THE ROSENBAUM LAW FIRM P.C.

Perspectives

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For Retirement Plan Sponsors
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Avoid Paying Retail on 401(k) Plans If You Can

Edison Case in California May End Up Being a Landmark Case

Edison International, the California based utility lost a court case in Federal court brought by participants of their 401(k) Plan. While this case may not appear earth shattering, I think the details of the case could have ramifications nationally.

This is not a typical revenue sharing case. Edison paid for the bulk of the administration of their Plan by Hewitt through their own pocket. While the funds in the Plan did provide some revenue sharing to Hewitt, Edison had replaced some of these funds over time with funds that paid less revenue sharing. So the Court rejected the participants' claims that Edison breached ERISA's duty of loyalty under ERISA §404(a)(1)(A) because there was no evidence that Edison picked funds based on revenue sharing.

What is interesting part of the case is the issue of retail vs. institutional class. For some inexplicable reason, Edison used retail share mutual funds in their Plan, which is perplexing for a Plan of a company like Edison. The Court claimed that Edison breach a duty of prudence under ERISA § 404(a)(1)(B) because Edison never considered using institutional class shares for there mutual funds that offered them, the William Blair Fund, the PIMCO Fund, and the MFS Total Return Fund. The court found that the staff for Edison recommended adding the retail share classes of these three funds without considering whether the institutional share classes offered greater benefits to the Plan participants.

Why is this case such a big deal? Mutual funds have share classes that look like alphabet soup with a different letter indicating a different fee or load. If a particular fund in a Plan offers multiple classes of shares, a Court may hold that an employer breached ERISA's duty of prudence by not considering a share class that was a better benefit for Plan participants. An advisor and a plan sponsor should be aware of the share classes offered for each mutual fund under their Plan and to determine whether an institutional class may be available to them. If not, they may learn the hard way like Edison International.

Payroll provider TPAs are not Fiduciaries

Just another reason why the Paychex and ADPs of the world should stick to payroll.

I have been practicing as an ERISA attorney for almost 12 years. I don't handle criminal matters because I don't have the background and I will probably land my client in jail. I stick to what I know. The retirement plan industry requires expertise and an intricate background to know the nuances of ERISA and the Internal Revenue Code. For the most part, third party administrations limit themselves to administering retirement plans because they stick to what they know. However, payroll providers like ADP and Paychex think that administering 401(k) plans is just a natural outgrowth of running payroll. Aside from making sure deferrals from payroll end up in the Plan's trust, 401(k) administration almost has nothing to do with payroll.

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While these payroll companies convince their customers that they can save money by having them handle the employer's payroll and 401(k) plan administration, they unknowingly cost the client in the long run because the administration is so poor. I have seen many instances where these payroll providers accept incorrect data from the client without double checking and run tests based on that faulty data. The worst aspect of these payroll providers is that is when the plan sponsor has no broker or adviser to handle fund selection; they present the plan sponsor with a fund lineup. The problem is that these payroll providers can not give any investment advice and disclaim any role as a fiduciary, which unknowingly exposes the plan sponsor to liability under ERISA 404(c).\

In a recent court case, Zang v. Paychex, a U.S. District Court Judge in Western New York that Paychex did not breach fiduciary duty by offering a fund menu with revenue sharing producing funds because Paychex was not a fiduciary and the plan sponsor ultimately picked the funds. Paychex was not considered a fiduciary because the administrative services agreement specifically stated that they served no role.

I always say you get what you pay for, that is why the 401(k) administration services of payroll provider are a little left to be desired.

Tell the 401(k) Chicken Littles, The Sky Won't Fall.

Fee disclsoure will not destroy the retirement plan industry, people will still defer.

When I first started in the business in 1998 as a junior ERISA associate for a small firm in Syosset, I was trained by a paralegal named Marge can't be called an ERISA paralegal because her career predated ERISA. I never appreciated Marge until years later and some of her pearls of wisdom still resonate today.

When talking about change in the retirement plan industry (at the time of the GUST restatements), Marge said when the Tax Reform of 1986 went into effect for retirement plans in 1989, several ERISA law firms and administration firms closed their doors because they could not make the transition for one reason or another.

That pearl still resonates today because of the implementation of 401(k) fee disclosure next year. While most of the industry supported fee disclosure, mutual fund and insurance companies lobbied long and hard against it. One of the claims against fee disclosure is that it will hurt the industry. On the message boards, I came across one individual who thinks that the ills of the 401(k) industry are the fault of those who champion fee disclosure. He also claimed that fee disclosure will cause participants to stop deferring and that only low cost third party administration firms will thrive.

Fee disclosure for 401(k) plans will not cause the sky to fall. People will continue to defer, third party administration firms will continue to be in business. While low cost providers may do well in a fee disclosure environment, low cost is not the only consideration for sponsors in their plan's administration. If people only concentrated on price, we would all be driving Yugos. As with the Yugo, plan sponsors will consider cost, but will also look to quality of service. Quality of service certainly doomed the Yugo.

Plan providers that embrace fee disclosure will thrive. Those providers that can't make the change to fee disclosure because they thrived on hiding fees will die. That is business. If you cannot change with the times, the times will change you. Fee disclosure may change the landscape of the retirement plan industry, but I am confident the industry will adapt.

2 Cents on ETFs in 401(k) Plans.

The advantages of exchange traded funds are stripped in the daily 401(k) world.

I always say that if we lived in an ideal world, we'd all be using Macs instead of PCs and Betamax would have won the VCR format war. If we lived in an ideal world, we'd all be using Exchange Traded Funds (ETFs) in 401(k) plans. We don't live in an ideal world.

On August 9th, I was quoted in the Wall Street Journal regarding the use of ETFs in 401(k) plans. Personally, most of my non-retirement money is invested in ETFs. I like ETFs because of its transparency, liquidity, and different investments styles and sectors that they offer.

The 401(k) daily platform is based on no transaction fee mutual funds. Trading of ETFs have trading costs. Since most 401(k) plan fees are paid by the participants, this will only increase their cost and will impact their rate of return. The advantages of ETFs will also be lost in the daily 401(k) world because participants won't be allowed to time the trading of their ETF holdings or invest in exotic ETFs, ERISA §404(c) won't allow a double inverse Chinese ETF as a proper plan investment.

While ETFs typically meet their underlying benchmarks and most mutual funds don't meet the benchmarks, there is still an alternative to ETFs. They is something called index mutual funds. Perhaps you have heard of them. They have been around for almost 30 years and they have done a good job of meeting their underling benchmarks and could be traded with no transaction fees on a daily 401(k) platform.

While the 401(k) platform rids an ETFs of all its advantages, those that advocate ETFs in 401(k) still have yet to explain why ETFs are better than index funds. If you can explain why ETFs are better than index mutual funds in 401(k) plans, let me know

In The News.

Ary Rosenbaum and The Rosenbaum Law Firm P.C. were featured in the Pittsburgh Post Gazette, the August 2nd issue of the Wall Street Journal, and Human Resource Executives Online talking about 401(k) plans.

The Rosenbaum Law Firm P.C., together with the Alumni Association of Stony Brook Univeristy will be hosting a networking event to benefit the Stony Brook University Political Science Department on Wednesday, August 18th from 6 to 8 pm. call 631-632-4995 for details.

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