Too Many Choices, Too Little Time for 401(k) Plan Sponsors

By Ary Rosenbaum, Esq.

Life can be like a smorgasbord table at a wedding, too many choices, too little time. As a retirement plan sponsor choosing whether to sponsor a 401(k) plan or change a current one, there are too many choices that you don't understand. This article will serve as an introduction on what choices you can make as a 401(k) plan sponsor and whether that choice may be a right fit or not for the plan you have or are planning to have.

Expenses: Employer Paid vs. Plan Paid

Usually, 401(k) plan expenses are borne by the plan participants. However, every plan provider gives you the opportunity to pay it from company assets. While the idea of having the plan pay the fees seems more affordable, if you are an individual participant as well, your retirement savings is paying part of the freight of administering the plan. Having the employer pick up the expenses of the plan is positive on two steps. First, it's tax deductible as a business expenses. In addition, the likelihood of being sued by a plan participant or being investigated by the Department of Labor for breach of fiduciary duty is less likely if the expenses are not paid from plan assets because plan participants aren't being negatively affected. How should the fees be paid? It depends on your fiscal situation and many companies can't afford to maintain a plan, so they pass the expenses to plan participants. However if the expenses can be paid by the employer, it should be considered to help limit liability.

Bundled vs. Unbundled vs. Alliance

There are three ways a plan sponsor can purchase plan services, either the services come bundled, unbundled, or a combination called the alliance approach. The bundled model is where one single vendor provides all investment, recordkeeping, administration, and education services. It's considered a one stop-shop. In the unbundled model, the plan sponsor becomes the "bundler" by getting services through a combination of independent service providers for each

critical plan task. In addition, services could also be provided through an alliance approach which combines features from both the bundled and unbundled models. The provider in the alliance generally provides recordkeeping, administration, and education services just like the bundled provider, but forms one or more alliances with partners to provide a wide array of investment options and other specialty services. Which type of provider is best? It really depends on the size of the plan and the sophistication of your human resources staff. The bundled provider is usually a better fit for smaller plans because it seems to be more costs effective because unbundled providers may have higher minimum fees that are incompatible with plans of lesser asset sizes. The one stop shop approach of the bundled provider offers more ease, but the unbundled provider approach may offer a system of checks and balances between independent providers and offer the plan sponsors to pick different providers that are the best of the best. Like a tailored suit, picking which provider approach is about fit and feel.

Trustee directed vs. participant directed

401(k) plans traditionally were valued on an annual basis and the investments were directed by the plan's trustees. As computer technology improved through the early to mid 1990s with the push of the mutual fund industry, daily valued 401(k) plans where the investments were participant directed become more prevalent. The reason? Plan sponsors are on the hook for liability if the plan is trustee directed and ERISA Section 404(c) protects plan sponsors from investment losses if the plan investments are directed by the participants. However, Section 404(c) only protects plan sponsors who go through a fiduciary process that gives participant enough information to make informed investment decisions which includes the development of an investment policy statement, review of plan investment options, and offering education to plan participants. Which is best? Trustee directed plans cost less than participant directed plans because annual valuations cost less than daily valuation. While ERISA 404(c) plans are supposed to cut down a plan sponsor's fiduciary liability, a plan sponsor who isn't up to the task of doing their job in giving their employees enough information to invest maybe more at risk for liability than if

the plan was trustee directed because the trustees are usually making the investment decisions based on sound investment advice from their financial advisors. If you are up to the task and you have a knowledgeable retirement plan advisor, a participant directed plan will cost more but save more in potential liability.

Passive vs. Active

This is the investment debate that will be debated for a millennium to come. The argument is whether investments should be made in active investments, a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index or passive investing (index funds). This decision will be made by the investment advisor you select, so it's your decision whether to seek an investment advisor who prefers an active or passive strategy. While the goal of active investing is to outperform the index, a large majority of investments and advisors fall short. While passive investing tries to meet the benchmark index set by the investment, investment expenses and 401(k) plan expenses (if paid by the participants) make that impossible. What's best? I'm not going to touch that with a ten foot pole, it just depends on what you are most comfortable with.

Mutual Funds vs. Exchange Traded Funds (ETFs)

The newest debate is whether 401(k) plans should be invested in mutual funds or exchange traded funds (ETFs). While mutual funds have dominated the industry because many of the no-transaction fee 401(k) platforms are operated by mutual fund companies, ETFs (which typically track a stock benchmark index) have slowly been gaining traction because of fee disclosure (ETFs are more transparent) and the costs in trading them (they trade like a stock) have dramatically decreased. Which is best? Again, this is one determined by your financial advisor. If you are a passive investor, ETFs should be considered. If you like the active strategy of investment, an EFTF is not a good fit.

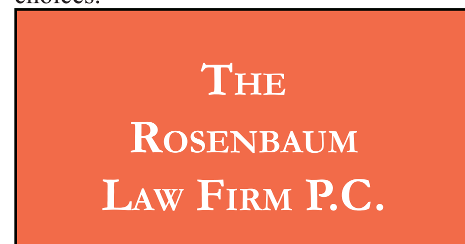
Safe harbor vs. non-safe harbor

401(k) plans must go through discrimination testing to make sure that they don't discriminate in favor of highly compensated employees. Plans that fail testing may have to make corrective contributions to non-highly compensated employees or in some cases, refund money to highly compensated employees that will be taxable. To avoid the issues of failed testing, the Internal Revenue Service (IRS) instituted safe harbor plan design. The safe harbor plan design requires plan sponsors to produce a notice of this election to plan participants at least 30 days prior to the plan year (December 1 for calendar year plans). The notice specifies that the employer will make a fully vested contribution to the non-highly compensated employees which may be the form of a 3% contribution to all participants or a matching contribution to those who make salary deferrals in the plan. What type of plan should opt for a safe harbor plan design? Plans that have had testing issues in the past as well as plans old and new that have demographics showing very poor participation by non-highly compensated employees.

New Comparability vs. Uniform Method of Allocation

While the profit sharing contribution under a 401(k) plan is always discretionary, an employer has a choice in its method of allocating that contribution. It can use a uniform method of allocation of comp to comp (uniform percentage of compensation to all employees), integrated (give a larger contribution to those who are paid in excess of the Social Security Wage Base), a points system, or on an age weighted basis. Another type of contribution which must be specially tested (usually at an added fee) is something called new comparability or cross tested method of allocation. Under this allocation, employees are divided into groups with the hopes of giving larger benefits to highly compensated employees while making a minimum gateway contribution to the non-highly compensated employees. The allocation can be made in conjunction with the 3% safe harbor non-elective contribution where that 3% is used to offset the minimum gateway contribution. Under new comparability (subject to testing), the non-highly compensated employee would get a minimum gateway contribution of the lesser of 5% or 1/3 of the highest allocation provided to a highly compensated employee. In English, if a rank and file employee gets a contribution of 3% of salary, the top paid people can get 9%. If the rank and file get 5%, the top paid people can get 20%+. Who is this a fit for? Employers, who can afford the contribution and want to reward their highly compensated employees, but maintain a minimum contribution to their rank and file employees.

These are just some of the many choices you will have to make in reviewing or implementing your 401(k) plan. Choices may be confusing, but if you have the right financial advisor, TPA, and ERISA attorney, you will be given enough information by them to make educated choices.



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