

Retirement Plan Sponsors and Fiduciary Risk

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Retirement Plan Sponsors and Fiduciary Risk

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Plan sponsors must study risk to minimize potential liability.

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s business financial scandals continue to surface, retirement plans are coming under increasing scrutiny. Plan participants are more aware of their retirement plan accounts and are questioning plan sponsors, administrators and trustees with regard to investment choices and plan issues.

Although the rules have not changed significantly regarding fiduciary liability, there is a heightened awareness regarding fiduciary liability and risk. Fiduciaries are asking more questions about their

responsibilities to plans and their participants, as well as their personal liability should plans or their administration come under question.

And well they should. The responsibilities are significant, and the consequence of failing to meet those responsibilities can be equally significant. Flagrant fraud is criminal, of course, but negligence is a more nebulous area. There are numerous ways that a retirement plan can fall into mismanagement, either by innocent error or by ineptitude, and become the focus of a criminal investigation. Plan administrators hold a significant duty to ensure the proper administration of

a plan, not only to benefit plan members and the sponsoring organization but also to protect themselves against any personal claim of wrongdoing.

Fiduciary Defined

To fully understand the responsibility and potential liability in the administration of a retirement plan, it's important first to understand who holds "fiduciary" status with regard to a plan. The Employee Retirement Income Security Act (ERISA) defines a fiduciary as someone who exercises discretionary authority or control over the management of an employee benefit plan or the disposition of its assets or someone who gives investment advice about plan funds or property for a fee or compensation or has the authority to do so. Additionally, ERISA defines a fiduciary as anyone who has discretionary authority or responsibility in plan administration or anyone who is designated by a named fiduciary to carry out fiduciary responsibility.

Typically, fiduciaries include the plan administrator, plan sponsor, members of any employee benefit oversight committee, trustee and outside investment managers. Fiduciary status not only extends to the individuals named in plan docu-

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ments as having express authority and responsibility in a plan's investment or management, but it also covers those individuals who exercise any discretion or control over the plan, regardless of title.

A fiduciary can have his or her responsibilities specifically defined in a plan as long as the duties are specific and the fiduciaries act prudently in implementing the allocation of duties. A named fiduciary may appoint a plan's investment manager and allocate investment responsibility to that manager.

Investment Policy

One of the primary responsibilities of a fiduciary is to monitor the investments and costs of a plan. This is an extremely high priority in the retirement plan world. As a starting point, every plan should have an investment policy. The investment policy serves as the guiding principle for individual decisions regarding management and investments of plan assets.

At a minimum, an investment policy should document the method for selecting, monitoring, evaluating, retaining and firing investment managers. The policy should state the guidelines for supervising investment performance and for making this information available to participants and beneficiaries. If these guidelines are well documented, a fiduciary's overall risk associated with a plan is greatly reduced. As long as a fiduciary makes decisions and transactions that are consistent with the plan's stated investment policy, there is little room for any kind of claim of wrongdoing.

An investment policy should clearly outline investment objectives with regard to the return, time period, risk levels, liquidity and income requirement of a plan. Different plans will have different objectives depending on the type of plan, employees' ages, the financial condition of the plan sponsor, economic and industry characteristics, expenses and liquidity requirements.

For example, plan needs differ between defined-contribution and defined-benefit plans. A policy should understand and minimize risks related to all investments, generate favorable returns without undue compromise of policy guidelines, provide for adequate liquidity and ensure the ability to meet funding retirements. A plan should offer a sound mix of diversified investments. The specific mix of assets depends on plan needs.

An investment policy should be reviewed periodically to ensure its relevance to the plan's objectives and participant needs. The review should consider the plan needs, participant investment knowledge, employee ages and investment time horizons, compensation ranges and contribution patterns. The role of an investment policy statement is to promote internal and external communication of investment policy, ensure the continuity of policy during changeovers in personnel and provide a guideline for potential policy changes.

Investment Selection

The selection and ongoing evaluation of investment options is key to minimizing any potential fiduciary risks. An investment committee is advisable to spread the duties and responsibilities across a number of shoulders. The committee will not only ease the burden of duty and risk on any one individual but also lend confidence to the decision-making process.

The selection and ongoing evaluation of investment options is key to minimizing any potential fiduciary risks.

Members of this committee can include representatives from the plan sponsor and plan trustees. The duties of each committee member should be documented. An investment committee must consider whether it possesses the expertise necessary to select and review investment options or whether it needs advice from a professional. For the committee to operate on its own, committee members must be able to interpret research report data and understand relationships between risk and return. Committee members also must understand long- and short-term risk patterns of different asset classes.

Whether investments are selected by an individual fiduciary or a committee, a fiduciary must be able to exercise the appropriate care and prudence in assessing the investments for initial selection and evaluating those investment deci-

sions over time. Selection and monitoring criteria include

- performance over periods of three, five, 10 and 15 years;
- performance compared with benchmarks and peer averages, such as performing in the top 25% of peers;
- risk measures, such as the volatility of returns over time and sensitivity to market movements;
- risk-adjusted return relative to risk, evaluating trade-off compared with its peers;
- style consistency, determining whether an option is investing according to its primary objective and has in the past;
- expenses, such as internal investment expenses compared with averages of similar investments; and
- the tenure and stability of the investment management firm.

If a committee concludes that does not have the ability to manage a plan's assets with these factors in mind, the committee should consider hiring an outside investment advisor.

Diversification

An investment committee needs to consider the diversification of investment options to minimize fiduciary risk. The committee needs to consider if there are enough investment options with different risk and return characteristics. Are there ap-

Some special considerations exist with respect to employer stock issues.

propriate opportunities for participants to minimize their risk by spreading assets across the three main categories of assets (capital appreciation/equities, current income/bonds and capital preservation/cash)? Are there enough options that have the potential to provide returns over the long term that will outpace inflation?

Some special considerations exist with respect to employer stock issues. Is the stock suitable on the basis of written selection and criteria guidelines established for the plan? Will the administration of the employer stock add significant costs? And what issues relating to securities law need to be considered?

Self-directed brokerage accounts are a popular option in today's environment. Is such an account suitable on the basis of written selection and criteria guidelines established for a plan? Access to a broad range of investments may be suitable only for sophisticated investors, but a plan fiduciary typically cannot limit this option to only the highly compensated employee group, because doing so may violate nondiscrimination rules.

Monitoring Performance

A fiduciary is responsible for monitoring investment performance to ensure that investments continue to meet plan objectives. Failure to monitor performance can lead to allegations of mismanagement. To demonstrate the effective monitoring of investments, an investment committee should meet at least annually to review investment performance and determine how it compares with the underlying investment policy and independent market indexes.

A process should be established to place funds into a watch category when their performance comes into question. While funds are under watch, the committee must determine if each fund in question should remain an investment option within the plan or be deleted.

Monitoring Cost

A committee should evaluate investment costs associated with a plan. Investment costs have undergone a great deal of scrutiny over the past few years. The U.S. Department of Labor and the Employee Benefits Security Administration have made more information available to employers and employees. The goal is to help both employers and employees make informed decisions on investment fees and how they relate to a plan in place.

Investment expenses should include an analysis of expense ratios, 12(b)1 fees and any wrapper fees by investment. In addition, record keeper and administration costs should be tracked for education programs, enrollments, distribution

expense, loan fee processing, balance inquiry expense and investment transfer costs. A plan administrator also should consider external audit fees, Form 5500 filings and fiduciary insurance premiums. The costs of a plan should be compared not only with prior years but also with the initial proposal to hold the service provider accountable. Any significant variances should be discussed with the provider and resolved between the two parties.

An investment committee also should evaluate the performance and cost of any outside investment advisors on an annual basis. Is the service timely? Are questions answered to the plan sponsor and the participants? Are answers adequate? Are voice response units and other resources as accessible as promised? If service has been comprised and costs seem out of line, it may be time to discuss the situation with the provider or consider changing providers.

Establishing Fees

It's also important to determine and document who will pay the numerous fees associated with a plan. Typically, investment fees are deducted from the participants' accounts, but the participant or the sponsor can pay withdrawal fees. The size of a plan may dictate who will pay which costs. For investment options, a plan may incur more costs if a wider variety of options are offered; that can result in the availability of options with higher expense ratios. If daily valuation transactions are allowed, there is typically a higher expense associated with this.

Many providers allow plan sponsors to invest in their families of funds as part of their packages. They may also give sponsors the option to invest in other fund families, which can increase charges because they are not the fund manager's funds. A fiduciary's responsibility is to ensure that responsibility for fees is clearly established and documented to all concerned parties so that there can be no question or allegation of the mismanagement of fees after the fact.

Ensuring Section 404(c) Compliance

ERISA Section 404(c) requires plan sponsors to provide participants with enough information and education to make their own investment decisions and to have adequate access to their accounts to change their allocations. Sponsors are not responsible for guaranteeing investment re-

turn, but that won't stop disappointed plan participants from attempting to hold plan sponsors and fiduciaries responsible for poor investment performance.

To fully comply with Section 404(c) and minimize the risk for personal liability, fiduciaries must ensure that plan participants understand the provisions of a plan and have adequate opportunity to ask questions and make changes. The fiduciary and the investment committee should ensure ongoing education and communication to plan participants to meet this obligation.

A fiduciary is required to educate plan participants, but not necessarily to offer investment advice. There is a fine line between the two, and it's important for fiduciaries to distinguish the difference and act deliberately. (See Exhibit 1.) Each participant must be allowed to allocate assets in his or her account on the basis of individual preferences, desires, risk tolerance and retirement objectives. Participants should be allowed access to change their allocations at least once every three months.

A fiduciary is required to educate plan participants, but not necessarily to offer investment advice.

To make key investment decisions and achieve successful investment strategies, participants need timely information, such as prospectuses and fund fact sheets. Participants must either receive or be able to review on demand enough information to enable them to make informed investment decisions.

Plan fiduciaries must make accessible education tools and communication materials to educate plan participants, such as interactive software, Web site tools and advisor presentations. Communication efforts should be reviewed and measured on the basis of participation rates, contributions levels and asset allocation among the available options. Minutes of annual meetings should be retained along with all permanent documents relating to a plan, and they must be available to plan participants for review.

EXHIBIT 1
Advice or Education?

Legal experts debate the extent to which plan sponsors and fiduciaries should provide investment advice to plan participants. On one hand, some experts contend that rendering investment advice puts plan sponsors and fiduciaries at increased risk for liability. Conversely, other experts say that it is the duty of plan sponsors and fiduciaries to offer investment advice, because some plan participants are not adequately educated in the complexities of investments and need such advice to make informed decisions.

Each plan sponsor and its fiduciaries must make policy decisions regarding the extent to which the sponsoring organization will provide investment advice. The U.S. Department of Labor (DOL) provides guidelines to define the difference between "education," which is required by the Employee Retirement Income Security Act, and "advice," the requirements for which are not as precisely defined.

The following does not constitute "investment advice," according to the DOL:

➤ **Plan information:** (a) Information and materials that inform a participant or beneficiary about the benefits of plan participation, the benefits of increasing plan contributions, the impact of preretirement withdrawals on retirement income, the terms of the plan or the operation of the plan; or (b) information on investment alternatives under the plan (e.g., descriptions of investment objectives and philosophies, risk and return characteristics, historical return information or related prospectuses).

➤ **General financial and investment information:** Information and materials that inform a participant or beneficiary about (a) general financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return and tax deferred investment; (b) historic differences in rates of return between different asset classes (e.g., equities, bonds or cash) on the basis of standard market indices; (c) the effects of inflation; (d) estimating future retirement income needs; (e) determining investment time horizons; and (f) assessing risk tolerance.

➤ **Asset allocation models:** Information and materials (e.g., pie charts, graphs or case studies) that provide a participant or beneficiary with models, available to all plan participants and beneficiaries, of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles, where (a) such models are based on generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds or cash) over defined periods of time; (b) all material facts and assumptions on which such models are based (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates and rates of return) accompany the models; (c) to the extent that an asset allocation model identifies any specific investment alternative available under the plan, the model is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained; and (d) the asset allocation models are accompanied by a statement indicating that in applying particular asset allocation models to their individual situations, participants or beneficiaries should consider their other assets, income, and investments (e.g., equity in a home, IRA investments, savings accounts and interests in other qualified and nonqualified plans) in addition to their interests in the plan.

➤ **Interactive investment materials:** Questionnaires, worksheets, software and similar materials that provide a participant or beneficiary with the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income, where (a) such materials are based on generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds or cash) over defined periods of time; (b) there is an objective correlation between the asset allocations generated by the materials and the information and data supplied by the participant or beneficiary; (c) all material facts and assumptions (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates and rates of return) that may affect a participant's or beneficiary's assessment of the different asset allocations accompany the materials or are specified by the participant or beneficiary; (d) to the extent that an asset allocation generated by the materials identifies any specific investment alternative available under the plan, the asset allocation is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained; and (e) the materials either take into account or are accompanied by a statement indicating that in applying particular asset allocations to their individual situations, participants or beneficiaries should consider their other assets, income, and investments (e.g., equity in a home, IRA investments, savings accounts and interests in other qualified and nonqualified plans) in addition to their interests in the plan.

The following would constitute "investment advice," according to DOL guidelines:

- a person renders advice to a participant or beneficiary as to the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property; and

EXHIBIT 1 (continued)

- a person either directly or indirectly (a) has discretionary authority or control with respect to purchasing or selling securities or other property for the participant or beneficiary or (b) renders the advice on a regular basis to a participant or beneficiary, pursuant to a mutual agreement, arrangement or understanding (written or otherwise) with the participant or beneficiary that the advice will serve as a primary basis for the participant's or beneficiary's investment decisions with respect to plan assets and that such person will render individualized advice on the basis of the particular needs of the participant or beneficiary.

Changing Providers

Changing existing service providers is an area in which plan fiduciaries may have heightened liability exposure. Plan participants will surely have questions about the impact of a change in service providers on their benefits. If they perceive that "the old plan was better," fiduciaries may be questioned about why the change occurred.

To justify a change in service provider and avoid any appearance of impropriety, fiduciaries must exercise caution and perform proper due diligence. Fiduciaries need to examine a service provider from a number of different angles to lower their risk for personal liability. Is the service provider meeting the needs of the sponsor and the participants? Are the investment vehicles performing in accordance with plan objectives? Are the fees and expenses in line with expectations?

A plan administrator should compile a list of plan features and compare them with plan objectives. Indeed, objectives may have changed since the plan was developed. Do participants want more Internet access or personalized financial planning? An employee survey may be helpful in assessing whether participants believe that a plan is accomplishing its objectives.

Once a plan administrator has determined the key features of a plan, outside service providers should be contacted for proposals. The plan administrator must prepare prospective service providers with extensive information, including

- the features of the plan (401[k], profit sharing, defined benefit, age weighted, cross-tested),
- the desired number of investment options,
- the number of participants,
- total plan assets,
- reports to the plan sponsor and the frequency of the reports,
- educational meetings and

- daily valuation fees that the plan will pay as well as fees that the plan sponsor will absorb.

To facilitate the easy comparison of proposals, provide prospective service providers with a format they should follow in preparing their proposals.

Conversion costs will include the implementation of a new plan document and the enrollment of participants, including setting up participants on the computer system, verifying amounts to the prior record keeper's data and setting up existing loans. Many times, there is a blackout period during the conversion of plan assets.

Finally, it's important to seek a clarification as to whether any services involve extra costs, such as annual nondiscrimination testing and Form 5500 filings. Of course, it's also important to check a service provider's references. Depending on the fiduciaries' expertise, it may even be prudent to hire an independent consultant to examine each proposal and provide an apples-to-apples comparison to enable an educated decision. Proper due diligence is an important protection for fiduciaries in considering a change in service provider.

Best Practices

A foundation for best practices incorporates understanding the entire team's role in the administration of a plan. The plan sponsor must know its responsibilities in plan administration. It must understand the third-party administrator's responsibilities and the participants' role in the day-to-day operations.

Current technology has allowed a plan sponsor to be "out of the loop" when a participant is dealing with the third-party administrator directly. Voice response units and Internet capabilities in many ways have minimized the time commitment of plan sponsors in processing enrollments, distributions, loans and the remittance of contributions. However, they have not minimized the

overall responsibility of the plan sponsor. The plan sponsor still has a fiduciary responsibility to ensure that the plan is administered in accordance with the plan document.

Adopting best practices in administering a plan will improve the overall management of the plan, which reduces liability. Best practices focus on getting back to the basics. A plan sponsor must police the third-party administrator, reviewing the plan document and related amendments to ensure that plan provisions are administered correctly.

Employee census data are often incorrect. A fiduciary should establish checks to ensure that critical data (birth date, hire date, termination date if applicable) are transmitted correctly to the third-party administrator. The data need to be accurate in the system to ensure the proper tracking of enrollment dates and vesting. If rehires occur, break-in service dates must be tracked to avoid errors and inappropriate application of plan provisions. Individual contributions must be verified. These often are subject to misposting because of changes in the way spreadsheets are formatted.

Forfeitures are another key area for error and oversight for which a fiduciary ultimately is responsible. Often, the starting number is inaccurate because of incorrect service data in the census data. Even more significantly, forfeitures often are overlooked entirely. A large cumulative balance may be in a plan without the plan sponsor being aware of it. It's important for a fiduciary to return to the plan document to ensure the proper usage of these forfeitures. The plan sponsor must review and reconcile these amounts on a regular basis for accuracy. This should not be left up to the third-party administrator.

Compensation is another a key element of a plan that often is overlooked. This is due in large part to a lack of communication at the plan sponsor level. Top management many times does not communicate to the payroll department what wages can be deferred for 401(k) plans. Payroll codes may be added, and deferrals may not be computed. Or in some instances, manual checks are cut and deferrals are not made.

Documentation and Control

Fiduciaries must manage and retain a significant measure of documentation to create a record of activity, which also serves as protection against liability. (See Exhibit 2.) Many times, the third-party

EXHIBIT 2
Document Retention Checklist

The documentation and retention of critical documents are essential measures in reducing the risk for fiduciary liability. Following is a checklist of critical documents that must be retained.

- Plan documents and all amendments
- Adoption agreements if prototype plans
- Summary plan descriptions
- Summaries of material modifications
- Summary annual reports
- Correspondence to plan participants
- Correspondence with attorneys regarding any participant disputes
- Investment policy statements
- Minutes of all meetings with investment managers, record keepers and trustees
- Trust agreements
- Agreements with investment managers and third-party administrators
- Correspondence with the U.S. Department of Labor
- Board resolutions
- Determination letters
- Employee Retirement Income Security Act fidelity bonds
- Trustee reports
- Form 5500 and audited financial statements
- Plan procedure manuals
- Contracts with investment management professionals and all related correspondence
- Initial requests for proposals for investment management
- Reports on investment managers' performance

administrator provides a good packet, but this should be expanded to include items such as the transmission of census data, the remittance of contributions and any other pertinent procedures performed at the plan sponsor.

This measure of careful documentation protects a current fiduciary by creating an accurate record of all provisions and activity, and it facilitates a smooth transition in the event of any change in personnel. Web access has emerged as

a convenient way to transact aspects of a plan, such as adding participants or allocating profit sharing dollars. However, fiduciaries are responsible for safeguarding the assets of a plan, and the Internet is notoriously vulnerable to hacking.

A plan sponsor needs to ensure that there are proper controls surrounding Web access. If an individual can alter participant information or account data, the plan sponsor needs to have the appropriate checks in place to ensure that plan assets are safeguarded. Failing to adopt proper controls surrounding Web access increases fiduciary risk.

Conflict of Interest

A fiduciary has a duty of loyalty to a plan. It must act with complete and undivided loyalty to the beneficiaries and must avoid transactions that might create a conflict of interest. Transactions that are specifically prohibited include the sale, exchange or leasing of any property between a plan and a "party in interest"; the lending of money or other extensions of credit between a plan and a party in interest; the furnishing of goods, services or facilities between a plan and a party in interest; or acquiring and retaining employer securities or real property in violation of ERISA.

A party in interest is defined as including mostly everyone who has a direct or indirect association with a plan. ERISA defines a party in interest as including

- a plan fiduciary;
- legal counsel or an employee of the plan;
- any other person providing services to the plan;
- an employer whose employees are covered by the plan;
- an employer organization (such as a union), any of whose members are covered by the plan;
- a direct or indirect 50%-or-more owner of an employer sponsor of the plan;
- certain relatives of anyone previously listed;
- employees, officers, directors and 10% shareholders of certain other parties in interest; and
- certain persons having statutorily defined direct or indirect relationships with other parties in interest.

EXHIBIT 3

Fiduciary Liability Insurance

Fiduciary liability insurance is essential for benefit plan fiduciaries. Policies cover liability arising from violations of any of the responsibilities, duties or obligations imposed by the Employee Retirement Income Security Act, which defines fiduciaries' roles. Insurance also covers liability arising from

- counseling employees regarding their pension and benefit plans,
- offering interpretations regarding provisions of such plans,
- handling related documentation or administering enrollment and
- terminating or canceling employees according to the provisions of the plan.

The ties that bind such parties can be obscure or difficult to identify, so it's important for fiduciaries to ensure that they are not stepping into dangerous territory when planning a transaction on behalf of a plan.

Consequences of Breach

A plan fiduciary who breaches the fiduciary requirements of ERISA can be held personally liable for losses sustained by a plan. The fiduciary must restore to the plan any profits realized by the fiduciary through the improper use of the plan assets. The fiduciary may also be removed from the position.

A plan fiduciary has no cofiduciary liability. A fiduciary is liable for the fiduciary breaches of other fiduciaries if the fiduciary participates knowingly or conceals a breach or does not make the effort to remedy the circumstances. In addition to personal liability, a fiduciary could be liable for attorney fees, punitive damages, lost profits of the plan and civil penalties. Fiduciary insurance can help protect the plan sponsor and the individual against personal losses when faced with specific allegations. (See Exhibit 3.)

Given the complexity of retirement benefit plans and the heightened scrutiny of such plans, anyone acting as a fiduciary for such a plan would be well advised to pay close attention to detail in ensuring that the plan is properly managed.

RETIREMENT PLANS

B e n e f i t s

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