The Smaller The 401(k) Plan, The Bigger The Problems

By Ary Rosenbaum, Esq.

401(k) plans are in a world of contradictions. It's one of the few employer provided benefits that an employee usually pays for. Most 401(k) plans offer participant directed investments and participants are usually the least equipped to make financial investment decisions. 401(k) plan sponsors can be held legally responsible for administration fees that their plan providers were not legally required to tell them about until January 2012. Based on my experience, one of the biggest contradictions is that the smaller the 401(k) plan, the bigger the problems.

It is natural to assume that larger 401(k) plans which have more participants and more assets than smaller plans that should have the largest problems. However, it's the larger plan's size that makes it easier to manage and avoid some of the administration, compliance problems, and fee issues that smaller plans have. This contradiction is based on the fact that in the daily valued 401(k) plan, all plans are not created equal. Asset size dictates pricing, level of care, and level of service for 401(k) plans so a larger plan will be at an advantage over a smaller one.

Over my 12 years as an ERISA attorney, it has been my experience that smaller 401(k) plans are more likely to have issues concerning plan compliance, hidden administration fees, and increased fiduciary liability as it pertains to participant directed investments than their larger counterparts. There are a quite a few reasons for this predicament.

Larger 401(k) plans are typically sponsored by larger companies and smaller 401(k) plans are sponsored by smaller companies. One of the major differences between a larger and smaller company is the experience of the human resources staff that will handle most of the 401(k) issues. Larger companies have a human resources director with a background in employee benefits or they may even actually employ their very own certified employee benefits specialist. A smaller company that sponsors a 401(k) plan will have a less experienced human resources staff with almost no retirement plan experience or if there is no h.r. manager, this function may actually be handled by own of the owners of the company. The difference between the two is that a larger company with a staff that is well versed in retirement benefits will have an easier time to act as a check and balance on plan providers to ensure that they are doing their jobs, as well as picking up the slack when the providers drop the ball. The human resources staff of a smaller company may have a difficult time in identifying retirement plan issues, often relying too much on the plan providers to their detriment because it's the plan providers that cause most of the errors that cause huge 401(k) problems.

When it comes to selecting a third party administration (TPA) firm for their plan, larger 401(k) plans have a wider variety of providers to choose from because thanks to economies of scale and larger revenue

sharing payments received because of increased asset size, they pay less in fees as a percentage amount when compared to plan assets. Larger 401(k) plans will likely choose unbundled TPAs as a result, which avoids some of the large fees charged by bundled providers and insurance based platforms. Smaller 401(k) plans choose bundled providers or insurance company based platforms because of the low base fees, unaware of some of the wrap fees layered into the specific plan investments. That is why so many smaller 401(k) plans are insistent that they pay nothing for plan administration when they do, at a larger percentage in fees as compared to plan assets. It is a fact that the TPAs that were the first to fully disclose fees before they were legally required were unbundled providers because they were less likely to be less forthcoming because they had no connection to the assets in the Plan. Having 12 years of experience in the business, I do believe that unbundled TPAs are a better value than bundled providers and insurance company based platform providers because they offer a better level of care and a better understanding of retirement plan design to suit the needs of their clients. Most of the 401(k) plan errors that I have had to correct where errors committed by bundled providers and payroll provider TPAs.

Smaller 401(k) plans are more likely to hire financial advisors with less of a background in retirement plans than larger 401(k) plans. Many small plans employ financial advisors who have very few retirement plans under management, which means they are less likely to be familiar with some of the requirements that retirement plans must meet to ensure continued qualification under the Internal Revenue Code and ERISA. Larger 401(k) plans are more likely to hire financial advisors that have more experience in the most important roles that a 401(k) plans financial advisor has, such as the development of an investment policy statements (IPS), constant review of plan investments to see if it still meets the requirements of the IPS, as well as providing education to plan participants to meet the requirements of ERISA §404(c). I call inexperienced financial advisors who have a very small book of retirement plan assets, small potato financial advisors because of their lack of experience when it comes to the fulfillment of their duties. These advisors are less likely to fulfill their duties in helping plan sponsor through the fiduciary process and some may also hold the same belief of the free 401(k) administration myth discussed above.

One of the biggest advantages that larger 401(k) plans have over smaller plans is a legal requirement that most plans would like to avoid. Retirement plans with more than 100 participants generally are required to procure an independent audit from a CPA firm to accompany their Form 5500. While the audit is there to check the financial status of the plan, it is often a check and balance against other plan providers to ensure that the plan operates according to their plan document and the law. From experience, I have seen audits root out unnecessary fees charged by a TPA as well as finding compliance issues dealing with lack of repayments on participant loans. While no audit is fool proof, it is an effective mechanism to oversee that the TPA and financial advisor are doing their jobs correctly. I had one client who discovered that their TPA was pocketing revenue sharing payments received from mutual funds companies instead offsetting their fees as promised and it was the auditor that caught the fraud. A plan which didn't require an audit would never have recovered those pilfered amounts.

While I do believe that smaller 401(k) plans are more likely to have larger problems than larger plans when it comes to compliance, limiting fiduciary liability, and minimizing administrative cost, it doesn't have to be that way. Smaller plans have larger compliances issues because they don't implement a system of checks and balances in place to ensure that plan providers are doing their jobs in a correct manner. A system of checks and balances is a situation where a plan sponsor can simply hire independent, professional plan providers that ensure that the other providers are doing their job. So a smaller 401(k) plan should utilize the services of an independent TPA, and independent financial advisor (which means not linked to the TPA), and an independent ERISA attorney. From experience, the best retirement plans are where all plan providers are well versed in the retirement plan business, so they understand their duties and the duties of the other providers.

Bigger doesn't have to be better as long as smaller 401(k) plan sponsors start taking their fiduciary liability more seriously. The first step is assembling a top notch team of independent plan providers.

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