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Most Common Nonconformities and Opportunities for Improvement in 401(k) Plans Found in Fiduciary Assessments

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ISO (International Organization for Standardization in Geneva) Standard 9000 for quality management systems and Standard 19011 on assessments (audits) provide the Guidance for these assessments. A fiduciary assessment identifies possible weaknesses in procedures and policies that could give rise to a breach of duties and a resulting lawsuit by participants or fiduciaries.

Our fiduciary assessment process contains three levels:

1. A Level I Self-Assessment of Fiduciary Excellence (SAFE) is conducted. This consists of the Plan Sponsor completing a survey of 22 questions. These questions elicit information about the extent of the sponsor's compliance with the 22 prudent fiduciary practices that comprise a Global Standard of Fiduciary Excellence. These Practices are based on standards outlined by the government in legislation, court decisions, regulatory opinion letters, and advisory bulletins.
2. Once the Plan Sponsor has completed the responses to the Self-Assessment, we review the answers with the Plan Sponsor for accuracy. Next, we gather and review all the documents that relate to the retirement plan. After that, we interview all the plan's key "players," both internal at the Plan Sponsor's offices and the outside advisors.
   Based on our review and interviews, we prepare the initial draft of our fiduciary assessment. At that time, we arrange to meet with the key players to clarify any questions and to test our hypotheses.
   Finally, a Level II Consultant's Assessment of Fiduciary Excellence (CAFE) is prepared and presented to the Plan Sponsor and Administrator. This report will contain any Plan Nonconformities (that is, procedures or processes of the Plan that do not meet our fiduciary standards), Plan Opportunities-for-Improvement findings, and recommendations. Any Nonconformities must be addressed and eliminated before the final step, a Level III Certification, can be completed.
3. The last step in the fiduciary assessment is an independent review of the Level II CAFE Assessment and

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finally, Certification by the Centre for Fiduciary Excellence (www.cefex.org) that the Plan meets the Global Standard of Fiduciary Excellence. The Plan Sponsor is notified of the Certification by CEFEX. The Sponsor can place the Certification on its Web site for all to see, and is listed with CEFEX as having passed the Certification process.

During the Level I and Level II steps of the process, our findings almost always contain some Nonconformities or Opportunities-for-Improvement. Here are some of the most common fiduciary concerns that we find:

The Investment Policy Statement (IPS) is too simplistic or a sample IPS was given to the Plan Sponsor by a Service Provider that does not address some of the key components of the IPS. These components are discussed further below.

The roles and responsibilities of the investment committee and other nonfiduciaries are not clearly delineated in the IPS. The IPS should give direction to the members of the Committee (assuming that there is one) and to functional fiduciaries who work with the plan on a daily basis (i.e., the benefits personnel).

Adequate Investment Measurement Standards for the selection of monitoring of investments are not contained in the IPS. These standards should contain, at a minimum, regulatory oversight, minimum track record, stability of the organization, minimum Number of Assets in the investment, holdings consistent with Style, Correlation to Style or Peer Group, Expense Ratios/Fees, and Risk-Adjusted Performance.

The IPS does not have provisions for the controlling and accounting for expenses, including hidden or "soft" dollars. An income statement of revenues and expenses may be developed with the assistance of the advisor or service provider for a clear determination of what these dollars actually are.

The IPS does not contain a Watch List time horizon or alternative time horizon for the elimination of investments that fail the measurement standard criteria. While the Watch List criteria may be adequately addressed in the IPS, there should also be a time horizon, and perhaps a specification for how long the Committee will give the investment to meet the standards, such as four consecutive quarters of nonconformity with the investment standards, or, as an alternative, six out of eight rolling quarters of nonconformity.

The absence of language or measurement standards for the selection of Qualified Default Investment Alternatives (QDIAs). Potential failures of QDIAs commonly have not been addressed for transparency, adequate fee disclosure, or suitability. As a result, these investments may not be appropriate or prudent for the workforce.

The IPS is not signed by the current members of the Investment Committee. A failure of the members of the Investment Committee to acknowledge the policies outlined for its performance is an indication that such policies are not being taken seriously. It may be that the Investment Committee is not even aware it exists.

Committee members do not understand their fiduciary responsibility. There is a dearth of fiduciary education training. Committee members commonly "don't know what they don't know." It is hard to comply with rules and standards that you do not know exist.

Investment Committee Bylaws either do not exist or are inadequate. If there are no Bylaws, the authority of the Investment Committee is unclear. Commonly, there is even vagueness as to who is really on the Committee. Bylaws make it clear who's on first, what's on second, and no one better be "I don't know."

There is inadequate Investment Committee documentation and/or minutes. One thing that case law has demonstrated over and over again is that compliance with ERISA is judged by the procedure undertaken by the fiduciary, not the results. Furthermore, courts find records of fiduciary action created contemporaneously with the action very probative; recollections created after the lawsuit is underway have very little probative value. Therefore, a Committee's actions should be properly documented and a fiduciary file kept on an ongoing basis.

There is little or no congruence between the IPS and the Monitoring Report of the Investments. The IPS represents the standard for Investment Committee decisions, as outlined by the Plan Administrator. A lack of congruence between the IPS and actual Committee action can be prima facie evidence of a breach of duty.

The Monitoring Report lacks an adequate number of Investment Measurement Standards. If there is no clear standard for performance, how can the performance be judged as successful or failed? If the Committee is not applying appropriate standards, then there is little value to its periodic analysis.

Investments that have failed the Watch List criteria and time horizon remain on the options menu. Evaluation of investments is only valuable if results are acted upon. A Committee that evaluates investments, finds them wanting, and then takes no ameliorative action will look silly defending its actions on the witness stand during the fiduciary breach lawsuit.

The Investment Monitoring is highly dependent upon Service Providers and not Independent Investment Monitoring. It is appropriate for the Committee to rely on professional advice to augment its own knowledge and qualifications. However, taking investment advice solely from those

who make money off the investments is a little too much like letting the fox guard the henhouse. The Committee would do well to have some amount of independent advice.

There is a lack of due diligence on QDIAs. Too often, investments are summarily deployed as a QDIA at the recommendation of the Service Provider without proper due diligence. The protection offered by a QDIA choice may not be as effective as it could be.

The Committee and the Plan do not comply with ERISA 404(c) and the regulations underlying it. ERISA Section 404(c) enables Plan Sponsors to minimize their fiduciary liability with regards to participant-directed plan investments, if certain requirements are met. Most Plan Sponsors and even Service Providers think compliance is easy, when the regulations are significantly more complex than that. We send a 30-page questionnaire to Service Providers to see how they help the Plan Sponsor to conform to these requirements. Very few do an adequate job of keeping the Plan Sponsor and the Committee on track.

There is no or inadequate due diligence on "safe" investment options, e.g., Stable Value Vehicles or Money Market Investments. In 2008, this became a very critical issue. In some cases, there was a loss of book value due to a deterioration in the credit rating status of wrap insurers that insure the difference between book and market values. In others, there has been an exiting of wrap insurers from the market place due to their risk management concerns regarding their ability to sustain crediting rates.

A general lack of fee and performance benchmarking for the 401(k) plan and its service providers is apparent. Plan Sponsors have no idea whether the fees they are paying are competitive, whether the services they are receiving are sufficient, or an understanding that recordkeeping systems drive a lot of plan costs. Many benchmarking services are available that would give the Plan Sponsor some understanding and concern. In 2011, this will become especially critical with the implementation of new Labor regulations in relation to ERISA Section 408(b)(2), under which Service Providers are obligated to provide information about what they do for the plan and what they charge the plan for their services. The assessment of conformity to this new regulation has become a focus of our more recent fiduciary assessments. In our experience, most Plan Sponsors are dealing with Advisors or Brokers who do not currently disclose their services and fees. This new regulation will also require these service providers to disclose whether they have affirmatively taken on some of the fiduciary responsibility for the investments in the plan. Failure to disclose this information properly could result in prohibited transactions for the service provider and a breach of fiduciary duty by the Plan Sponsor or Administrator. One solution to this additional due diligence requirement is to have a Servicing Agreement outlining fees and service provided by the Service Provider, along with its taking fiduciary responsibility for the investments.

Negative findings in DOL investigations or verdicts of fiduciary breaches in lawsuits are very expensive ways of learning that the retirement plan fiduciaries are not operating in conformance with legal standards. Reviewing the above list of common problems, as well as possibly obtaining a fiduciary assessment by a private evaluation entity, can provide the proverbial "stitch in time."

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