401(k) Plan Sponsors Maybe Cutting Their Nose To Spite Their Face

By Ary Rosenbaum, Esq.

I once worked for a man who was the type of person who wouldn't have minded to have lost $5 to save $3. I was at a Synagogue where the fundraising chairperson would only always organize events at the very last minute and never wondered why we never netted as much needed funds as we should have. I once worked at a law firm where the marketing department was busy working on articles written by the firm's administrator that would draw no business. So needless to say, I don't like when people cut their nose to spite their face or people who just don't see the bigger picture. So this article is about how employers can avoid cutting their nose to spite their face when it comes to retirement plans.

It's an employee benefit, buddy

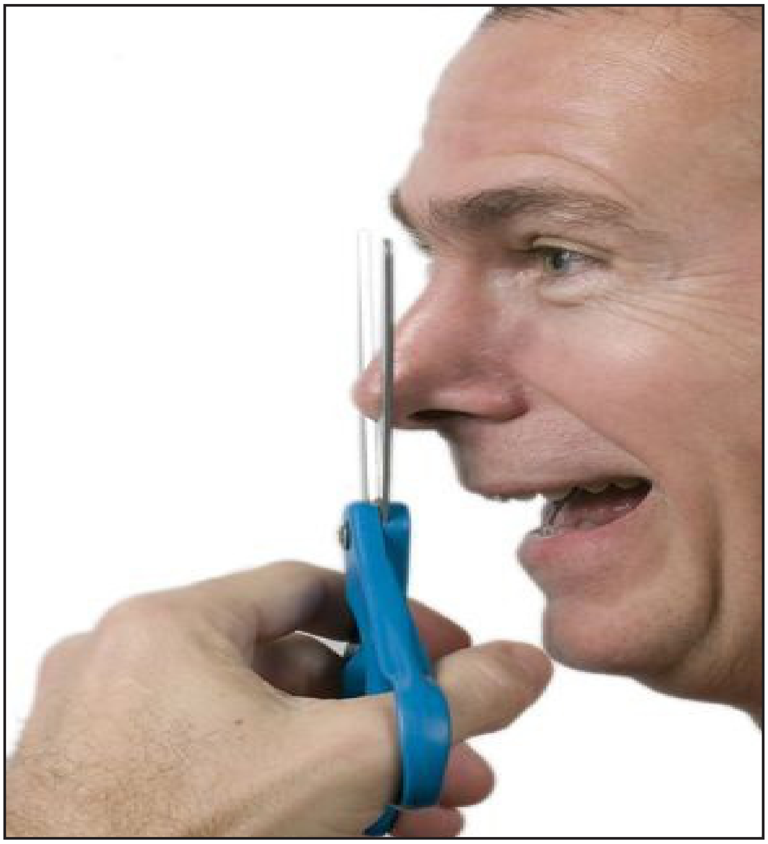
I worked at an employee benefits firm that had lousy benefits. The health insurance kept on changing each year with the premiums going up and the quality of service going down. Our 401(k) plan was at an expensive bundled insurance platform so we could keep our premier pricing there and that platform wasn't on our side. They offered that hokey legal insurance plan because one of the partners was touting it. Yet the only employee benefit they ever complained about is when they stopped providing free milk for the K Cup machine. Seriously, plan sponsors need to recognize that whether they have a retirement plan or consider implementing one is that it's an employee benefit. A retirement plan like any other employee benefit is a tool to retain and recruit employees. So if the employer isn't offering a retirement plan or a small business plan (such as a SEP or SIMPLE-IRA) with less allowable retirement savings, they stand to lose and/or fail to recruit a high level of employees. Even if they offer a retirement plan, a poorly run plan isn't going to do much either in terms of recruitment. So an employer could certainly cut their nose to spite their face by not remembering the basic of what a retirement plan is all about, being an employee benefit that could be an effective tool in recruiting and retaining employees.

Using the retirement plan as a patronage mill

When I was in college, I was very involved in politics. I had a friend who pointed that the political party could shell out $250,000 for a town supervisor's race that they were going win anyway and couldn't spend $40,000 on a congressional race because Town Hall had thousands of employees and that was the spoils for the party to stock their faithful supporters. While that's a common practice to turn government jobs into some sort of patronage mill, it can't be done and shouldn't be done when selecting retirement plan providers. A retirement plan must be for the exclusive benefit of its participants. In addition, a retirement plan sponsor is a fiduciary and that means they have the highest duty of care in law and equity. There is also prohibited transaction rules which are supposed to bar plan sponsors, fiduciaries, and other disqualified person from using plan assets for their direct or indirect benefit. So the owner of the company sponsoring a plan can't use his wife as the financial advisor for the plan. While the prohibited transaction rules are there, it's limited. There is nothing wrong in the prohibited transaction rules that would bar a plan sponsor from hiring their cousin as a plan provider. However, selecting plan providers has to be done on the up and up. Selecting plan providers should be based on an actual rational criterion such as experience, cost, level of service, and reasonableness. Selecting plan providers through nepotism, cronyism, or to curry favor will be put under the microscope through litigation or governmental review. Even if there is an appearance of impropriety, which suggests that the selection of the plan provider was not done properly, that's an issue. Just ask Oracle who was sued because they selected a bundled plan provider, which included proprietary mutual funds. What was the problem? That mutual fund company is one of the largest institutional shareholders of Oracle. Even if nothing improper was done, the appearance of impropriety invited this costly litigation. If it's wrong, a plan sponsor should avoid it in selecting plan providers. If it looks wrong, a plan sponsor should avoid it as well.

Not caring who the TPA is

Many retirement plan sponsors use their financial advisor or ERISA attorney as the plan provider they rely on most. There is nothing wrong with that as long as the financial advisor or ERISA attorney intro-



duces the plan sponsor to a third party administrator (TPA) that could do a credible job in helping the plan sponsor with the day to day operation of the retirement plan. Plan sponsors need to understand that it matters who their TPA will be because, with all due respect to financial advisors, ERISA attorneys, and other plan providers, the most important plan provider that a plan sponsor can hire is the TPA. Why? It's the nature of the position; the TPA does the bulk of the work. Day to day administration involves a lot of moving parts including preparation of Form 5500, trades, reconciliation, transfer of funds, and compliance testing. Since there are so many pieces to a TPA's puzzle, the likelihood that there is some sort of error rises based on the lack of quality on the side of the TPA. The problem with hiring a bad TPA is that the plan sponsor is on the hook for the liability, penalties, and headaches that go with it.

Not understanding plan design and not wanting to give contributions to employees

One of the most poorly understood ideas is how much employers can maximize tax savings and retirement savings for their highly compensated employees just based on plan design. Plan design is an art, it's like chess in terms of how the numbers move in providing minimum benefits to rank and file employees and maximum benefits to highly compensated employees. A retirement plan with a poor design is inefficient and inefficiency costs money because that might lead to more dollars in the hands of the government. For example, 401(k) plans that fail their deferral discrimination testing may require highly compensated employees to receive all or a portion back of their salary deferrals. Refunds are never good because they're a taxable event and it can simply be corrected through a safe harbor plan design. Too many employers have inefficient plan designs when they give the same percentage of compensation contribution to their employees when rules out there allow for a disparity of contributions between highly compensated and non-highly compensated employees. An example is a 401(k) plan where every employee gets a 3% of compensation contribution. If the 401(k) plan added a new comparability/cross-tested allocation, highly compensated employees may get a contribution up to 9% of their compensation while non-highly compensated employees get that 3%. In addition to cross testing and safe harbor plan design, another huge tactical advantage is the combination of a 401(k) plan with a cash balance or defined benefit plan. I have seen huge retirement savings offered to highly compensated employees (who are usually the owners of the business) while providing a benefit to the rank and file employees. It seems like a no brainer for the plan sponsor to add a more efficient plan design, but surprisingly a majority of retirement plans out there have an inefficient plan design. Why? First, many plan sponsors have a TPA (usually a payroll provider or bundled provider) that aren't experts in plan design. Second, too many plan sponsors don't want to commit to such contributions because of cost. Third, there are actual plan sponsors that wouldn't want to fund contributions where the highly compensated employees get the bulk of it just because the rank and file get a minimum contribution. Plan design is the biggest area where I see plan sponsors cutting their nose to spite their face because they have a TPA that can't offer an efficient formula or because they just don't want to maximize tax savings because they have to give a benefit to the rank and file.

Not understanding the real role of a financial advisor

A financial advisor is an integral part of a 401(k) plan. A financial advisor is there to help manage the fiduciary process of the plan. That process is creating an investment policy statement to serve as a blueprint to select and replace investment options. It also includes offering some type of education and/or advice to plan participants to make sure they had enough information to make informed investment decisions if they were directing their own investments in the plan.

Not reviewing and benchmarking fees

While fee disclosure is one of the best things that ever happened to the retirement plan industry in the last dozen years, I'm still surprised by the number of plan sponsors who still don't review the disclosures they received from plan providers. Reviewing isn't enough, plan sponsors also have to benchmark those fees against what other plan providers. So many plan sponsors leave themselves open to liability just because they aren't doing their job as plan fiduciaries which means only paying reasonable plan expenses.

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