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Investment Matters

Best Practices for Your Plan's Investment Committee

You do have an investment committee, don't you? In the absence of an officially designated — and properly structured — investment committee, your company's executives and board of directors may find themselves assuming fiduciary responsibilities they may not have been aware of.

However, by designating a committee with certain specific responsibilities over plan investments, fiduciaries can often mitigate their exposure. (This committee is usually separate from the benefits committee, which is responsible for non-investment related issues.) Such a committee would be responsible for:

- Establishing a formal process to manage investment strategies.
- Initiating investment decisions.
- Analyzing and monitoring investment-related expenses.
- Establishing due diligence procedures for selecting and monitoring investments.
- Selecting and monitoring any "prudent experts."

Who Should Serve?

Obviously, any committee with responsibility for plan investments should include members with significant financial/investment experience and a thorough understanding of capital markets. It doesn't have to be a huge committee — three to five members usually will suffice. This typically includes senior members of Human Resources, Finance and Operations, with a Chief Financial Officer or similar person heading it up. Larger firms may also consider the inclusion of in-house legal counsel.

Be aware that ERISA calls for the use of a "prudent expert," so be ready to look outside the committee for expertise, if needed. A good example is the need to engage an independent advisor to assist with the selection and monitoring of plan investments if members of the committee lack that expertise. The required standard of care under ERISA is that of a "prudent expert" — not a "prudent person." In other words, it's not how a member of your investment committee might invest his or her *own* money, but rather how an expert would invest *someone else's* money.

Consider these best practices for forming an effective investment committee:

Make it formal. Ideally, your board of directors will take formal action and appoint an investment committee with an explicit delegation of authority.

Adopt a charter. The committee's roles and responsibilities should then be further outlined via a charter document, which specifies exactly what responsibilities are being delegated to the committee. In general, investment committee charters fall into three main types:

- A 401(k) Investment Committee, which provides investment oversight.
- A 401(k) Administrative Committee, which provides administrative oversight.
- A 401(k) Oversight Committee, which provides both investment and administrative oversight.

Adopt a statement of investment policy. Note the word "statement." This

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Plan Compliance

Understanding the Corrective Distribution Process

The term itself sounds ominous: "corrective distribution." Many plan sponsors are alarmed to receive notification from their trustee or third party administrator that such a distribution is required to make their plan "whole."

In reality, this means that too much was deferred to an employee's account (an excess deferral) and the excess amount must be distributed back to the employee (a corrective distribution).

> *An excess deferral is not what puts a plan in violation — it is the failure to make a corrective distribution in a timely manner that does.*

How It Happens

According to the IRS, problems with elective deferrals tend to occur because of the failure to monitor one or more of the following:

Employee limitations – The employer mistakenly believes that deferral limits apply to the plan rather than to the participant, which is actually the case.

Calendar year limitations – If the plan year is something other than the calendar year, problems can occur when the administrator bases deferral limits on the plan year deferrals, rather than deferrals made during the calendar year, as required by the law.

Employee transfers – Violations can also occur when employees transfer between divisions and plans of the same employer, and the employer and/or plan administrator mistakenly allows them to defer the maximum amount under each plan.

How It Is Discovered

Problems with excess deferrals are typically brought to light using the Actual Deferral Percentage (ADP) test and the Actual Contribution Percentage (ACP) test. These tests provide a limit on the amount by which certain benefits provided under the plan to highly compensated employees (HCEs) may exceed the benefits provided to non-highly compensated employees (NHCEs). If it passes the ADP and ACP tests, a plan satisfies the nondiscrimination requirements of the law.

How It Is Fixed

Failure to make a required corrective distribution in a timely manner can result in some substantial penalties — everything from an excise tax to disqualification of the entire plan.

Yet, it is critical for plan sponsors to understand that an excess deferral is not what puts the plan in violation. Rather, it is the failure to make a corrective distribution in a timely manner that results in a violation. Ultimately, a plan sponsor's obligation is to conduct proper testing and have a plan in place to promptly correct excess deferrals.

Here, the clock starts ticking at the close of the plan year in which the mistake occurs. Plan sponsors then have a statutory 12-month "correction period" in which to act. If corrective distributions are made after the first 2½ months of the correction period, the employer is liable for an excise tax. If correction is not made within the correction period, the plan is considered "disqualified."

Once the statutory correction period has passed, employers may still seek relief through the IRS' Employee Plans Compliance Resolution System (EPCRS). Under the Self-Correction Program (SCP), mistakes must be fixed within two years after the end of the statutory correction period (i.e., the 12-month period following the close of the plan year). After this time, the Voluntary Correction Program (VCP) must be used, unless the failure can be classified as insignificant.

Deferral Best Practices

There are some best practices plan sponsors can employ to avoid excessive deferrals in the first place:

1. Complete ADP/ACP nondiscrimination tests in a timely manner. A 401(k) plan must perform an ADP test as of the last day of each plan year to confirm that HCEs do not contribute disproportionately more to the plan than NHCEs. Plans, including 403(b) plans, that accept employee post-tax contributions or employer matching contributions must perform an ACP test as of the last day of each plan year.

2. Carefully review plan documents. Testing is only as accurate as the data being tested. So go over plan documents and employee data to ensure that employees are correctly classified as HCEs or NHCEs, that the proper definition of compensation is used, and that proper testing/correction methods are employed.

3. Build in some options. Plans with matching contributions and/or employee after-tax contributions can be structured so that the employer can adjust the contribution rates of the HCEs in order to prevent the plan from failing the ACP test. Similarly, some plans are designed with a discretionary matching contribution formula, where the employer can declare a different rate of matching contributions for the HCEs. ■

Questions about corrective distributions? Our experienced staff can provide answers.

Need to Know

Tips for Selecting a High-Quality Auditor

As a plan administrator, you have a clear fiduciary responsibility to ensure the quality of your plan's audited financial statements.

Hiring an experienced, high-quality auditor is a critical first step. An audit performed by an unqualified firm can result in operational failures being missed and a deficient audit being submitted. Such an audit may be rejected by the IRS or DOL. Ultimately, plan sponsors and administrators can be held personally liable for not obtaining a quality audit in accordance with ERISA.

A quality audit is about more than carrying out the plan sponsor's fiduciary duty to file a complete and accurate Form 5500 each year.

So, what do you look for in an auditor? Chances are, the audit firm can deliver a quality audit by meeting these four criteria:

1. They are members of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center (EBPAQC). The AICPA sets stringent quality control standards for audits — standards that not all firms can meet.

2. They perform a number of employee benefit plan audits annually. Experience really does count. Department of Labor audit studies show more deficiencies in benefit plan audits performed by firms that issue fewer than 25 benefit plan audits a year. Of course, there are plenty of quality firms who may not meet this threshold. The key is to find a firm that makes a significant commitment to training and staff resources to ensure the quality of its audits.

3. Their audit approach conforms to GAAP and ERISA. Traditional audit programs and tools may not be adequate for the unique nature of employee benefit plans. Look for a firm versed in the compliance and financial reporting aspects required by both GAAP and ERISA.

4. Their auditors receive training and continuing education specific to employee benefit plans. ERISA requirements, laws, regulations and financial reporting requirements are constantly changing. It is important that your auditor is aware of these developments to avoid audit deficiencies and qualification issues in your plan.

In the end, the higher the quality of the audit, the more reliable the information that's available to prudently manage and administer the plan. ■

Please contact our office today to discuss your plan's audit needs.

Investment Committee Best Practices

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does not need to be an exhaustive guide that outlines every investment vehicle and analytical method. Nor should it create inflexible restrictions that tie the hands of your Investment Committee. But the investment policy statement does need to provide direction to guide the committee in its task, including:

1) Stating the goals, investment strategy and permissible (and prudent) investment options.

2) Identifying the factors to be considered in selecting investments, such as performance, fees and other factors. Also stated should be factors to be considered in eliminating investments.

3) Describing the specific activities the committee will engage in to properly monitor investment performance, as well as the performance of investment advisors.

Not So Fast

Your board is ultimately responsible for making sure that the committee is making prudent investment decisions. One way to do this is for the committee to address the board at least annually with an update on the status of the plan, as well as potential future actions. ■

We can assist you with the proper establishment of your investment committee charter. Please contact us for more information.

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Are You Ready for an EBP Audit?

Experienced auditors say the key to a smooth annual employee benefit plan audit is to have everything ready for your audit team when they arrive.

- **One month out** – Begin gathering plan-related and investment-related documents. As a best practice, these documents should always be easily accessible, organized and current. Ask your auditor for a planning list or checklist of documents you will need.

Tip: Inform your auditor of any significant changes to the plan (changes in third party administrators, new investments, amendments to plan documents, etc.), as well as any issues or concerns that have cropped up since the last audit.

- **Two or three weeks out** – Perform your own internal audit. Pull data on a few plan participants and run some test calculations to uncover any obvious deficiencies.

Tip: Reconcile data among all service providers prior to the audit. For example, ensure that the trustee investment statements match the participant account information provided by your third party administrator.

- **The day of** – Be prepared for a half-hour to hour-long kick-off meeting. Have the appropriate plan administrators on hand to answer general questions and provide an overview of significant events that occurred during the plan year. Plan for a brief status meeting at the end of the first day.

Tip: It's critical to have a dedicated contact person available to address additional questions and needs while your audit team is onsite.

- **As the audit progresses** – Request weekly status updates to ensure that there are no pending requests or open items that need to be addressed.

Tip: To allow sufficient time for review, ask to receive drafts of the financial statements, internal control recommendations/management letter, and the management representation letter a week or two prior to the expected report issuance. ■