There Is No Such Thing as Free 401(k) Administration

By Ary Rosenbaum, Esq.

There is no such thing as the Easter Bunny, or the Tooth Fairy, or the Boogeyman. While we can laugh at it, it's surprising to note that many plan sponsors still believe they pay nothing for 401(k) plan administration even in a time where they get fee disclosures that claim that they do. So this article is about the myth of free 401(k) administration. So Virginia, there is no such thing as free 401(k) administration.

The myth of free 401(k) administration

The myth of free 401(k) administration is the idea that since a plan provider such as a third party administrator (TPA) charges a nominal up front charge or nothing at all, that's all the cost that a plan is being charged for the administration of their plan. Financial advisors and competing TPAs are amazed when potential clients insist that they are being charged nothing or close to nothing for their plan when these plan providers know full well that these plan sponsors are taken to the cleaners. While fee disclosure regulations require plan providers to reveal the fees they receive to plan sponsors, there are still some plan sponsors that insist they pay nothing for administration and there are several TPAs that still insist they work for free.

Who the "Free" TPAs are

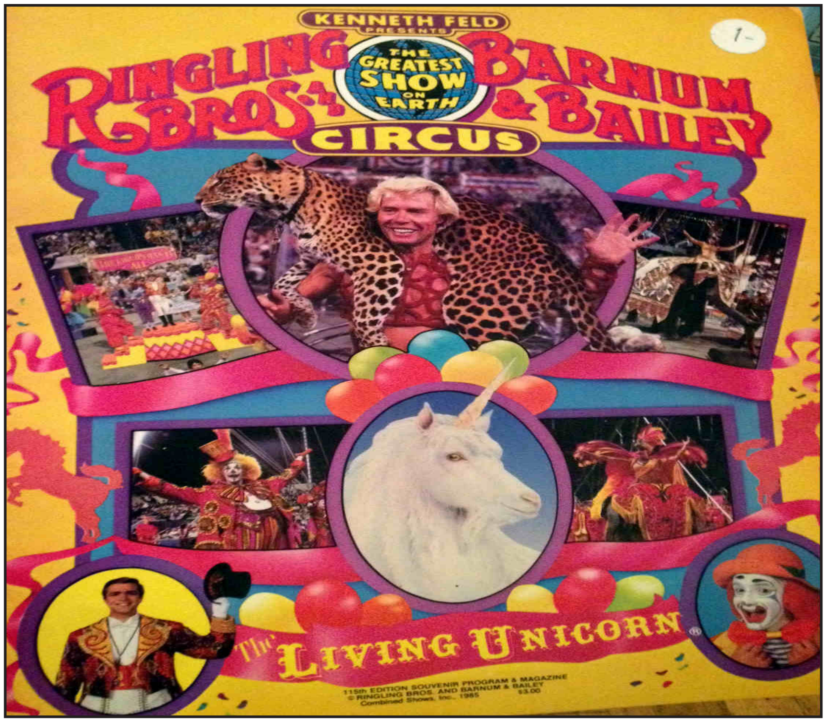
The TPAs who have helped perpetuate the myth of free 401(k) administration tend to be either bundled providers (where one single vendor provides all investment, recordkeeping, administration, and education services and that vendor is either an insurance company or mutual fund company) or those using an insurance company based platform or those TPAs that are payroll providers.

Administration costs money

I worked for TPAs for over 9 years and it's a thankless business because TPAs do the bulk of the work of a 401(k) plan and get none of the credit. In addition there is so much cost that is associated with running a 401(k) administration practice, especially if the practice offers daily valuation. Recordkeeping software, computer infrastructure, and staff are just some of the huge costs that are associated with daily 401(k) administration. Since there is such a huge cost in maintaining a TPA practice, it's impossible for a TPA not to charge fees. TPAs have not taken a vow of poverty; they must be compensated in some way.

Mutual fund company TPAs aren't free

Since the 401(k) industry is dominated by mutual funds, it should come as no shock that many mutual fund companies offer services as a bundled provider because it's an effective means of distributing their mutual funds. Mutual fund distribution is extremely important for mutual fund companies because their bread and butter are the funds' asset management fees and more assets under management equal more revenue for the mutual fund company. While many mutual fund companies only offer TPA services for larger plans, there are a few mutual funds companies that have been rather aggressive in offering TPA services to small and medium size plans. While mutual fund companies do offer an attractive alternative as part of a one stop shop, plan sponsors are under misimpression that the mutual fund companies' TPA services are free. Mutual fund companies make their money as a bundled provider through those very same mutual fund management fees that I had discussed earlier. Many of the same companies that offer TPA services are the very same mutual funds companies that offer revenue sharing or sub TA fees to unbundled TPAs for plans that use their funds. So by keeping plans under their roof, these mutual funds companies can keep their revenue sharing/ sub-TA fees to themselves. These mutual fund



companies also guarantee the fees they make, by suggesting that a percentage of a plan's assets (up to 100%) be invested into their own proprietary mutual funds. Having a mutual fund lineup dominated by one mutual fund company can be considered a liability risk.

Neither are insurance company TPAs

The myth of free 401(k) administration is also associated with insurance company providers whether it is through an unbundled or bundled arrangement. While insurance companies do offer different types of programs that cater to plans of all sizes, the myth is associated with insurance based platforms devoted to 401(k) plans that are small (size dictated by plan asset size). Insurance company providers offer a" low" cost 401(k) program that is attractive to small companies or new 401(k) plans that have very few assets. While most independent TPAs may have minimum annual recordkeeping fees that may be between $2,500 and $7,500, an insurance company can offer their platform for $1,500 or less in administrative expenses (whether bundled or unbundled, using an independent TPA), or even "free." How can an insurance company offer recordkeeping services for free? Well, the recordkeeping services aren't free; they're "free." The mutual funds that an insurance company offers on platform include the mutual fund (with their underlying management fee) and a wrap fee. While the local department store offers free wrapping, the insurance companies' wrap fee isn't free. The wrap fee is an additional asset based fee that a Plan sponsor rarely sees or never sees if they swear they get their administration for free. So while participants think the mutual fund on their 401(k) plan's "shelf" is the brand named mutual fund they have known to love, it's really that same mutual fund with some added fat (a wrap fee of added expenses). There is nothing wrong with a wrap fee because an insurance company needs to make money and the fact is without this wrap fee, most small 401(k) plans would probably never be implemented because of the high administrative cost for Plans that don't use the insurance company based platforms.

Fee disclosure regulations helped end the myth or so we thought

Much of the myth of free 401(k) administration has been debunked when the Department of Labor 408(b)(2) fee disclosure regulations were finally implemented in 2012. All plan providers including insurance companies and mutual fund companies have had to disclose to plan sponsors and fiduciaries all direct and indirect compensation they receive in providing services to the plan. So if plan sponsors actually read the disclosures (as they should, to avoid increased liability), they will notice that the "free" administration that they have been receiving for the plan came at a price far greater than they ever imagined. In order to avoid having their transaction with their "free" TPA to be considered a prohibited transaction (with financial penalties attached), plan sponsors and fiduciaries must determine whether the fees they are paying are reasonable for the services provided. The only way to do that is to shop the plan to other providers and utilize independent retirement plan consultants and ERISA attorneys to help with a plan fee review.

Fee disclosures doesn't stop TPA sales people from making false claims

In 1985, the Ringling Bros. circus said that they had a unicorn, yet few people believed them because they know unicorns aren't real. A TPA salesperson will tell plan sponsors that their services are free and almost all plan sponsors will believe them because they don't know that TPAs need some sort of remuneration to be in business. Just because a TPA sales person tells you their services are free, you should know better. TPA services aren't like a free sample it's very expensive to properly administer a retirement plan so a TPA must be compensated in some way. Whether it's offering integration with their payroll service or using their funds or fully disclosed expenses, TPAs must be compensated in some fashion. Plan sponsors need to understand that their TPA does make money on working on their plan and determine through fee disclosures how they are paid and if the disclosures are confusing, ask them to explain how they are compensated. Fee disclosures aren't fool proof, it's a system based on plan providers being fully truthful in disclosing their fees and I'm sure that there maybe a few TPAs out there that are fudging the truth. That is why it's extremely important for plan sponsors to benchmark their fees either using a service or by seeking out other plan providers for a fee quote. If plan sponsors are aware that TPAs must be compensated in some way for the work they do, then TPA sales people who aren't truthful about their claims about free service will be called on the sport for their lies.

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