ADVISOR INSIGHTS

More on the Troubling Framework of the Retirement Plan Industry

Contributor Scott Simon takes a deep dive into the ways plan sponsors may unwittingly expose plan participants to conflicts of interest.

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In last month's column, I shared a story that shone a light on the troubling framework of the retirement plan industry. The article received such a good reception--at least based on the feedback that I received in my email inbox--that I thought it worthwhile to expand further on the theme.

To review, I related how my registered investment advisory firm took over a 401(k) plan as the investment manager as defined in section 3(38) of the Employee Retirement Income Security Act of 1974. The plan's new record-keeper--a well-known insurance company--was surprised to find out that it wouldn't have the power to select, monitor, and replace the plan's investment options, such as including its lucrative proprietary stable-value fund, or SVF.

At its essence, the insurance company record-keeper--first, foremost, and always--exists to sell insurance products. In the spirit of capitalism, it is therefore a voracious profit-seeker. That doesn't make this insurance company (or any other insurance company or mutual fund family, for that matter) bad at all. But the insurance company's inherent nature as a revenue-maximizing entity must be recognized for what it is.

It's important to recognize that the insurance company offers its record-keeping services only as a way to access vast captive audiences of participants in retirement plans in order to sell (preferably) its own products or (less preferably) the products of others (through revenue-sharing and other ways). Yes, an insurance company makes money from the critical record-keeping services it provides to a plan, but the real dough is in provision of a plan's investment options as well as the cross-selling of nonplan financial products.

The insurance company makes money in this environment in at least three ways: 1) on the investment options it provides for retirement plans, 2) on the insurance and other products it sells onsite through its licensed commissioned insurance salespeople, and 3) on the insurance and other products it sells through its website.

The first way that the insurance company expected to make money off plan participants was to map all existing plan investment options into its own mutual funds (and others) including its own SVF (which, by the way, is not a mutual fund). For example, replacing the 45% of total plan assets that were invested in the previous insurance company record-keeper's SVF with the new record-keeper's SVF would give it a profit of $1 million-$2 million over the next year--and that figure would increase every year thereafter (assuming that more assets continually flowed into its SVF). However, the insurance company was denied this opportunity to make money off plan participants because my RIA took on that responsibility (and liability) as the plan's (nonconflicted) section 3(38) fiduciary investment manager.

But the insurance company had a second way of making money off plan participants: It thought it could sell insurance products onsite at the plan sponsor through its commissioned insurance salespeople. These sales would be accomplished under the guise of providing "enrollment," "education," "information," or other such services by sitting down and meeting with plan participants to establish personal "relationships."

Of course, one obvious way to deny the insurance company record-keeper the ability to make money off plan participants by offering them its own financial products would be to prohibit that outright through insertion of explicit language in the agreement between the plan sponsor and insurance company. That would seem to eliminate the possibility that plan participants could be exposed to the conflicts of interest that exist when insurance company agents are allowed to work with plan participants onsite at the plan sponsor.

Unfortunately, that's not normally the case. The basic problem that cannot be eliminated in a contract is the business model and the regulatory structure under which the insurance company chooses to operate: a nonfiduciary standard with regard to the plan sponsor and its plan participants. This is an important point that must be understood.

When an entity such as an insurance company and its agents operate under a nonfiduciary standard, they have no legal responsibility to work in the "sole" interest (the ERISA standard) or even in the "best" interest (the RIA standard under the Investment Advisers Act of 1940) of plan participants. In fact, the only fiduciary duty that an insurance company has is to the insurance holding company that owns all the company's business units. There is nothing illegal or sinister about that arrangement; indeed, it is a quite common business model used in the financial-services industry. However, that business model does nothing to help plan participants. On the contrary, it can be harmful to them given the inherent conflicts of interest involved.

So while it's a good idea in a written contract to prohibit the insurance company from making money off plan participants in the first two ways described earlier, it's even better to not allow the company's agents to violate that prohibition in the first place. And the only way to do that is to physically ban them from being onsite at the plan sponsor, whether during the conversion process from the old insurance company record-keeper to the new or at any other time thereafter including any onsite office.

After all, the insurance company in the case I have been describing was hired to provide record-keeping/custodial, and so on, services only, not investment services, which came under the purview of my RIA as the section 3(38) investment manager. Those two distinct services often get muddled within the framework of the retirement plan industry--and that often leads to bad outcomes for plan participants.

In the planning meeting with the plan sponsor's working group to map out the conversion process, one of the insurance company representatives kept using the phrase "the best of both worlds." The way in which he used it described a deceptively attractive course of action: Both the insurance company and my RIA should provide investment education to plan participants. But allowing insurance company salespeople anywhere near plan participants to provide such services would not be wise, because it could lead participants to eventual financial harm given the inherent conflicts of interest involved, as well as the lack of any fiduciary standard.

Well, that would seem to wind things up. But wait, let's not forget that the insurance company had a third way of making money off plan participants: on the insurance and other products it sells through its website. That is, perhaps, the most subtle way, but discussion of it will have to wait for a future column.

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