

Fiduciary compliance reviews: For your defined-contribution plan

A fiduciary compliance review is not the same as the annual ERISA audit. We will explore some of the aspects of the review and some areas it should focus on.



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As a plan sponsor for a 401(k), 403(b), money-purchase, or profit-sharing plan, you have most likely heard of the terms fiduciary audit or fiduciary compliance review. In fact, you've probably received a number of advertisements and phone calls from firms selling these services. So you may be asking yourself, "Do I need a review?" In this article we'll explore the answer by examining some of the aspects of a fiduciary compliance review and goals that should be set for the project, and whether it is conducted internally or by an independent third party.

A fiduciary compliance review or audit is not the same as the annual independent accountants' plan audit required under the Employee Retirement Income Security Act (ERISA) for Form 5500 purposes. The primary focus of the annual ERISA audit is to examine the plan's financial integrity. In contrast, the purpose of a fiduciary compliance review is to determine whether the plan meets Internal Revenue Service (IRS) and Department of Labor (DOL) rules, the focus of each agency being different. The IRS focuses on the plan document and whether the plan is operating in accordance with the document and the tax laws. The DOL is interested in ensuring that the rights of plan participants under the plan are protected.

WHO OR WHAT IS A FIDUCIARY?

To briefly summarize, a person or entity becomes a retirement-plan fiduciary under ERISA by title or by action, including the following:

- Exercising discretionary control or authority over the management of the plan or the plan's assets
- Providing investment advice to a retirement plan or plan participants for a fee
- Having discretionary authority over plan administration
- Being named in the plan document as a fiduciary
- Being named as a directed trustee to do any of the following:
 - Provide custodial or trustee services for plan assets
 - Process plan withdrawals
 - Provide plan reporting
 - Process transactions requested by a plan administrator

For more details on the responsibilities of being a retirement plan fiduciary, go to www.milliman.com and look under publications for the white paper *Am I a Fiduciary?*

In general, professional-service firms providing the following are typically not a fiduciary, unless they were to provide or perform any of the actions indicated above:

- Legal services
- Accounting or auditing services
- Record-keeping or third-party administration services
- Actuarial services

We should also note that performance of the above services could result in the professional-service firm becoming a fiduciary by action, especially if it exercises discretionary control over the retirement plan to which it provides services.

ERISA requires a plan fiduciary to act prudently with the best interests of the plan participants in mind when making plan-related decisions. A plan fiduciary's duties include the selection and monitoring of plan investments and ensuring that the plan operates in accordance with the plan document, investment policy statement, administrative policy, loan policy, and qualified domestic relations order (QDRO) policy. In addition, a plan fiduciary must avoid conflicts of interest when making plan-related decisions because doing so could potentially lead to prohibited transactions.

During 2008, the U.S. Government Accountability Office (GAO) published a study indicating that plan sponsors and fiduciaries confront many challenges in fulfilling their duties as a plan fiduciary. The report highlights the fact that sponsors may not fully understand the importance related to the delegation of responsibilities required in the administration of their retirement plan. For example, a sponsor can delegate functions, such as record-keeping, nondiscrimination testing, investments advisory services, employee education and advice, and trustee services. The GAO report indicates that disclosure is important, but sponsors may not be fully aware of their responsibilities related to the delegation of tasks to the various vendors who administer their retirement plan.

In addition, the report refers to prior GAO reports, where the GAO has recommended that Congress amend ERISA to provide the DOL with the power to: 1) require 401(k) service providers to disclose to plan sponsors any compensation received with respect to the plan, and 2) recover plan losses against service providers, even if they are not a fiduciary to the plan.

As you can see, being a fiduciary requires a thorough understanding of the retirement plan, clear delineation of who is responsible for the fulfillment of the services required to administer the plan, and a thorough understanding of the expenses related to the investment-management and administration services provided to the plan.

WHAT AREAS SHOULD A TYPICAL FIDUCIARY COMPLIANCE REVIEW COVER?

A typical fiduciary compliance review, whether conducted internally or by an independent third party, should generally cover:

- Plan services and service providers
- Plan document, policies, procedures, and operations
- Plan reporting, disclosures, and notices
- Nondiscrimination testing
- Investments, fees and expenses, and fiduciary due diligence

DEFINE WHO IS RESPONSIBLE FOR PROVIDING SERVICES TO THE PLAN

There should be a clear delineation of who is responsible for providing services to the plan, and fiduciaries should detail who will be providing the following:

- Record-keeping and processing
- Nondiscrimination testing and reporting
- Investment monitoring and consulting
- Education and communications
- Plan documents and amendments
- Trust and custody services for plan assets
- Payment processing services for loans and distributions
- Tax reporting services for plan distributions

Fiduciaries should have each service provider commit in writing to the services they are providing.

As a plan sponsor, drafting an administration flowchart or service-provider matrix, indicating the responsibilities and services provided by each of the vendors, could be helpful in developing an understanding of who is responsible for the tasks related to the administration of a retirement plan. With bundled service providers, a plan sponsor may find this difficult because they often wrap and meld many of the services. This exercise will help a plan sponsor understand what each vendor is responsible for, and the interactions among all of the vendors. See Figure 1 for a sample service provider matrix.

PLAN DOCUMENTATION, DISCLOSURES, AND NOTICES

ERISA requires a qualified plan to have a written plan document. In addition, the IRS requires periodic plan amendments to update the plan, often on an annual basis. Along with the plan document and amendments, the plan should also have the appropriate executed board resolutions signifying the sponsoring entity’s approval of plan-related actions and a trust agreement that defines the role and responsibilities of the plan trustee in overseeing the plan assets.

Compliance with ERISA in the drafting of the plan and the periodic amendments is mandatory. Often, plan sponsors work with a third-party service provider that provides a plan document and that will monitor any required updates, giving the plan sponsor a signature-ready document with the necessary amendments and plan restatements as updates are needed. If a sponsor works with internal or external attorneys, it is important to clarify their role and indicate if they will be responsible for monitoring document compliance and providing guidance on required updates. As the plan is amended, plan participants must be notified of the changes in the form of a Summary of Material Modifications (SMM) or an updated Summary Plan Description (SPD).

Another part of the disclosure process requires plan sponsors to file informational reports with both the IRS and DOL. Plans that are subject to ERISA must file Form 5500, an annual informational filing that includes general information about the plan, plan assets, and demographics. In addition, defined-contribution plans must provide summarized information from the Form 5500 to participants in a report called the Summary Annual Report (SAR).

Figure 1: Sample Service Provider Matrix

| Service Provider | Recordkeeper | Attorney | Communications | Trustee | Custodian | Payroll Vendor | Investment Consultant | Compliance |
|---------------------------------|---|---|--|--|--|---|---|---|
| Services Provided | <ul style="list-style-type: none"> • Recordkeeping • Website • Call Center • Disclosures/ Notices • Monitor 402(g), 415 limits | <ul style="list-style-type: none"> • Plan document • Ongoing amendments • Monitors document compliance | <ul style="list-style-type: none"> • Enrollment kits • Statement inserts • QDIA notices | <ul style="list-style-type: none"> • Loan and distribution processing • Annual certified trust statement | <ul style="list-style-type: none"> • Custody of plan assets | <ul style="list-style-type: none"> • 401k/Roth deferrals • Transmit deposit report and data to recordkeeper | <ul style="list-style-type: none"> • IPS Development • Ongoing monitoring | <ul style="list-style-type: none"> • Plan document • Form 5500 • Nondiscrimination testing |
| Vendor Contact Details | Name, phone#’s, email address, etc. | | | | | | | |
| Is provider a Fiduciary? | No | No | No | No | No | No | Yes | No |

Although there is no specific ERISA requirement for a plan to have an investment policy statement (IPS), a plan should nonetheless have one in order to prudently select and monitor plan investments, consistent with the fiduciary duty of prudence. The IPS defines the selection and monitoring process for plan-related investments. While an IPS is not required, ERISA does require that a plan must have a funding policy to ensure that the fiduciaries charged with the responsibility for managing and investing plan assets do so in a manner that is consistent with the objectives of the plan and the liquidity needs of the plan to satisfy payment obligations. The IPS may be designed to further the purposes of the plan and its funding policy.

As one can see, there are many requirements regarding the plan document and trust agreement, ongoing plan amendments, and Form 5500 reporting. In addition, there is the distribution of the required SPDs, SMMs, and SARs to plan participants. A fiduciary compliance review will look for these documents and ensure that they are signed, kept up to date, and distributed to participants in a timely fashion, and that processes are in place for the documents to be reviewed periodically.

PLAN POLICIES, PROCEDURES, AND OPERATIONS

Often, along with the plan document, a plan sponsor will maintain policies or procedures—such as an administration manual, participant-direction procedures, QDRO policy, and loan policy—that further define the plan provisions and administration. These items clarify the administrative responsibilities of the plan sponsor and any service providers with which the plan sponsor contracts.

When the administration of the plan does not follow the terms of the plan document, an operational failure occurs. For example, in a perfect world, the plan allows for loans and the record-keeper allows participants to request a loan via the participant Web site. The trustee and/or custodian will cut a check to the participant for the loan request and the payroll company will deduct loan repayments from the participant's paycheck. If one service provider or vendor disregards the instructions regarding loans in the plan document or loan policy, an operational failure could occur. It is important for the sponsor to understand the requirements and provisions defined in the plan document, in addition to having confidence that all vendors understand and adhere to the administration of the plan, as dictated by the plan document and related policies in place.

NONDISCRIMINATION TESTING

Nondiscrimination testing (also referred to as *compliance testing*) is made up of the required annual compliance tests plan sponsors must conduct in order to ensure that their retirement plan does not discriminate in favor of the highly compensated employees (HCE). The tests cover benefits or contribution and deferral limitations under Internal Revenue Code (IRC) sections 402(g) and 415, minimum coverage under IRC section 410(b), actual deferral percentage/actual contribution percentage (ADP/ACP) testing under IRC sections 401(k) and (m), HCE determination under IRC section 414(q), and, possibly, average benefits testing under IRC section 401(a)(4).

In addition, there are aspects within the tests that must be examined, such as the definition of compensation and the hours of service requirements for plan participation and benefit calculations. For more dispersed organizations, sponsors will need to take into consideration controlled groups and possibly separate lines of business (SLOBs) when performing the tests.

Because the scope of this white paper is an overview of the aspects of a fiduciary compliance review, we will not go into all of the aspects of the nondiscrimination testing requirements. However, there are many options and interpretations of the plan provisions and regulations with regard to each of the tests that are required, as well as a dependence on complete and accurate data for each employee. Often plan sponsors outsource the nondiscrimination testing to a third party that completes all of the required tests and that typically drafts the responses on the Form 5500. Even where the testing is outsourced, the plan sponsor is ultimately responsible for its completion and accuracy.

INVESTMENTS AND FIDUCIARY DUE DILIGENCE

During the request for proposal (RFP) process, plan sponsors should start to develop a thorough understanding of the fees and expenses related to the administration of their retirement plan. As a fiduciary, a sponsor's duty is to obtain answers to key questions, understand plan expenses, and act in the best interest of plan participants. The lowest cost is not necessarily the goal; an understanding of the fees through the third parties' full disclosure of any revenue sharing and potential conflicts of interest is more important.

Plan sponsors should also have an IPS that defines the responsibilities of the plan sponsor (often sponsors will build a retirement-investment committee to work internally and review the recommendations of their service providers). If the plan sponsor outsources its investment services to a consultant, the IPS should define the role of the consultant with regard to the selection and monitoring of investment managers for the plan. Some of the aspects that may be defined include:

- Selection and monitoring of plan investments
- Verifying there is a diversified mix of plan investments across money market, bond, and equity options
- Investment performance
- Investment-management expenses and policies
- Risk measurements of the investments

The due diligence and investment-selection procedures outlined in the IPS are ongoing projects and not one-time events. Sponsors should regularly review and benchmark their plan administration expenses to comparable plans based on size (number of participants and assets) and complexity. Investments should also be benchmarked regularly to market indexes and to peer groups regarding performance and expenses.

As part of the due diligence process, sponsors should look for any potential conflicts of interest and expect full disclosure from their vendors. Generally, the plan sponsor should not engage in any transactions between the plan and a party-in-interest involving plan

assets; otherwise a prohibited transaction could occur. The term party-in-interest includes a plan fiduciary, persons or organizations providing services to the plan, employees of the employer, and, potentially, spouses of other parties-in-interest.

WHAT'S THE GOAL OF THE PROJECT?

In defining the scope of the fiduciary compliance review, a few questions should be answered:

- Do we feel that we should review our plan and its procedures as a preventive measure?
- Are there known issues or problems in the oversight or administration of the plan?
 - Plan document or procedures may not have been updated in a long time
 - There may have been errors or omissions in the operation of the plan
- Has the IRS or DOL been in contact regarding a future audit?
- What should we know and be prepared for if there are any problems that may come up in an audit?

In general, sponsors should start by developing a scope or level of the fiduciary compliance review. Will it be a limited review focusing on one area or a deep dive into all aspects of plan design, administration, and expenses?

The review can be as simple as using the IRS list of top 10 issues identified during their examinations, or the quick compliance checklist that is part of the Form 5500 instructions.

THE IRS TOP 10 LIST

1. Late deposit of 401(k) deferrals
2. Improper 401(k) accelerated deductions
3. Failure to use correct compensation
4. Improper exclusion of eligible employees for purposes of ADP and/or ACP testing
5. Misclassification of highly and non-highly compensated employees for purposes of ADP/ACP testing
6. Failure to correct or timely-correct ADP and/or ACP failures
7. Incorrect employer matching contributions
8. Deferrals in excess of code section 402(g) limits
9. Failure to timely provide the safe harbor plan notice
10. Failure to meet hardship distribution requirements

This list can be accessed via the IRS Web site at <http://www.irs.gov/retirement/article/0,,id=135260,00.html>

The quick compliance checklist from the Form 5500 instructions contains a series of questions for plan sponsors, which when answered may indicate areas of non-compliance with the ERISA requirements. Some of the questions include:

1. Have you provided plan participants with an SPD, SMM, and annual summary financial report?
2. Is your plan covered by a fidelity bond?
3. Did the plan pay participant benefits on time and in correct amounts?
4. Have plan assets been used to pay plan expenses not authorized by the plan document?
5. Are the plan's investments diversified in order to minimize the risk of large losses?

GOING DEEPER

A deep dive into a fiduciary review will look at the items noted in the IRS's top 10 list and dig deeper into each of the following areas:

- Plan services
- Plan document, policies, procedures, and operations
- Plan reporting, disclosures, and notices
- Nondiscrimination testing
- Investments and fiduciary due diligence

Plan document files, amendments, and trust agreements will be reviewed to ensure they are up to date with all required amendments and restatements according to IRS-prescribed deadlines and filing cycles. Operations will be reconciled back to the plan document and any applicable policies and procedures to ensure the sponsor and administrators are following each area of documentation. The review will drill down into the testing and nondiscrimination issues looking at all aspects from confirming the data provided and the nondiscrimination testing definitions to parameters from the plan document and regulatory requirements in place at the time. To finish off the deep dive, a review of the plan investments and plan-related fees will assist in determining the total cost of the administration of the plan by adding plan administration expenses to investment-management expenses (the total cost).

WHAT SHOULD YOU DO IF YOU FIND SOMETHING AMISS?

If a problem is found during the review, consider it a good thing: It is better that you, as the sponsor, find an issue first, rather than the IRS or DOL. You should review the impact of the error to determine if it is operational. Does it only affect a few participants or is it widespread? Also, how long has the problem occurred and what is the approximate cost to participants? Finally, what steps will be required to make the correction? If the issue is compliance-related, you should, again, determine the impact, the amount of time it has been occurring, and the appropriate course of action

to remedy the issue. The Employee Plans Compliance Resolution System (EPCRS) of the IRS allows sponsors to make corrections for failures regarding the administration of their retirement plan while maintaining the plan's tax-deferred status.

SUMMARY

A fiduciary compliance review should be looked at as a periodic tune-up to the retirement-plan vehicle. It should accompany and test the procedures that a plan sponsor has in place regarding the administration of its retirement plan. A sponsor may also use the review to shore up and streamline internal processes and communications with vendors while developing a better understanding of their retirement plan.

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