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Designing the Perfect 401(k) Plan

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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, after giving that caveat, I addressed the question considering those primary reasons a company adopts a retirement plan and, in light of today's legal and legislative environment, what steps I believe could be taken to mitigate fiduciary risk.

The primary reasons why an employer adopts 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 a means to move historically productive employees, who participate in the plan, from the workforce to retirement with potentially adequate finances, and
4. Provide a low cost tax efficient compensation to the general employee population by avoiding social security taxes, potentially workers compensation, and federal and state unemployment taxes on employer contributions.

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 justifications for incurring the cost of establishing and maintaining a 401(k) plan.

Due to the current legal environment, the "perfect" plan would include a risk mitigation strategy that would maximize protection for the company, its shareholders, and fiduciaries. Based on today's existing legal and legislative 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 at the lowest possible cost to the company,
3. Minimize the amount of time and effort expended by executive management on the 401(k) plan, and
4. Protect the company (plan sponsor's) brand name 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 primary issues listed and the current legal environment are the driving factors that must be addressed when designing the "perfect" 401(k) plan, the general benefits and features of the "perfect" 401(k) plan might include:

1. Safe Harbor matching feature to avoid the cost of discrimination testing.
2. Adoption of the automatic enrollment feature with auto re-enrollment each year at the safe harbor level.
3. Adoption of the automatic increase feature would apply to each participant according to the safe harbor level.

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4. Compliance with section 404(c) to avoid liability for participant investment decisions.
5. Compliance with section 404(c)(5) safe harbor to eliminate liability for investment decisions of those employees who fail to make an investment decision using a Qualified Default Investment Arrangement (QDIA).
6. Annually re-enroll every participant into a default unless the participant opts out.
7. Offer the following investment options:
    a. Money Market or Stable Value
    b. Total U.S. Bond Market Index
    c. Total U.S. Stock Market Index
    d. At least five Target Based Funds with the underlying assets passively managed
8. No passive investment will be used if it includes any payments of any kind to any party other than the investment manager.
9. The named fiduciary will be appointed to select the lowest priced passive investment option available to the plan and shall re-evaluate the decision at least every three years to determine if a similar investment option is available at a lower cost. Passive investment mandates can be filled by registered investment companies, collective funds, or separate accounts.
10. Draft an Investment Policy Statement (IPS) that embraces a passive investment approach to minimize the risk of large losses, minimize fees, and achieve broad diversification. The IPS would acknowledge that are no performance guarantees for any investment. Furthermore, the only guarantee offered by actively managed fund is typically higher expenses. Therefore, the committee will adopt a passive approach since performance studies consistently provide that most active managers underperform the index over long periods of time.
11. The company would pay all expenses separately with the exception of the internal investment management fee of the investment alternatives.
12. Investment advice to plan participants of any type would not be offered.
13. Investment materials or education would be provided only to the extent necessary to meet any legislative or regulatory requirements.
14. Only service providers and advisors with appropriate credentials and experience would be retained. Services would be paid for on a per hour, per head, or project basis only.
15. Only services that were absolutely necessary would be retained. Services would be paid for on a per hour, per head, or project basis only.

Depending on the assumptions i.e., objectives, the structure of the perfect plan could change but by following these fifteen steps a company could maximize its benefits to the participants, minimize its costs to provide those benefits, minimize its time managing the plan, and minimize the risk associated with sponsoring a 401(k) plan according to the criteria initially outlined.

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 Witz 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.

Fiduciary Risk Assessment LLC

Creator of the 404c Master Diagnostic™

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