Six Best Practices

for
401(k) Plan
Business Owners

Protect Against Legal Liability
and
Realize Your Plan's Potential Benefits

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Executive Summary

Increasing scrutiny of 401(k) plans by the Department of Labor and Internal Revenue Service has created a new environment fraught with risk for business owners. Both government services are now vigilant about enforcement. ***Audits are increasingly common and steep fines are being levied, even on plans with less than $10 million.*** Essentially, business owners should have two main goals with their 401(k) plans:

1. Protect against legal liability; and
2. Realize your plan's potential benefits

This document is intended to give you, the business owner (and plan sponsor), brief insights into how you can achieve those goals with six best practices:

- **Protect Against Legal Liability**
  – Document everything and follow process
  – Shift fiduciary responsibility for investing
  – Cut fees for investing and service providers

- **Realize Your Plan's Potential Benefits**
  – Invest with index funds
  – Get investment advice from a fiduciary
  – Customize your plan design

About the Author
Larry Stein is the CEO of Disciplined Investment Management, LLC. Its 401(k) mission is: ***To provide significantly greater advice and services than insurance companies and mutual funds – at roughly half the cost.***

The author of two investment books (most recently *Peace of Mind Investing*), he is also a Contributor to the RetireMentor column for Marketwatch. Larry is a Qualified Plan Financial Consultant (QPFC®), an Accredited Investment Fiduciary (AIF®), a CERTIFIED FINANCIAL PLANNER (CFP®), and has an M.S. in Taxation. Contact Larry at 847-602-6485 or Larry@Disciplined-Investment.com

1. Document Everything and Follow Process

One of the best ways to protect you and your organization against legal liability is to document everything.

For example, you should document:

- Committee meeting discussions
- Service provider selections and the rationale
- Investment policies (Investment Policy Statement)
- Plan communications with employees

Process is mission critical. Though it may sound illogical, in the 401(k) world, ***the outcome of an event can be less important than whether you adhered to a well-designed process that adheres to your plan documents.*** Document the process and document that you adhered to it – that will go a long way toward keeping you safe.

"There are actions you can take to demonstrate that you carried out your responsibilities as well as ways to limit your liability. Since a fiduciary needs to carry out activities through a prudent process, you should document the decision-making process to demonstrate the rationale behind the decision at the time it was made."

– Internal Revenue Service
"IRC 401(k) Plans – Operating a 401(k) Plan"

2. Shift Fiduciary Responsibility for Investing

Retirement plan sponsors (business owners) are burdened by loads of legal liability. Fortunately, there is one opportunity to relieve you of a very significant source of 401(k) plan liability.

Under ERISA, you can delegate the fiduciary responsibility (and liability) of plan investing to a Section 3(38) investment manager fiduciary. As long as the 3(38) manager is selected and monitored prudently, the fiduciary responsibility is shifted and plan sponsors are not liable for investing losses.

Moreover, ***as a fiduciary, your investment manager is legally responsible for selecting investments that are in the best interests of you and plan participants***.

An ERISA Section 3(38) fiduciary:

- Takes discretion, authority and control of the plan's assets
- Must select investments in the best interests of plan participants
- Can relieve plan sponsors of the liability related to plan investing

"ERISA allows named fiduciaries to delegate fiduciary responsibility to an 'investment manager' if permitted pursuant to the plan documents. ***Risk Management Tip: Appointment of a 3(38) manager can be a key risk mitigator."***

– Marla Kreindler & Julie Stapel, Winston & Strawn LLP at The ERISA Industry Committee

3. Cut fees for investing and service providers

Plan fees are now under extreme scrutiny by regulators. In response to claims of excessive fees, in 2012 the US Department of Labor began to *require that plan sponsors provide fee disclosures annually to participants.* **Since investment fees are generally the largest cost, they represent a major source of legal liability (see quote below).**

Despite efforts to enforce transparent fee disclosure, it can be difficult to evaluate the fees offered by some plans, especially "bundled plans" (all in one plans) offered by insurance companies and mutual funds. Here are some typical fees:

- **Investment fees**: Mainly due to high-cost actively managed mutual funds
  To reduce fees, consider low-cost index funds
- **Administration fees**: Fees charged by those who handle plan operations
- **Recordkeeper fees**: Charge for recordkeeping and interface with participants

Fiduciary News: **In your opinion, what is the greatest fiduciary liability 401k plan sponsors face?**

Fred Reish: ***"At this point, it is excessive expense ratios for investments and excessive compensation for service providers."***

– Exclusive Interview with Fred Reish: 401k Plan Sponsors Who Fail to Properly Evaluate Fees "At Risk"– By Christopher Carosa, Fiduciary News, August 20, 2013

4. Invest with Index Funds

Many retirement plans invest with actively managed mutual funds. ***This may not be an optimal choice from the standpoint of both legal liability (see previous page) and investment performance.***

Fees are critical to investment performance. Morningstar, an independent investment research service noted for its star-ranking system, contends: ***"Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance."***

Index funds offer three key advantages compared with active mutual funds:

- **Low cost**: Generally less than 0.20% vs. 1.00% or more for active mutual funds
- **Performance**: Relatively few active mutual funds outperform indexes over the long term. In a Vanguard study of active mutual funds over the 15-year period ended 12/31/2010, ***84% of large cap managers and 93% of small cap managers underperformed*** their respective indexes.
- **Inability to select winning funds**: An MSCI study ended 3/31/2010 showed that less than 10% of active mutual managers achieved top quartile performance in three successive, three-year periods. With such random odds, how can you choose the best funds in which to invest?

"A very low-cost index is going to beat a majority of the amateur-managed or professionally managed money."
– **Warren Buffett**, **Chairman of Berkshire Hathaway**, May 6, 2007

5. Get Investment Advice from a Fiduciary

Independent surveys suggest that plan participants would like to receive professional investment advice. **But can you really trust the wisdom of a 1-800 service team? Are they truly experts? Do they have your best interests at heart?**

To ensure the investment advice you receive is in the best interests of you and your participants, make sure your professional is a **3(38) fiduciary, the highest level of investment fiduciary responsibility.** With a 3(38) investment fiduciary handling your investments, you will:

- Work with an investment advisor who is on the same side of the table as you
- Have investments selected in the best interests of you and plan participants
- Be able to delegate most of the liability related to the plan's investing

An AARP survey shows the importance of receiving fiduciary investment advice. Note: Typical plans do not provide 3(38) fiduciary-level investment advice.

"Fewer than four in ten (36%) respondents would trust the advice from an advisor who is not required by law to provide advice that is in their best interest."

– "Fiduciary Duty and Investment Advice: Attitudes of 401(k) and 403(b) Participants"
by S. Kathi Brown, from AARP Research, September 2013

Realize Your Plan's Potential Benefits

6. Customize Your Plan Design

Business owners who use basic prototype plans may be missing out on an opportunity to significantly increase their deferrals and reduce their taxes.

Don't accept a cookie-cutter prototype plan. Instead, hire an independent third-party administrator who will meet with you and customize a plan to fit your specific personal and business objectives. They may also recommend cash balance plans and other strategies that can greatly expand your contributions and tax deductions, while reducing required contributions for employees.

The difference can mean hundreds of thousands of dollars in contributions and tax deductions to each business owner per year.

An expert in plan design can make a major difference in your:

- Contributions and tax deductions
- Legal liability (since plans can easily drift out of compliance)
- Ability to attract top talent to your organization

"Plan documents are legal documents and legal documents have legal consequences. Prototype plan documents that have that fill in the blank document look can be very cost efficient, but they have their limits and there are very often situations where the plan sponsor's needs cannot fit within the confines of the plan document's limited choices."
– Ary Rosenbaum, The Rosenbaum Law Firm, August 3, 2011