Avoid The One-Stop Shop For 401(k) Administration

By Ary Rosenbaum, Esq.

Consumers flock to big box stores like Wal-Mart, Target, and Costco because they offer convenient, one-stop shopping with the added benefit of cost savings. Ideally, such one-stop shopping for 401(k) plans would allow your company's trustees to select a Third Party Administrator (TPA) that is able to provide the full range of administrative, legal, and investment services. It would also seem that the ease of dealing with only one retirement advisor would have the added benefit of reducing plan administration cost. This construct seems to make sense on paper, but in reality, big box TPAs often administer 401(k) plans in ways that result in higher plan administration costs, conflicts of interest, dual loyalties, and a potential for increased liability to the plan sponsor.

As an ERISA attorney, I have a strong bias against "producing" TPAs (TPAs who act as the one stop shop) because I saw the potential and actual abuses of "producing" TPAs first hand.

In the movie Casino, Robert DeNiro's character describes the system of checks and balances gambling houses use to guard against cheating. He tells how the dealers are watching the players; the box men are watching the dealers, and the floor men are watching the box men. In effect, there are always a bunch of eyes in place keeping transactions on the up-and up. The same should be true for 401(k) plans.

When it comes to fee disclosures, the world of 401(k) plans is still shrouded in deceptive terms and practices. Of course, there are those TPAs who disclose all their fees in an easily understood manner. But there are some who obfuscate the manner in which they are compensated. This might explain why most 401(k) participants don't know how much they pay to participate in their company's plan.

Even most small to medium-sized employers probably don't know how much they actually pay for the plans they sponsor (especially since fee disclosure regulations won't take effect until July 2011). To minimize their liability as plan fiduciaries, plan sponsors must know the true cost of running their plan. If they are ignorant of the numbers; they run the risk of making decisions with disastrous results and potential liability.

At the center of deceptive fee practices of the 401(k) industry is something called revenue sharing fees. Revenue sharing occurs when an investment company rebates some of its fees to other service providers, such as a TPA. I liken revenue sharing to kickbacks, a term that doesn't win any friends among TPAs. But, what would you call it when 401(k) money is steered to a specific mutual fund, and that fund company, in turn, pays revenue sharing to the TPA, and some mutual fund companies pay better revenue sharing than other mutual fund companies?

Choosing revenue sharing funds is a common practice in the 401(k) industry because the money paid by the mutual fund companies is supposed to be used to defray the fees that TPAs charge to the account balance of 401(k) plan participants (since most 401(k) plans have the participants and not the plan sponsor pay the cost of administration). Therefore, revenue sharing payments to the TPA be an attractive way for participants to save on 401(k) administration fees that they still won't fully know about until 2012 (but that's another story!).

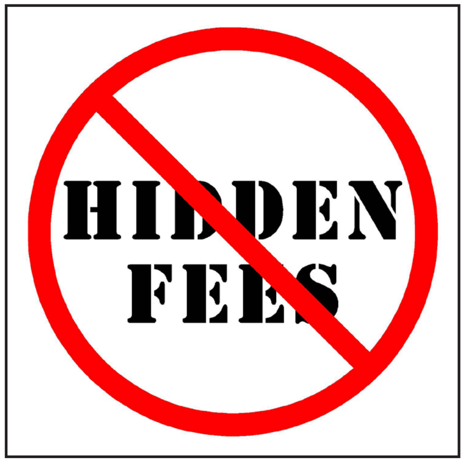
Granted, there's nothing illegal about these revenue sharing arrangements per se, but in the interest of ethical transparency, TPAs would do well to reveal how these fees are being disbursed. Plan sponsors and participants need to know that responsible TPAs use these fees to offset the fees that they are charging the plan and/or plan sponsor, not to line their pockets. By pocketing these fees, unethical TPAs have increased the cost of plan administration without notifying their client.

To avoid questionable revenue sharing arrangements, plan sponsors should not use their TPA's in-house investment advisory firm. Generally speaking, an independent financial professional, such as a broker or registered investment advisor, is far more interested in providing helpful investment advice and education than would be any in-house advisor. An in-house investment advisor who works in-house for a TPA will always be saddled with conflicting loyalties: a loyalty to do the best by the client, along with a loyalty to provide a mutual fund lineup that will produce the greatest amount of revenue sharing fees to the TPA, so the TPA's fees can be minimized in the eyes of the plan sponsor. An in-house TPA investment advisor may sacrifice a high quality mutual fund because it doesn't produce as much revenue sharing as a lower quality mutual fund. Independent investment advisors are free of this conflict altogether. Conversely, while an independent investment advisor will consider revenue sharing in the selection of mutual funds, he or she is more interested in performance than helping the TPA's price structure. Let's face facts: for an independent advisor, fund performance equals job security. If fund performance falters, there are countless numbers of substitute advisors standing in line with promises of better results. What would you rather have, better performing funds or funds that pay better revenue sharing? You can't have both and I can assure you, no plan sponsor has ever been sued by a 401(k) participant by having better performing funds.

While I am sure that many producing TPAs that act as a one-stop shop handle their role as an investment advisor in an ethical manner, the potential abuse, conflict of interest, and dual loyalty will always be there. Like I always say, the best way to avoid a conflict of interest is to avoid a potential conflict of interest.

As part of their one-stop shopping model, most TPAs offer plan document services and rely on in-house ERISA attorneys to produce the necessary plan documents to ensure proper compliance. Many of these TPA attorneys are very good. I know; I was one for nine years.

The problem with these in-house attorneys is that they can never maintain an attorney-client relationship because a TPA is not a law firm. While an in-house TPA attorney will put the TPA's interests in front of the client's, an independent ERISA attorney will always act as an advocate for the client because it's part of his or her job. Most TPA firms regard their legal department as one ancillary service in their big box offerings, while an independent ERISA attorney is out there all alone with a pushcart of skills and expertise. An independent ERISA attorney's role is to minimize client liability while rooting out unnecessary administrative costs and ensuring the client's compliance with the plan. Here, too, the in-house TPA ERISA



attorney will always wrestle with a potential conflict of interest because there is no attorney-client relationship. There are many issues in the day-to-day operation of a 401(k) plan including those caused by the TPA's own mistakes. If a problem arises, guess whose side the TPA ERISA attorney will take? (Hint: Legally, he or she is not required to be on your side.)

Hiring an independent investment advisor and ERISA attorney is a Casino-like checks and balances process with the attorney checking up on both the broker and TPA, the broker checking both the attorney and TPA, and the TPA checking everybody. This checks and balances can only work when the TPA, investment advisor, and ERISA attorney are independent from each other.

Here's an example of such a system of checks and balances in action: one of my clients also has an independent broker. The TPA promised to offset all fees with fees generated by revenue sharing. Following an audit, an independent investment broker and I determined the TPA was withdrawing fees from the plan quarterly, resulting in an annual withdrawal of $18,000. We also discovered the TPA had reneged on the agreement and was pocketing the revenue sharing, so we were able to get restitution to the client. The client would not have realized the same result if he client had relied on using the services of the TPA's attorney and investment advisor. The client's retention of an independent ERISA attorney and broker is the only reason the violation was discovered.

One last reason to avoid the 401(k) one-stop shop is what I call trying to replace one head of a three headed "monster". Let's pretend the big box client is not enjoying a good working relationship with the in-house advisor and/or attorney. After terminating the TPA's legal department and/or investment services, this same client will find it much harder, if not impossible, to maintain a working relationship with the TPA. If, on the other hand, the client secures the services of an independent investment advisor and ERISA attorney, not only do these independent professionals serve as a system of checks and balances, they allow the client the flexibility necessary to jettison a 401(k) component that isn't working, whether it's the TPA, the investment advisor, or the independent ERISA attorney. With a volatile stock market and the issue of whether 401(k) plans are the proper vehicle for retirement, plan sponsors must maintain control in their role as plan fiduciaries while protecting themselves from needless exposure to liability.

When it comes to company 401(k) plans, it's buyer beware. That enticing, one-stop big box TPA might just end up costing you more than you'll ever know.

The Rosenbaum Law Firm P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw