The Curse Of Participant Directed 401(k) Plans

By Ary Rosenbaum, Esq.

401(k) plans are the Rodney Dangerfield of qualified retirement plans because they certainly don't get anyrespect. 401(k) plans are blamed for the retirement crisis in this country, the phase out of pension plans, and quite possibly for being on the grassy knoll one November day in Dallas.

Seriously, 401(k) plans are deferred compensation plans, no more and no less. As with any program implemented by government, 401(k) plans are littered with many problems but its benefit outweighs its drawbacks. It is interesting to note that many of the criticisms of 401(k) plans like high fees, poor performing mutual funds, and lack of investment education to participants are attributed to the aspects of daily valued, participant directed 401(k) plans.

401(k) plans have been around for the last 30 years and its growth can be attributed to the growth of daily valued, participant directed plans which was as a result of technology and a booming stock market in the late 1990s. It was the best thing for the growth of 401(k) plans. It was the worst thing for the growth of 401(k) plans. Participant directed 401(k) plans spurred the growth of 401(k) plans, but it came at a price. The cost is that participants, plan sponsors, and financial advisors gave up a lot without realizing it. While this article does not condemn the use of a participant 401(k) plan, it is important to realize that they have their drawbacks and only one group within the 401(k) plan industry has totally benefited from its growth.

The Cost to Plan Sponsors

Prior to the growth of participant directed 401(k) plans, companies that sponsored retirement plans that had trustee directed investments where the investments were made by the plan's financial advisor and the trustees of the retirement plan. Since the trustees were directing the plan's investments and most trustees were the owners and/or officers of the employer, the thought was that there was an increased liability if participants sued when plan investments suffered. So one of the selling points of a participant directed 401(k) plan was the fact that plan sponsors and trustees would have limited liability under ERISA Section 404(c) if employees would chose their plan investments.

The problem with that selling point is that there such a misunderstanding of ERISA 404(c) that participant directed

401(k) plans actually increased the liability of plan sponsors instead of decreasing it. The major misconception of fiduciary liability under ERISA is that fiduciaries like plan sponsors and trustees are liable for poor investment return. ERISA is not concerned with actual investment results, but more concerned about the actual fiduciary process of selecting investments. So under a trustee directed retirement plan, a plan sponsor and plan trustees that follow the prudent process of hiring a financial advisor that implements an investment policy statement (IPS), holds regularly scheduled meetings with the financial advisor, and makes investment decisions based on the financial advisor's recommendations and the IPS will likely prevail in any lawsuit brought forth by a plan participant.

The problem with participant directed 401(k) plans is that plan sponsors and trustees have a false sense of security, that if they simply provide a lineup of mutual funds to plan participants, they are limited from liability. The sad fact is that most plan sponsors don't follow the process required by ERISA 404(c) such as implementing an IPS, reviewing investment options offered to participants with a financial advisor, and offering investment education to participants so that they can make informed investment decisions. The idea of giving participants a bunch of Morningstar profiles to participants isn't enough and so many plan sponsors learn that the hard way. Participant directed 401(k) plans have made plan sponsors less diligent in the process of being prudent in the selection of investments, thereby increasing their liability.

Of course what those that sell daily participant directed 401(k) plans don't mention is that the cost of administering these plans are certainly more expensive than plans that are trustee directed. Participant directed 401(k) plans also prior to the implementation of fee disclosure regulations in July 2011, have hidden fees like revenue sharing that plan sponsors are unaware of. Of course, plan fiduciaries have the duty to understand the cost of administering their plan and determine whether the fees they are paying are reasonable for the services provided. The fees for trustee directed plans are pretty straightforward, there is a base fee and per participant charge. For participant directed 401(k) plans, there may be a base fee, per participant head charge; asset based fee, as well as revenue sharing payments received by the third party administration (TPA) from mutual fund companies. So it is certainly no surprise that almost all of the lawsuits brought by participants against plan sponsors and trustees over high retirement plan fees are from participant directed 401(k) plans.

While the advent of participant directed 401(k) plans spurred plan sponsors to ditch retirement plans such as defined benefit plans where they contributed the bulk of retirement savings to their employees, it comes at a price tags of increased exposure to litigation. In a high litigious nation like ours, that is not a good thing.

The Cost to Plan Participants

When I first started as an ERISA attorney, I relished the idea of being a participant in a 401(k) plan where I could direct my plan investments. Of course, I have always had an interest in investments unlike 99% of 401(k) plan participants.

The advent of the participant directed 401(k) plans made three transfers that affected plan participants. First by helping the phase out of pension plans, it transferred the burden of providing retirement savings from the employer to the plan participant. With higher administration fees for daily 401(k) recordkeeping, the cost of paying for plan administration was transferred most of the time from the employer to the plan participant. Of course, the role of picking investments for retirement were transferred from the ones most prepared to make those decisions to the participants, who most of the time are the least prepared to make those decisions.

While I will always enjoy my role of picking out my investments for retirement, the fact is that too many plan participants are not getting the investment education from their employers that they need to make sound investment decisions. When I was an associate of a law firm where their plan had no investment advisor until I demanded one, I was flabbergasted by my fellow employees who related their investment decisions making including one who told me that he invested 100% of his contributions in a mid cap fund because that was the middle of the stock market. I didn't make that up.

Participant directed 401(k) plans were developed with the idea that plan participants would be more interested in electing their investments, thereby increasing participation and decreasing the plan fiduciary's liability. It hasn't worked that way. Participants had their employer provided employer contribution retirement plan with low fees and experienced investment management traded for a participant provided contribution retirement plan with higher fees and inexperienced investment management. Doesn't seem that fair of a trade.

The Cost to TPAs

While one would think that higher fees and the popularity of daily valued, participant directed 401(k) plans would be a boon to TPAs, it hasn't been. The cost of entry to the daily valued 401(k) business is so high that many top notch TPAs decided to forego that business because of the cost, low margins, and competition of lower cost providers like payroll companies. Many of the low cost providers do a terrible job of administration and keep many of the good TPAs on the sidelines. In addition, participant directed 401(k) plans require much more administrative support which has thinned out the ranks of qualified TPA professionals just like expansion in baseball diluted the talent pool of major league baseball players as too many 401(k) professionals entering the business have limited background and limited training, wreaking havoc on 401(k) plans

everywhere. If you ask many TPAs, many of them lament for the good old days where most plans were balance forward, trustee directed retirement plans.

The Cost to Financial Advisors

Participant directed 401(k) plans have stripped away one of the financial advisors' more important roles, the actual investment of a client's portfolio. Not only are financial advisors reduced in their role, their rate of pay for participant 401(k) plans are at least half as less as what they would receive if they were helping trustees direct the investments. Most financial advisor will tell you that dealing with 401(k) plans don't cut their workload in half.

Participant 401(k) plans do take a lot of work, especially offering participants investment education and offering one on one meetings. This is why many financial advisors who invest private accounts for clients have sworn off working with participant directed 401(k) plans.

Investment advisors when working with private accounts and trustee directed retirement plans have a wide slate of investment products to use to invest their client's portfolio such as hedge funds, exchange traded funds (ETFs), individual bonds, and trusts. Of course since participant directed 401(k) have been controlled through a large part by the mutual funds industry, it is no surprise that participant directed fund lineups are dominated by mutual funds with only a small sliver of 401(k) plans offering ETFs.

So while participant directed 401(k) plans should have been a godsend for financial advisors, it did strip them of most of their investment tools and their prowess in actually managing their client's investments, as well as slicing their fees in half without lightening the workload.

The Only Winners

It should be no surprise that the only clear winners in the participant directed 401(k) business is the mutual fund industry. The industry controls most of the 401(k) daily trading platforms, which of course makes sure that mutual funds are the easiest form of investments to trade by offering no transaction fee trading. Before participant directed 401(k) plans, the industry was dominated by the insurance companies who were offering annuities as a major form of plan investments. So while the domination of the 401(k) industry hasn't been a completely negative experience, it has added a variety of problems that required the implementation of fee disclosure regulations, namely the hidden revenue sharing payments made to TPAs by some mutual funds companies which can look like a kickback so a TPA and financial advisor will select funds that steer revenue sharing payments to offset what a plan participant will pay in fees to a TPA. As long as the mutual fund companies dominate the 401(k) industry, it will be hard for other investment products like ETFs to break that daily 401(k) investment ceiling.

I am not advocating that everyone moves their participant directed 401(k) plans to a trustee directed model. It should be noted that the boon in participant directed 401(k) plans came at a huge price to most of the parties in the industry, except for the mutual fund industry.

THE ROSENBAUM LAW FIRM P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw