within two years, it was dead (for a variety of reasons). Now I only wished that I could have predicted the future of the credit crisis of 2008 and next week's Power Ball numbers. For retirement plan sponsors, the future of retirement plans is actually here and they need to know about the existing issues of their plan that could increase the potential for liability.

Fee Disclosures

Unless a plan sponsor has been living under a rock, they must know that fee disclosure regulations promulgated in 2012 actually require fee disclosures of participant-directed 401(k) plans both to plan sponsors and plan participants. I knew way back in 2007 that fee disclosure was inevitable because of the inherent inequality that plan sponsors had a fiduciary duty to pay only reasonable fees for plan administration and most plan providers weren't fully transparent in disclosing their fees. So a plan sponsor could suffer pecuniary harm for breaching their fiduciary duty of only paying reasonable plan expenses because the providers they hired weren't fully truthful in the fees they were charging. Many in the retirement plan industry predicted that many plan sponsors would terminate their plans because of this disclosure and that there would be a race to the bottom on fees because plan sponsors would only select the cheapest provider. Well, Chicken Little was wrong; the sky didn't fall with fee disclosure. While disclosures have put pressure on fees, plan sponsors didn't terminate their plans, the cheapest providers didn't win out, and only some of the non-transparent bundled providers exited the business. The problem with fee disclosures is that many plan sponsors fail to use their disclosures to benchmark their fees to determine reasonableness and that's a problem if an agent from the Department of Labor (DOL) comes calling with a random audit. Fee disclosures are like the exercise equipment in my house, they serve no purpose if they aren't being used. So plan sponsors need to make sure they get their fee disclosures and that they actually use them to benchmark their fees to determine whether they are exercising their duty in only paying reasonable plan expenses.

The Changing Fiduciary Definition

The DOL released a new fiduciary regulation that will finally require brokers who work on retirement plans to serve as a fiduciary. Prior to this rule change, there was an interesting unfairness in this business when registered investment advisors (RIAs) and stockbrokers can both claim that they were 401(k) advisors, but only an RIA was required to be a fiduciary to the plan because they provided investment advice to the plan sponsors for a fee. So that meant that RIAs had to make investment suggestions that were in the client's (the plan sponsor's) best interests while brokers only had to meet a suitability standard that has a lower duty of care than being a plan fiduciary. Now with a new fiduciary definition, brokers are now fiduciaries who can only push investment products if it's in the best interest of their plan sponsor client. The takeaway of these new regulations (which will be effective in 2017) is that if plan sponsors have a broker as their plan advisor, they need to know whether the broker will remain their advisor when the rules becomes effective. That is because many broker-dealers may not want to be in the retirement plan business if their brokers need to be fiduciaries. So a broker-dealer may designate a specific broker in the office to handle retirement plans or partner up with RIAs who will serve as the fiduciary definition or leave the retirement plan space altogether. So a plan sponsor should certainly find out whether their broker intends to remain their



401(k) advisor in the not-so-distant future.

The threat to medium and small plans is real

When I first started my practice six years ago, I positioned myself in helping small to medium sized plans limit their plan sponsor's potential fiduciary liability at a flat fee. There were a few "experts" who were critical of my marketing because they believed I was selling fear because small to medium sized plans were not at risk of being sued or getting in trouble with the Internal Revenue Service (IRS) and/or the DOL. These "experts" always asked for a case where a plan participant sued a small to medium sized employer for issues regarding their 401(k) plan. At that point, there were no cases, but I was insistent that small to medium sized employers would eventually get sued once ERISA litigators got through the larger plans. Well as Jim Lampley said when George Foreman won the heavyweight title at age 45 by knocking out Michael Moorer: "It happened! It happened!" So for these "experts", a new class-action lawsuit was filed in federal court in Minnesota that targets excessive 401(k) fees in a plan with just $9 million in assets. The suit, Damberg v, LaMettry's Collision Inc., claims that plan fiduciaries breached their duties under ERISA for allowing excessive fees to be charged for plan investments, record keeping, and administration. Whether the lawsuit has merit or not is irrelevant, the fact that a small plan like that could get sued shows that litigation is an actual threat to small to medium sized plans. In addition, I have always stated that a lawsuit is only one way where a plan can get into trouble. More IRS and DOL oversight in enforcing code and regulations through the use of audits are a far bigger threat to small to medium sized retirement plans. It's also a bigger threat when plan sponsors find out that there are thousands of new agents that the DOL hired over the past several years to conduct field examinations of retirement plan sponsors. The DOL doesn't collect billions in sanctions and penalties because all retirement plans are in compliance. The threat to small to medium sized plans is real and plan sponsors need to know that.

The Revenue Sharing Game is pretty much over

Remember when disco was big in the 1970s? Then when Disco Demolition Night in 1979 happened in the middle of a planned Chicago White Sox doubleheader, the disco craze was in its death spiral. Revenue sharing in 401(k) plans was something I always had a problem with. It's the idea that certain mutual funds would pay a fee back to a plan's TPA to offset administrative expenses. I had a problem because only certain mutual funds paid this "kickback" and these funds could just be selected by plan sponsors because their TPA cited how this revenue sharing could lower plan expenses. Revenue sharing to me is the same as payola (where radio disc jockeys were paid to play certain records by record companies in the 1950s). Payola is illegal, revenue sharing is not. The problem with revenue sharing is that plan sponsors assumed that it would lower plan expenses, but it actually increased plan expenses because the funds that paid revenue sharing had higher expenses ratios than mutual funds that didn't. Index mutual funds can't pay revenue sharing payments when their fund expense ratio is only 10 basis points. People scoffed at my issues with revenue sharing, but litigation over the short term has found plan sponsors to be breaching their fiduciary duty by using revenue sharing payments as the only factor or a major factor in selecting mutual funds for their 401(k) plan. I always believe that plan sponsors are better off in using low cost mutual funds that pay no revenue sharing, so that it indicates the plan sponsor selected mutual funds that are better for the retirement savings of their participants than some illusory gimmick to "lower" plan expenses by using higher cost, revenue share paying funds.

Beware of the alphabet soup of mutual fund share classes

Mutual funds in the retirement plan business have an "alphabet soup" of share classes that can often be confusing and expensive for plan sponsors. Different share classes of the very same mutual fund have different expense ratios and it's usually tied to how large the 401(k) plan is. Share classes with lower expense ratios are often reserved for larger 401(k) plans, but the problem is that many advisors and plan sponsors aren't very vigilant in following up on whether their 401(k) plans are eligible to be in lower expense ratio institutional share classes. Plans that have billions in assets have been sued because the plan sponsor and their advisor were too lazy in determining whether the plans were eligible for lower expense institutional share classes. So a plan sponsor can be liable when it's determined that they paid "retail" (using retail share classes) when they could have paid "wholesale" (using institutional share classes) for the very same mutual funds that the plan uses. So plan sponsors and their advisors need to determine through the alphabet soup of mutual fund share classes on which share class is right for them.