The Hidden Dangers for the 401(k) Plan Sponsor

By Ary Rosenbaum, Esq.

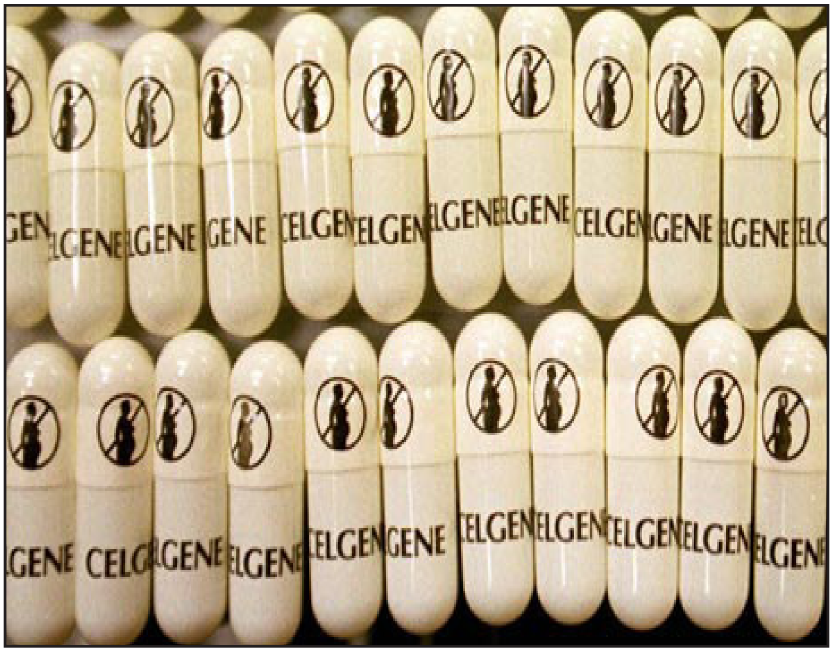
Thalidomide was supposed to be the wonder drug that helped women manage morning sickness until they discovered it caused birth defects. Asbestos was supposed to be the ultimate fire resistant material that was later found out to cause mesothelioma when produced or when disturbed. When companies decided to ditch defined benefit pension plans for a cheaper alternative in the 401(k) plan, they also had a hidden danger with a 401(k) plan, but it doesn't have to be that way. Unlike dangerous products like Thalidomide and Asbestos, a 401(k) plan doesn't have to be a danger. If managed correctly, a 401(k) plan is an effective retirement plan for the employer and employees. If not, it's retirement plan thalidomide except the plan sponsor doesn't know the danger. This article is about the hidden dangers of a 401(k) plan and what steps plan sponsors can take to minimize that threat.

The switch to 401(k) plans

The 401(k) plan has been around for over 30 years and there are many reasons for their popularity. By employers switching from defined benefit plans to 401(k) plan over, employers saved money by switching the burden of funding retirement to the employees. However, most 401(k) plans up until the mid-1990s were still like traditional pension plans where the employer made the investment decisions guided by experienced financial advisors. Thanks to great marketing by the mutual fund companies, 401(k) plans went to daily valuation and that increased the potential liability that plan sponsors could have in sponsoring these plans. The frequentness of the valuations didn't cause the increase, but who was making the investment decisions did. By switching direction of plan investments to participant direction under a daily valued 401(k) plan, it also switched the selection of investments from employers aided by financial advisors to the folks who have the least amount of background to make these tough decision, the plan participants. By switching the direction of investments to participant direction, it increased the liability a plan sponsor could suffer from having participants make investment decisions, which was 180 degrees from what participant direction was supposed to, which was minimize the plan sponsor's liability. Unfortunately, it hasn't turned out that way.

The hidden danger of participant direction

When mutual fund companies saw the potential of 401(k) plans, they ramped up their marketing to push for daily valued 401(k) plans where participants could direct their own investments. By switching direction of investments from the plan sponsor/trustee to the participant, mutual funds would be the main form of investments (which are less likely the case for trustee directed plans). More mutual fund shares sold, more management fees earned by mutual fund companies. The mutual fund companies and the third party administrators (TPAs) that offered daily valued plans touted that participant direction limits a plan sponsor's liability. The problem is that they never told them the details and the dangers associated with it. ERISA §404(c) is a section within the Employee Retirement Income Security Act that states that participant direction of investments will not hold the employer liable for any gains and losses that a plan participant experiences. The problem is that most plan sponsors don't know that ERISA §404(c) isn't a suicide pact; just handing direction to plan participants isn't enough to minimize liability. ERISA §404(c) is a sliding scale in offering protection, dependent on what plan sponsors do for their participants. Plan sponsors need to provide information to plan participants in order for them to make informed decisions. The problem is that too many participants don't have the background or knowledge to make informed investment decisions and too many plan sponsors have done very little in helping their employees out. At the very least, plan sponsors need to offer investment education to plan participants so they could understand the basics of financial investing. Simply handing out mutual fund brochures or Morningstar profiles isn't going to do the trick. In addition, plan sponsors should consider offering investment advice to participants where they could seek the advice of a plan provider in order to determine which investments should be selected by them based on their age and financial situation. Offering investment education and/or advice has been shown to increase the investment return by plan participants and the fact is that plan participants don't sue plan sponsors for any ERISA §404(c) breach if they are making money in their own investments. It's imperative that if plan sponsors offer or want to offer participant direction in their 401(k) plan, they should make sure that plan participants get the information they need to make informed investment decisions. If they do that, whatever the plan participants loses in their 401(k) account isn't going to be the plan sponsor's headache. Of course educating plan participants is just one thing to minimize liability under ERISA §404(c); there is another big prong to take care of.



Hiring a bad financial advisor is just as good as hiring no advisor, actually it's worse

Any qualified plan under ERISA should have a financial advisor working on it. Whether a plan has the participants or trustees direct the investment, a financial advisor is an integral part to a well-run 401(k) plan. The problem is that there are too many financial advisors who don't handle their duty, which is to help the plan sponsor minimize their fiduciary liability. A financial advisor is supposed to assist the plan sponsor in managing the fiduciary process. To help limit liability whether the plan is participant or trustee directed, that means developing an investment policy statement (IPS) that dictates which investments will be offered under the plan and when they should be jettisoned for a better investment. It also means showing up to meet the plan fiduciaries every so often to review and replace plan investments instead of being a "milk carton" advisor who hasn't been seen by the plan sponsor in years despite collecting the quarterly fee. Having a financial advisor who doesn't do their job is as bad as having no advisor. Actually it's worse because you're paying someone to do nothing and a plan sponsor has to pay reasonable fees for plan services and no fee is reasonable if the requisite work isn't being done.

Being responsible for the mistakes of a provider

Regardless of the provider a plan sponsor chooses, they are on the hook for liability because a plan sponsor is a fiduciary and they are always on the hook for liability. So while plan providers cite their ERISA fiduciary status by throwing numbers like 3(16), 3(21), and 3(38) that assumes a lot of liability, plan sponsors will always be on the hook if they hire an incompetent plan provider that offers an ERISA section numbered service. Too often, plan sponsors bemoan that that it's not fair that they take the blame of the incompetent plan provider such as a TPA that hasn't done a proper valuation report since the Carter administration. All's fair in love, war, and being a plan fiduciary. The blame and liability go with the position of plan fiduciary.

Fees, fees, fees

A plan sponsor has a fiduciary duty to pay reasonable plan expenses and thanks to fee disclosure regulations, now gets a disclosure of fees from their plan providers and they have to make sure that participants in a participant directed 401(k) plan get disclosures of fees as well. If the plan sponsor and/or plan participants don't get the requisite disclosures, you know who gets the blame? Not the plan provider, but the plan sponsor. The distribution of fee disclosures isn't enough; plan sponsors have to benchmark their fees against what other providers offer to make sure that the fees are reasonable for the services provided. That means checking what's out in the marketplace and see if a plan sponsor finds out they are being overcharged for what they are getting, they have a fiduciary to make a plan provider change. Fees have to be reasonable for the services provided, so a plan fiduciary can make a big mistake by just picking the cheapest provider and finding out that the service isn't very good. In addition, plan sponsors have a duty of prudence to make sure that the expense ratios of the investments offered in the plan are reasonable, based on the size of the plan.

A 401(k) plan doesn't have to be a hidden danger; it can be an effective retirement savings vehicle for plan participants. All that is required is a vigilant plan sponsor aided by competent plan providers.

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