

401k Risk Management: A Plan Sponsor's Guide to Reducing Liability



In today's unstable market, investors may be tempted to look for a scapegoat in the face of dismal returns. Employers are particularly vulnerable due to liability associated with the management of their 401(k) plan, especially in times of uncertainty and volatility.

As fiduciaries, business owners sponsoring a 401(k) plan have a solemn responsibility to protect the interests of their employees, no matter what the overall market is doing. The underlying question is, "How do I minimize the exposure I could face as a plan sponsor?" The key in limiting liability is to design a plan, from the ground up, to minimize risk.

The first step is to focus on the benefits being provided to participants. If participants are receiving adequate benefits from a 401k plan, there is less chance of litigation. Adequate benefits are the result of a well-run plan, which is characterized by high levels of participation, significant deferral rates, quality investing by participants, and the utilization of a documented and prudent process to manage the plan.

A plan sponsor who wants to minimize risk while maximizing benefits should:

1. Automatically enroll. While just three out of four eligible workers chose to participate in their company's 401k last year, the national average for participation in automatically enrolled plans is about 90%¹. The dramatic increase in participation resulting from automatic enrollment significantly reduces the potential risk of the employer and the fiduciaries because it eliminates potential claims from people who did not get into the plan. Further, with automatic enrollment, any employee who does not want to participate has to affirmatively file an election to get out of the plan.

2. Automatically increase deferrals. With automatic deferral increases, plan sponsors start employees at a deferral rate (usually 3% or 4%) and increase the deferral rates 1% or 2% per year, up to a maximum that is often 10-15%. Of course employees can elect out of the increases by filing an election to do so. There are two risk management

advantages in automatic deferral increases: many employees will end up with substantial retirement benefits; those employees who do not wish to participate will have to opt out. In combination, these two "defenses" are likely to reduce the risk of any potential fiduciary violation associated with the adequacy of deferrals.

3. Automatically default into qualified default investment options (QDIA). The new QDIA rules provide a fiduciary "safe harbor" for plan sponsors, their responsible officers and committees, for the participant who defaults into a QDIA. The default investments could include target maturity or age-based funds, risk-based lifestyle or balanced funds, and managed accounts. From a risk management perspective, there are two advantages: a safe harbor investment, and if a participant decides to invest in something other than a QDIA, he or she must file an affirmative election to invest differently.

4. Abide by the Global Fiduciary Standards of Excellence. There are an estimated five million people who have the legal responsibility for managing someone else's money, yet there is a surprising lack of detailed information that defines the investment management process they should follow. The Foundation for Fiduciary Studies (www.fi360.com) has developed the *Prudent Practices for Investment Fiduciaries* which outline the 22 practices that a 401k plan sponsor should follow in order to meet the Global Fiduciary Standards of Excellence.

The most important thing to remember is that the fiduciary plan sponsor must be prudent. In short, plan sponsors are not to be judged by the results they obtain—they are not guarantors of results—but their performance is measured by the steps they have taken to get there. **1**

Michael J. Searcy,
ChFC, CFP®, AIFA® is
President, Searcy
Financial Services, Inc.
P | 913.814.3800
E | Mike@Searcy
Financial.com

Jessica Maldonado,
AIFA®, PPC™ is
Director of Operations,
Searcy Financial
Services, Inc.
P | 913.814.3800
E | Jessica@Searcy
Financial.com

¹ "2006 PlanSponsor DC Survey: Brave New World." *PlanSponsor Magazine on the Web* November 2006.