



free  
market  
fiduciary  
review

MATSONMONEY™

## The Free Market Fiduciary Review

This Free Market Fiduciary Review is intended to assist:

- Fiduciaries in analyzing how well their organization meets a fiduciary standard of excellence; and,
- Fiduciaries in improving their long-term investment performance.

Each question is intended to be answered in the affirmative, "Yes or No." A careful inquiry should be made into all "No" responses to determine whether:

1. There is an omission or shortfall in the fiduciary's procedures; and/or
2. The question is not applicable to the fiduciary.

The Key Findings are not:

1. Intended to be a legal opinion;
2. Intended to represent specific investment advices; nor are they.
3. A financial audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding financial statements.

### **How to Interpret the Key Findings**

The Key findings are presented under the fiduciary practice most applicable with the Finding. With each fiduciary practice, an opinion is rendered as to whether:

1. The fiduciary practice appears to have been met; or
2. There appears to be one or more fiduciary shortfalls.

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All investing involves risks and costs. Your adviser can provide you with more information about the risks and costs associated with specific programs. Your adviser is not affiliated with Matson Money, Inc. No investment strategy (including asset allocation and diversification strategies) can ensure peace of mind, guarantee profit, or protect against loss.

Index performance returns do not reflect any management fees, transaction costs or expenses. In addition, the index is unmanaged and not available for direct investment; therefore its performance does not reflect the expenses associated with the management of an actual portfolio. Actual results of accounts under Matson Money's management may have been materially different. Performance results and comparative indices assume reinvestment of dividends and income plus capital appreciation.

## The 20 Must Answer Questions for Fiduciaries

- |   | Yes                      | No                       |
|---|--------------------------|--------------------------|
| 1. Does your plan have an Investment Policy Statement?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are all plan documents updated in accordance with ERISA and the law?                             | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Have all costs (explicit and implicit) been accurately expressed and accounted for?              | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Does your plan offer prudent and diversified investment options?                                 | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Do you have an education process in place?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Have all trustees acknowledged their fiduciary status?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Are you aware of the problems associated with self dealing?                                      | <input type="checkbox"/> | <input type="checkbox"/> |
| 8. Are all service agreements/contracts in writing, up to date and in accordance with the law?      | <input type="checkbox"/> | <input type="checkbox"/> |
| 9. Do you have a formalized process for participants to use when selecting investment options?      | <input type="checkbox"/> | <input type="checkbox"/> |
| 10. Are you familiar with the guidelines of the Prudent Investor Rule?                              | <input type="checkbox"/> | <input type="checkbox"/> |
| 11. Do you conduct formal reviews on your plan?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 12. Do you have an investment committee?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 13. Are you aware of the remaining liability when seeking safe harbor under 404c provisions?        | <input type="checkbox"/> | <input type="checkbox"/> |
| 14. Have all finders' fees/12 b-1 fees been accounted for and appropriately applied to your plan?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 15. Are you prepared to defend yourself in the event of a Department of Labor (DoL) audit?          | <input type="checkbox"/> | <input type="checkbox"/> |
| 16. Can you articulate in a scientific/statistical manner the relevant amount of risk in your plan? | <input type="checkbox"/> | <input type="checkbox"/> |
| 17. Are selected asset classes consistent with the identified risk, return, and time horizon?       | <input type="checkbox"/> | <input type="checkbox"/> |
| 18. Do you know where your plan options fall within the Markowitz Efficient Frontier?               | <input type="checkbox"/> | <input type="checkbox"/> |
| 19. Do you know how to measure volatility for your investment options?                              | <input type="checkbox"/> | <input type="checkbox"/> |
| 20. Are you working with a 3(38) Fiduciary?   | <input type="checkbox"/> | <input type="checkbox"/> |

Appendix A: Additional Plan Questions and Answers.

**When you have achieved the ability to answer “yes” to all of these questions, you will be on your way to a high level of investing peace of mind.**

**All investing involves risks and costs. No investment strategy (including asset allocation and diversification strategies) can ensure peace of mind, guarantee profit, or protect against loss.**

## The 20 Must Answer Questions for Fiduciaries

### **1. Does your plan have an Investment Policy Statement?**

The preparation, execution, and maintenance of your IPS is one of your most critical fiduciary responsibilities:

- A well-written IPS is the narrative, or business plan, of how you are going to manage your fiduciary duties and responsibilities.
- Case law clearly references the development and maintenance of an IPS as a critical fiduciary function.
- The IPS helps to negate second-guessing or "Monday morning quarterbacking" and ensures continuity of the investment strategy.
- During bull markets almost any investment strategy will generate impressive results - "High tides lift all boats." The real value of the IPS is seen during periods of market decline. It is during these difficult times that decision-makers feel the need "to do something." The IPS can have a calming effect, reminding decision-makers of why the investment strategy was structured in the first place.
- The IPS provides a baseline from which to monitor investment performance. In addition, proposed changes to the investment lineup can be evaluated and reviewed against the strategic policy.<sup>1</sup>

### **2. Are all plan documents updated in accordance with ERISA and the law?**

Plan documents must be kept current with the governing laws set forth. Federal law requires employers to give a copy of the Summary Plan Description to participants when they enroll into the plan. Employers are also required to hand out new copies after five years if there are changes to the plan or after 10 years if there is no change. There are enough changes in federal law that companies tend to give out copies to employees more than once every five years.

### **3. Have all costs (explicit and implicit) been accurately expressed and accounted for?**

In order for the fiduciary to fulfill the general fiduciary obligation to manage investment decisions with the requisite level of care, skill, and prudence; and the specific obligation of the fiduciary to defray only reasonable and necessary expenses; the fiduciary must establish procedures for controlling and accounting for investment expenses.

Investment management costs and expenses can be broken down into four categories, and the IPS should contain instructions and procedures on how these fees and expenses will be accounted for and monitored. The fiduciary is cautioned that each can be obscured or moved from one category to another to create apparent savings. The fiduciary should examine:

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<sup>1</sup>The Center for Fiduciary Studies Fiduciary Review ([www.fi360.com](http://www.fi360.com))

- Money manager fees and/or the annual expenses of mutual funds
- Trading costs, including commission charges and execution expenses
- Custodial charges, including custodial fees, transaction charges, and cash management fees
  - Consulting and administrative costs and fees. In the case of defined contribution plans, demonstrate that 12b-1 fees, subtransfer agency fees, and/or other revenue sharing arrangements have been appropriately applied to offset recordkeeping and other administrative costs of the plan.<sup>2</sup>

#### **4. Does your plan offer prudent and diversified investment options?**

One of the challenges of writing a complete IPS is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the portfolio's asset allocation and rebalancing limits.

The strategic asset allocation should be that specific mix of asset classes that meets the mutually agreed upon risk/return profile of the investor or investment committee.

The rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing, in essence, controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles.

While the legal requirement for diversification is clear, the need for rebalancing is not explicitly addressed. Nevertheless, rebalancing is an inherent concept of diversification, where the goal is to create a portfolio that balances appropriate levels of risk and return. That balance, once achieved, can only be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification.

The process of setting an appropriate rebalancing limit is somewhat subjective. Ordinarily, rebalancing limits of plus-or-minus five percent should keep the parameters tight enough to maintain the risk/return profile of the strategy, yet require rebalancing only once or twice a year. When it is necessary to rebalance, the fiduciary should determine the cash flows over the next quarter to determine if the portfolio can be rebalanced with contributions or disbursements.<sup>3</sup>

#### **5. Do you have an education process in place?**

Education is an important part of creating participant awareness. It is important to note that general education is different than investment advice. Investment advice could lead to fiduciary liability exposure, where participant education could actually provide insulation for fiduciaries. To provide clarification, the Department of Labor has highlighted the kinds of information that it does not consider investment advice:

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<sup>2</sup>The Center for Fiduciary Studies Fiduciary Review ([www.fi360.com](http://www.fi360.com))

<sup>3</sup>IBID

The following information does not constitute investment advice, regardless of who provides it, how often they do so, or how they deliver the information:

1. Information about the plan, such as:

- plan investment alternatives
- fund descriptions
- risk/return characteristics
- historical returns
- prospectuses

2. General financial/investment information, such as:

- diversification
- dollar cost averaging
- compounding
- advantages of tax deferral
- risk/return
- how to estimate future retirement needs
- historical differences in rates of return between different asset classes
- impact of inflation

3. Asset allocation

4. Interactive investment materials - on the theory that they allow the participant to independently create their own models and draw their own conclusions, and thus no "advice" per se is rendered. In fact, these can even be used in individual sessions without crossing the line.<sup>4</sup>

## 6. Have all trustees acknowledged their fiduciary status?

A fiduciary is defined as someone acting in a position of trust on behalf of, or for the benefit of, a third party. Fiduciary status is difficult to determine, and is based on facts and circumstances. In general, the issue is whether a person has control or influence over investment decisions. It is not uncommon for fiduciaries to be unaware of their status.

Fiduciaries have the most important, yet most misunderstood role in the investment process: to manage the investment practices, without which the other components of the investment plan can be neither defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with fiduciary status further reinforce this important concept.

The legal and practical scrutiny a fiduciary undergoes is tremendous, and it comes from multiple directions and for various reasons. It is likely that complaints and/or lawsuits alleging fiduciary misconduct will increase. Although some of these allegations may be entirely justified, most can be avoided by following the Investment Practices outlined by the Center for Fiduciary Studies. Fiduciary liability is not determined by investment performance, but rather on whether prudent investment practices were followed. Typical industry best practice would be to acknowledge this status in writing.<sup>5</sup>

<sup>4</sup>The editors at [www.plansponsor.com](http://www.plansponsor.com), [http://www.plansponsor.com/solution\\_type1/?RECORD\\_ID=11599](http://www.plansponsor.com/solution_type1/?RECORD_ID=11599)

<sup>5</sup>The Center for Fiduciary Studies Fiduciary Review ([www.fi360.com](http://www.fi360.com))

## **7. Are you aware of the problems associated with self dealing?**

The fundamental duty of the Plan Sponsor is to manage investment decisions for the exclusive benefit of the retirement plan participant and/or trust beneficiary. If a friend, business associate, and/or relative stands to benefit at the expense of the participant/beneficiary, then a breach of duty has occurred. If a Steward even thinks he or she may have a conflict of interest—they probably do. The best advice is to end the relationship, or avoid it in the first place. The Plan Sponsor should always be asking: Who benefits most from this decision? The answer should always be: the client. The best explanation for this practice can be found in ERISA §406 which prohibits fiduciaries from engaging in acts of self-dealing.<sup>6</sup>

## **8. Are all service agreements/contracts in writing, up to date and in accordance with the law?**

ERISA recognizes that a fiduciary, in discharging his duties, may need to seek assistance from other persons, such as investment advisers and managers, and may delegate certain responsibilities to them. However, when hiring advisers or purchasing goods or services, ERISA's general fiduciary rules would require that the fiduciaries take reasonable steps to protect the plan from losses and misunderstandings. Thus, fiduciaries should reduce any agreement of substance to writing in order to define the scope of the parties' duties and responsibilities, to ensure that the plan is managed in accordance with the written documents that govern the plan, and to confirm that the parties have clear, mutual understandings of their roles in conducting plan business. Under ERISA, investment managers are required to acknowledge in writing that they are a fiduciary with respect to a plan. [ERISA §3(38) (C)] Except for investment managers, however, there is nothing explicit in ERISA requiring a written service agreement or contract. But, the fiduciary standards of ERISA imply that service agreements and contracts be reviewed carefully and therefore by extension suggest that they be in writing. Making sure these documents are current and providing that there are no fiduciary conflicts of interest and that they are ERISA compliant is also a requirement of fiduciaries. Agreements and contracts should be periodically reviewed by legal counsel to ensure that none of these breaches of fiduciary duty have occurred.<sup>7</sup>

## **9. Do you have a formalized process for participants to use when selecting investment options?**

It is important for investors to realize that risk and return are related. According to capital market research (Fama/French 1990) it is possible to build portfolios that capture specific dimensions of return by utilizing asset classes in a diversified manner. This practice combined with an expected modeled return and an investment time horizon can provide participants with the necessary information to select pertinent investment options. Typically a risk/return questionnaire combined with participant education regarding certain objectives can accommodate a necessary process for participants to use when selecting investment options.

## **10. Are you familiar with the guidelines of the Prudent Investor Rule?**

Think of the Restatement 3rd of Trusts (Prudent Investor Rule) as the bible of trust investment law

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<sup>6</sup>IBID

<sup>7</sup>Legal Memorandums prepared by Reish, Luftman, Reicher & Cohen, Prudent Investment Practices: Practice No. 1.4

in America. The Restatement is the scholarly and authoritative forebear of the Uniform Prudent Investor Act. A restatement is a legal treatise that examines the common law and state statutes in a particular field of law and restates them as broad legal principles. These principles (as formulated in a restatement of law) often become a source of authority that is given great respect by courts and legislatures. The first volume of the multivolume Restatement 3rd of Trusts, which covers the Prudent Investor Rule, was published in 1992.

One of the overarching goals of the committee drafting the Restatement was to revise and supersede the Prudent Man Rule. According to this rule, first set forth in the 1830 Massachusetts case of *Harvard College v. Amory*, the goal of a fiduciary is to make the assets it manages productive by seeking the highest income possible while safeguarding the value of the principal. The Prudent Man Rule gradually became prevalent in most U.S. jurisdictions through legislation and court opinions and was the rule in the Restatement 2nd of Trusts.

The Prefatory Note to the Uniform Prudent Investor Act explains: "From the late 1960s the investment practices of fiduciaries experienced significant change. The [Uniform Prudent Investor Act] undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as 'modern portfolio theory.'"

The committee drafting the Restatement, therefore, sought to revise and supersede the Prudent Man Rule by incorporating modern theories of investment and finance into the general language of the Restatement's Prudent Investor Rule. This underscores the central importance of Modern Portfolio Theory in investing and its tremendous influence in prompting and shaping the reform of U.S. trust investment law. In fact, Modern Portfolio Theory provides the theoretical underpinnings of the Restatement as well as the Uniform Prudent Investor Act.<sup>8</sup>

## 11. Do you conduct formal reviews on your plan?

A formal review can be a tool for fiduciaries to use in their due diligence procedures. The review should be designed to identify fiduciary shortfalls as well as provide for guidelines to develop a formal plan to address these shortfalls. A review should be conducted on all associated documents pertaining to the plan. Examples of processes to review a plan are stated below:

- A plan sponsor needs to **ANALYZE** their plan and make sure that the plan complies with applicable laws, trust documents and written investment policy statements. The plan sponsor should have an understanding of all the implicit and explicit fees associated with their plan as well as making sure that all the plan documents are up to date.
- A plan sponsor has a duty to **DIVERSIFY**. Even if the plan is a self directed plan, the plan must have asset choices that offer diversification for the participants. Some considerations that are helpful for plan sponsors: A) What is the time horizon of the investment strategy? B) What asset classes will be considered? C) What will be the mix of among the asset classes? D) What sub-asset classes will be considered? E) Which managers/funds will be selected? The plan sponsor utilizing this approach will help them be able to select asset classes that are consistent with identified risk,

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<sup>8</sup>Fiduciary Focus: Keep Your Eye On The Octopus, W. Scott Simon, 09/07/2006

return and time horizon.

- A plan sponsor must implement an INVESTMENT POLICY STATEMENT. The IPS is probably the most important function that a plan sponsor can implement. The IPS will ensure that the investment process remains intact during market upheavals and provide guidance for the plan. The IPS will outline the specific investment strategy and serves as a guide or roadmap for the plan and its participants.
- A plan sponsor must MONITOR and SUPERVISE the plan to make sure that selected funds are comparable to their appropriate index, peer group as well as meeting the guidelines of the Investment Policy Statement. The plan sponsor must monitor and supervise the fees and the expenses of the plan.
- A plan sponsor should utilize the expertise of OUTSIDE MANAGERS. There is relief under ERISA when an outside expert is being used to manage the plan assets. This becomes very important for plan sponsors if the outside manager takes on the role as Co-Fiduciary.<sup>9</sup>

## 12. Do you have an investment committee?

There are numerous parties involved in the investment process, and each should have their specific duties and requirements detailed in the IPS. This ensures continuity of the investment strategy when there is turnover, helps to prevent misunderstandings between parties, and helps to prevent omission of critical functions.

- The roles and responsibilities of all parties are documented in the IPS.
- All parties demonstrate an awareness of their duties and responsibilities.
- All parties have acknowledged their status in writing.

The Investment Committee (Committee) shall perform the functions of an investment fiduciary responsible for the prudent management of the Investment Portfolio (Portfolio). The Committee will comply with all applicable fiduciary, prudence, and due diligence requirements experienced investment professionals would utilize; and with all applicable laws, rules, and regulations from the various local, state, federal, and international political entities that may impact the Portfolio. The Committee shall have the exclusive authority to establish, execute and interpret an investment policy statement for the Portfolio. The Committee shall be responsible for the selection and retention of professional advisers to the Portfolio, which may include, but not necessarily be limited to, Investment Managers, an Investment Adviser, custodians, attorneys, accountants, and clerical staff.<sup>10</sup>

## 13. Are you aware of the remaining liability when seeking safe harbor under 404c provisions?

The Department of Labor (DoL) has stated, "the only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan." Section 404(c) relieves plan fiduciaries of liability for investment losses when a plan participant or beneficiary exercises independent control over the investments of his individual account.

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<sup>9</sup>The Center for Fiduciary Studies Fiduciary Review (www.fi360.com)

<sup>10</sup>IBID

However, too many plan sponsors believe that all they must do to be a 404(c) plan is to:

- a. Offer daily valuation
- b. Offer at least 3 different investment options
- c. Hand out prospectuses to plan participants

While complying with those criteria will put a plan well on its way to being a 404(c) plan, they would not be sufficient. In fact, while many 401(k) programs meet the operational structural requirements to comply with 404(c), the area in which most inadvertently fall short is simply to acknowledge officially their intent to comply with 404(c), and to tell participants of that intent and what it means.

The good news is; if the Plan complies with these regulations, the Plan fiduciaries receive a benefit, relief from liability for investment losses due to the participant direction of investments. If the Plan fails to comply, fiduciaries don't get this benefit, but the failure doesn't cause a "breach" of ERISA and there is no "penalty" for failing to comply. Put another way, because 404(c) provides a defense for plan fiduciaries against a possible claim by a plan participant - but doesn't mandate compliance - the plan fiduciaries are not exposing themselves to additional liability if they try to comply with 404(c) but fail.

Amazingly, many studies today and surveys of company retirement plans show that few plans satisfy the roughly 25 requirements of this regulation. Most of the investment fiduciaries for 401(k) plans are probably unknowingly and legally responsible for the prudence of participant investment decisions.

A recent class action lawsuit filed against the Enron 401(k) Plan focuses the significant value of complying with ERISA 404(c). The DoL has filed an amended brief to the Secretary of Labor in opposition to motions by the defendants, including Enron's committee members, in their attempt to dismiss the class action lawsuit filed against them. The brief lays out that the DoL's thinking on a host of important fiduciary issues and concludes, "The only circumstances in which ERISA relieves the fiduciary responsibility for a participant directed investment is when the plan qualifies as a 404(c) plan." The brief goes on to explain that a fiduciary "is not liable for losses to the plan resulting from the participant's selection of investments in their own account, provided that the participant exercised control over the investments and the plan met the detailed regulations of a Department of Labor regulation." The brief goes on to point out that the 404(c) regulation sets out the detailed conditions for qualifying as a 404(c) plan.

If fiduciaries are legally responsible for participant investments, why aren't fiduciaries taking the steps necessary to be protected by the 404(c) shield? Why would a fiduciary expose themselves to claims from the widow of a 65-year-old participant who invested entirely in a technology fund? What about the 25-year-old who is invested entirely in cash year after year? People would argue that those are imprudent decisions, and unless the plan complies with 404(c), they have the legal responsibility of the plan's investment fiduciaries.

It is inconceivable that a responsible officer or committee member would accept that potential liability if they understood the risks and if they knew that section 404(c) was available. It appears that attorneys, consultants, and investment advisers of retirement plans have not done an adequate job of explaining 404(c) and its value to plan sponsors.

Of course you don't get a free ride by complying with just 404(c) or eliminate the potential exposure to liability. Plan fiduciaries still have the responsibility for selecting investment options offered to participants and for monitoring that the options continue to be appropriate. A 401(k) Plans investment program requires more than just the top investment choices of the month. If the plan fully complies with 404(c), fiduciaries still are accountable for the available options in the plan. DoL notes, "The scope of ERISA 404(c) relief is limited to losses or breaches which resulted from the participant's exercise of control. Section 404(c) plan fiduciaries are still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options on the plan and to monitor their ongoing performance."

## So what does it take to comply?

- Have all eligible participants been clearly informed that the plan intends to comply with 404c?
- Have participants been given the name, address and phone number of the plan fiduciaries responsible for providing investment information?
- Does the plan have a written Investment Policy Statement (IPS) and does it explicitly state that the plan intends to comply with 404c?
- Has the plan's annual Summary Plan Description been checked against specific requirements of 404c? Has this process been documented in the plan's compliance file? Have plan documents been reviewed by an ERISA compliance attorney?
- Does the plan have a published schedule of participant information and education events? Is a document file maintained, containing copies of all communications with plan participants? At every meeting with plan participants, is a list of attendees recorded and filed?
- Have any restrictions on transferring to or from an investment choice been clearly communicated to participants?
- Have all transaction fees and commissions that affect the participant been disclosed? Specifically, have participants been given a description of the annual operating expenses of each designated investment alternative?
- The DOL has defined four specific categories of participant communication that do not constitute "investment advice" for purposes of limiting 404c protection. They are :
  - 1) plan information
  - 2) general financial and investment information
  - 3) asset allocation models
  - 4) interactive investment materials, such as worksheets, PC illustrations, etc. The common denominator of all four is that they don't steer the participant in any particular investment direction. Does the plan's investment advice meet this test?
- If an asset allocation model identifies a specific investment alternative available under the plan, have participants been advised that investment alternatives with similar risk and return characteristics also are available?
- If calculators are used in investor education, are they based on generally accepted investment theories? Do they clearly disclose the "what if" assumptions on which they are based, such as retirement age, income levels, inflation rates, rates of return, and all plan investment alternatives?
- Has the plan taken a survey of participants to determine their level of investment knowledge? Are plan communications written in a style and language that participants can clearly understand?

- Are plan fiduciaries aware of specific duties that may not be delegated or protected under 404c, including prudent selection and monitoring of investment menu choices?
- Does the plan have a formal process for evaluating investment managers' adherence to fund objectives, including a written evaluation report?
- Does the plan have fiduciary liability insurance from a carrier such as American International Group (AIG); Lloyd's of London, Reliance Insurance, Travelers Property Casualty, or Chubb Executive Risk? The cost of this coverage typically is about 5% of the coverage limit purchased - \$25,000 per year for a \$5 million policy. Premiums can double or triple for participant-directed plans that offer either of two investment choices:
  - 1) company stock
  - 2) a self-directed brokerage option.<sup>11</sup>

#### **14. Have all finders' fees/ 12 b-1 fees been accounted for and appropriately applied to your plan?**

The fiduciary has a duty to control and account for investment expenses. This requires the fiduciary to account for all dollars spent for services, whether those dollars are paid directly from the account or through soft dollars, 12b-1 fees, or other fee-sharing arrangements.

In addition, the fiduciary has the responsibility to identify those parties that have been compensated for placing portfolio assets with a particular vendor to ensure that no party is unduly compensated. It is not uncommon for a broker to receive a commission stream in perpetuity on assets placed with a particular vendor. Though the broker should, ordinarily, be entitled to some form of compensation for the introduction, the fiduciary has a responsibility to apply a reasonableness test to the amount of compensation received by the broker.

In the case of a bundled, wrap, or all-inclusive fee investment product, there are basically four cost components. The fiduciary should investigate how the various service vendors associated with each component are compensated to ensure that no one vendor is receiving unreasonable compensation, and to compare the costs of the same services on an ala carte basis. The four components are:

1. The money manager who is selecting the stocks and bonds for the portfolio
2. The brokerage firm that is executing the trades
3. The custodian that is holding and safeguarding the securities
4. The investment adviser or broker who is servicing the account

In the case of defined contribution plans, it is customary to offer investment options that carry 12-b-1 fees. The 12-b-1 fees are often used to offset the plan's record-keeping and administrative costs. For a new plan with few assets, such an arrangement is, ordinarily, beneficial for the participants. However, as the assets grow, the fiduciary should periodically determine whether it is more advantageous to pay for the record-keeping and administrative costs on an ala carte basis, switching to mutual funds that have a lower expense ratio, and reducing the overall expenses of the investment program.<sup>12</sup>

#### **15. Are you prepared to defend yourself in the event of a Department of Labor (DoL) audit?**

<sup>11</sup>Enron, 404(c), and a personal liability of officers by Fred Reish and Joe Faucher, Spring 2003

<sup>12</sup>The Center for Fiduciary Studies Fiduciary Review ([www.fi360.com](http://www.fi360.com))

Being prepared is a necessity when it comes to a DoL audit. A letter similar to the following could be expected if this were to occur:

815 Olive Street, Room 338  
St. Louis, MO 63101  
314-539-2691 FAX 314-539-2697



*Note: Retyped from a faxed copy*

January 27, 1998

Re: \_\_\_\_\_ 401-K Plan and Trust

Dear \_\_\_\_\_,

This letter confirms our conversation of January 26, 1998. At that time an appointment was made to conduct a review of the \_\_\_\_\_ 401-K Plan and Trust at your office beginning on Monday, February 9, 1998 at 9 a.m.

The Pension and Welfare Benefits Administration of the U.S. Department of Labor has been delegated the authority under Section 504 of the Employee Retirement Income Security Act of 1974 (ERISA) to make periodic investigations of employee benefit plans to determine whether such plans are conforming with the provisions of Title 1 of the Act, or any regulations or orders thereunder.

This review is an official investigation pursuant to Section 504. This review will cover, but will not be restricted to, the 401-K Plan years beginning January 1, 1993 to present. Our investigation will consist of, but will not be limited to a review of the following:

1. The 401 (k) Plan document including all amendments, addenda and attachments.
2. The 401 (k) Plan Summary Plan Description (SPD) including all amendments, addenda and attachments.
3. All Summary Material Modifications (SMM) to the 401 (k) Plan including all amendments, addenda and attachments.
4. The 401 (k) Plan Forms 5500 with accompanying financial statements for plan year 1993 to the present.
5. The 401 (k) Plan Summary Annual Reports (SAR) for plan year 1993 to the present.
6. Promotional material relating to the 401 (k) Plan for plan year 1993 to the present.
7. Documents sufficient to show a description of all 401 (k) investment options and changes in the investment options since the inception of the plan.
8. The prospectus or other disclosure material relation to investment options provided to the sponsor and/or the participants of the 401 (k) plan.
9. Communications from plan sponsor and plan administrator to 401 (k) participants for

plan year 1993 to present.

10. Sample 401 (k) Plan participant account statement.
11. The 401 (k) Plan Statement of Investment Policy.
12. Documents sufficient to show the 401 (k) Plan investment guidelines, including but not limited to:
  - a) the evaluation of the specific needs of the plan and its participants
  - b) the investment objectives and goals of the plan
  - c) the standards and benchmarks of investment performance to which the 401 (k) Plan investments are compared
  - d) the classes of 401 (k) Plan investments authorized
  - e) the styles of investment authorized
  - f) the required diversification of the 401 (k) portfolio among and within classes of investment
  - g) the restrictions on investments
  - h) the guidelines relating to direct brokerage
  - i) the guidelines relating to proxy voting and tenders
13. Documents sufficient to show the guidelines and standards to be used by investment managers and investment consultants for the format, content and frequency of reports relating to the following:
  - a) investment performance
  - b) fees and commissions charged to the plan, the participants, and the plan sponsor**
  - c) compliance with investment guidelines
  - d) disclosure of actual and potential conflict of interest
14. Documents sufficient to show the guidelines and standards to be used by administrative Service providers for the format, content and frequency of reports relating to the following:
  - a) performance
  - b) fees and commissions charged to the plan, the participants and the plan sponsor
  - c) compliance with investment guidelines
  - d) disclosure of actual and potential conflicts of interest
15. Documents sufficient to show the 401(k) Plan policies and procedures relating to the hiring and monitoring of investment managers and other service providers.
16. All documents relating to the identification of investment managers and/or administrative service providers for the purpose of the possibility of providing services to the 401(k) Plan.
17. All correspondence to and from potential investment managers and service providers relating to their consideration as an investment manager and/or service provider to the plan.
18. Minutes of all meetings relating to the identification, consideration and selection of potential investment managers and/or service providers to the plan.
19. All consulting agreements where a consultant was engaged to assist with selecting investment options, investment manager and/or other service providers to the plan.
20. All Request for Proposal (RFP) or other solicitations issued to potential 401(k) record keepers
21. All proposals and correspondence to and from the plan or on behalf of the plan to response to RFP's.
22. If RFP process was not conducted, all documents relating to the investigation and selection of 401(k) recordkeeper and investment options
23. 401 (k) Plan Trust Agreement.

24. All contracts or other agreements between investment managers, third party administrators and any other service providers to the 401(k) plan with the plan or plan sponsor
25. All Trustee Reports for plan year 1993 to the present
26. All insurance contracts relating to the plan investments and operations.

To facilitate the investigation while minimizing any inconvenience the investigation may cause you, please have the above listed documents available for review upon my arrival. Also, please have available copies of the following reports that may be retained for our files:

1. The 401(k) Plan document including all amendments, addenda and attachments.
2. The 401(k) Plan Summary Plan Description (SPD) including all amendments, addenda and attachments.
3. All Summary Material Modifications (SMM) to the 401(k) Plan including all amendments, addenda and attachments.
4. The 401(k) Plan Forms 5500 with accompanying financial statements for plan year 1993 to the present.
5. The 401(k) Plan Summary Annual Reports (SAR) for plan year to the present.
6. The prospectus or other disclosure material relating to investment options provided to the sponsor and/or the participants of the 401(k) Plan.
7. Sample 401(k) Plan participant account statement.
8. The 401(k) Plan Statement of Investment Policy.
9. All consulting agreements where a consultant was engaged to assist with selecting investment options, investment manager and/or other service providers to the plan.
10. 401(k) Plan Trust Agreement
11. All contracts or other agreements between investment managers, third party administrators, and any other service providers to the 401(k) plan with the plan or plan sponsor.
12. All insurance contracts relating to the plan investments and operations.

In addition to the records listed above, other records of the Plan may be required for examination during the course of the investigation and we may request that you provide duplicate copies of any other records we wish to retain for our files. Also we request that the Plan's Administrator, Trustee and any other Plan fiduciary be available to answer questions relating to the administration of the Plan and the investment of the Plan's assets.

The examination of documents and request for copies of records may also be made for any other plans sponsored by \_\_\_\_\_ and its affiliates. These records may include, but shall not be restricted to, transaction journals, brokerage statements, participant records, canceled checks, deposit notices and bank statements.

Your cooperation in this matter will allow for a more efficient examination. If you have any questions regarding this examination, please call me at \_\_\_\_\_ .

Sincerely,

\_\_\_\_\_  
Senior Investigator

## 16. Can you articulate in a scientific/statistical manner the relevant amount of risk in your plan?

Historically, fiduciaries were governed by the common law of trusts, which required that the riskiness of each investment in a portfolio be measured in isolation. But in Labor Reg. §2550.404a-1 (42 FR 54122, 1977), the DoL determined that ERISA redefined the investment duties of fiduciaries to require that:

*...the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory...* [Laborers, 173 F. 3d 313, at 317]

In addition per ERISA §404(a)(1)(B) :

(2)...*appropriate consideration*" shall include, but is not necessarily limited to:

- (i) *A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, **taking into consideration the risk of loss** and the opportunity for gain (or other return) associated with the investment or the investment course of action,*
- (ii) *Consideration of the following factors as they relate to such portion of the portfolio:*
  - (A) *The composition of the portfolio with regard to diversification;*
  - (B) *The projected return of the portfolio relative to the funding objectives of the plan*  
[Emphasis added] [29 C.F.R. §2550.404a-1(2)(B)(i-iii)]

The focus of the regulations is on structuring a portfolio that takes into account the relationship between risk and return, and on properly balancing that relationship in light of the objectives of the trust. That process requires that the levels of risk and reward must be identified and compared.<sup>13</sup>

## 17. Are selected asset classes consistent with the identified risk, return, and time horizon?

Section 404(a) of ERISA imposes on fiduciaries an obligation to act prudently. A fiduciary is required to act:

*...with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.* [ERISA §404(a)(1)(B)]

In addition, the fiduciary should take into consideration the following factors:

- (A) The composition of the portfolio with regard to diversification;
- (B) The liquidity of the current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
- (C) The projected return of the portfolio relative to the funding objectives of the plan.  
[29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)]

<sup>13</sup>Legal Memorandums prepared by Reish, Luftman, Reicher & Cohen, Prudent Investment Practices: Practice No. 2.1

A central theme of the regulations is that the fiduciaries diversify the plan's investment portfolio "as a mechanism for reducing the risk of large losses." [See preamble to DoL Regulation §2550.404a-1, 44FR 37255 (June 25, 1979)] In discussing the duties of the fiduciaries in investing plan assets, the DoL also emphasized the importance of looking at individual investments within the context of the plan's portfolio as a whole and the fact that certain investments may, in themselves, entail risk but that, in the context of the portfolio, may be appropriate.

By spreading plan investments over several prudently selected asset classes, a fiduciary may reduce a plan's exposure to losses due to adverse economic and market conditions, or against the fortunes of a particular field of business or industry, and thereby minimize the risk of large losses.

The DoL has emphasized the importance of asset allocation strategy in DoL Interpretive Bulletin 96-1, Participant Investment Education. [29 C.F.R. §2509.96-1] In explaining its views on the circumstances under which providing investment-related information to participants and beneficiaries in participant-directed individual account pension plans would not constitute the rendering of investment advice under ERISA, the DoL recognized the use of asset allocation models as an investment strategy. It stated that:

*Asset allocation models must be based on generally accepted theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time.*

The DoL further stated that:

*This requirement was included to ensure that any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification.*

Thus, the fiduciary is responsible for selecting different asset classes consistent with the plan's identified risk, return, and time horizon.<sup>14</sup>

## **18. Do you know where your plan options fall within the Markowitz Efficient Frontier?**

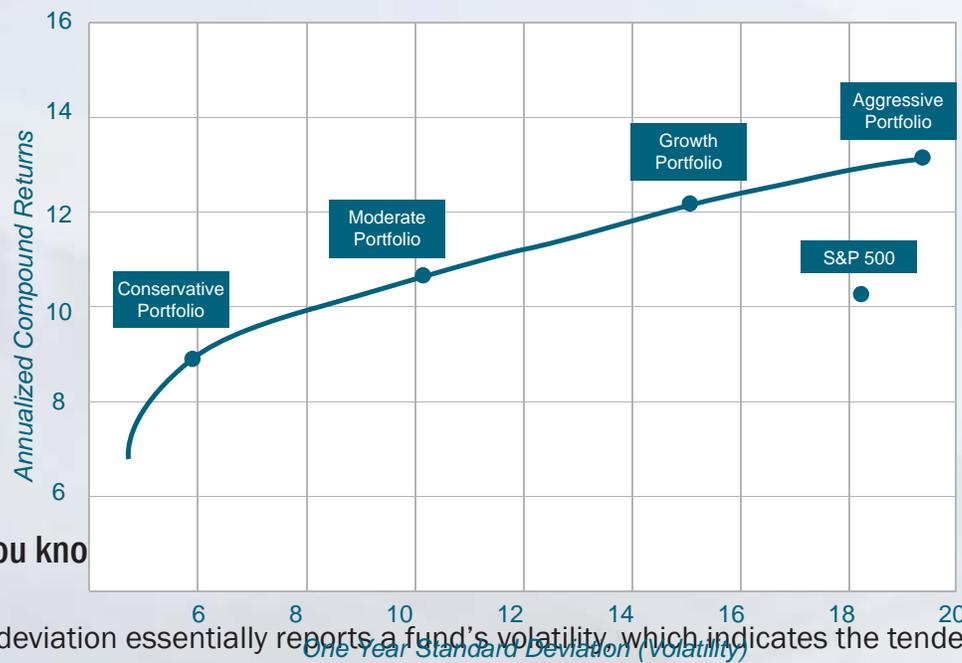
The graph following is referred to as "The Efficient Frontier." Based on the concept of Modern Portfolio Theory, which earned Harry Markowitz the Nobel Prize in 1990, this chart allows

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<sup>14</sup>Legal Memorandums prepared by Reish, Luftman, Reicher & Cohen, Prudent Investment Practices: Practice No. 2.4

individual investors to maximize expected returns for any level of volatility. By plotting the annualized compound return and the annualized standard deviation of your current portfolio, you can see how free market investing strategies can be used to either increase the expected return of your portfolio for the same level of volatility or decrease the volatility of your portfolio for the same expected rate of return.

January 1973-December 2013



## 19. Do you know

Standard deviation essentially reports a fund's volatility, which indicates the tendency of the returns to rise or fall drastically in a short period of time. A security that is volatile is also considered higher risk because its performance may change quickly in either direction at any moment. The standard deviation of a fund measures this risk by measuring the degree to which the fund fluctuates in relation to its mean return, the average return of a fund over a period of time.

A fund that has a consistent four-year return of 3%, for example, would have a mean, or average, of 3%. The standard deviation for this fund would then be zero because the fund's return in any given year does not differ from its four-year mean of 3%. On the other hand, a fund that in each of the last four years returned -5%, 17%, 2% and 30% will have a mean return of 11%. The fund will also exhibit a high standard deviation because each year the return of the fund differs from the mean return. This fund is therefore more risky because it fluctuates widely between negative and positive returns within a short period.

A note to remember is that, because volatility is only one indicator of the risk affecting a security, a stable past performance of a fund is not necessarily a guarantee of future stability. Since unforeseen market factors can influence volatility, a fund that this year has a standard deviation close or equal to zero may behave differently in the following year.

This graph, referred to as Markowitz's "Efficient Frontier," plots annualized compound return and standard deviation of a portfolio. It illustrates how free market strategies can either increase expected returns for the same level of volatility or decrease portfolio volatility for the same expected rate of return. This graph represents back-tested performance, the inherent limitations of which are discussed in the endnotes, and assumes reinvestment of dividends, but does not deduct fees and expenses which would reduce returns. It is for illustrative purposes only and does not reflect actual performance of any portfolio managed by Matson Money.

To determine how well a fund is maximizing the return received for its volatility, you can compare the fund to another with a similar investment strategy and similar returns. The fund with the lower standard deviation would be more optimal because it is maximizing the return received for the amount of risk acquired.<sup>16</sup>

## **20. Are you working with a 3(38) Fiduciary?**

An ERISA section 3(38) fiduciary must make decisions for which it has legal responsibility (and therefore legal liability), because such a fiduciary is charged with ERISA-defined “discretion.” Under ERISA, if an entity has discretion to make a decision, that entity is responsible for that decision, not the entity that appointed it. This gives a plan sponsor significant cover from fiduciary risk. An ERISA 3(38) fiduciary decides what investment options such as stand-alone mutual funds or model portfolios should be placed on a plan’s selection menu, where to remove them from the menu and, if it does remove them, what investment options will replace them. The plan sponsor no longer has any such responsibilities because the sponsor has delegated them to the 3(38) fiduciary.

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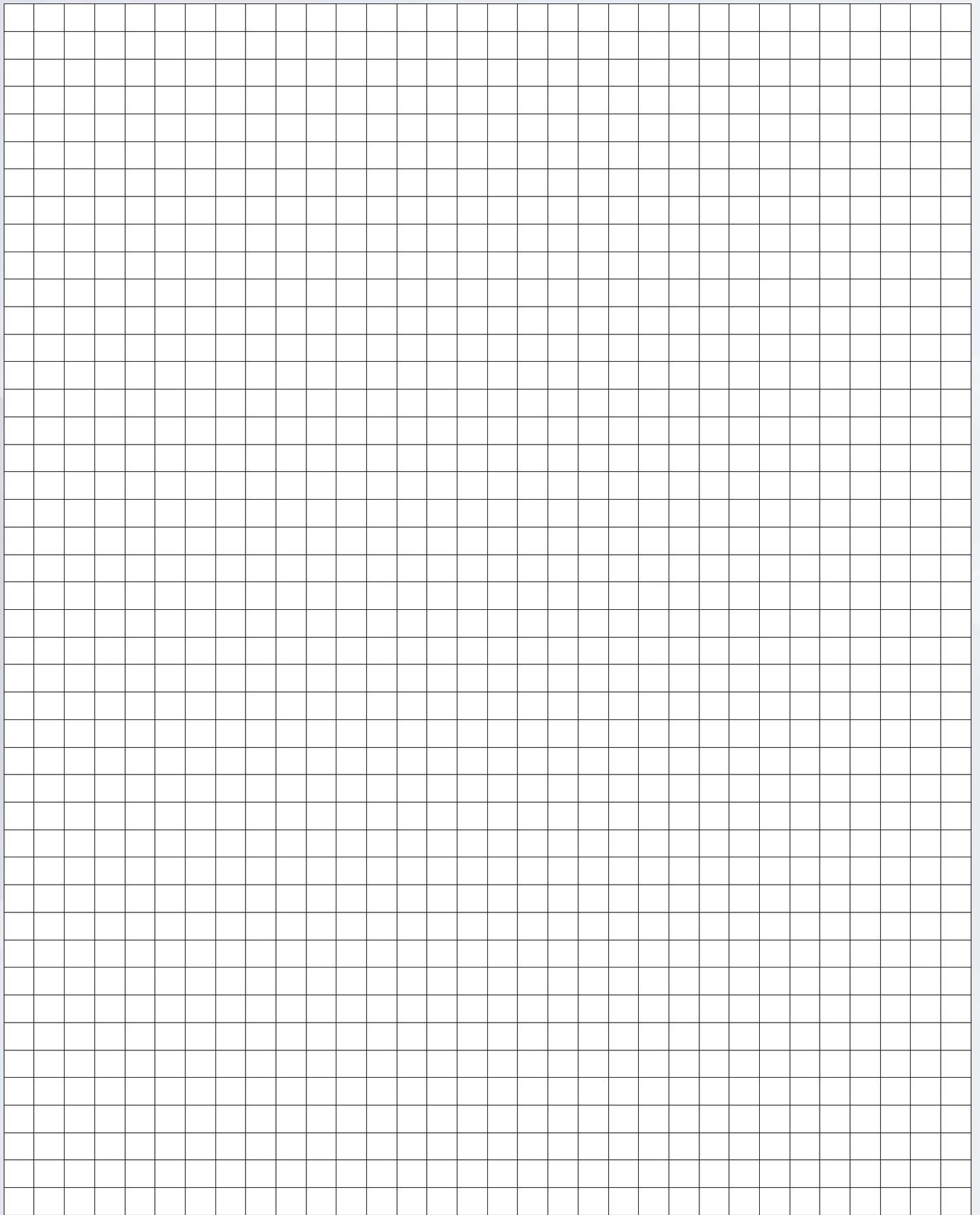
<sup>15</sup>[http://money.aol.com/investing/fct1/\\_a/asset-allocationportfolio/20050225133309990006](http://money.aol.com/investing/fct1/_a/asset-allocationportfolio/20050225133309990006)

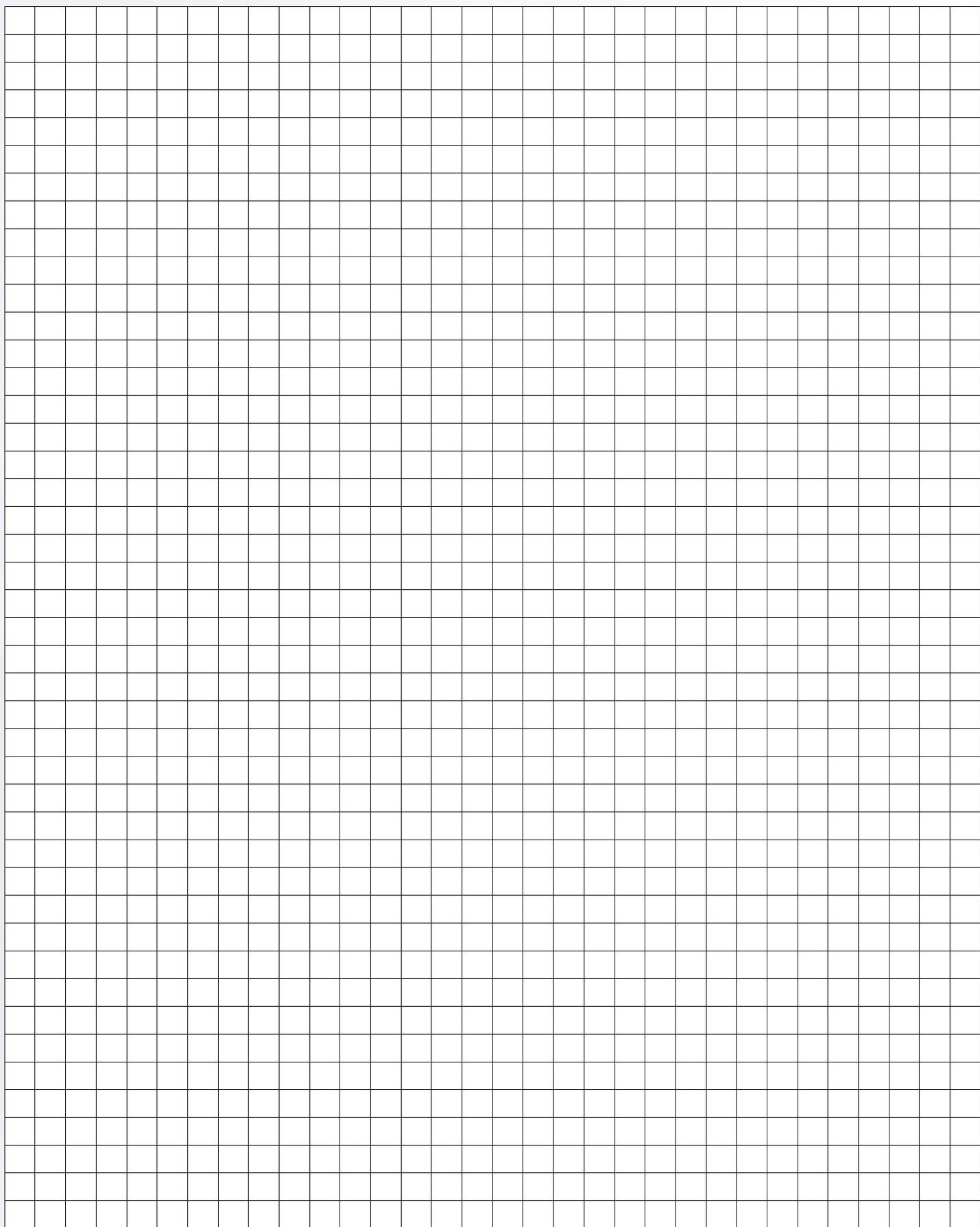
<sup>16</sup>Understanding Volatility Measurements July 23, 2003 | By Shauna Croome

# Appendix A

1. If the three biggest problems facing your plan could be magically solved what would those three problems be?
2. How much are these problems costing you?
3. How long have you had these problems?
4. What have you done to try and fix them?
5. Are these problems important?
6. Are you one of the largest participants in your plan?









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