Fiduciary Risk Assessment LLC

Fiduciary UPDATE

Volume 1 Issue 1 **May 19, 2008**

In Search of the "Perfect" 401(k) Plan

By David J Witz, AIF® Managing Director and Founder of Fiduciary Risk Assessment LLC of Charlotte, North Carolina. If you would like to discuss this issue further, you may contact Dave at dwitz@fiduciary-risk.com or call him at 704.564.0482.

A thought provoking question was asked of me, and I assume others, during the fi360 Annual Conference held in Charlotte, NC May 8th and 9th. The question, "how would you design the perfect 401(k) plan?" My initial reaction to this question was that there is no such thing as a universally perfect 401(k) plan since the definition of "perfect" is subjective. However, recognizing that "perfect" is in the eyes of the beholder, I attempted to identify the criteria I felt was most important to the plan sponsor who desired to provide retirement benefits with a corresponding coherent risk mitigation strategy in light of today's legislative, regulatory, and legal environment. Obviously, changes to the criteria or soliciting an opinion from someone else using the same criteria could yield a different opinion. With this in mind, the criteria used and the recommended structure follows.

The primary reasons for adopting a 401(k) plan include:

1. Attract quality employees,
2. Retain quality employees to minimize the cost of attracting and training new employees,
3. Provide an alternative source of compensation i.e., a fringe benefit that avoids social security taxes, workers compensation, and federal and state unemployment taxes on employer contributions, and
4. Provide a means to move historically productive employees, who participate in the plan, from the workforce to retirement with potentially adequate finances.

Of the four reasons, three serve the best interests of the company and its shareholders while the fourth is more in tune with social paternalism. Although there may be other reasons why a company might adopt a 401(k) plan, these four reasons represent logical and historical justifications for incurring the cost of establishing and maintaining a 401(k) plan.

In addition to the above, the "perfect" plan would include a risk mitigation strategy that would maximize protection for the company, its shareholders, and fiduciaries. Based on today's legislative, regulatory, and legal environment, the risk mitigation strategy might include the following objectives:

1. Reduce the risk of litigation against the company and its fiduciaries,
2. Maximize benefits to the participants within the parameters of the company's retirement budget,
3. Secure necessary service providers at the lowest possible cost to the company,
4. Minimize the amount of time and effort expended by executive management on 401(k) plan administrative oversight, and
5. Protect the company (plan sponsor's) brand name and/or public image.

From an executive's perspective, retirement benefits are voluntarily offered fringe benefits. Every dollar spent on outsourced services is a dollar that is not available for the shareholders or participants. In addition, every hour an executive spends on fringe benefit issues is a lost opportunity cost for the shareholders and participants.

Assuming the issues outlined above are the driving factors that dictate the design of the "perfect" 401(k) plan, I suggest the general benefits and features of the "perfect" 401(k) plan might include:

1. A Safe Harbor match to reduce the cost and burden of discrimination testing.
2. Automatic enrollment.
3. Annually re-enroll those not participating.
4. Auto increase feature that moves participants to a 15% deferral rate.

5. A Qualified Default Investment Arrangement (QDIA).
6. Annually re-enroll every participant into a QDIA unless the participant opts out.
7. Offer a limited investment menu i.e.,:
    a. Money Market or Stable Value.
    b. Total U.S. Bond Market Index.
    c. Total U.S. Stock Market Index.
    d. A series of Passively Managed Lifestyle or Target Funds.
8. The underlying holdings of the Lifestyle or Target funds will represent the lowest cost index options.
9. No investment will be used if it includes revenue sharing of any kind unless it can be credited back to the fund from which it came.
10. Implement an Investment Policy Statement that embraces passive investment management as the investment process.
11. Quarterly - monitor investment performance to confirm strong correlation to each investment's benchmark index.
12. Quarterly - monitor investments to confirm the plan is using the lowest priced index fund the plan is eligible to access.
13. Passive investment mandates can be filled by registered investment companies, collective funds, or separate accounts.
14. Comply with section 404(c).
15. Plan sponsor will pay all plan expenses. No expense shall be paid from plan assets except the internal investment management fee and, if necessary, trustee and/or custodian services.
16. Only services that were absolutely necessary would be retained.
17. Service fees for terminated employees will be billed against their individual account.
18. Investment advice to plan participants will not be offered.
19. Investment materials or education would be provided only to the extent necessary to meet any legislative or regulatory requirements.
20. Only service providers and advisers with appropriate credentials and experience would be retained.
21. All services retained shall be re-bid tri-annually.
22. Service providers shall be paid a fee by the unit, hour, or project. Service providers shall not be paid a percentage of assets.

Depending on the assumptions or objectives, the structure of your "perfect" plan could change from the structure I have outlined above. However, your challenge is to design an alternative structure than the one I have articulated using the same criteria without adding cost, time, or risk.

Again, designing the "perfect" plan is a subjective process that is dictated by the criteria used and influenced by the biases of the individual consultant or adviser. If you have a different opinion on how to design the "perfect" plan, send it to me.

Fiduciary Risk Assessment LLC is not engaged in the practice of law or accounting. Any recommendation outlined in this article should be discussed with personal legal counsel, your advisor, or consultant to determine its application to your specific circumstances. David J Witz, AIF® is the Managing Director of Fiduciary Risk Assessment LLC a Charlotte-based service provider that offers web-based fiduciary assessment tools to the retirement industry and expert witness services. The web site is www.fiduciary-risk.com.

Phone 704-564-0482 * dwitz@fiduciary-risk.com * www.fiduciary-risk.com