It is important to scrutinize your 401(k)plan the way you would any investment, and that includes an understanding of how the plan is administered.

Understanding 401(k) Mechanics: A Look at How the Plans Operate

By Albert J. Golly Jr.

Over the past decade, the fastest-growing type of retirement plan has been the 401(k), which has become the most popular means of retirement saving for both employees and employers. In 1992, the most recent year for which statistics are available, assets in these plans topped $800 billion.

Aside from their popularity, 401(k) plans were again thrust into national media headlines in November 1995, when the Department of Labor reported that a handful of companies (about 300—and generally very small ones) had not deposited their employees' contributions either in a timely manner or at all, using the employee's plan contributions to bolster their corporate cash flow. In many cases, employees of these firms were unaware that contributions deducted from their paychecks were not deposited on time or at all. As a result, Secretary of Labor Robert Reich has called for greater scrutiny of 401(k) plans.

Given this slight potential for a problem and the greater importance of a 401(k) investment to one's retirement nest egg, it is necessary to understand the mechanics of a 401(k) plan to confirm that your contributions are properly deposited into your 401(k) on a timely basis and in the investment choices you have selected, and that your plan is being administered properly.

This article will look at 401(k) plans from the standpoint of the information that is available to you and what should be made available to you from your employer, what to do if you do not receive the appropriate information, and how to make sure your contributions are properly deposited.

Background

Traditional defined-benefit retirement plans were structured to provide a monthly retirement sum to an employee if the person met the necessary requirements in terms of years of service to have a vested benefit. Most employees paid little or nothing into these plans; employers bore all of the costs and were mandated to fund the plans by a federal law, ERISA, passed in 1974. However, employers have in recent years shifted their focus to 401(k) plans to save money and to encourage their employees to save. In effect, the burden of amassing enough retirement assets has shifted from employers to employees.

Let's look briefly at how a 401(k) plan operates:

An employee participant first designates how much he wishes to contribute on a pretax basis. This has the advantage of reducing the employee's salary for income tax (but not for Social Security tax) purposes. The employee usually has available some investment vehicles to which he may allocate his contributions. The employer may even match some of the contribution, which may be allocated to company stock if the company so wishes, or to one of the investment choices selected by the employee. The dollars deposited into the plan grow on a tax-deferred basis until retirement.

Employees have the ability to take their vested accumulated plan assets with them when they leave their employer; these assets can remain in a tax-deferred account either by depositing them into the new employer's plan or into an IRA, or the employee can take distribution of the assets by paying taxes and a 10% penalty for early withdrawal if they are under age 59^1/$_2$.

Employers like 401(k) plans because of reduced fiduciary liability and plan costs. Investment of the assets becomes the employee's "problem" and not that of the employer.

Who Runs the Plan?

401(k) plans generally involve a structure consisting of the company, a recordkeeper, a trustee/custodian, investment vehicles managed by an outside money manager, and, possibly, an investment consulting firm. The representatives of the company usually consist of the human resources department and a management-selected committee responsible for overseeing the plan. The human resources area advertises the plan to the employees, deducts the contributions from paychecks and transmits the money to the trustee. The committee is charged with ensuring the proper administration of the plan in an oversight mode.

Corporate use of outside administrators ("outsourcing") has

Albert J. Golly Jr., CFA, is principal of Golly Investment Management, an investment advisory firm based in New York City.

proved popular recently because it shifts the burden of doing all or most of the work to an outside vendor. Costs may even be lower with outsourcing. However, outsourcing does not end the responsibility of the company to monitor the plan and ensure that it is being properly administered by the outside vendor(s).

Recordkeepers are hired to keep track of the cash inflows, outflows, and employee loans from the plan. They also keep the plan participants' accounting records for their investment in the plan and are responsible for sending the participants periodic reports of their 401(k) assets, or forwarding the reports to the employer for mailing to the participants. Recordkeepers also carry out the non-discrimination testing that is legally required of plans on a periodic basis. This testing is done to determine the participation rate of lower-paid employees in the plan. Since a 401(k)'s pretax deduction feature is particularly favorable to higher-paid employees and executives, the government wants more lower-paid workers in the plan so that the plan is not a "perk" or tax avoidance for the more highly paid. Failure to pass the test results in a reduced contribution rate for the more highly paid employees, possibly resulting in some of the deducted dollars being handed back to them, thus increasing their taxable income.

Some small companies do their own recordkeeping. We shall see later that this can raise a warning flag to employees in companies that might be tempted to use the employees' contributions in the business.

A trustee/custodian is hired to make disbursements from the plan, take contributions from the employees and to hold the plan's assets. The trustee/custodian is also used to pay bills to outside vendors for services rendered to the plan. This firm is generally a bank or a trust company.

Outside money managers are hired to provide the investment options made available to the participants. These providers consist of mutual fund families, bank commingled trusts, and investment advisory boutique firms offering individually-managed accounts. Of these, the trend is definitely for some form of commingled fund managed by banks, insurance companies and/or mutual fund families.

Some plan sponsors employ the services of different vendors, adopting a "mix and match" approach of, say, one recordkeeper, a different trustee and mutual funds from various fund families. This allows the plan to choose from the best available in each category. However, a more recent trend has been for 401(k) plans to use a "bundled" approach. This means basically one-stop shopping—a company can go to the XYZ family of funds and find all of the plan's needed services available under one roof. This has the advantage of simpler administration and no need to expend time selecting various vendors. A disadvantage is that one fund family might not have the best mutual funds in each asset class. In that case, ease of administration could come at the expense of outstanding performing funds not available in that particular asset class of the bundled fund family. Another variation on a bundled product is an "alliance" in which a recordkeeper will offer multiple mutual fund families to a plan sponsor along with other needed services. This has the advantage of allowing a company to select mutual funds from a wide variety of choices, perhaps even a broad spectrum of outstanding funds. A disadvantage is the somewhat higher cost to the plan.

The last player in the 401(k) may be an investment consulting firm that provides services similar to those provided to defined-benefit plans—performance measurement and monitoring, portfolio manager and investment style review, and recommended changes to the investment options offered to the plan participants to replace a poorly performing fund or to expand options for participants. However, consultants are not used as much on 401(k) plans as they are on defined-benefit plans.

All of the above players incur a fiduciary responsibility when providing services to a 401(k) plan and can possibly be sued if the services are negligently carried out or there is incompetence or fraud. An employer may reduce (but not eliminate) his fiduciary responsibility by adopting the Department of Labor's 404(c) regulations and offering at least three different investment options with distinctively different risk and return characteristics, which when combined would create a diversified portfolio with reduced risk. In addition, the employer must allow the participants to transfer assets among the options at least once every 90 days. While adopting the 404(c) safe harbor regulations reduces the employer's fiduciary responsibility, that action does not eliminate all responsibility. Employers are still responsible for proper administration and management of the plan and for using due diligence in hiring outside service providers.

Information That Must Be Given to 401(k) Plan Participants

• ***Employee enrollment form***: To be filled out by the employee, this indicates the percentage amount the employee wants to contribute to the plan and how the employee wants contributions allocated among the investment options.

• ***Summary Plan Description***: Abbreviated listing of plan provisions, including vesting rules for employer contributions, distribution rules, and grievance procedures.

• ***Information on investment options (upon enrollment in plan, and in periodic reports)***: Regulatory definitions are sketchy, and the amount of information varies from company to company. Firms using mutual funds usually provide prospectuses and periodic reports.

• ***Periodic Financial Statements***: Reflects the participant's account, including contributions, any outstanding loans, income earned, capital gains and losses, plus the beginning and ending balance.

What Documents Should Plan Participants Receive?

No employee can be forced to participate in a 401(k), but those who choose to do so must be given:

• Employee enrollment forms,
• A Summary Plan Description (SPD), and

• Information on the investment options.

On the employee enrollment form, the employee indicates the percentage of his paycheck that he wishes deducted under the tax-free limit and the investment options to which he wants to allocate his ongoing contributions. Some plans allow aftertax contributions to the plan; these dollars grow on a tax-deferred basis but are included as a separate category on the employee's periodic statements.

The Summary Plan Description is an abbreviated listing of the plan provisions (the plan's "mechanics") and describes various items such as the vesting rules for any employer matching of contributions, distribution rules, and grievance procedures. In addition, the Summary Plan Description offers the complete plan document for a fee—a valuable offer if an employee wants to appeal an employer decision or contest some part of the 401(k) plan.

While employers must provide information on the plan's investment choices, the regulatory definition of appropriate material is sketchy at best. Employers are loathe to do anything that might smack of investment advice, a situation that would increase their fiduciary liability if an employee sues. Firms that use mutual funds usually provide fund prospectuses and the fund's semiannual reports.

Investment education is another problem; companies do not want to be investment advisers to their employees. One solution has been to hire vendors who create videos or use humorous situations to try to make investment managers out of ordinary, non-financial people. Another answer is the creation by mutual fund families of so-called "Lifestyle" funds. Three or four balanced strategies are crafted to cater to different investors. Thus, a young person would supposedly choose an aggressive balanced approach while an older person would supposedly select a more conservative balanced approach. The Labor Department is currently in the process of issuing rules that will allow employers to provide more information without forcing them to register with the SEC as investment advisers.

In December 1995, the Labor Department issued an Interpretive Bulletin that would define the investment education provided by employers to employees without the employer being designated a fiduciary and having to register as a registered investment adviser with the Securities and Exchange Commission. The proposed regulation would create a "safe harbor" for employers, allowing them to discuss investments in general, explain the value of diversified portfolios (with samples), discuss the concepts of risk and return and provide impartial investment information on the plan's investment options. The bulletin did, however, comment on the fine line between investment education and investment advice. The Labor Department has solicited comments from employers and the providers of plan services on the bulletin.

What About Ongoing Information?

Of course, 401(k) plan participation is an ongoing process, and therefore employers must provide participants with two types of reports:

• Periodic financial statements reflecting the person's particular account, and
• Periodic reports on the investment options.

The periodic financial reports include: beginning balances, contributions, loan amounts, income earned, capital gains and losses, and ending balances. You should carefully review these reports to verify their accuracy. You may not know the income or gains/losses numbers, but you do know your contribution amounts from your paychecks. Keep in mind that even with the most honest employer there will probably be a delay after the end of the recording period of up to six weeks. Delays do not equal malfeasance.

The periodic reports on your plan balances may or may not break out the amounts you contributed and your employer matched, and there is no legal requirement for an employer to separate the two balances. If your employer makes a matching contribution in company stock, that balance will show up as a separate line on the periodic report. If the employer makes a match using the same investment options you have chosen, it will be harder to differentiate the balances if they are not broken out in the report. You should keep track of your contributions so that you will have some idea of the approximate amount that is yours. In addition, be sure you know the vesting policy if you receive an employer match. Vesting is the right an employee acquires to receive employer-contributed benefits. Plan participants immediately vest in their own contributions and in the earnings on their contributions. However, you may or may not immediately vest in any matching contributions made by your employer; the employer may legitimately delay full vesting for a number of years (up to seven). If you plan to leave the company, have a substantial amount residing in the employer's matching contribution, and are very close to vesting, you might want to stay at that employer to vest in the employer's match.

Investment option information must also be reported to participants. This can take the form of official reports from mutual fund families or digested material from the employer or recordkeeper. In many cases, employees receive only perfunctory performance information sometimes with an offer to receive an updated or annual report, if so desired and requested. If your employer makes such an offer, take him up on it and read the additional material carefully.

Receipt of these reports should trigger a review of your overall asset allocation and cause you to consider any changes to your asset mix and/or your contributions. You always have the option to make switches among the options and to change the allocation of your contributions. Use the reports to cause a re-evaluation.

What Problems Can Occur?

Certain problems can occur with a 401(k). These include:

• Errors in plan administration,
• Failure to effect transfers expeditiously, and
• Fraud or negligence, but it is important to keep in mind that this is extremely rare.

Errors can occur with any recordkeeper. There is no way you

can independently check on the reputation of an outside recordkeeper. But if you detect an error, contact your human resources department with full details on your claim. Retroactive corrections will occur providing that you can demonstrate that an error occurred. Pay stubs are a good place to start.

Problems with transfers can be more problematical. Most plans employ daily valuation so that a participant can find out each day what her account is worth and in many cases can effect transfers each day through an 800 number prior to the close of business (4 p.m. Eastern time for mutual funds). Some plans only allow transfers at the end of a month or a quarter. This has the advantage of lower costs for the plan and reduced opportunities for participants to try to time the market on a short-term basis (probably a good thing). However, as a participant you should be aware of when telephoned transfer instructions are actually effected. An egregious example occurred before the October 1987 stock market crash. On September 30, a number of investors instructed their plans to transfer their stock positions to less volatile investment options; however, the plan administrators in keeping with the plan's provisions effected the transfers at the end of October, after the market drop! It pays to know the transfer rules.

Fraud and negligence are extremely rare—the overwhelming majority of plans (almost 100%) are administered with the employee's good in mind. But what if you suspect that yours is not?

The first thing to look for is the existence of an outside recordkeeper. If there is one, you should be more confident in the plan and your employer. If your statements come from your employer and are perennially late or have numerous errors, you can question the human resources department as to their recordkeeping procedures and ask for an accounting verification (audit trail) of the plan. A legitimately run plan will not hesitate to accede to your requests.

Employees should remember that employers have up to 90 days to deposit the participants' contributions into the plan. (This may well change with Secretary Reich's recommended reduction of the delay to one week, but as of now that is the rule.) So you should keep in mind that failure to make an immediate deposit is clearly within federal law and regulations and is not necessarily a sign of fraud.

Should you suspect a violation of the law and/or the plan, you can complain to the Pension Welfare Benefit representative located in your local Department of Labor office. Be sure that you have sufficient facts to justify your accusation. Threatening to sue on your own by claiming violation by the employer or one of the vendors of their fiduciary responsibility just won't work. You are better off going to the government.

What if You are Dissatisfied with the 401(k) Plan?

Let's say that you are unhappy with the investment choices offered in the plan or want the plan liberalized to allow more frequent transfers. What can you do?

The only logical option is to present your human resources department with a cogent reason for changing managers, adding new funds, or making changes in the plan. The odds that you will succeed are slim unless you convince a large percentage of your fellow workers to support you. Keep in mind that the more liberal the plan, the higher the costs, and these costs are ultimately borne by the participants.

Plan costs are a difficult issue to grapple with because of the myriad of fees (e.g., management, recordkeeping, trustee, and consulting) and the fact that companies do not have to divulge the plan's fees. The one fee you can learn about is the management fee ("expense ratio") for a mutual fund by reading the prospectus. More and more companies are starting to pass on all of the plan's fees to the participants. You might be able to detect the fee level if the fees are detailed on your periodic financial reports. Protesting fees, however, will generally get you nowhere.

Conclusion

If you are eligible for and participate in a 401(k) plan, you should scrutinize the plan with the same care as you would for any investment.

But you should also make sure that you understand the mechanics of the plan, so that you can make the best use of it, and to ensure that the plan is being administered properly. Great investment vehicles cannot outweigh a plan design that does not work in your interest.