

EVOLVING BEST PRACTICES FOR 403(b) PLAN FIDUCIARIES

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On July 26, 2007, the Internal Revenue Service published its long-awaited final regulations under Section 403(b) of the Code. The final regulations, which were issued in proposed form in November 2004, will replace regulations issued in 1964 that have not been comprehensively revised in more than 40 years.

The final regulations, like the proposed rules, consolidate legislative and regulatory developments over the last four decades that have significantly eroded the differences between 403(b) plans and other salary reduction arrangements such as 401(k) and 457(b) plans. While the new regulations generally codify existing rules, they also impose new documentary requirements; eliminate good faith compliance with the statutory nondiscrimination requirements for nonelective contributions; and generally narrow the universal availability standard for elective deferrals by requiring that each employee have an effective opportunity to make deferrals and limiting some of the categories of employees that may be excluded in applying the universal availability requirement.

In conjunction with the issuance of the IRS regulations, the Department of Labor has issued Field Assistance Bulletin 2007-2 in which it discusses the impact of the IRS's final regulations on its safe harbor regulation under which employer programs for the purchase of annuity contracts or custodial accounts funded solely through salary reduction agreements are not treated as employee pension benefit plans for purposes of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

The IRS's final regulations are generally effective January 1, 2009, although deferred effective dates apply to certain church plans and 403(b) plans maintained pursuant to a collective bargaining agreement in effect on July 26, 2007.

I. Statutory Background

Section 403(b) of the Code provides an exclusion from an employee's gross income for contributions made by an eligible employer to purchase an annuity contract for the employee's benefit. A 403(b) plan may be funded in one of three ways:

1. Through annuity contracts issued by an insurance company and purchased for the employee by the employer;
2. Through custodial accounts meeting the requirements of Section 401(f)(2) of the Code and invested solely in mutual funds, which are treated as annuity contracts under Section 403(b)(7) of the Code; and
3. In the case of a church employer, through retirement income accounts.

To qualify for the exclusion from gross income provided by Section 403(b) of the Code, contributions under the 403(b) plan must be nonforfeitable, meet certain nondiscrimination requirements and be limited in amount.

II. 403(b) vs. 401(k)

While the effect of various amendments made to Section 403(b) of the Code in the past 40 years has been to diminish the distinctions between 403(b) plans and other tax-favored employer-provided retirement plans (such as 401(k) plans and 457(b) plans for state and local government entities), the following significant differences continue to exist:

1. 403(b) plans are limited to certain employers and employees, i.e., employees of a public school, employees of an organization exempt from tax under Section 501(c)(3) of the Code, and certain ministers.
2. 403(b) plans may only be funded with an annuity contract, a custodial account holding only mutual fund shares, or a church retirement income account.
3. The coverage and nondiscrimination rules applicable to elective contributions under 401(k) plans do not apply to 403(b) plans. Instead, there is a universal availability requirement for elective deferrals.
4. The consequences of failing to satisfy many of the Section 403(b) rules differ, and frequently are less severe, than their qualified plan counterparts.
5. The Code Section 415 plan aggregation rules apply differently to 403(b) plans.
6. Catch-up elective deferrals unique to 403(b) plans are not available under the other types of plans that permit employee elective contributions.
7. Employers may make nonelective contributions for former employees for up to five taxable years after termination of employment.

III. Plan Document Requirement

A major change effected by the final (and proposed) regulations, and consistent with the trend toward making 403(b) plans and qualified plans uniform, is the new requirement that a 403(b) plan be maintained pursuant to a written defined contribution plan which, in both form and operation, satisfies the Section 403(b) regulations. The plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, and the time and form under which distributions will be made. The plan may incorporate by reference other documents, such as the insurance policy or custodial agreement, which, as a result of the reference, become part of the plan. In the event of any conflict between the plan and documents incorporated by reference, the plan governs. The plan document may allocate responsibility for performing administrative functions and must identify who is responsible for complying with those Code requirements, such as loans and hardship withdrawals, that apply on an aggregated basis to all contracts issued to a participant. The IRS has stated that it expects to publish guidance that includes model plan provisions that may be used by public school employers to satisfy the written plan requirement.

Responding to concerns that the adoption of a written plan document would jeopardize the exclusion from ERISA coverage of salary reduction-only plans under the Department of Labor's safe harbor for Section 403(b) programs, Field Assistance Bulletin 2007-2 addresses the interaction of ERISA and the final IRS regulations. Specifically, the Field Assistance Bulletin provides guidance (to the Employee Benefits Security Administration's national and regional offices) on the extent to which compliance with the IRS regulations would cause employers to exceed the limitations on employer involvement permitted under the Department of Labor's safe harbor.

According to the Department, the following activities by an employer would not cause its tax sheltered annuity program to be excluded from the safe harbor:

- conducting administrative reviews of the program's structure and operation for tax compliance defects;
- discrimination testing and compliance with maximum contribution limitations under the IRS regulations;
- fashioning and proposing corrections of operational failures;
- developing improvements to the program's administrative processes to avoid the recurrence of tax defects;
- obtaining the cooperation of independent entities involved in the program to correct tax defects;
- keeping records of its activities;
- terminating the program in accordance with the IRS regulations;
- certifying to an annuity provider facts within the employer's knowledge, such as employee addresses, service records and compensation levels; or
- limiting the funding media or products available to employees, or the annuity providers that may approach an employee, to a number designed to afford employees a reasonable choice of investments.

The Field Assistance Bulletin confirms, however, that an employer could not remain within the safe harbor if it had responsibility to make, or in fact made, discretionary determinations in administering the program, such as authorizing plan-to-plan transfers, processing distributions, satisfying joint and survivor annuity requirements, or making determinations with respect to hardship distributions, qualified domestic relations orders or eligibility for, or enforcement of, loans.

The Field Assistance Bulletin concludes that tax exempt employers will be able to comply with the new IRS 403(b) regulations while remaining within the Department of Labor's safe harbor, although the question of whether any particular employer has established or maintains an ERISA plan as a result of complying with the IRS's 403(b) regulations will continue to be determined on case-by-case basis.

IV. Fiduciary Issues under ERISA

- A. Are You A Fiduciary? ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it. Regardless of whether he has knowledge of his status, an ERISA fiduciary must (1) act for the exclusive purpose of providing retirement benefits to plan participants, (2) fulfill a duty of loyalty to the participants, (3) act prudently, and (4) avoid conflicts of interest and acts of self-dealing known as prohibited transactions.

The definition of a fiduciary includes any person who exercises any authority or control respecting the management or disposition of plan assets. Assuming that an investment professional lacks such control, he could also be a fiduciary to the extent that he renders advice for a fee or other direct or indirect compensation, with respect to any monies or other properties of the plan, or has any authority or responsibility to do so. In other words, if you receive compensation for which you have the responsibility to provide investment advice or for which you actually provide investment advice, you will be a fiduciary.

- B. ERISA Fiduciary Standards Are The "Highest Known To The Law"

ERISA is well-known for imposing numerous fiduciary duties on the employer and any other fiduciaries of a plan. Specifically, plan fiduciaries are subject to ERISA's "prudent man standard of care," which in turn is comprised of the following five duties:¹

1. Duty of Loyalty. A fiduciary must discharge his duties solely in the interest of plan participants. Thus, the fiduciary must avoid conflicts of interest when making any fiduciary decisions.
2. Exclusive Purpose Rule. A fiduciary must discharge his duties for the exclusive purpose of providing benefits or defraying reasonable expenses only. The plan must not pay more than reasonable compensation for services rendered to the plan.
3. Duty of Care. A fiduciary must discharge his duties 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." This standard of care is also known as the "prudent expert" standard, since fiduciaries are expected to perform their duties with substantive expertise.
4. Duty to Diversify. A fiduciary must diversify the plan's investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

¹ Section 404 of ERISA.

5. Duty of Obedience. A fiduciary must discharge his duties in accordance with the documents and instruments governing the plan insofar as they are consistent with ERISA.

These fiduciary standards are often referred to as the “highest known to the law.”² Employers and individual fiduciaries are generally subject to personal liability for any harm or loss sustained by the plan or its participants as a result of a breach of these duties.³

V. **Best Practices Arising from 401(k) Fee and Other ERISA Litigation.** In light of 401(k) fee litigation and similar class actions, employers are beginning to adopt best practices that involve more aggressively negotiating and monitoring service provider fees. Employers have taken proactive steps to adopt the following standards which recognize that fiduciaries are judged not on the results they achieve but on the processes they follow and that such processes evolve over time. Financial advisers and broker-dealers should be aware of these best practices and prepared to assist in their implementation.

A. Identifying Fees. Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses which include the actual expenditure of hard dollars, as well as indirect fees. Although the recently finalized regulations under section 408(b)(2) of ERISA allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar amount, even if it is an estimate. Under the new regulation, service providers will be automatically obligated to make fee disclosures to plan sponsors. The new rules are effective July 16, 2001.

1. Services. The services to which fees relate may include the following:

- (a) Trustee services, (b) recordkeeping, (c) administration, (d) investment advisory, (e) investment management, (f) and brokerage.

2. Types of Indirect Fees. There are at least eight kinds of indirect 401(k) plan fees and expenses of which plan fiduciaries should be aware. These include: (a) SEC Rule 28(e) soft dollars, (b) sub-transfer agent fees, (c) 12b-1 fees, (d) variable annuity wrap fees, (e) investment management fees, (f) sales charges, (g) revenue sharing arrangements, and (h) float. So-called “R funds” are mutual funds specifically designed as pension plan investments and often carry one or more of the above-referenced indirect fees.

B. Comparing Investment Management Fees or Expense Ratios Against Benchmarks.

1. Duty to Evaluate Services. Plan sponsors should engage in an objective process that elicits the information necessary to assess the qualifications of

² Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

³ Section 409 of ERISA.

service and investment providers, the quality of the services offered and the reasonableness of the fees charged in light of the services provided. A provider should never be selected simply because it is the cheapest.

2. Objectives of Benchmarking. In meeting their duty to evaluate the services being provided to a plan, plan sponsors will attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate it is delivering above-average investment performance for the plan participants. Benchmarking services can help employers meet their obligations under ERISA with respect to plan fees in the following ways:
 - a. Assist the employer in its efforts to identify and calculate all plan fees, including any “hidden” indirect compensation paid by the plan’s investments (or investment providers).
 - b. Equip the employer with the ability to use benchmarking services as part of a prudent review process to evaluate and monitor the plan’s services and fees on an ongoing basis.
 - c. Provide the employer with the competitive pricing information that a prudent expert might have, to help assess the reasonableness of the plan’s current service arrangement.

3. Guidelines for Selecting Benchmarking Services. Benchmarking services are offered in many forms. Financial advisers should inform their plan sponsor clients that the decision to engage a benchmarking service provider is itself subject to the same fiduciary standards under ERISA which would apply to selecting service providers for the plan generally. In addition, financial advisers who work with plan sponsors should encourage them to make the following inquiries with respect to any prospective provider of benchmarking services:
 - a. What are the qualifications and credentials of the provider? How long and to how many clients has the provider been offering benchmarking services?
 - b. Does the provider offer benchmarking analyses for all of the plan’s investment and administrative service fees? To what extent are benchmarking analyses provided separately for each individual fee (as opposed to total fees)?
 - c. Will the provider be able to identify all indirect compensation paid to the plan’s service providers from the plan’s investments and investment providers? Does the provider consider all indirect compensation paid with respect to the benchmark group of plans?

- d. How reliable is the provider's data for the benchmark group of plans? Is data obtained directly from the various plans' recordkeepers? Does the data gathering method used by the provider prevent inaccurate data submission? Is stale and outdated data disregarded?
 - e. What is the size and profile of the plans included in the benchmark group? How many plans are included in the benchmark group? Can the benchmark group be customized?
 - f. Does the provider offer any benchmarking analyses with respect to the quality of the investment and administrative services provided to the plan?
 - g. In order to make a direct comparison, the actual fees of the various plans are often converted into a per-participant fee or asset-based fee. Does the provider use both per-participant fees and asset-based fees as baselines for its comparisons? If not, why?
 - h. After the benchmarking analyses are completed, what type of consulting services and support will be available to the plan fiduciary in interpreting such analyses?
- C. Continuous Monitoring. Continuous monitoring will become a best practice standard. In addition to a broad range of qualitative and quantitative questions about the investment managers or mutual fund, plan sponsors should ask whether the fees are reasonable with respect to investment performance and related services plan participants are receiving.
- D. Documenting Reviews of Investment Vehicles and Fees. Plan sponsors will document their periodic reviews of investment vehicles, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings. The documentation should demonstrate a thoughtful process addressing key questions or discussions, and decisions made. When selecting a new provider, documentation will show the solicitation of bids from multiple providers.
- E. Hiring Independent Third Party Investment Experts. More plan sponsors will employ independent third parties (e.g., benchmarking services or other consultants) to assist with reviewing the investment performance and fees of investment managers and related service providers. While these vendors typically provide reports and recommendations for analysis by the plan sponsor, there is an inherent conflict of interest when vendors report on proprietary funds or even nonproprietary funds where long-term business relationships and revenue agreements may influence the reports and recommendations.

- F. Conducting Fiduciary Audit. When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outsider fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.
- G. Fiduciary Manual. Use of a fiduciary manual is intended to help fiduciaries reach a better understanding of their responsibilities and to help them comply with ERISA's fiduciary standards. When properly designed, it serves as a reference tool (*i.e.*, a guide for plan fiduciaries when they have questions, such as identifying fiduciaries or determining the scope of their responsibilities and liabilities). A fiduciary manual can also provide compliance tools that fiduciaries may use to monitor investments and service providers.
- H. Disclosure to Participants. As new Department of Labor requirements become mandatory in the near future, plan sponsors and their advisers should be prepared to administer any new participant communication requirements. This includes meaningful fee information which entails participant education as to the various factors which can influence fees.

VI. Practices Relating to Financial Literacy of Plan Participants

In 1995, the U.S. Department of Labor launched a national pension education campaign whose theme was, "Save! Your Retirement Clock is Ticking." As the clock ticks on, the aging U.S. population and the accelerating shift from defined benefit plans to defined contribution plans has made the issue of financial literacy increasingly important in ensuring a secure retirement income. The media, including television, radio, web sites, books, magazines and newspaper columns devote substantial attention to the topic. This has led policy makers to recommend measures that are rapidly evolving into a set of best practices that employers should consider adopting with respect to the administration of 403(b) and other individual account plans that place the responsibility and the risk of investment choice on the employee.

A. Prior Developments in Closing the Information Gap

As early as 1996, the Department of Labor acknowledged the importance of closing a so-called information gap by providing plan participants and beneficiaries with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. To allay plan sponsor fears that such efforts might be interpreted as giving investment advice for which the plan sponsor could be held liable, the Department issued Interpretive Bulletin 96-1 which describes four "safe harbors" representing examples of the type of information, materials and educational services that can be furnished to participants without constituting investment advice. The Department noted that there could be many more such examples of investment education that did not reach the level of investment advice. Subsequently, the Department's so-called SunAmerica ruling (Advisory Opinion 2001-09A) implicitly recognized the need for advice by allowing investment providers to recommend asset allocation models to plan participants if the source of such advice is independent of the provider.

B. Pension Protection Act

In 2006, the U.S. Congress attempted to increase the availability of participant-level investment education and advice by enacting a new prohibited transaction exemption as part of the Pension Protection Act. To qualify for relief, an RIA, broker-dealer or other fiduciary adviser is required to ensure that their fees for providing advice will not vary based on any recommended investment options that are selected by a participant. Alternatively, the investment advice can be provided through the utilization of an objective computer model that is independently certified not to favor investment options that would result in greater fees for the adviser. Unfortunately, the finalization of regulations implementing these provisions has bogged down in political wrangling.

C. Current Proposals Based on Existing Law

In the meantime, efforts to address the employee information gap are underway based on regulations that are already in place. While some employers were initially concerned about the risks that offering advice might entail, the prevailing concern has shifted to the risk of not offering it. In 2007, the ERISA Advisory Council formed a Working Group on Financial Literacy of Plan Participants and the Role of the Employer which has made a series of recommendations for consideration by the Secretary of Labor relating to participant education and advice. Included in the recommendations was a proposal for the Department's creation of a best practices grid that would point to the core financial literacy skills needed for the successful retirement of differently situated employees and a call for the expansion and updating of Interpretive Bulletin 96-1 to accommodate innovation in the financial marketplace.

The primary concern driving the Working Group, as well as attentive employers, is that, despite the ease and convenience of investing over the Internet, employees are not doing well in handling responsibility for their own retirement. The Working Group concluded that an effective educational program for plan participants requires giving them the tools to make sound investment decisions. The witnesses who appeared before the group testified unanimously that participants must have a familiarity with concepts such as the time value of money, asset allocation, risk management and taxation, as well as knowledge about the plan's investment options. It should be noted that general financial investment concepts will be within the safe harbor of Interpretive Bulletin 96-1 and will not be considered as the rendering of investment advice, provided that the information has no direct relationship to the plan's investment alternatives.

Although understanding investment basics is necessary, it is not enough, and participants also need to have a working knowledge of particular plan design features, such as the ramifications of the plan's various distribution options, the calculation of minimum withdrawals, and the rules relating to rollovers. It is to be noted that furnishing information as to the benefits of plan participation and/or increasing plan contributions, the effect of pre-retirement withdrawals on retirement income, the terms of the plan and how the plan operates are all matters that are within the safe harbor of Interpretive Bulletin 96-1.

The modern 403(b) plan demands active participant involvement. However, the Working Group discovered that participants and non-participants alike had no idea how much money will be required to provide an income stream at retirement that will support the participant's current standard of living. Further, participants frequently misunderstood concepts, such as life expectancies, investment returns and other variables that are elements of a proper retirement income replacement calculation. Consequently, it urged the Department to encourage, assist and facilitate the inclusion in plan communications of retirement income replacement calculations and final pay multiples on a per participant basis. As stated in the group's report, "Plan communications should encourage participants to have a numerical goal, whether as a result of a sophisticated or elementary formula, and repeat that message. At the very least, participants should be able to determine and have access to an estimated account balance necessary for retirement." Retirement calculators are not investment advice under Interpretive Bulletin 96-1; the Working Group's recommendations would extend this treatment to such matters as mandatory 20% tax withholding, the 10% penalty tax on early withdrawal, and calculations of guaranteed income for life.

D. Delivery of Investment Education

The Working Group found that third party education via the Internet is not being widely used. The reason for this is simple; employees want one-on-one help from a person they can trust. Generally speaking, they do not have the confidence to implement advice provided to them via on-line tools. Regarding the medium for delivering financial literacy training, all of the Working Group's witnesses agreed that face to face financial counseling works best. As to the timing of the message, it was agreed that several meetings and several counseling sessions over a lifetime work best for the purpose of modifying participant behavior and learning financial topics. Mandatory one-to-one counseling may be appropriate before certain events, such as retirement, making a lump sum withdrawal or electing the purchase of an annuity with plan assets.

In recognition of the fact that successful programs are continuous, many plan sponsors have adopted a comprehensive educational regimen that uses a variety of techniques, such as posters, voice messaging, email, seminars, individual counseling, asset allocation models and tools, and reference material on the company's intranet site. Because cost is likely to be an inhibiting factor, a standardized set of counseling and instructional materials may be developed to assist employee decision making.

The available literature indicates that employee response to workplace financial education programs is generally favorable. Some employers have reported that the reaction to pre-retirement planning seminars has been that the seminar was one of the best benefits offered. Employees frequently comment that the employer should have provided the program much earlier. Studies have found that employees who attended training workshops subsequently increased their participation rate in 401(k) or 403(b) plans. While other strategies, such as automatic enrollment, might produce a similar result, studies have also shown that such financial education is effective in eliminating bad financial habits. This is critical because, in the end, training and communication must pave the way to action that leads to retirement income adequacy.

E. Beneficial Effects of Financial Education Programs

Employers should recognize that they are primarily responsible for helping employees transition from work to retirement. Financial education programs are one means of furnishing this assistance, and because they increase the efficacy of retirement savings, as well the rate of plan participation, will be added to the list of plan sponsor best practices. From a plan sponsor's perspective, these programs have the added beneficial effect of reducing unwise investment decisions by employees that could ultimately be the basis of a legal action because of the feeling that the company had not adequately vetted investment alternatives or had somehow mishandled the retirement plan. Financial advisers and investment providers may be called on to assist employers in designing and/or implementing an appropriate program.