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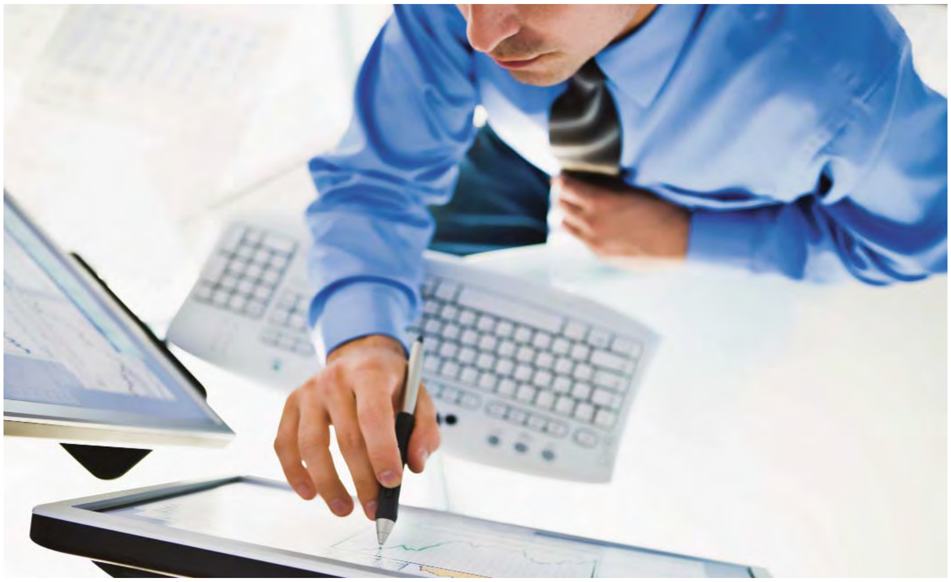
A Primer: 401(k) Plan Investments and Fiduciary Responsibilities

by Michael M. Eisenberg, Esq.

Two of the most important and challenging aspects of an employer's fiduciary duties are (i) the selection of suitable 401(k) investment options and (ii) providing participants with appropriate tools and guidance to facilitate the intelligent investment of their account balances. For many participants, 401(k) and profit sharing plan account balances represent not only their retirement savings but also a substantial portion of their overall assets and sometimes even an emergency fund that may be accessed through loans and, in extreme cases, hardship withdrawals.



While participants generally understand that participating in a 401(k) plan is a smart thing to do, they frequently do not have the knowledge and/or experience to properly invest their account balances. Surveys consistently point to the fact that plan participants need and want guidance in this regard. Similarly, while most employers want to help, they are sensitive to the time, required expertise, and liability associated with such an undertaking.

The solution and challenge: Selecting 401(k)/profit sharing plan service providers that have the expertise, experience, and resources to (i) advise on (and monitor) the proper selection of investment options and (ii) deliver effective guidance and tools to enable participants to make prudent investment decisions.

Selecting 401(k) Plan Service Providers

Arguably, the most important decision a plan sponsor makes is which service provider(s) to hire. The right service provider delivers the advice and administrative support necessary to make a plan function effectively and efficiently. This in turn produces better results that serve to attract and retain employees while minimizing administrative burdens and fiduciary liabilities.

So, what should a plan sponsor consider in order to make an informed decision when selecting service providers? There are a number of factors that should be evaluated, including the (i) scope and quality of advisory services, (ii) depth and breadth of investment options, (iii) administrative systems and support services, (iv) educational and investment guidance for plan participants, and (v) fees.

The last factor noted above (service provider fees) represents the biggest potential source of misinformation in retirement plan management. Historically, retirement plan "vendors" have been able to avoid the full disclosure of direct and indirect fees received from the employer and/or other sources such as mutual funds. Indeed, payments by mutual funds to service providers are a common source of indirect revenue. This so-called "revenue sharing" often results in significantly greater than reported fees/expenses, with significant adverse impact on net investment performance and benefit accruals.

Can plan sponsors get help in selecting 401(k) plan service providers? The short answer is yes, and the best place to start is often your accountant.

In recognition of this and other issues, the Department of Labor ("DOL") is requiring greater fee and expense disclosure. However, the disclosure requirements have yet to be fully implemented and generally apply only to larger company plans, leaving many plan sponsors to take it upon themselves to request and evaluate the appropriate information. Clearly, plan sponsors should require service providers to disclose all sources (direct or indirect) and amounts of revenue.

When designing and implementing a retirement plan, employers need to ask and answer many questions. For example: What type of 401(k) plan is right? What is the smartest plan structure? Should the plan sponsor elect safe harbor? Does it make good business and employee benefit sense to integrate the 401(k) with a profit sharing or other form of qualified retirement plan? Should the plan sponsor consider implementing a supplemental plan to make highly compensated employees whole? What administrative support do we need? Do we need to provide retirement planning and investment guidance to participants? If so, how should we do it? What categories of investments are appropriate? How many alternatives are enough and not too much? Selecting an independent, experienced, expert advisor is therefore critical to the overarching objectives of optimizing plan results on the most efficient basis possible.

The availability of a wide range of suitable and excellent investment options is similarly important. Since investment options must be reviewed and perhaps changed from time to time, it is important that a broad range of appropriate mutual funds be available at all times. In addition, to assist plan participants in selecting appropriate investment options, it is helpful if the service provider makes available one or two special types of composite investment options: target date funds, which consist of a combination of equity, bond, and money market funds, and which will be invested more conservatively as time passes and the participant reaches his or her "target retirement date;" and structured portfolios, which also consist of equity, bond, and money market funds but which do not become more conservatively invested over time. Instead, such portfolios allow participants to invest based upon their respective risk tolerance.

An important aspect of an employer's fiduciary duty is determining the investment options available under the plan.

Can plan sponsors get help in selecting 401(k) plan service providers? The short answer is yes, and the best place to start is often your accountant. Accounting firms generally know or work with employee benefits experts who can guide you through the complex retirement plan regulatory landscape. Some firms provide independent fiduciary and compliance reviews, while others can help solicit Requests for Proposals from investment advisors and/or plan administration firms, and aid in other aspects of conducting a vendor search.

Selecting Plan Investment Options

An important aspect of an employer's fiduciary duty is determining the investment options available under the plan. What are the factors a plan sponsor should consider when determining how the investment lineup should be chosen for a participant-directed retirement plan such as a 401(k) plan? Ideally, a qualified retirement plan investment advisor should be employed.

An advisor should enable the plan sponsor to put a formal written Investment Policy Statement ("IPS") in place. The IPS should:

- Detail the methodology that will be used in both selecting and monitoring the plan's investment lineup;
- Detail the steps that will be taken when the selection and monitoring criteria trigger changes to the fund lineup;
- List the criteria for benchmarking the relevant noted factors; and
- Incorporate fees and costs, and governance and management of investments, into the process.

Should a participant-directed retirement plan incorporate index mutual funds (or "Exchange Traded Funds," which act similarly to index funds) or actively managed funds? Ever since Burton Malkiel wrote his classic book "A Random Walk Down Wall Street" in 1973 and Vanguard introduced the first index mutual fund in 1976, there has been much debate about active versus passive management.

According to research published by Morningstar, only one-third of active funds beat their respective investment category index over a (recent) three-year period. Other studies have shown that, while active funds have often failed to beat their benchmarks, they do provide added value when a disciplined approach is adopted over longer periods. The selection of a qualified advisor, employing a strong, disciplined approach, can help plan sponsors navigate the selection process. Many knowledgeable advisors will employ a combination of actively and passively managed funds in 401(k) lineups. Investment management fees will clearly be a factor in making this determination. Index funds charge dramatically lower fees, while active managers must achieve sufficiently high returns in order to compensate for the higher fees they charge.

Providing Investment Advice to Participants

In addition to selecting best-in-class investment lineups, plan sponsors are increasingly seeking to provide help to participants in selecting from among those investment options. Many have simplified the decision-making process by making target date funds and/or structured portfolios available. In addition, some plan sponsors have gone further to make available to plan participants the services of qualified investment advisors.

Under recent final regulations issued by the DOL, plan sponsors and their service providers are permitted to provide such investment advice to plan participants using either a "certified computer model" or a "level fee arrangement." The computer model must be developed by a fiduciary advisor based on certain objective criteria and be subject to an annual audit, while the level fee arrangement must essentially guarantee that the fiduciary advisor's advice will not affect his or her fees (or those paid to his or her employer). In order to minimize potential fiduciary liabilities, plan sponsors who wish to make such advice available to their participants should make sure that their service providers are competent registered investment advisors who fully understand the rules. ■

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