

Taking Control of the Fiduciary Function

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This is the second in a series of three articles on fiduciary concerns.

In our last article, we discussed some investment related issues confronting HR professionals and other fiduciaries of retirement plans covered by ERISA. Here are some fundamental steps that every fiduciary should take to minimize their exposure to litigation related to plan investments.

Know Your Fiduciaries

A fundamental issue for many fiduciaries is that they do not know they are fiduciaries. In those situations, the door is wide open for missteps to occur. Accordingly, a plan sponsor must develop a list of all fiduciaries to the plan. All named trustees would be on that list, likely including senior HR and finance people and possibly some board members. As discussed last time, the person responsible for naming and removing trustees is also a fiduciary. Next, does anyone have functional responsibilities that could make them a fiduciary, even if they are not named as a trustee? Of course, all outside service providers to the plan should be considered as possible fiduciaries.

Next, the specific functions of each person should be spelled out. While ERISA does not mandate any special knowledge or experience for fiduciaries, it would be imprudent to let them perform fiduciary tasks without being sure they had the skills and resources to do the job correctly. Written procedural guidelines, coupled with ongoing training and evaluation, is a minimum for company employees who have fiduciary duties. Obviously, the plan needs a due diligence process for hiring and retaining outside service providers. The fiduciary responsibility of the plan trustees includes continuous oversight of all functions that are delegated.

It should come as no surprise that some fiduciaries will not wish to continue in that role when faced with the reality of their obligations and potential legal exposure. Frankly, it is in the best interest of the other fiduciaries if the unwilling are replaced. Of course, the plan sponsor should maintain adequate fiduciary liability insurance for all named trustees and employees who are fiduciaries to the plan.

Delegation of Fiduciary Duties

The delegation of fiduciary duties is generally caused by one of two things – the fiduciary is an employee of the sponsor and has too many other obligations or, the fiduciary does not possess the requisite competence to carry out his or her responsibilities effectively. The latter is very often the case with the investment process. ERISA contemplates delegation and provides some specific guidelines that every fiduciary must follow.

First, the plan document must expressly provide for prudent procedures to be followed in the delegation of duties among fiduciaries or to others. If the plan document is not clear about these procedures, there may be limited relief from liability as a result of the delegation. Even after the requirements of the plan have been satisfied, let's say with due diligence in the selection of a service provider, a fiduciary's duty regarding delegated functions continues in the monitoring phase. The fiduciary with oversight responsibility should establish a formal process for monitoring, including a timetable for regular written and oral reports. This is critical in the investment management area, where

so much delegation takes place. Not only must the delegating fiduciary receive regular investment reports, but he or she must continuously ascertain that the manager is complying with the terms of the investment policy statement and the asset management contract.

Participant-Directed Accounts

Last time, we talked about plans where participants choose their own investments from a menu provided by the trustees. If managed correctly, such a program can help a fiduciary avoid liability for the specific investments chosen by the participants. However, the rules are paramount and, if not followed, the fiduciary will retain responsibility, even where the participant actually made their own choices.

There are several pieces of information that must be furnished automatically to all participants and beneficiaries. A key item is a notice of limited liability, stating that the plan is intended to be a Section 404(c) plan. There also needs to be a description of all investment alternatives, including risk and return characteristics. The investment managers must be identified, along with an explanation of how to give investment instructions. Prospectuses and proxy materials must be delivered either before or immediately after purchase, and all transaction fees must be disclosed. All of these seem so simple, yet they are required to be provided automatically, creating a situation where the fiduciary must have a functioning system on autopilot to comply with the rules. For further reading on self-directed plans and a related fiduciary compliance checklist, go to <http://www.tillitgroup.com/news.html> and scroll down to "Self-Directed Plans.....".

Even after complying with these rules, the fiduciary retains the responsibility for the investment choices offered under the plan. ERISA requires at least three choices, although the average plan has fifteen, with some plans offering far more. Fundamentally, the choices must allow the participant the opportunity to diversify. They must be prudently chosen by the fiduciary at the outset, and then monitored regularly to ensure that they represent appropriate investment alternatives. A fiduciary courts disaster by developing a menu of choices without due diligence or follow up. Retaining fund choices that are unusually high cost or that continually lag against their peer groups are common failures among fiduciaries who adopt a "set it and forget it" approach with participant-directed plans.

Employer Stock

High-profile cases, such as Enron, have caused a great deal of concern over employer stock as a choice in 401(k) plans. In that case, there were allegations of bad behavior at a corporate and plan level, partially obscuring the key issue. In short, the fiduciary has an obligation to consider whether or not employer stock is an appropriate choice in the menu of investment options offered to participants. Poor company stock performance, even for a brief period of time, spawned the most recent wave of class action activity, without any allegations of bad behavior – just bad stock performance. There is a debate under way as to whether or not fiduciaries with inside information about the company should make it available to participants, even if doing so would violate SEC rules.

The use of company stock is advantageous for plan sponsors and is still desired by many employees. However, these highly publicized cases have caused many sponsors to change their guidelines for company stock. According to a Fidelity Investments survey, 66 percent of plans have no restrictions on trading company stock and 21 percent are considering the removal of any restrictions that currently exist. The survey also noted that 44 percent of companies still make 401(k) matching contributions in company stock and, in plans where company stock is offered at all, an average of 26 percent of assets are invested in it. The prudent fiduciary must take great pains when company stock is offered, particularly in the area of participant education. A retirement portfolio must be diversified to minimize the risk of large losses and, accordingly, there should be a measured amount of employer stock in the mix. At some point, the prudent fiduciary might want to impose a cap on the percentage of an

individual participant's account that can be represented by company stock. This may cause howls of protest from some participants, but it may be the best decision for the participants as a group.

Fees and Expenses – There is a Lot to Know

Fees charged to participant accounts can have a significant impact on long term investment results. Therefore, it is critical that trustees understand the fees being paid, as well as any compensation paid to service providers from other sources. It is only through complete disclosure that trustees can negotiate the lowest possible cost. In a recent study by Deloitte Consulting, 88 percent of plan trustees believed they understood fees in their plan. However, only 57 percent understood the concept of revenue sharing. This is in spite of publicity over the last year regarding compensation of investment advisors. This is a complex area and plan trustees may wish to consider retaining independent and objective consultants to review the cost structure of their plan.

Documentation and Oversight

There are many things a prudent fiduciary is supposed to “do.” It is a time-consuming responsibility and a great deal of financial exposure exists. The most critical thing a fiduciary must have is contemporaneous documentation for each material decision that affects the plan. A fiduciary can avoid liability for bad investments if the process through which they were chosen and monitored was thorough and prudent. That can only be established afterwards if sufficient documentation exists.

Virtually every 401(k) plan will need to delegate some fiduciary duties. Plans with many participants or sophisticated investment issues will undoubtedly delegate most of the fiduciary tasks. As indicated earlier, the fiduciary will retain the ultimate responsibility for the oversight of delegated duties -- this piece cannot be outsourced. In the area of investments, this means a critical eye must be used in evaluating performance, adherence to the investment policy statement, and fees charged to the participants. Merely accepting reports prepared by the investment manager or advisor “for the file” is insufficient to meet this obligation. The prudent fiduciary will always separate the implementation of investment policy, which is the task of the investment manager, from the oversight of that implementation. If the fiduciary does not have the capability to perform oversight in that way, then they must retain consultants who are independent of the implementation process and can lend totally objective support.

Closing Thoughts

The prudent fiduciary can overcome the enormous workload and responsibility associated with a retirement plan by intelligent delegation and documented oversight of plan administration and the investment process. In our next article, we will talk about where the fiduciary issue is headed and make some predictions about what plan sponsors, advisors and the regulators will be doing over the next few years.

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