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Fiduciary Governance of a Qualified Plan

by Pete Swisher, CPC, QPA

Governance of a qualified plan encompasses every detail of setting up, running and terminating a plan, and doing it right means establishing a comprehensive written governance process appropriate to the plan size. Most sponsors are ill equipped to devise and implement such a process; they need help from a new breed of elite pension consultants. ASPPA's Qualified Plan Financial Consultant (QPFC) education and credentialing program is aimed at developing this new breed of consultant.

A 401(k) or other retirement plan is a business necessity to the typical plan sponsor, but often not a business priority. Yet the sponsor's status as a fiduciary gives it a nearly unprecedented level of authority and responsibility, the "punctilio of an honor the most sensitive," and rare is the sponsor who thoroughly understands this responsibility, consistently fulfills it and can prove through documentation that it has done so.

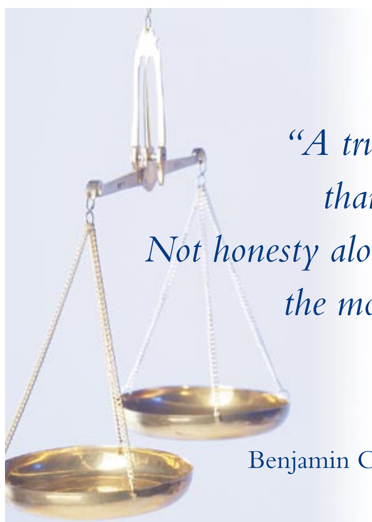
Total Plan Governance

Plan governance is a holistic exercise covering every aspect of running a successful retirement plan. It has many faces, represented by the industry's many specialists: TPA, attorney, accountant, auditor, investment advisor and others. A plan sponsor is lucky if it can handle even its own roles effectively; the rest must be outsourced. Sponsors understand this fact and have no reluctance to outsource, but they rarely know enough to ensure *effective* and *compliant* outsourcing. The sponsor's needs can be summarized in this two-part plea for help:

- What needs to be done?
- Do it.

The Difficulty of Knowing What Needs to Be Done

Simply ***knowing what must be done*** can be difficult; building a process to ***ensure it gets done*** even more so. Consider the example of the Summary Plan Description (SPD), a disclosure mandated by ERISA §102:



"A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."

Benjamin Cardozo, Supreme Court Justice, 1932-1938

Example: "What's an SPD?"

A company hires a new human resources manager with minimal 401(k) experience. The company employs a large number of Hispanic workers, and 15% of the employee population speaks only Spanish. After one month on the job she receives an e-mail from the plan's 401(k) recordkeeper:

> "Subject: New SPD
>
> Dear HR Manager:
>
> Attached is the new SPD—we worked on this with your predecessor. Please call if you have any questions."

The HR manager replies,

> "Dear Recordkeeper:
>
> What's an SPD?"

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This e-mail exchange raises many questions:

- How is the HR manager supposed to know what an SPD is, much less what all of the company's other responsibilities are with respect to the plan?
- How is the HR manager supposed to know that the SPD must be distributed to participants within specific time frames, and what those time frames are? Or that posting a copy or leaving a stack in the break room is not sufficient? Or that e-mailing is only okay if certain conditions are met, and what those conditions are? Or that a version of the SPD must be available in Spanish based on the ERISA §102(c) rules?
- Whose job is it to teach her?

The SPD is a good example of something that must be done that often fails to get done. Most sponsors receive the SPD by e-mail or hard copy with instructions for distribution but don't follow the instructions. The SPD is also a good example of how sponsors can misunderstand the allocation and delegation of responsibilities. Most sponsors perceive the SPD to be a responsibility they have outsourced, not retained, when the reality is they remain responsible for almost every aspect of SPD creation, updating and distribution.

Is All This Complexity Fair?

The rules governing qualified plans are complex beyond the comprehension, or approval, of most business people, but put this complexity in perspective:

> The tax breaks associated with qualified plans represent approximately *$400 billion per year of lost tax revenue* for the United States—the single largest set of tax breaks in the Code.[1]
>
> Retirement plans are the largest financial assets for the majority of Americans, representing more than *$16 trillion in assets*[2], more than the entire Gross Domestic Product of the US ($13.1 trillion in 2006[3]). The pension system is second only to Social Security in impact on national retirement security and is a major policy issue.
>
> Before ERISA, ordinary people had few protections. In some cases workers lost everything when a company went under—such as Studebaker, whose collapse was one of the triggering events leading to ERISA.

The government therefore looks at the world of qualified plans as one that ***requires*** extensive regulation and oversight.

The Purpose of Plan Governance

Compliance is *not* the purpose of plan governance; *success* is the purpose. Compliance is simply the environment in which this purpose is achieved. Similarly, liability protection is not the purpose; protection is merely a side effect of good governance. Compliance and liability protection are therefore part of plan governance but not its *primary purpose*, which is:

- **Participant Success.** To help employees and their families achieve a successful retirement; and
- **Organizational Success.** To help the plan sponsor achieve its organizational objectives, such as recruiting, rewarding and retaining good people, controlling costs and funding owners' benefits.

The Fatal Flaw

My experience is that the overwhelming majority of plan sponsors cannot correctly identify who the plan fiduciaries are or what they do. I call this problem the *fatal flaw of a fiduciary governance process,* since a process without a leader is an invitation to failure. Common sense dictates that, to supervise something, one must:

- Identify who is in charge;
- If multiple parties share responsibilities, spell out how those responsibilities are divided;
- Set clear expectations; and
- Hold the leaders accountable.

These steps provide the basic framework for overseeing anything, from getting kids to clean their rooms to running companies and winning wars. Failing to follow them is a fatal misstep.

Is it hyperbole to say that the *overwhelming majority* of sponsors cannot correctly identify the plan fiduciaries or how duties are divided among them? Matt Hutcheson, CPC, says, "In my experience, most 401(k) plans are operated on an ad hoc basis. Many fiduciaries admit that they are neither well informed nor organized; those responsible for day-to-day operations of the plan are usually left to make up procedures as they go along."[4]

Example: At a meeting with the investment committee for a large company's retirement plan, the advisor asks, "Who is the Plan Administrator?" The committee chairman responds, "ABC Insurance Company." But ABC is the plan recordkeeper and contract administrator, not the Administrator as defined by ERISA §3(16)(A). A few more questions reveal that the committee members do not know that the Administrator role is one of the primary fiduciary roles in the plan, what the Administrator is responsible for under ERISA or who the Administrator is for their plan (it turns out to be *them*).

In the wake of Enron, WorldCom and the recent rash of 401(k) class actions, sponsors are concerned about fiduciary issues, so naturally vendors are eager to be seen as curing the sponsor's fiduciary woes. Nearly every vendor in the US now has the term "co-fiduciary" appearing somewhere in its marketing materials, and sales pitches tend to foster an impression of risk transfer. "My vendor is a fiduciary; I have outsourced fiduciary oversight to them" is a common misperception, and an example of the fatal flaw at work.

Scott Simon of Prudent Investment Advisors, LLC pulled no punches on this topic in his *Fiduciary Focus* columns on **Morningstar.com** in 2006, where he discussed "phantom" fiduciaries who supply plan sponsors "with deceptive contracts that are legally toothless against the consultant":

> *"And that, folks, is a clinic on how to gut from a fiduciary-consultant contract…fiduciary duties so that the consultant can claim that it is an 'ERISA fiduciary' while bearing no real fiduciary responsibility… In such situations, many plan fiduciaries are misled because they see (assuming they read their contracts) and hear …the magical word fiduciary."*[5]

In the box below, see how the fatal flaw manifests itself in a common service arrangement, which includes:

- An investment and recordkeeping product with 300 fund options;
- A non-fiduciary broker who sells the product to the sponsor and provides ongoing service for the product at plan and participant level;
- An advisory service sold by the product vendor as an add-on whereby an independent RIA chosen by the vendor recommends a fund menu from among the 300 funds available in the vendor's product; and
- A bank, chosen by the vendor, providing directed trustee services for a $500 fee.

This arrangement is a common, viable service arrangement. The point is not that there is anything wrong with the arrangement itself, but that sponsors routinely misperceive who is responsible for what.

Client Perception	Reality
"Our broker said he's a co-fiduciary; he's the one responsible for the investments."	The broker is a non-fiduciary and his contract says so. What he actually said was, "This service is a co-fiduciary service," referring to the product's add-on advisory service, not himself.
"We have a bank trustee in addition to the advisor; we've outsourced the trustee function."	The trustee has many functions, only one of which has been outsourced—custody—because the bank is trustee in name only; it is a passive, directed trustee, accepting the directions of a named fiduciary rather than exercising discretion itself, and chosen by the recordkeeper as a product (non-fiduciary) decision to provide this add-on service. The client remains the named fiduciary for all other investment purposes, which means that the bulk of the trustee role has not been outsourced—only the title.
"Our vendor is a fiduciary, too."	The recordkeeper sells an add-on service whereby an independent RIA chosen by the recordkeeper will provide investment advice with respect to which of the 300 funds available in the recordkeeper's product are prudent choices for the final fund menu. The named fiduciary—the client—must still choose the final fund menu. The recordkeeper claims non-fiduciary status.
"The Plan Administrator? That's ABC Recordkeeping, our vendor."	Clients routinely confuse the Plan Administrator, one of the two main fiduciaries in a qualified plan (the other is the trustee), with the contract administrator or TPA, a non-fiduciary service provider who executes ministerial tasks for the Administrator.
"We've outsourced everything."	The sponsor has outsourced not one single fiduciary duty besides custody. It has outsourced the performance of ministerial tasks and hired a fiduciary advisor who provides a very limited scope of advice. There is nothing wrong with the arrangement; the fatal flaw lies in the sponsor not understanding what the arrangement actually is.

Today's 401(k) marketplace has many experts but few or no quarterbacks: there is a market vacuum waiting to be filled by a new breed of pension consultant.

Sponsors and Fiduciaries Must Know the Answers to These Questions

The cure for the fatal flaw is to correctly identify every person who is a fiduciary and clearly delineate the responsibilities of each. A sponsor or fiduciary should therefore be able to answer these questions readily:

- Who are the plan fiduciaries (all of them)?
- Who is the Plan Administrator?
- If the Plan Administrator is the plan sponsor or a committee, which specific individuals fill this role?
- Who is/are the trustee(s)?
- Is the trustee fully discretionary or have some duties of the trustee been retained by a named fiduciary who directs the trustee? If so, who is that named fiduciary, and which specific duties are allocated to each party?
- Is there an investment advisor [*i.e.,* as defined by ERISA §3(21) and Labor Reg. §2510.3-21(c), not an RIA or broker that the sponsor *describes* as an investment advisor]? If so, what is the specific scope of the advice to be rendered? Will the advisor have any discretion? If so, over what?
- Is there an investment manager [*i.e.,* as defined and discussed in ERISA §§3(38), 403(a)(2), 405(d)(1) and the associated Labor Regs, not a manager of investments as the term is commonly used]? If so, over what assets does the manager have discretion? Have any limitations been placed on that discretion? If so, by whom?
- Who is/are the fiduciary or fiduciaries responsible for appointing and/or monitoring each of the other fiduciaries?
- What fiduciary responsibilities have been retained by the plan sponsor? Who fills that fiduciary role on behalf of the sponsor (*e.g.,* the owner or board of directors)?
- Do the contracts for all fiduciary service providers correctly identify them as fiduciaries and correctly delineate their responsibilities (*e.g.,* if a broker whose contract identifies him as a non-fiduciary provides services that meet the functional definition of investment advice—not an uncommon scenario—there is a disconnect; the documents should reflect the reality)?
- What fiduciary decisions are made by the board of directors? Are all of the directors involved in fiduciary decisions, or only certain directors? Are all directors who make fiduciary decisions aware of their status and responsibilities?
- Are all other fiduciaries aware of their status and responsibilities?
- Can you prove it (*i.e.,* by producing signed appointment forms on which each fiduciary acknowledges the specific duties delegated or allocated to it and the general responsibilities of a fiduciary under ERISA)?

The fatal flaw of plan governance can be described simply as an inability to answer these questions—a failure to identify ***who is in charge of what***.

The Role of the Advisor

Sponsors are ill equipped to devise and implement a comprehensive governance process. They need a quarterback—someone who knows what must be done and can help the sponsor oversee the parties tasked with doing it. Today's 401(k) marketplace has many experts but few or no quarterbacks: there is a market vacuum waiting to be filled by a new breed of pension consultant.

The Elite 401(k) Advisor and the Five Disciplines

The elite advisor is a specialist who blends expertise in five bodies of knowledge to form a new specialty of comprehensive plan governance:

- Plan design and administration;
- Fiduciary and legal issues;
- ERISA-specific investing;
- Plan and participant level service; and
- Education and advice for owners, executives and employees.

Execution: The Five Disciplines in Action

Execution means being able to combine the five disciplines to create opportunities and solve problems. Above all, execution means being able to *communicate in a way that causes the client to take appropriate action*. Good consulting is an act of leadership, and the role of the elite advisor is to lead the governance process to deliver successful outcomes.

The elite advisor's two most important functions in the governance process are to help *draw the lines and fill the gaps*. The advisor helps identify who the fiduciaries are and draw clear lines between them, identifying who is responsible for what. The advisor then helps the client fill the gaps between service providers; those functions that remain the responsibility of the client alone, such as new hire processing and payroll.

How many of today's retirement plan advisors, most of whom are investment salespeople and investment advisors, can realistically be expected to become "elite advisors" as described here? Not many. And how realistic to expect any but the largest plans to follow detailed governance processes? Not very (not yet, anyway). But the fact remains that clients need the help, creating a market vacuum waiting to be filled. After all, plan qualification and fiduciary prudence are not optional—nor is effective overall governance—and the advisor who can deliver it better, for large plans and small, can corner the market.

Building a Fiduciary Governance Process—Principles to Follow in Building a Governance Process

Large Plans Call for More Detail than Small Plans

As a general rule, more money and more participants call for more oversight. How much is enough? Think in terms of expense: fiduciaries are obligated to ensure plan costs are reasonable; therefore the amount of oversight that is appropriate must be determined in part by cost—it would be inappropriate for a $2 million plan to hire an army of attorneys and consultants like a $2 billion plan must.

If the Process is Not in Writing, There is No Process

My boss the physician has a rule borrowed from medicine; if it's not in the chart, it didn't get done. Attorneys will tell you that the three keys to winning in court are "documentation, documentation, documentation." It's tough to document following a process that is not itself documented. The need to document one's procedural prudence, however, must be balanced against the need to avoid documenting one's failures.

Balance the Need for Written Process against the Risk of Building a "Roadmap for the Plaintiff's Lawyer"

My co-speaker at the 2007 Western Benefits Conference, ERISA defense attorney and then-current ASPPA Vice President Sheldon H. Smith, APM, cautioned sponsors and advisors on the danger of failing to follow one's own process: "If your client is…not about to follow what you've put down in writing for them to follow, all you're doing is creating a roadmap for the plaintiff's lawyer." Having a written process that is not followed is, therefore, worse than not having a written process, because "the plaintiff's lawyer can just walk right through you."[6] You can't get away from the need for written process, but whatever process you establish must operate on something close to auto-pilot; it must get done.

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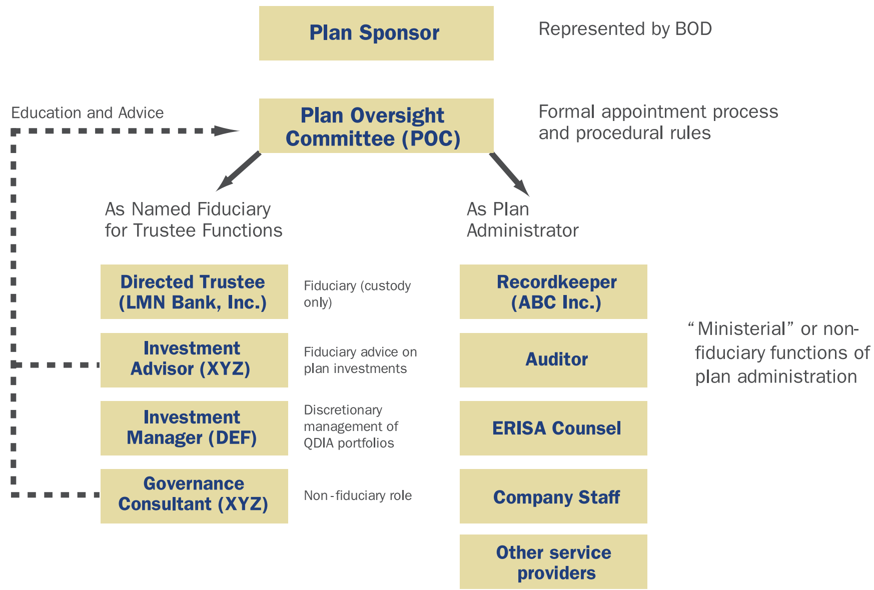
Skeleton of a Fiduciary Governance Process

The process should include the following:

- Identification of fiduciaries, including a process for selecting and monitoring them;
- Allocation and delegation of fiduciary duties:
  - "Allocation" is the term for division of responsibilities among named fiduciaries (generally done in the plan document);
  - "Delegation" is when named fiduciaries delegate to other fiduciaries (who are not named fiduciaries); and
  - Both allocation and delegation should be done in writing and in accordance with ERISA, DOL Regulations and the plan document;
- Governance structure: It is helpful to establish a general overview or flowchart of how the plan will run. *(Refer to the organization chart that follows for an example of a sample oversight structure.)*
- Process for selection and oversight of service providers;
- Process for oversight of employees involved in operating the plan, such as internal fiduciaries, HR employees and the payroll department;
- Investment process and policy;
- Process for fulfilling the plan administrator's responsibilities, such as handling SPDs, SMMs, SARs, qualification compliance, audits, SAS 70 reviews, the "practices and procedures" so critical in EPCRS, etc.[1];
- Oversight of settlor functions, such as plan design (who will get what benefits?), plan provisions

Sample Oversight Structure



(the details of eligibility, entry, vesting, etc.) and who pays plan expenses (generally a non-fiduciary decision);

- The participant communications program, which has three distinct purposes:
  - — To maximize participant success rates;
  - — To generate employee goodwill toward the employer by taking credit for the good things the plan does; and
  - — Compliance; and
- The checklist—a document of surpassing importance.

Organizational Chart for Plan Governance

It helps everyone to understand fiduciary relationships if they have a chart like the sample above.

Conclusion

Sponsors need help creating and running effective governance processes; they need a quarterback. And the best person for the job is a new breed of elite pension consultant or advisor who blends expertise in multiple disciplines to form a new discipline—comprehensive plan governance. If your goal is to become an elite advisor, ASPPA's QPFC credential is the place to start.

Editor's Note: This article is an abridged version of the Introduction to 401(k) Fiduciary Governance: An Advisor's Guide*, the 2008 textbook for the PFC-2 course of ASPPA's QPFC credential.*

*Pete Swisher, CPC, QPA, is vice president and senior institutional consultant for Unified Trust Company, NA, in Lexington, KY. He serves as a pension consultant and external wholesaler representing Unified's services through independent 401(k) advisors. Pete serves on The ASPPA Journal Committee, and is also a CFP®. (**pete.swisher@unifiedtrust.com**)*

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1 From the IRS Q&A session at the 2007 Western Benefits Conference.
2 The US Retirement Market, 2006, The Investment Company Institute.
3 Bureau of Economic Analysis, August 30, 2007.
4 "How to Structure, Organize, and Operate an Investment Committee for Your 401(k) Plan," Matt Hutcheson, Legal Management News, Spring 2004.
5 "Non-Fiduciary Investment Consultants" Parts 1 and 2, W. Scott Simon, from the Fiduciary Focus column on **www.Morningstar.com**, May 4, 2006 and June 1, 2006.
6 "Old Demons and Recent Developments in ERISA §404(c)," Session 19 at the 2007 Western Benefits Conference.
7 SPD (Summary Plan Description); SMM (Summary of Material Modifications); SAR (Summary Annual Report); SAS 70 (Statement of Accounting Standards Number 70); EPCRS (Employee Plans Compliance Resolution System, or "Ep-kers")—the Administrator's list is long and fraught with peril.

unified trust
COMPANY, N. A.

2353 Alexandria Drive, Suite 100
Lexington, KY 40504 USA
(859) 296-4407
(877) 411-8781 toll-free
www.unifiedtrust.com