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Exercising Fiduciary Authority and Control Over the Investment Menu in §403(b) Plans Subject to ERISA

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Summary:

New IRS regulations impacting all §403(b) plans, which generally became effective January 1, 2009, mandated the adoption of a written plan document. Although many tax-exempt organizations had minimal involvement in plan operation in the past, many have decided to modernize their §403(b) plans as a result of reviewing their plans for purposes of these new tax rules. In modernizing their arrangements, various §403(b) plan sponsors assumed greater control over their plans, thereby rendering their plans subject to ERISA. A plan will generally become subject to ERISA if the employer centralizes investments under a single provider, encourages participation, makes employer contributions, or exercises any kind of discretionary authority over plan operation.

The sponsor and fiduciaries of a §403(b) plan subject to ERISA are responsible for the management of the plan and its investments in accordance with ERISA's prudence and diversification requirements. To comply with ERISA, it is customary for plan sponsors to appoint fiduciary committees to oversee the management of the plan's investment menu in accordance with a written investment policy statement. It is imperative for the sponsor to retain control over the plan's investments. Many §403(b) plan sponsors did not make any contractual or operational changes beyond those required under the new IRS regulations. Thus, even though the plan became subject to ERISA, many plan sponsors did not increase their level of control, if any, over their respective plan's investment menu.

A plan sponsor's lack of control over the investment menu poses a challenging problem for §403(b) plans subject to ERISA, because the plan sponsor cannot make investment changes that are necessary for fiduciary purposes. The inability to change the plan's investment menu or the requirement of obtaining each participant's signature to effect such change can put plan fiduciaries at risk. If an investment menu change must be made, but the current provider is unable to make the change, the plan sponsor should explore contractual and operational solutions (e.g., replacement fund through a different provider). Ultimately, if the plan's existing provider will not implement a proposed menu change, the plan sponsor will have little recourse but to terminate the relationship and move to a different provider.

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INTRODUCTION

Many employers sponsoring §403(b) plans recently modified their arrangements as a result of the final regulations under §403(b) of the Internal Revenue Code (the ''New IRS Regulations''), which generally became effective on January 1, 2009. In accordance with one of the requirements under the New IRS Regulations, plan sponsors must adopt a written §403(b) plan document.[1] Before these rules became effective, employers were only required to adopt plan documents to the extent the §403(b) plan was covered by the Employee Retirement Income Security Act of 1974, as amended (ERISA). The U.S. Department of Labor (DOL) has clarified that the adoption of a §403(b) plan document to comply with the New IRS Regulations will not automatically cause the plan to become subject to ERISA.[2] However, in the course of modernizing their arrangements to comply with these new tax rules, various §403(b) plan sponsors have assumed greater control over their plans, thereby rendering the plans subject to ERISA.

MANY §403(b) PLAN SPONSORS HAD MINIMAL INVOLVEMENT BEFORE THE NEW IRS REGULATIONS

Before the New IRS Regulations, many tax-exempt organizations sponsoring §403(b) plans had minimal involvement in the plan's operation. In many instances, the employer did little more than remit employee funds taken through payroll deductions to an investment provider maintaining the employee's §403(b) plan account. In these types of arrangements, employees typically had the flexibility to contact any number of §403(b) plan investment providers and invest in an annuity contract or a custodial account restricted to mutual fund investments, as applicable, offered by the applicable provider (the ''Provider's Investments'').[3]

Due to the administrative burden of setting up and maintaining multiple payroll feeds with §403(b) plan investment providers, many employers established a maximum number of ''payroll slots'' for such providers. If an employee expressed a desire to invest in a new Provider's Investments, but existing providers had already exhausted the §403(b) plan sponsor's payroll slot maximum, the employee was still able to invest in the desired Provider's Investments *indirectly*. For example, such employee could (1) make payroll contributions for investment with a provider authorized to receive such contributions from the employer (a ''Direct Provider''), and (2) immediately transfer his or her benefit under the Direct Provider to the desired provider (the ''Indirect Provider'').[4] Generally, the employee was able to select an Indirect Provider without the prior approval or operational assistance of the employer.

Under these prior tax rules, in the IRS's view, §403(b) plans that utilized Indirect Providers were problematic, because the plan sponsor did not necessarily have access to information concerning the participant's investments through the Indirect Provider.[5] Accordingly, the plan sponsor would not have sufficient information to ensure compliance with IRS requirements for §403(b) plans (e.g., whether the participant was taking excessive plan loans or in-service distributions in violation of IRS rules).

2009 IRS REGULATIONS PROMPTED EMPLOYERS TO CHANGE §403(b) PLANS

The New IRS Regulations mandate a written §403(b) plan document containing all material terms, including the terms governing a participant's transfer from a Direct Provider's Investments to an Indirect Provider's Investments.[6] In addition, plan sponsors are required to enter into information sharing agreements with the plan's Indirect Providers, so that the sponsor has the information necessary for it to ensure compliance with the IRS rules for §403(b) plans (e.g., whether a severance from employment has occurred permitting a plan distribution). If an Indirect Provider refuses or is unable to enter into an information sharing agreement, participants are no longer permitted to transfer their benefits to such provider.[7] These requirements effectively force §403(b) plan sponsors to

[1] Adoption of the §403(b) plan document was permitted to be delayed until December 31, 2009, provided the plan sponsor operated the plan during 2009 in accordance with the requirements of Notice 2009-3, 2009-2 I.R.B. 250.

[2] DOL Field Assistance Bulletin 2007-02.

[3] In addition to annuity contracts, §403(b) plans may invest in custodial accounts maintained by a bank, or an approved nonbank custodian, that are invested exclusively in the shares of registered investment companies (i.e., mutual funds). §403(b)(7).

[4] In-service transfers from one Provider's Investments to another Provider's Investments under a §403(b) plan were permitted under Rev. Rul. 90-24, 1990-1 C.B. 97.

[5] *See IRC 403(b) Tax-Sheltered Annuity Plans — Questions and Answers*, which is available on the IRS's website at *http://www.irs.gov/retirement/article/0,,id=172433,00.html*.

[6] Treas. Regs. §1.403(b)-3(b)(3) provides that the §403(b) plan document must be in writing and that its provisions must satisfy various requirements, including Treas. Regs. §1.403(b)-10(b)(2), concerning investment transfers within the same §403(b) plan. The rules concerning investment transfers would also apply to a participant's transfer from an Indirect Provider's Investment to another Indirect Provider's Investments.

[7] However, the New IRS Regulations generally would permit the transfer of participant funds from a *non-compliant* Indirect

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identify, and ''approve'' on some level, all the plan's investment providers.

Prompted by the New IRS Regulations, many tax-exempt organizations investigated their §403(b) arrangements with the assistance of their service providers, in order to develop a transition strategy for complying with the new set of tax rules. In addition to reviewing the plan's investment features, many employers also reviewed the non-investment features of their §403(b) plans and explored making design changes.

As a result of this process, a substantial number of employers decided to transform their §403(b) plans from a ''no cost'' perk offered as a convenience for employees to a meaningful benefit program designed to help employees through their retirement years. For example, sponsors implemented automatic enrollment features, added matching contributions and initiated communication campaigns to promote retirement savings. However, with this added level of involvement in plan design and administration, these employers, in effect, enlisted to serve their plans as ERISA fiduciaries.

EMPLOYER'S INVOLVEMENT IN §403(b) PLAN CAN TRIGGER ERISA REQUIREMENTS

Avoiding ERISA Coverage Through Regulatory Safe Harbor

Section 403(b) plans are generally subject to ERISA if the plan is ''established or maintained'' by a tax-exempt organization on behalf of its employees.[8] As provided under a DOL regulatory safe harbor, a §403(b) plan will be not deemed to be established or maintained by the employer if:

(1) employee participation is completely voluntary;

(2) all rights under the §403(b) plan's annuity contracts or custodial accounts are enforceable solely by the employee;

(3) the involvement of the employer is limited to:

- publicizing the program without endorsement,
- collecting contributions through payroll deductions,
- limiting the investments available to employees to a number and selection which is designed to afford employees a *reasonable choice* in light of all relevant circumstances; and

(4) the employer receives no compensation, other than reasonable reimbursements for payroll deduction costs.[9]

In Field Assistance Bulletin 2007-02, the DOL confirmed its longstanding position under this regulatory safe harbor. It also clarified that an employer's adoption of a written §403(b) plan document in satisfaction of the New IRS Regulations would not, in and of itself, cause the plan to become subject to ERISA. In providing this guidance, the DOL recognized that the New IRS Regulations may require a plan sponsor to limit the availability of investments to plan participants. However, the DOL warned that the plan sponsor may only limit the available investments to a number designed to afford employees a *reasonable choice* in light of relevant circumstances. This warning was repeated in DOL Field Assistance Bulletin 2010-01, which states that a safe harbor plan generally must offer a choice of more than one §403(b) plan investment provider and more than one investment product.[10]

Employer Involvement Falling Outside Of the Safe Harbor

A plan will generally become subject to ERISA if the employer centralizes investments under a single provider, encourages participation, makes nonelective employer contributions (e.g., matching contribution), or exercises any kind of discretionary authority with respect to plan operation (e.g., determining eligibility for hardship distributions). The employer's engagement of a third-party administrator (''TPA'') to exercise any discretionary authority under the plan would also be a form of employer involvement outside the safe harbor. Additionally, negotiating with plan investment providers to change the terms of their products, such as the conditions for hardship withdrawals,

Provider (without an information sharing agreement) to any compliant provider under the plan.

[8] Section 403(b) plans can also be sponsored by, or on behalf of, public schools and churches. However, governmental plans are automatically exempt from ERISA, and church plans are similarly exempt unless ERISA coverage is elected.

[9] DOL Regs. §2510.3-2(f).

[10] DOL Field Assistance Bulletin 2010-01, Q&A-16. The DOL stated that a safe harbor plan may use a single Direct Provider, so long as the plan also offers an Indirect Provider. The DOL also recognized that there may be unusual circumstances in which an employer is able to demonstrate potential administrative burdens, justifying its decision to use a single provider offering a wide variety of investment products.

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would cause the plan to become subject to ERISA.[11] An employer's decision to unilaterally move employee funds from one provider to another would also be inconsistent with the regulatory safe harbor.[12]

Thus, by increasing their involvement above and beyond the minimum requirements of the New IRS Regulations, many §403(b) plan sponsors failed to satisfy one or more conditions of the regulatory safe harbor for avoiding ERISA coverage. As a consequence of their providing meaningful §403(b) plan benefits to their employees, a large number of tax-exempt organizations have converted their §403(b) arrangements into ERISA plans, and they are now subject to the fiduciary requirements and standards of care under ERISA.

FIDUCIARY DUTIES IMPOSED ON EMPLOYERS UNDER ERISA

Under §403(b) plans subject to ERISA, the plan sponsor and other fiduciaries are responsible for the management of the plan and its investments in accordance with the demanding standards of ERISA §404. There are four central duties under this provision, which require fiduciaries to act:

(1) for the exclusive purpose of providing benefits and paying reasonable plan expenses;

(2) in accordance with the ''duty of prudence'';

(3) by diversifying plan investments so as to minimize the risk of large losses; and

(4) in accordance with the plan's documents.

In the case of an §403(b) plan subject to ERISA, the plan's participants are typically permitted to make the investment allocation decisions for their personal accounts. But, even though investments may be participant-directed, the plan sponsor remains responsible for these investment allocation decisions, unless the conditions of ERISA §404(c) are met.[13] Once these conditions are satisfied, the plan fiduciary is responsible for the prudence and diversification within the plan's investment menu, but is not responsible for the actual investment allocation of participants' accounts.

CUSTOMARY FIDUCIARY PRACTICES DESIGNED TO FOSTER COMPLIANCE WITH ERISA

To foster compliance with these fiduciary standards, it is customary for plan sponsors to appoint fiduciary committees to oversee the management of the plan's investment menu. It is also a recommended practice for the committee to have a written charter to provide guidance on its composition and designated duties. Because the *procedural* aspects of the duty of prudence contemplate an objective process for selecting, monitoring and changing the plan's investment line-up, the DOL encourages the adoption of a written investment policy statement (''IPS'') to assist the investment committee or other plan fiduciaries to discharge these duties solely in the interests of the participants and beneficiaries of the plan.[14]

To comply with the *substantive* aspects of this duty, which is sometimes called the ''prudent expert'' rule, a plan sponsor should seek the assistance of a qualified advisor, such as a registered investment adviser (''RIA''), if it lacks the necessary expertise and experience to carry out a prudent evaluation of the investment menu.[15] Furthermore, investment meetings and reviews should be properly documented.[16] Fiduciary reviews should also ensure the prudent selection of service providers to the plan, including a proper evaluation of the reasonableness of fees.

If a §403(b) plan is subject to ERISA, it is imperative for the plan sponsor to retain control over the plan's investment offering to participants in order to carry out its fiduciary duties. Consistent with its responsibilities under ERISA §404, the plan sponsor must have the power to make changes to the §403(b) plan's menu in accordance with the prudence and diversification standards under ERISA. Employers that recently converted to, or otherwise ''establish or maintain,'' §403(b) plans subject to ERISA should confirm with their providers that they possess this necessary authority and control over plan investments.

MANY §403(b) PLAN SPONSORS DO NOT HAVE SUFFICIENT CONTROL OVER THE INVESTMENT MENU

Historically, §403(b) plans not subject to ERISA typically have not conferred any control over plan investments to the plan sponsor. For example, in the

[11] DOL Field Assistance Bulletin 2007-02.

[12] DOL Field Assistance Bulletin 2010-01.

[13] To satisfy the requirements under ERISA §404(c), participants must have an ''opportunity to exercise control'' over their accounts, which also requires sufficient investment-related disclosures, and the plan must offer a ''broad range of investment alternatives'' within the meaning of the related DOL regulations.

[14] DOL Interpretive Bulletin 08-2, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines*, 29 CFR §2509.08-2.

[15] *See, e.g., Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998).

[16] DOL Interpretive Bulletin 08-2.

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case of Indirect Providers, the plan sponsor may not even be aware of the identity of the plan's various Indirect Providers or the amount of employee funds held by each Indirect Provider on behalf of the plan.

With the rollout of the New IRS Regulations, employers participating in §403(b) plans were effectively required to ''centralize'' plan administration with the cooperation of their providers, but these changes generally did not impact or increase the sponsor's control over the plan menu. The New IRS Regulations generally did not require plan sponsors to modify the investment provisions, if any, of their agreements with Direct Providers. And even though these new tax rules required plan sponsors and Indirect Providers to enter into *information sharing* agreements, these agreements, by their nature, were unrelated to plan investments.

Although a large number of §403(b) plan sponsors assumed greater control over their plans than required for purposes of the New IRS Regulations, causing their plans to become subject to ERISA for the first time, many of these sponsors did not make any contractual or operational changes beyond those required under the New IRS Regulations. As a result, these sponsors did not establish a meaningful level of control over the plan's investment menu.

POTENTIAL OPERATIONAL AND CONTRACTUAL HURDLES FOR §403(b) PLAN FIDUCIARIES

A lack of control over plan investments poses a challenging problem for sponsors of §403(b) plans subject to ERISA. Specifically, if a §403(b) plan investment provider is not able to accommodate the fiduciary needs of a §403(b) plan subject to ERISA, the provider could conceivably prohibit a plan sponsor from making changes to the plan's investment menu, even though they may be deemed essential for fiduciary reasons. For example, a service agreement might state that the plan's investment menu must always include the standard offering of funds available through the provider. Other §403(b) plan arrangements might give sole investment authority to participants, leaving the plan sponsor without any contractual right to restrict the participant's investment choices.

Although these types of arrangements may be sufficient for a §403(b) plan that is not subject to ERISA, once the plan becomes subject to ERISA, such restrictions can put plan fiduciaries at risk. Plan fiduciaries are subject to personal liability under ERISA for any investment losses incurred under the plan as a result of any breach of their duties.[17]

REQUIRED ACTION IF EXISTING PROVIDER IS UNABLE TO MAKE INVESTMENT CHANGES

In the event the plan's fiduciaries conclude that an investment menu change must be made (e.g., replacement of a problem fund in an asset category), and if the existing provider does not permit such change *due to a lack of fund availability*, the plan sponsor should explore the possibility of making a replacement fund available through the addition of a different Direct or Indirect Provider. If the existing provider does not permit an investment menu change *for contractual reasons*, the plan sponsor should explore entering into replacement agreements with the provider and the plan's participants.

Ultimately, if the plan's current provider is unwilling or unable to facilitate a proposed menu change (e.g., existing provider will not eliminate problem fund from menu after another provider makes a replacement fund available), the plan sponsor will have little recourse but to terminate the relationship and move to a different provider. Of course, plan sponsors should endeavor to make any necessary investment changes with the existing provider's cooperation, before incurring the administrative costs of moving to another provider that can accommodate their fiduciary needs.

A plan sponsor could, in theory, allow participants to keep their existing investments in the incumbent provider's problem fund and merely require new contributions to be invested in a replacement fund available through a different provider. However, this approach carries liability risks for the plan sponsor, to the extent it might be held responsible for allowing the problem fund to continue in the plan's investment line-up (even if it is closed to new contributions).

CONCLUSION

A substantial number of §403(b) plans have become subject to ERISA for the first time as a direct result of the enhancements and changes adopted by their plan sponsors, which were above and beyond those required under the New IRS Regulations. In light of their new status as plan fiduciaries, these §403(b) plan sponsors have an obligation to manage the plan's investment menu prudently and in accordance with the other fiduciary standards of ERISA. Although it may require wrangling with historical

[17] ERISA §409(a).

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contracts and administrative arrangements, sponsors of §403(b) plans subject to ERISA should make every effort to coordinate with their providers and participants, so as to ensure they maintain the appropriate authority and control over the plan's investment menu.

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