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No Good Deed Goes Unpunished: The High Price Of Today's Broken 401(k)

If the road to hell is paved with good intentions, perhaps the same could be said about many of today's 401K plans. Employers craft benefit packages with the best of intentions, yet, there's a good chance you may be administering or participating in a retirement plan not in compliance with new Employee Retirement Income Security Act of 1974 (ERISA) regulations. Last year nearly 75% of plans audited by the Department of Labor (DOL) were either fined, received penalties or had to make reimbursements for errors. If your 401K plan were audited today, would it pass muster? Or, would your company face steep fines and possible criminal indictment?

Every employer, also called the plan sponsor, needs a thorough review of their 401K plan to reduce any chances of unnecessary litigation, keep unscrupulous financial services firms out of participants' pocketbooks, and be up-to-date with current regulations. It is advisable for plan sponsors; particularly those with small plans, (defined as plans with less than 100 participants) to have their 401K professionally benchmarked to reveal any hidden fees, expenses, and liabilities within it. Small plans may carry fees as high as 3% per year. According to Demos.org, over a participant's lifetime, these fees can rob investors of nearly 35% of their total returns. Should financial advisors, who put up no capital and take no risks, take over 1/3 of participants' returns when they put up all of the capital and take on all of the risk?

We don't think so. If your company's 401K plan hasn't been audited by the government yet, you won't have to wait long—the DOL brought on nearly 1000 new hires. Their role is to enforce ERISA rules by serving as watchdogs and issuing government fines (or worse) to offending employers. An estimated 88 individuals, including: plan officials, corporate officers, and service providers were criminally indicted for offenses related to their benefit plans, according to the DOL. It's important to note plan sponsors (that's every employer!) will assume fiduciary responsibility. When the government's rules are not met, substantial fines can accrue. Last year's average, as reported by the DOL, was $600,000 per plan—an increase of almost $150K in the past 4 years alone.

So how did this all start—and how did it spin out of control? The 401K was first created in the late 1970's as the U.S. government tried to limit the amount of cash-deferred compensation plans being offered. An enterprising business consultant to Johnson & Johnson discovered a loop hole which allowed highly compensated executives and their employees to save more of their pre-tax dollars for retirement. And the 401K was born. Today's plans can be relatively complex, however, the original plans were straightforward and offered only two investment options: a guaranteed fund and a single equity mutual fund. As executives wanted to add more flavors to the menu, these options got more complicated; two options became fifteen; which in turn became thousands. As the menu of investment options grew, an opportunity for middlemen to get involved at the expense of the American worker through layer upon layer of fees presented itself. Institutions offering small plans, largely brokerage firms and insurance companies, knew that plan sponsors would be unlikely to realize their plan participants were bearing unnecessary expenses or that enterprising salesmen had created revenue streams in excess of their annual advisory fee by selecting investment options laden with upfront sales charges, mark-ups, and recurring fees.

Fast-forward to last year when EBSA released a final rule for increased transparency about fees in 401K plans. While the news didn't receive much fanfare, ERISA mandates state that fees paid both at the participant level and the plan level be "usual and customary" for what the market dictates. If your plan was compliant five years ago, it's not necessarily compliant today; there is a high likelihood it isn't. Robert Hiltonsmith's research in *The Retirement Drain: The Hidden and Excessive Costs of 401(k)s,* showed excess fees robbing investors of as much as 33% of their returns. According to a recent piece in Fortune, excessive fees accumulated over 30 years can erode as much as 37% of returns. Demos, a New York-based think tank, concluded that an ordinary American household will spend nearly $155K in 401(K) fees over their lifetime.

If you are an employer offering a 401K plan, it is unlikely you chose it with the intention of robbing plan participants of their retirement money or putting yourself in the proverbial hot seat by unintentionally breaking the law. So what do you need to do today to pass muster with the U.S. Government – especially if it has not been reviewed since the new rules took effect last August? First and foremost, hire a professional to benchmark your 401K plan. We also recommend:

Build a 404(c) compliant line-up which provides a variety of investment options. 404c compliance allows you, the plan sponsor, to shift responsibility for investment results to plan participants. Provided your plan allows employees to choose from a menu of varied investment choices, it's vital that your menu is 404(c) compliant. Essentially, what this does is relieve your plan fiduciary of the liability arising from your participants individual investment decisions. Consider a fund line-up that consists of a broad group of low cost passively managed index funds, with little overlap, that give employees access to multiple asset classes.

Hire a co-fiduciary. As a plan sponsor you have a duty to act in the best interest of your participants. This means that you need to be a prudent expert. If you are not, you need to go out and find that expertise. We believe that it's not only intelligent for that advisor to be a fiduciary, IT IS IMPERATIVE. The firm that you choose to put your plan together, must share in your risk, not profit from it. So rather than working with a broker, who may be compensated by steering the plan sponsor towards funds that increase the sponsor's risks, yet pay the broker a higher commission, we strongly suggest your investment advisor serve as a fiduciary, choosing the investment choices that are best for your employees and the plan sponsor.

Provide participants with education and support.
Any retirement plan provider should provide the plan sponsor with comprehensive enrollment materials, educational content, a website with interactive tools, and access to an investment advisor that participants can access for one-on-one support in order to make better financial decisions. Educated participants are less likely to make uninformed decisions, and, not offering educational information sessions could put employers at risk. The investment advisor should also conduct a risk tolerance review with each plan participant.

Adopt a formal, written investment policy. ERISA Section 402(b)(1) requires retirement plans to provide a "procedure for establishing and carting out a funding policy and method consistent with the objectives of the plan." A formal investment policy identifies: a) the investment goals and objectives of the plan; b) sets the decision-making process for structuring the overall make-up of the portfolio and selecting investments; and c) specifies the measuring tools for ongoing performance assessment. The investment policy should focus on how investment decisions are made, rather than the investments themselves. Adhering to ERISA Section 404(c) guidelines with a formal, written investment policy provides plan sponsors added protection.

Be wary of the "No Cost" plan. Many group annuity insurance firms understand businesses don't want to pay anything when beginning a 401K for participants, so, they offer to charge a wrap fee as an alternative. It essentially marks up the cost of the underlying investments by as much as 1-1.5% per year. The firms that do this know this fee isn't enough to cover their administrative and recordkeeping expenses for your plan upfront. However, after 5 years, when there's a $2-3M payroll, they know it's unlikely their rates will be renegotiated. So plan sponsors continue paying excess fees which line the pockets of plan administrators and their brokers. Reuters recently wrote about one such lawsuit involving Mass Mutual. The best way to avoid such headaches is to know what you are getting into from the get go; professional benchmarking is valuable here.

Consider adding options to allow contributors to increase annual tax deductible retirement contributions beyond the statutory $17,500 annual pre-tax contribution limits.

A Profit Sharing Plan will enable higher income earners to save as much as $50,000 per year for retirement through tax deferred contributions.

A Defined Benefit Plan, on top of this, may enable some participants to save $200,000 per year in pre-tax contributions.At 5% in annual appreciation, a plan participant would have accumulated over $2M in additional tax deferred savings, assuming only $50,000 in annual pre-tax contributions.

Just because your plan was compliant 5 years ago doesn't mean it is today.

Prudent plan sponsors will have an independent 3rd party benchmark their plan at least once per year. Today's new rules, as well as the DOL's attention on small businesses, could mean more employers in the hot seat. Don't be punished for your good deeds! Be clear as to what burdens in your 401K plan lie on you—and what do not.

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