The Ins and Outs of Auditing a 401(k) Portfolio

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Introduction

Who we are and why we are here

Agenda

Meet your speakers

Julia Kirby
Managing Director
Regulatory & Compliance
Deloitte & Touche LLP

Julia has more than 25 years of experience in assisting financial and non-financial institutions with regulatory compliance matters. She has reviewed existing fiduciary programs, developed internal audit testing programs, and conducted reviews for Regulation 9 compliance.

Prior to joining Deloitte, Julia managed the trust internal audit function of a super-regional financial institution. As an examiner with the Federal Reserve, Julia was a Trust examiner and a Consumer Compliance/CRA examiner. Before working at the Federal Reserve, Julia was a bank examiner for the State of Illinois Commissioner of Banks and Trust Companies. Julia also serves on multiple committees of the Fiduciary Investment Risk Management Association, where she was formerly on the Board of Directors.

Joshua Uhl
Senior Manager
Regulatory & Compliance
Deloitte & Touche LLP

Joshua specializes in advising broker-dealers and registered investment advisors on regulatory and business operations topics, including sales practices, advisory services, supervision, trading, supporting technology and operational structures.

For the past year, Josh has been leading Deloitte’s initiative focused on the DOL Fiduciary Rule; developing a suite of services, methodologies, tools, and accelerators for the Rule.

Currently, Josh advises many of Deloitte’s leading clients on their DOL rule related efforts, is regularly featured as a speaker at industry events and public forums, and publishes thought leadership related to the rule.

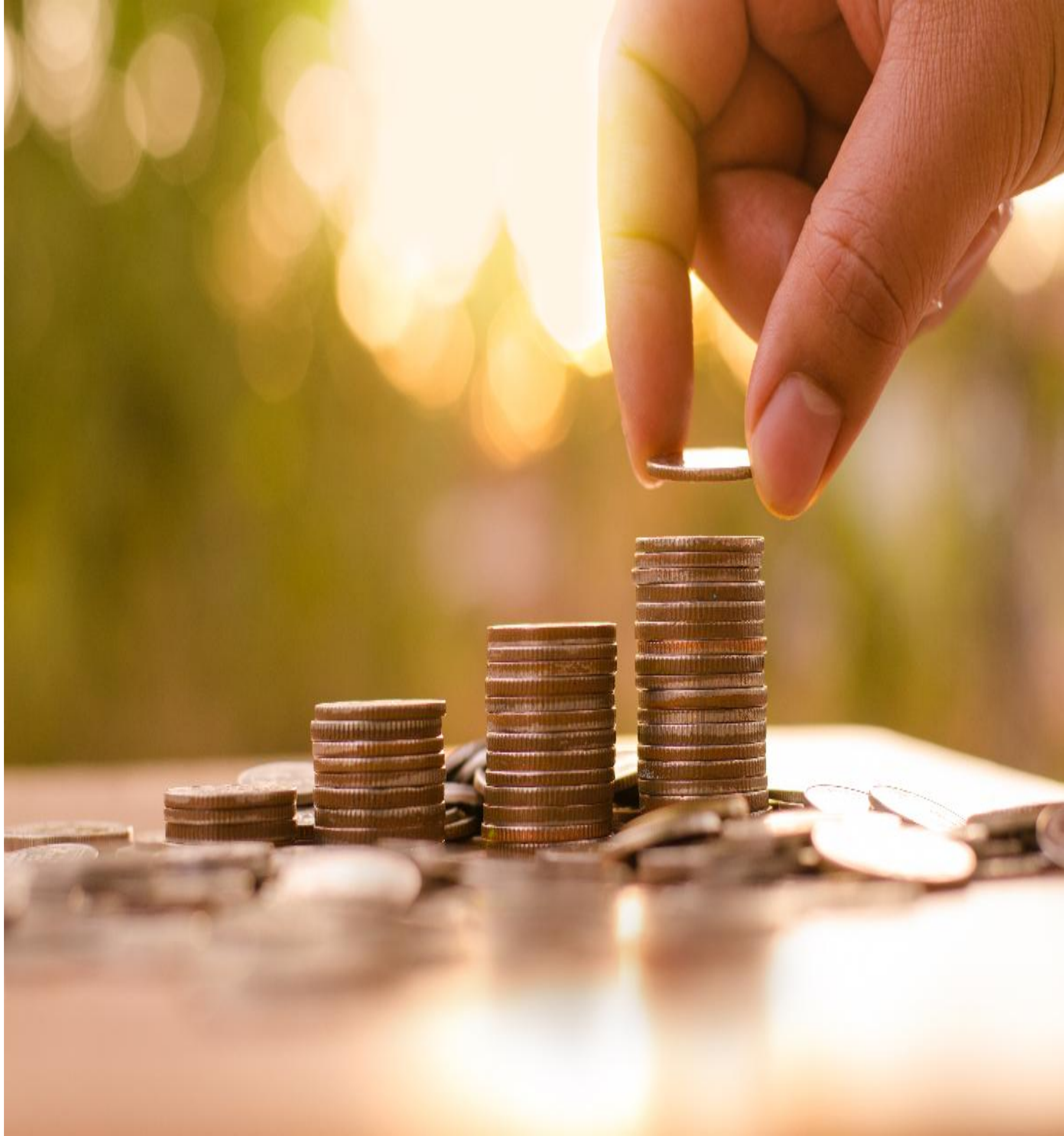
Prior to joining Deloitte, Joshua was with the Financial Industry Regulatory Authority’s (FINRA) department of Member Regulation.

Today's objectives

1. Discuss the basic internal audit (IA) expectations for coverage of 401(k) accounts and operations:
    a. Risk assessments
    b. Testing methodologies
2. Discuss DOL fiduciary rule and considerations for your IA program
3. Facilitate knowledge sharing among the participants

IA’s Risk Assessment for identifying 401(k) risks

The what, how, and why for assessing risk



Before the risk assessment, determine what type of IA objectives you have

IA leaders tend to fall into four types of leadership roles.

Catalyst

- Influence behaviors
- Bridge silos across organization
- Solve problems and achieve strategic objectives

Strategist

- Aligned with business strategies
- Partnering with business to anticipate risks
- Provide advice to achieve business strategies

Steward

- Objective and independent assurance
- Focused on compliance
- Insights to audit committee focused on protecting value

Operator

- Balancing capabilities, talents, and costs
- Fulfilling audit mandate in cost effective manner
- Training leaders for new roles

What are some risks associated with 401(k) accounts?

Risks within 401(k) accounts arise from legal, regulatory, administration, investment, and operational areas. Each of these areas should be considered when conducting the risk assessment and when developing testing

- ERISA, IRC and DOL regulations
- Size and complexity of the portfolio
- Asset management including investment allocations, consideration of concentrations, conflicts, affiliated mutual funds or CIFs, timeliness of investment activities, valuation, review for discretionary accounts
- Operations – employer and employee contributions, reconciliations, processing of plan loans, 5500 reporting, escheatment, account statements, proxy voting
- Participant recordkeeping
- Plan distributions including authorizations, lump sum or periodic participant distributions, hardship or in-service withdrawals, QDRO distributions, distributions at employee termination, early withdrawals, rollover distributions, federal tax withholding, OFAC checks
- Prior audit or examination findings
- Significant operational or management changes since prior audit
- Economic or supervisory concerns
- Litigation or consumer complaints

What does an effective risk assessment measure and provide?

The risk assessment helps to set the frequency of monitoring and testing activities across the enterprise, serves as a critical indicator of risk in providing transparency to senior management and the board, and enables a holistic view of risks

- **Quantity of risk** – the level or volume of risk that exists; typically characterized as high, moderate, or low
- **Quality of risk management** – how well risks are identified, measured, controlled, and monitored; typically characterized as strong, satisfactory, or weak
- **Aggregate risk** – the level of management concern, which is a summary judgment incorporating the assessments of the quantity of risk and the quality of risk management; typically characterized as high, moderate, or low
- **Direction of risk** – a prospective assessment of the probable movement in aggregate risk over the next 12 months; typically characterized as decreasing, stable, or increasing. The direction of risk often influences the oversight strategy, including how much testing and monitoring is needed
- **Inherent risk –** assessment of the nature, complexity, and volume of the activities giving rise to the risk in question. Inherent risk is the risk present without consideration of management processes and controls.
- **Residual risk –** remaining risk after the application of mitigating controls. Residual risk will dictate the frequency of a more rigorous independent testing and monitoring program while driving attention to the riskiest activities.

Illustrative risk assessment framework – identify and assess

Inherent Risk

Inherent risk assesses the nature, complexity, and volume of the activities giving rise to the risk in question. ***Inherent risk*** is the risk present without consideration of management processes and controls.

- *Risk Intensity and Other Internal Factors (Likelihood)*
- *Risk Intensity and Other External Factors (Severity)*

Inherent Risk Rating

Low | Moderate | High

Control Effectiveness

Businesses must establish ***preventive and detective controls.*** Control Effectiveness measures the Design and Performance of ***preventive and detective controls.*** This includes clear articulation of "what controls" are applied to "which Inherent Risk Activities."

- *Control Design*
- *Control Performance*

Control Effectiveness Rating

Strong | Adequate | Weak

Residual Risk

Residual Risk is the risk remaining after application of the mitigating controls. Residual risk will dictate the frequency of a more rigorous independent testing and monitoring program while driving attention to the riskiest activities.

Residual Risk Rating

Low | Moderate | High

How are risk controls evaluated?

Effectiveness is determined through review and testing of the design and performance of risk controls

Control Design	Control design indicates the existence of controls, where in the process the controls reside, and how well-positioned the controls are to mitigate the risk. Control design ratings are assessed as strong, adequate, or weak to determine whether the design sufficiently controls the risk, considering the following criteria: • Adequacy and completeness of control • Sustainability of control • Whether the control is preventive or detective • Level of automation in the control • Adequacy of information management system(s) supporting the control • Degree of accountability for execution of the control • Whether and how easily the control can be bypassed or otherwise defeated • Sufficiency of process to measure, report, and escalate risk issues
Control Performance	Control performance measures the adequacy or deficiency of controls as measured by review activities (business regulatory compliance testing, monitoring, and periodic evaluations), external regulatory exams, IA reviews, assessments by third parties, and applicable complaints. After a control(s) has been reviewed, tested, monitored or otherwise evaluated, its performance must be rated strong, adequate, or weak.

Control Effectiveness

Critical factors in evaluating control effectiveness:

- Results from business compliance testing
- Internal audit reviews
- Regulatory examination findings
- Results from other third-party reviews
- Applicable complaints

Illustrative control effectiveness matrix

		Control Design		
Control Performance	**RATING**	Strong	Adequate	Weak
	Weak	Weak	Weak	Weak
	Adequate	Adequate	Adequate	Weak
	Strong	Strong	Adequate	Weak

Why is an effective 401(k) risk assessment program important?

Risk management continues to be a primary focus of regulators and an important consideration for clients. Due to the size of many 401(k) plans, appropriate management of risk is key to protecting institutions from undue liability

- As a plan fiduciary, liability can arise from not only individual participants**,** but also from the plan sponsor or class action law suits.
- As our population ages and more people become dependent upon these funds for their ongoing income, managing these accounts in an appropriate manner should be a key objective.
- Risk management continues to be a primary focus of regulators and is an ongoing expectation for these accounts.
- Additional attention is being given to 401(k) accounts due to the DOL conflict of interest rule. The need to protect retirement income and related conflicts of interest continues to be a focus of many different regulators.

Developing your 401(k) portfolio testing approach

Testing methodologies, sampling and new technologies

Testing methodology

Testing methodology will depend on which activities and processes are in scope for your 401(k) portfolio.

Sample Control Objectives:

- New plan setups, plan mergers, and plan conversions are authorized and processed in a complete, accurate and timely manner in accordance with plan sponsor instructions and specific plan provisions.
- Plan parameter changes are authorized and processed in a complete, accurate and timely manner in accordance with plan sponsor instructions.
- Enrollments are authorized and processed in a complete, accurate and timely manner.
- Indicative data changes are authorized and processed in a complete, accurate and timely manner.
- Contributions (payroll deductions, loan repayments, loan payoffs, and rollovers-in) are authorized and processed in a complete, accurate and timely manner.
- Distributions are authorized and processed in a complete, accurate and timely manner.
- Investment transactions are processed in a complete, accurate, and timely manner.
- Prices / net asset values are received daily from an authorized source and are recorded in a complete and accurate manner.
- Fund transfers are authorized and processed in a complete, accurate and timely manner.
- Investment income (dividends, interest income, etc.) is processed and allocated to participant accounts in a complete, accurate and timely manner.
- Corporate actions are authorized and processed in a complete, accurate and timely manner.
- Reconciliations are performed in a complete accurate and timely manner.
- Statements are provided to participants and plan sponsors in a complete, accurate, and timely manner.

Testing methodology

A brief note on sampling – sampling methodology should be established at the IA department level and should reflect the identified risks of the portfolio being reviewed. If any different approach is used, document and explain why.

Sample test steps:

- Obtain and review the prior internal audit report and determine if all findings have been adequately addressed.
- Select a sample of X accounts at random and perform an administrative account review to determine if the account is being administered in compliance with the terms of the governing document, applicable laws and regulations and bank policy. Include in the review:
  - Evidence of annual account review/asset review
  - Maintenance of appropriate records to support transaction activity
  - Review of account history to determine that funds are kept invested in accordance with the terms of the account
  - Review fees to determine they are in line with current fee schedule or separate fee agreement signed by appropriate parties. Trace to ensure that fee income is booked to the correct general ledger account.
  - Trace account to inclusion on management's reports as applicable
- Review written policy manual for completeness and determine if process has been established to maintain the manual in compliance with the changing regulatory environment.
- Assess the process of reviewing new accounts. Run a listing of new accounts identified as being opened in the past 12 months. Select sample of X accounts and determine if new account review was completed pre-acceptance and post-acceptance.
- Obtain list of accounts closed in past 12 months and select a sample of X accounts. Review files to determine that accounts were closed in accordance with the terms of the account and that appropriate receipts were obtained evidencing proper distribution of funds. Review file for completed account closing checklist.
- Review record retention policy and process for maintaining, safeguarding and destruction of trust records.
- Review management's oversight of accounts with uninvested cash or overdrafts.
- Review investment policy and procedures. Obtain copy of buy list and approved brokers. Review process for updating both. Review any exception reports used to manage the investment process.
- Assess transactions and investment recommendations for conflicts of interest with the plan fiduciary
- Obtain a list of accounts with participant loans:
  - Select a sample of X accounts with loans and determine if governing documentation includes a written loan plan.
  - Determine if loans are managed by bank as trustee or if the plan sponsor is responsible for participant lending.
  - If managed by bank as trustee, review a sample of lending documents for compliance with Regulation Z.
- Review asset reconciliation for assets held at depository for outstanding exceptions.
- Discuss any Pension Benefit Guaranty Corporation (PBCG) issues with management.
- Review 5500 filing as appropriate.

Testing methodologies

- Audit focused specifically on 401(k) accounts:
  - Includes life cycle of account
  - Operations
  - Administration
  - Investments

- Audit coverage across functional audits:
  - Account opening
  - Investment management
  - Account closing
  - Receipts and disbursements

Overview of emerging technologies

The Robotic Process Automation (RPA) & Cognitive Intelligence (CI) spectrum ranges from enabling technologies that improve parts of business or risk processes to sophisticated technologies with cognitive elements

Area	Technologies	Description
Foundation	Data Integration	Integrated data to provide a consistent information foundation *(e.g. Audit Risk and Regulatory Data Warehouse)*
Analytics	Predictive Analytics	Software solutions using predictive models *(e.g. Risk Models)*
	Data Visualization	Software placing data in a visual context *(e.g. GRC Dashboards)*
Automation	RPA	Rules-based systems that mimic human behavior to automate parts of repeatable processes *(e.g., Testing and Sampling)*
Cognitive Intelligence	Natural Language Generation (NLG)	Applications that accept structured data inputs (~~Excel~~spreadsheet-like rows/columns), to generate seemingly unstructured narratives *(e.g., Audit Reporting, AML SAR reports)*
	Natural Language Processing (NLP)	Applications that process unstructured data (e.g., text) and allow querying and generation of structured data *(e.g., Regulatory Change/P&P Documentation Review)*
	Machine Learning (ML)	Applications that are able to improve predictability and operation based on data they receive over time. *(e.g., Fraud Analysis Applications)*
	Artificial Intelligence (AI)	Applications able to mimic human behavior, such as visual perception, speech recognition, decision-making, and translation between languages *(e.g., Risk Identification for Audit Risk Assessments)*

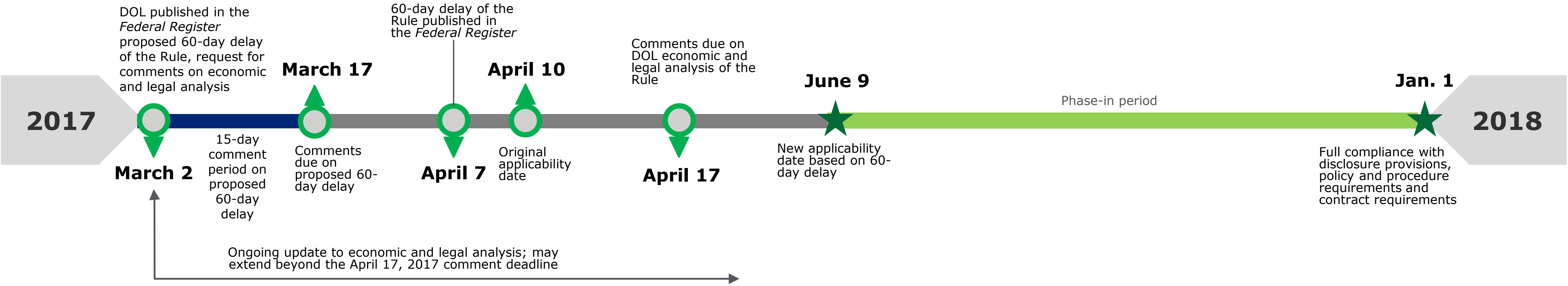
- RPA & are an extension of existing foundational and analytical technologies that offer large gains in quality and efficiency
- **What's changed:** convergence of 20+ years of AI research, improvements in Big Data, increased computing power

The DOL Fiduciary Rule

Current state of play as of May 24, 2017

Where things stand as of May 24, 2017

The new definition of fiduciary and exemptions will come into effect on June 9, 2017, however the DOL is conduct their analysis to determine whether the rule will be revised



Compliance with the Impartial Conduct Standards is required during the Transition Period

Rule Section	Standard	Description
1 Section IX(d)(1)(i)	Best Interest Advice	Investment advice is in the "Best Interest" of the Retirement Investor when provided with **care, skill, prudence, and diligence…without regard to the financial or other interests of the Adviser**, Financial Institution or any Affiliate, Related Entity, or other party
2 Section IX(d)(1)(ii)	Reasonable Compensation	Reasonable compensation implies that compensation must not be excessive, as measured by the **market value** of the particular **services, rights, and benefits** the **Financial Institution and Adviser** are **delivering** to the retirement investor
3 Section IX(d)(1)(iii)	Make no misleading statements	**Statements about** the recommended transaction, **fees and compensation, Material Conflicts of Interest**, and any other matters relevant to a Retirement Investor's investment decisions, **may not be materially misleading** at the time they are made

The DOL is conducting an analysis to determine whether the rule will be revised

Conducting an analysis of the issues raised in the President's Memorandum

- Examine whether the Fiduciary Rule may adversely affect the ability of Americans to gain access to retirement information and financial advice
- Prepare an updated economic and legal analysis concerning the likely impact of the Fiduciary Rule as part of that examination

Issuing a Request for Information (RFI) seeking:

- Public input on ideas for possible:
  - new exemptions or
  - regulatory changes
- Public comment on whether:
  - it is likely to take more time to implement these new approaches than January 1, 2018
  - an additional delay in the January 1, 2018 applicability date would reduce burdens on financial services providers and benefit retirement investors

Impartial Conduct Standard: Best interest advice

Core tenants of complying with the Best Interest Advice standard include mitigating the influence of conflicts of interest in an adviser's recommendations and following a prudent analysis process in order to arrive at an investment recommendation

Illustrative Best Interest Advice Framework

Mitigate conflicts

Advice should be given "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party"

Conflicts Registry

Identification of Conflicts

Conflicts to be identified and addressed include:

- Variable compensation
- Third party payments
- Affiliate payments
- Sales-based incentive compensation
- Non-cash compensation

Mitigation Activities

Mitigation activities may include:

- Leveling compensation
- Eliminating or leveling certain third party and / or affiliate payments
- Enhancing controls relating to non-cash compensation
- Eliminating sales-based contests and incentives

Prudent analysis process

Each fiduciary recommendation should be supported by a discrete prudent analysis that the adviser is required to perform in order to arrive at the recommendation. There should be controls and documentation to substantiate that the adviser performed the prudent analysis.

Enhanced requirements for rollover recommendations

DOL

A prudent analysis of the following factors and considerations is required for rollover recommendations:

- alternatives to a rollover including leaving the money in his or her current employer's plan, if permitted
- the fees and expenses associated with both the plan and the IRA
- whether the employer pays for some or all of the plan's administrative expenses
- the different levels of services and investments available under each option

To satisfy this requirement, the adviser and financial institution must make diligent and prudent efforts to obtain information on the existing plan.

FINRA 13-45

Rollover recommendations should reflect consideration of various factors:

- Investment options
- Fees and expenses
- Services
- Penalty-fee withdrawals
- Protection from creditors and legal judgements
- Required minimum distributions
- Employer stock

Rollover recommendations are subject to FINRA's suitability (rule 2111) requirements and must consider the customer's investment profile

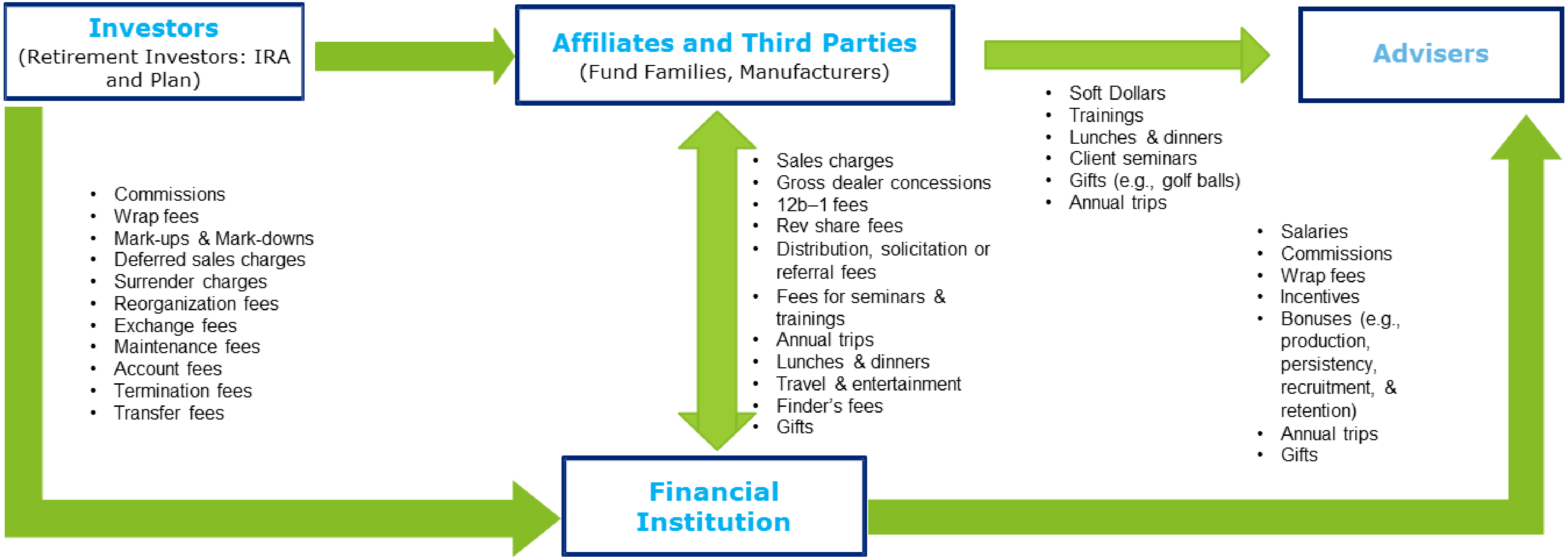
Advisers **"should discuss with the customer the various factors related to the [rollover] decision"**

Reasonable Compensation

Impartial Conduct Standard: Reasonable compensation

The first step in complying with the Reasonable Compensation standard has often been to **identify and inventory** the different compensation types (e.g., fees and charges) that are received as the result of investment advice and recommendations to retirement investors

Example of Compensation Types and Flows



Because these efforts include identifying direct and indirect cash and non-cash compensation received from both investors and third-parties, the level of effort required to accurately and completely capture this information has been sizeable

Impartial Conduct Standard: Reasonable compensation

After identifying the different types of compensation received, compensation streams must be **evaluated** for overall reasonableness on an upfront and ongoing basis

Illustrative Reasonable Compensation Evaluation Framework

Are the fees and charges **received** (from investors, affiliates and third-parties) reasonable in relation to the services provided? Are the services priced in accordance with the market value of those services?

1a What are the various **payments received** from **investors?**

1b What are the various **payments received from third parties** and for which product groups?

2 What are the **services of value** being provided in exchange for the compensation?

3 How does the **market value** similar services?

4 Rationalize relationship between the market value of services rendered, fees charged to the investor and compensation received

Additionally, a processes should be implemented for advisers to evaluate reasonable compensation that is embedded within the prudent analysis process that has been designed to meet the requirements of the Best Interest Advice standard

Make no misleading statements

Impartial Conduct Standard: Make no misleading statements

Proactive measures are expected to ensure that statements are not misleading at the time they are made, with particular focus being paid to statements pertaining to roll-over recommendations.

Illustrative Control Activities Designed to Prevent Misleading Statements

Review Existing Materials	Ensure Access to Information
Statements about recommended transactions, fees and compensation, Material Conflicts of Interest, and other matters relevant to a Retirement Investor's investment decisions, may not be materially misleading at the time they are made	
An analysis of existing materials, both printed and electronic, should be conducted to inventory and identify instances where information may need to be updated on an ongoing basis in order to be accurately reflected. Examples of materials to review include: • Prospectuses • Fact Sheets • Research and performance reports • Marketing materials • Disclosures • Contracts and agreements • Statements and Confirmations	Financial Institutions should seek to ensure that advisers access appropriate sources for accurate information at the time of a recommendation. Examples may include: • Firm systems • Product manufacturer websites • Third-party vendor solutions This requirement is of particular concern when making rollover recommendations, as the advisers must make considerable efforts to obtain current plan fee and expense information directly from the investor. Examples may include: • Participant statement • Summary plan document • Annual benefit notice

Policies should be evaluated ahead of June 9th

Firms are revising policies before the applicability date to support and evidence adherence to the Impartial Conduct Standards

"During the transition period, the Department expects financial institutions to adopt such policies and procedures as they reasonably conclude are necessary to ensure that advisers comply with the impartial conduct standards." *– DOL Transition Period FAQs, Q6*

	Impartial Conduct Standard	Potential policy considerations
Best Interest Advice	*Advice must be delivered with care, skill, prudence, and diligence…without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party*	• Conflict identification • Conflict mitigation • Advice delivery process including analysis and documentation requirements
Reasonable Compensation	*Compensation must not be excessive, as measured by the market value of the services, rights, and benefits the Financial Institution and Adviser are delivering*	• New product review • Compensation including incentive and third-party • Non-cash compensation
Make no misleading statements	*Statements about the transaction, fees, compensation, Material Conflicts of Interest, and any other matters relevant to a investment decision, may not be misleading at the time they are made*	• Written and electronic communication • Advertising and marketing review • Advice delivery process including analysis and documentation requirements

Particular consideration should be paid to policies designed to support the analysis and delivery of rollover recommendations

Supervisory structure considerations

Firms continue to define how existing supervisory structures will change to support oversight of the Impartial Conduct Standards

Illustrative

1 Review current state supervisory structure

- Confirm Rule exemptions that will be utilized across the business
- Review existing governance and supervisory structure
- Document key business decisions that will impact existing supervisory structure (e.g., prohibited programs and products)

2 Supervisory structure gap assessment

- Perform current state assessment against Rule and exemption requirements
- Identify key supervisory processes that will require enhancements for oversight of:
  - Best interest standards
  - Reasonable compensation
  - No misleading statements
- Identify high risk areas requiring enhanced controls to mitigate conflicts of interest
- Assess existing reporting lines and roles in the supervisory structure

3 Develop framework for enhancements

- Define enhancements to existing supervisory oversight functions (e.g., centralized vs. field)
- Develop key risk indicators to monitor adherence to Impartial Conduct Standards
- Prioritize process enhancements for day 1 compliance
- Design and enhance controls to address Rule and exemption requirements
- Develop framework for periodic review of conflicts across the supervisory structure

Objectives

1

- High-level summary of existing governance and supervisory structure
- List of key exemption strategies and business decisions impacting the existing supervisory structure

2

- List of impacted processes
- Areas requiring modified or new controls
- Documented reporting lines and functions

3

- Refined supervisory structure
- Management reporting inputs
- Enhanced controls
- Framework for periodic conflicts review

Mutual fund share classes

Current state of the marketplace

Mutual fund share class future-state options

Three primary share class options are being evaluated by asset managers and distributors

T shares	Clean shares	Load-waived A shares
Product Specifications		
New "transaction" shares created in response to the Rule. Features include: • Front end load based on transaction size • 25bps 12b-1 • No ROA or LOI discounting provisions	New or existing shares meeting requirements set in 1/11/17 No Action Letter. Features include: • No sales load • Distributors can set own commission schedules Variants emerging due to ambiguity in No Action Letter relating permissibility of certain fees: 1) "Clean-Clean" 2) "Clean-Dirty" 3) "Dirty-Clean"	Existing A shares sold at NAV. Features include: • No sales load • 12b-1 fee varies by fund; set in prospectus

T share load schedule

Transaction Size	Sales Load
<$250k	2.50%
$250k-<$500k	2.00%
$500k-<$1MM	1.50%
>$1MM	1.00%

Clean share variations

Clean-Clean	*Clean-Dirty*	*Dirty-Clean*
No 12b-1	**No** 12b-1	12b-1 incl.
No Sub-TA	Sub-TA incl.	**No** Sub-TA

Load-waived A share 12b-1 fees

Annual 12b-1 fee range
0 – 50bps

Mutual fund share class considerations

The Rule delay has caused the marketplace to pause or even regress in finalizing mutual fund share class strategies

T shares	Clean shares	Load-waived A shares
Benefits and Challenges		
+ Mitigates compensation conflicts + Mitigates conflicts related to discounting provisions + Widespread readiness by Asset Managers (“AM”) to launch – Dependent on AMs making shares available to purchase – Higher costs for large transactions/recurring purchases – Inconsistent waiver provisions across fund companies	+ Allows firms to set own commission schedule + Mitigates conflicts related to discounting provisions – Commission schedules must be disclosed in public prospectus – Difficult for distributors and clearing firms to operationalize – Inconsistent provisions may lead to continuing variable comp – Share class unlikely to be permissible for NTF platforms	+ Mitigates conflicts related to discounting provisions + Widespread availability in the marketplace + Already operationalized at most distributors – Varying 12b-1 fees could lead to continuing variable comp – May create conflict with products paying upfront commissions/loads – Substantial impact to revenue for brokerage-based firms
Marketplace Perspectives		
• AMs and distributors reviewing need for T shares with Rule delay – 1 wirehouse will be announcing its adoption of t-shares as an intermediate solution • Distributors increasingly uneasy about elimination of ROA and LOI discounting provisions	• Most view cleans shares as ultimate end-state • Significant questions remain about short-term operational readiness • Consistent provisions across funds are a must to mitigate conflicts	• Easiest short term solution, but significant revenue impact • Unlikely to be a viable option for firms planning to continue brokerage offerings • Conflicts relating to variable comp would remain

Q & A

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