THE EMPLOYER NEED FOR A 401(k) FIDUCIARY CHECKUP©

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401 (k) plans continue to be the most popular form of retirement plan. With over $2½ trillion in assets, the 401(k) market is already huge and every major financial institution and many smaller, regional and local players are out there vying for the opportunity to become your company's provider. Their products are sophisticated and reasons for having a 401(k) plan are compelling in that they offer:

- A relatively inexpensive fringe benefit
- A tool to attract and retain quality employees
- An opportunity for employees to defer income for retirement on a tax advantaged basis or, in the case of a Roth 401(k), to defer after-tax income for a tax free income retirement
- An opportunity for employees to direct their own investments from among investment options offered by the plan
- Portability of investment accounts if an employee leaves
- A tax deduction for the employer who makes matching contributions
- A means to ease employees from the workforce to retirement
- Professional management of retirement assets

Whether offered on a "bundled" basis, where a single provider undertakes record keeping and custodial services as well as enrollment and investment management, or on an "unbundled" basis, where services are obtained from different sources, service providers package 401(k) plans as a seamless and simple product. However, while often portrayed as a benign activity, establishing a 401(k) plan can also create a morass of potential liability which few employers understand and which many service providers fail to explain. This is not to suggest that employers should avoid establishing such a plan but argues that they should understand their responsibilities and manage the risks.

A retirement plan imposes on the employer an obligation to act solely in the interests of participants and on those involved in managing the investment of plan assets an obligation to follow a prudent investment process. What does this mean?

A prudent investment process involves a number of practices including the following:

- Identifying who are the plan fiduciaries and obtaining their written acknowledgments.
- Establishing quantitative and qualitative criteria for the selection and evaluation of investment options.
- Establishing a written investment policy statement to govern the prudent practices to be followed, i.e. the business plan.
- Conducting due diligence and documenting the process with respect to the selection of investment options and service providers.
- Following applicable "safe harbor" provisions.

- Conducting periodic and scheduled monitoring of investment performance, evaluating whether to change an investment option that falls short of selected criteria and documenting the process to provide a critical written record.
- Conducting periodic and scheduled monitoring of investment expenses and service provider fees and disclosing the results to plan participants
- Ensuring best execution, appropriate use of "soft dollars" and proper voting of proxies.
- Avoiding conflicts of interest and self-dealing.

These practices require that fiduciaries act as "prudent experts", a standard demanding professional investment expertise. As a result, knowledgeable employers will engage a Registered Investment Advisor, or RIA, to assist them with the investment process. These are investment professionals who will provide the plan with continuing investment advice and guide the plan fiduciaries through the investment process. They will acknowledge in writing their fiduciary status and act as co-fiduciaries.

Many more employers will get their advice from the securities broker who helps them to establish the plan and secure the initial investments. Securities brokers will claim that they do not act as fiduciaries even though they may offer services comparable to the RIA. The courts have recently challenged the status of brokers as being exempt from fiduciary responsibility and, under pressure from the financial services industry, the SEC is now considering new rules to restore some measure of exemption. In the meantime, employers would be well advised to insist that their broker clarify in writing the broker's fiduciary status.

Other employers may not use any investment advisor on a continuing basis and will apply an ad hoc approach to the investment process by checking things out only when a participant raises a question. Such employers, of course, are the most vulnerable.

And what is this vulnerability? The answer lies in the numerous law suits which have arisen since the collapse of Enron. These suits have alleged all kinds of wrongdoing in the management of 401(k) plans. Many law suits allege that plans have been overcharged for investment expenses and for hidden costs contrary to ERISA (the Employee Retirement Income Safety Act of 1974). Others allege failure to prudently manage assets or failure to appoint and monitor the performance of other fiduciaries. Other suits against public companies complain of mismanagement as a result of a fall in price of company stock offered as a 401(k) investment option.

Proliferation of lawsuits against employers alleging fiduciary breach may be expected as a result of a recent Supreme Court decision in which the Court gave the green light for individual 401(k) plan participants to sue for fiduciary breach, when previously only the plan as a whole could sue. As a result of this landmark decision, the plaintiff bar has 401(k) plans in its sights and employers should take heed. Also, current market volatility and a bleak economic outlook are causing plan participants to look closely at their investments, bringing into question the investment process pursued by their employer.

Some employers will seek “safe harbor” relief from liability for participant directed investment decisions, by conforming their plans to ERISA section 404(c). This limited relief comes at the price of additional due diligence and fiduciary oversight. To complicate matters, albeit unintentionally, the Pension Protection Act of 2006 (PPA) provides the means for employers to avoid fiduciary liability for investment losses when employers provide a Qualified Default Investment Alternative for plan contributions from participants who fail to make an investment election. At the same time, for employers wanting to provide participants with investment advice, a previously prohibited activity, the PPA now relieves employers from fiduciary liability for that advice when the plan adopts an Eligible Investment Advice Arrangement. Both of these new “safe harbors” require due diligence and fiduciary oversight if liability is to be successfully avoided thereby expanding the roles of fiduciaries in the investment process.

What all of this suggests is that employers should get their fiduciary house in order by performing an assessment of their conformity with prudent investment practices and making appropriate changes where conformity falls short. Such prudent practices are now well defined and a specific fiduciary assessment methodology and standard have been created. A good start would be for employers to look at the practices listed above and ask themselves to what extent they conform. Beyond that, employers should seek competent advice.

In conclusion, 401(k) plans offer the best opportunity for employees to save for retirement on a tax-advantaged basis. By sponsoring well designed plans and following prudent investment practices, employers have little to fear. They are not the guarantors of investment performance and they are not required to search out the lowest cost investments or service providers. They are required to follow and document conformity with prudent investment practices, noting that prudence requires an expert knowledge of the 401(k) investment process.

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