



BRIEFING »

Demonstrating a Prudent Process Under ERISA

Understanding Fiduciary Responsibilities in Today's Environment

Qualified retirement plan sponsors are required to comply with the guidelines listed in the Employee Retirement Income Security Act (ERISA). In order to limit fiduciary exposure, plan sponsors should understand their responsibilities and be knowledgeable of the issues facing retirement plans today. This allows them to form an effective fiduciary strategy.

Fiduciaries are the individuals responsible for compliance. They report to the government, oversee participant disclosure and plan administration. Fiduciaries also select and monitor plan investments regardless of whether investments are directed by the company or delegated to plan participants.

A lapse in performing the requirements set by the ERISA may subject plan sponsors to participant and beneficiary complaints and scrutiny by the Department of Labor. Fiduciaries are also liable for any damages caused to the plans and security breaches. Lapses may also result in civil penalties.

Demonstrating a Prudent Process Under ERISA

ISSUES FACING TODAY'S QUALIFIED PLAN SPONSORS

The Department of Labor, beneficiaries, plan participants, and fiduciaries can bring suits or launch inquiries against plan fiduciaries for lapses in ERISA mandated duties. The issues investigated often relate to the failure to prudently exercise plan responsibilities, particularly responsibility for plan administration and investments.

Today, these responsibilities are further complicated by the changing landscape of retirement savings plans. Some of the forces driving these changes include increased regulatory scrutiny, the widening gap between benefit plan assets and liabilities and employee savings and investment advice.

INCREASED REGULATORY SCRUTINY

High-profile bankruptcies and allegations of corporate misbehavior in some of the nation's largest companies have sparked a wave of increased regulatory scrutiny. The collapse of Enron and its declining stock price adversely affected employees' 401(k) plan savings accounts, especially the accounts heavily invested in Enron stock.

The popular 401(k) plan, currently the country's preferred retirement savings arrangement, lacks the extensive history, legislative guidance and legal precedence that exist with traditional, defined legislative guidance and legal precedence that exist with traditional defined benefit pension plans. This lack of guidance often leads plan sponsors to a wide interpretation of plan administrative procedures.

Regardless of the outcome, plan fiduciaries should carefully scrutinize their

plan's administrative decisions and then document, in writing, the responsibility and delegation of those decisions.

DEFINED BENEFIT PLAN FUNDING

One of the most pressing issues facing defined benefit plans is the matching of assets, liabilities and developing appropriate funding policies and asset allocation strategies. In order to determine funding obligations, plan actuaries calculate the life expectancy of employees and their beneficiaries, estimated level of plan forfeitures and form of benefit payments to be made and the future level of employee compensation. The assumptions lead to plan funding calculations.

When conditions such as activity in the capital markets and the plan's rate of return on its investments begin to change, actuaries will often adjust the plan's assumptions and its funding liabilities. Due to the traditional nature of pension plan calculations and the decline of interest rates, many defined benefit plans currently find themselves under-funded. Liabilities to employees are greater than plan assets.

One of the best ways defined benefit plan fiduciaries can address funding issues is to carefully review their plan's actuarial assumptions and plan investments. They should examine their asset and liability policies, ensure their plan follows a clearly defined allocation strategy and review the diversification of plan assets.

SHIFT TO DEFINED CONTRIBUTION PLANS

In an effort to overcome funding issues, plan sponsors have started to move away

from defined benefit plans and are now using contribution plans such as 401(k) arrangements.

According to data collected through IRS Form 5500, more than 60% of workers with retirement funds are covered by defined contribution plans. Only around 10% are covered by a defined benefit plan. The rest are covered by both. In 1992, the ratios were approximately 30%, 25% and 45% respectively.

EMPLOYEE INVESTMENT ADVICE

A significant difference between a defined benefit and a defined contribution plan revolves around the issue of employee-directed investments and the related employee communication, education and investment issues. Under defined contribution plans, employees are often given the assignment and the delegated responsibility to make investment decisions that will affect their long-term financial security.

To help employees make investment decisions, employers are looking to providers of investment advice services. However, the issue of employee investment advice lacks regulatory guidance and a history of legal precedence.

The plan sponsor should be knowledgeable of who is offering investment advice, who is the provider is, whether the provider follows a clearly defined process and how the advice is updated and communicated to employees.

EMPLOYEE INVESTMENT ADVICE

To protect themselves, fiduciaries should ensure that the following general guidelines are adopted, periodically

Demonstrating a Prudent Process Under ERISA

reviewed and modified as needed for changing circumstances.

The rule: Pay twice as much attention to managing fiduciary affairs as you would your own.

1. Adhere to a prudent fiduciary process that is free from self-interest.
2. Adopt and maintain formal plan documentation and follow all document review and approval procedures.
3. Establish appropriate investment objectives and create a formal investment policy statement
4. Select plan investments and investment management firms using the guidelines established under the investment policy statement; evaluate investment firms based on predefined criteria.
5. Enlist the assistance of an independent investment consultant if the experience and skill required to

perform investment functions are not available internally.

6. Ensure compliance with ERISA § 404(c) if the plan permits participant directed investments.
7. Establish an internal committee to regularly review and monitor plan investments; institute a periodic review process for all plan service providers including accounting and administrative firms.
8. Ensure that internal controls and compliance procedures are in place to prevent breaches of fiduciary responsibility.
9. Document the fiduciary decision-making and review process.
10. Communicate promptly with plan participants and beneficiaries and maintain copies of all plan communications, administrative and educational materials; record all internal memoranda.

CONCLUSION

One of the most effective defenses against any allegation that a fiduciary has breached his or her duties is to demonstrate a prudent process under ERISA. An understanding of the issues facing today's qualified retirement plans will help plan sponsors prepare written documentation. This process and the written documentation that backs it is often the most compelling evidence of compliance with ERISA's standards in today's environment.

Consulting Group offers a number of tools and investment services to help demonstrate an expedient fiduciary process. These services include extensive analysis of investment management firms, extensive asset allocation models and specialized materials and reports for plan fiduciaries. For more information, contact your Morgan Stanley Smith Barney Financial Advisor.

Although the statements of fact and data in this report have been obtained from, and are based upon, sources that the Firm believes to be reliable, we do not guarantee their accuracy, and any such information may be incomplete or condensed. All opinions included in this report constitute the Firm's judgment as of the date of this report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. Past performance is not a guarantee of future results.

© 2009 Morgan Stanley Smith Barney LLC. Member SIPC. Consulting Group, Portfolio Management Group and Investment Advisory Services are businesses of Morgan Stanley Smith Barney LLC.