Fiduciary Responsibilities

Fiduciary Responsibilities for Managing
401(k) Plans and Their Investments

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In today's world, employers who are unsophisticated or overly cost conscious tend to view plan documents as word processing forms, plan administration as pushing the right button on the computer, plan design as "fill-in-the-blank," and 401(k) investments as a group of mutual funds.

They do not understand the difficulty – or the importance – of properly designing and operating a 401(k) plan. As a result, they do not appreciate the value of advice from pension administrators, consultants, and attorneys. Because of their unwillingness to seek or pay for advice, their plans are often poorly designed to meet their business objectives and the needs of their employees. The administration of their plans may be inaccurate and incomplete, frustrating the efforts of the employer to provide a valued employee benefit.

On the other hand, sophisticated employers realize that, to meet their needs and those of their employees, plans cannot be bought "off the shelf." The plans must be designed to fit their workplace and their budget. Plan documentation must be tailored to the design of the plan.

In the participant-directed environment, the key to unlocking the value of a plan – that is, to provide superior retirement benefits for the employees – is the selection and monitoring of the investment options offered to the employees, including the removal of underperforming funds. These employers know that competent plan administration is important to employee satisfaction. It requires knowledge and effort to properly design, document, administer, and invest a 401(k) plan.

In other words, sophisticated employers know that a 401(k) plan must be properly set up and operated with the benefit of professional and technical advice. The Fiduciary Requirement ERISA imposes on employers the fiduciary responsibility to prudently operate their plans and manage the investments. While large companies have financial executives and in-house benefits staffs, small and mid-sized companies must rely on advice from their third-party administrators, consultants, brokers, and attorneys.

In recent years, internet sites have been developed to assist employers in setting up, administering, and investing 401(k) plans. These websites raise the question of whether 401(k) plans can be intelligently designed, administered, and invested without the benefit of assistance from pension experts. Expressed in legal terms, that question might be: Can an employer fulfill its fiduciary responsibilities under ERISA to properly administer a 401(k) plan and to prudently select and maintain investments without the benefit of professional advice?

This article discusses some of the most important fiduciary responsibilities under ERISA and the difficulty in complying with those requirements. While the article focuses on the need for advice, it does not address whether employers will want that advice in person, over the telephone, or via the internet. However, the article does point out the need for the advice to be proactive – that is, in many cases employers must be initially alerted to potential plan issues (and their fiduciary responsibilities), and then be given advice about the solutions.

The design of a plan is considered an employer, or "settler," function – as opposed to a fiduciary function. As a result, this article does not discuss design issues, other than to say that a well-designed plan can maximize the cost effectiveness of the plan, the benefit levels of the top employees, and the perceived value to all of the employees. However, one of the leading internet bundled providers – a mutual fund company – states in the "legalese" section of its website: "[ABC Mutual Fund Company] is not recommending a plan design. Answers to Plan Design Questions will provide a possible sample plan. Since there are many factors that go into designing a plan, you may want to consult your legal counsel or tax advisor as well." Realistically, what are the chances that an employer who is designing a plan on a website – probably to save money – will take the extra time and incur the expense of consulting with legal counsel or other advisors? Understandably, though, the mutual fund company wants to protect itself from liability for poorly designed or improperly documented plans created by unsophisticated employers using its website service, thereby shifting that liability to the employer.

Our discussion of the fiduciary responsibilities for operating 401(k) plans addresses these issues:

- Who are the responsible fiduciaries?
- Selection and monitoring of investments

- Accurate and complete administration
- Satisfying reporting and disclosure requirements

Who Are the Responsible Fiduciaries?

When an employer establishes an ERISA qualified plan, it is the initial fiduciary. In setting up the plan, the employer needs to decide whether to appoint individuals or committees to be responsible for some of the fiduciary responsibilities. If a plan committee is appointed, then the committee and its members are fiduciaries and must perform their assigned duties under ERISA's "prudent expert" standard. If the employer keeps some or all of those duties, then the officers or principals who act on its behalf are ERISA fiduciaries.

Further, the appointment of a fiduciary is itself a fiduciary act. Thus, whoever appoints the officers or committee members to oversee the administration and investment of the plan has a duty to prudently select those persons and to regularly monitor their performance. Typically, it is the Board of Directors or corporate president who appoints the fiduciaries and who, therefore, has those responsibilities.

In order for the directors, officers, and committee members to perform their duties competently, they must have advice about:

- Am I a Fiduciary?
- What are my fiduciary responsibilities?
- How do I fulfill those duties under the law?

Selection and Monitoring of Investments

The selection of investments for a participant-directed 401(k) plan requires that the officers or plan committee address the following questions:

- Is each individual option ("fund") a prudent and suitable investment option for the participants?
- Do the funds, in the aggregate, constitute a broad range of investment options?
- Is the investment package suitable for the abilities of the particular workforce? If not, can it be made so through investment education or advice?

In order to answer these questions, the employer will need professional advice – unless it has in-house investment expertise. For small employers, that "advice" may come from information provided by a broker. Larger employers may use RIAs – registered investment advisors.

Regardless of the source of information, these are difficult questions which require analysis, effort and, hopefully, consultation from competent sources. It may be difficult, or even impossible, for a small or mid-sized employer to know that they need to answer those three investment questions – much less to do the analysis – without the benefit of an advisor.

Some investment providers have developed 401(k) packages designed to assist employers in satisfying the requirements that each fund be well-selected and that the funds in the aggregate constitute a broad range. These investment packages offer valuable help to fiduciaries. However, how can a plan sponsor identify the investment packages with the "built in" help without a broker or other advisor?

To compound the problem, the fiduciaries have a duty to regularly monitor the funds and to remove funds that under perform. For small and mid-sized plans, that monitoring should be done at least annually. Some insurance companies, mutual fund companies, and banks that provide 401(k) investment products help fiduciaries by giving them performance, expense, benchmark, and other information and by removing underperforming funds from the investment packages. However, the responsibility falls on the fiduciaries to review those materials and to make the decision to retain or remove funds.

Are the fiduciaries aware of their responsibilities? Once aware, do they know how to perform those duties in a way that complies with ERISA? This is a difficult job, even with the help of an advisor; it borders on impossible without that help.

Other investment issues that require advice:

- Should the plan have an investment policy? How do you prepare one?
- Should the plan comply with ERISA Section 404(c)? If so, what do the fiduciaries need to do?
- As the plan grows larger, should the fees be re-negotiated and/or is the plan entitled to additional

"free" services?

Accurate and Complete Administration

The fiduciaries are also responsible for overseeing the administration of the plan. To do that properly, they need to understand the legal requirements and to monitor compliance with those requirements. While there are many aspects to plan administration, this article discusses only the following:

- Enrolling and covering the right employees
- Selection and monitoring of the administration firm
- Correction of problems
- Handling IRS audits and DOL investigations

Enrolling and Covering the Right Employees

Covering the right employees is essential to the proper administration of a plan. Two important areas where employers need advice to make sure that they cover the right employees or exclude workers who are not intended to be covered are:

- Is the employer a member of a controlled group or affiliated service group, causing other employees to be considered for testing or to be included in the plan?
- Are there other workers, such as temporary employees, leased employees, or mis-classified independent contractors, who may be entitled to benefits under the plan? Is the plan properly drafted to exclude those workers if they are reclassified as common law employees?

Just asking the questions, however, is not enough. The issues are fact-intensive and the analysis is complex. For example, the analysis of a potential affiliated service group – and its consequences and planning alternatives – may require a review of the entities' documents and related agreements, as well as research of the governing Code sections. How does as employer (plan sponsor) know to ask the right questions and, once asked, to find the answers? The failure to do so can result in disqualification of the plan or in a costly correction.

After the legal questions about the employer and the employees have been answered, the plan sponsor still faces an important coverage issue how to educate the employees about the plan, its investments, and the importance of making deferrals into the plan. Without significant participation by the rank-and-file employees (or substantial contributions by the employer), the officers or principals of the sponsor will be limited in their ability to defer and the plan's benefits may be diminished.

Employee participation is a function of thoughtful plan design, good communication, quality investments, and effective face-to-face enrollment meetings. The plan fiduciaries should evaluate the enrollment presentations offered by the completing providers to make sure that the employee will be given a clear and thorough explanation of the requirements to participate, the importance of deferring, and the basics of investing.

Selection and Monitoring of the Administration Firm

The fiduciaries have a duty to prudently select and monitor the firm that provides administrative services to their plan. The fiduciaries should ask these questions:

- What services are needed? Are all of those services being provided?
- Are the services performed well, and are they timely and accurate?
- What are competitors charging for the same service? Are the charges appropriate in relation to the needs of the plan?

The fiduciaries' job is not done when the administration firm is chosen. The provider's performance must be monitored. Monitoring is required regardless of whether the administration services are part of a bundled relationship with the investment company or are provided by an independent third party administrator.

Correction of Problems/Handling IRS Audits and DOL Investigations

In a perfect world, there would not be any problems. But inevitably, problems do occur. Employers and plan fiduciaries need help in correcting those problems. Also, plans are regularly audited by the IRS and investigated by the DOL. In selecting their service providers, employers should anticipate the possibility of a

government inquiry and make sure that one of those providers will be available to represent the plan in audits.

Other Administrative Issues

Examples of other important administrative issues are:

- Who is responsible for making sure that "excess" amounts are not being contributed to the plan – that is, amounts that violate the 415 limits on allocations, the 401(a)(17) limits on compensation, the 402(g) limits on deferrals, and the ADP and ACP limits on deferrals and matches for highly compensated employees? If excess amounts are contributed, who decides the best method of correction? How is that decision made?
- Who determines eligibility if employees to participate in the plan? If a mistake is made, how does it get corrected?
- What are the criteria for a hardship withdrawal? What steps must the fiduciaries take to comply with the qualification rules in approving a request for a hardship withdrawal?
- What administrative records must be kept? For how long? Does the administrator give the employer copies of the compliance records?

Before hiring an administrator, the employer should ask these questions – and others – of the candidates being considered for that job. The employer should be able to rely on the administration firm to do most of this work and to provide advice to the employer on the decisions it must make.

Satisfying Reporting and Disclosure Requirements

ERISA imposes a number of reporting and disclosure requirements on 401(k) plans. For example, plan sponsors and fiduciaries must file an annual report, Form 5500, with the government each year. In addition, participants must be given summary plan descriptions (SPDs), statements of material modifications (SMMs), and summary annual reports (SARs), at specified times. Also, participants must be given information about their benefits upon request and, if the plan wants 404(c) fiduciary protection, participants are entitled to detailed information about the plan and its investments. An ERISA fidelity bond must be obtained and, in some circumstances, the plan must be audited annually by an independent CPA.

It is almost impossible for most small and mid-sized employers to know these rules. As a result, plan sponsors need guidance in complying with the reporting and disclosure requirements. Some of the questions that should be asked and answered before selecting the provider of administrative services are:

- Will the plan receive a Form 5500 that is "signature ready" (i.e., fully completed and needing only a signature) from the administrator?
- Will the administration firm automatically prepare all needed SPDs and SMMs, together with clear instructions on how and when to distribute those materials to the participants?
- Which advisor will assist the employer in complying with the 404(c) requirements, including satisfaction of the rules on information to be given to the participants?

Conclusion

The administrative and investment duties of employers and their fiduciaries are numerous and complex. However, they can be navigated with help from advisors. The issue is not whether the advice and services will be provided in person, on the telephone, or over the internet. Instead, the issue is whether the employer and the fiduciaries will receive the advice needed for the investments and services to comply with ERISA and for the plan to provide high quality, well-appreciated retirement benefits to the employees.

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