An Analysis of Fiduciary Rules Applicable to 403(b) Plans, the Sponsors and Their Officers

With the issuance of Treasury Regulations governing 403(b) plans that become effective January 1, 2009, and the expansion of the reporting obligations for such plans beginning in 2009, there is heightened governmental interest in these plans. As a result, those responsible for the operation of a 403(b) plan are well advised to be aware of all the rules affecting their plan.

As a general proposition, private-sector 403(b) plans are governed by the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended, including the fiduciary and prohibited transaction rules in that statute. While it is commonly understood that all 403(b) plans are subject to the requirements of the Internal Revenue Code ("Code"), there is a misconception that private sector (i.e., nongovernment) 403(b) plans are exempt from ERISA. The purpose of this white paper is to explain that private sector 403(b) plan sponsors and fiduciaries are subject to ERISA's fiduciary rules and to describe some of the most important legal duties of those fiduciaries.[1]

There are three exceptions to the general rule that 403(b) plans are governed by ERISA. The exceptions are: (1) government plans; (2) plans sponsored by churches; and (3) plans to which the employer makes no contributions or over which the employer has limited involvement (e.g., where the employer does not select the service provider). All three of these categories of 403(b)s are exempt from ERISA.[2] However, a 403(b) plan sponsored by a tax-exempt entity, where the employer makes contributions on behalf of the employees and/or controls the plan, is governed by ERISA. Examples of an employer-controlled plan would include plans that have employer contributions or where a tax-exempt employer holds in its name the plan's funding instruments. As a result, most 403(b) plans sponsored by hospitals, private schools and universities, research institutes and other tax-exempt organizations are subject to ERISA's fiduciary provisions.

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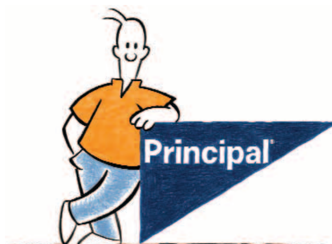

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We refer to these plans as "403(b) retirement plans" or as "private sector 403(b) plans" to distinguish them from those arrangements that are exempt from ERISA's rules.

What does this mean for those responsible for managing 403(b) retirement plans? Among other things, it means that, if they are unaware of ERISA's application, they do not know their legal responsibilities for administering the plan or for managing its assets. It means they are unaware that they are fiduciaries under ERISA and must operate the plan in accordance with its requirements. It means they are largely unaware of the obligation to act prudently in the selection and monitoring of investment options and services to act solely in the interests of the participants for the purpose of providing retirement benefits and to follow the terms of the plan document (an obligation with new teeth in light of the 403(b) Treasury Regulations). It means they are, in all likelihood, ignoring fundamental steps they must take to comply with the law.

ExecutiveSummary

ERISA applies to "employee pension benefit plans." These are plans established by an employer to provide retirement benefits to employees. Tax sheltered annuity or custodial plans established under Code section 403(b) are employee pension benefit plans and are thus governed by ERISA, unless they are specifically exempted. The exempted plans are limited to governmental plans, church plans and plans with very limited employer involvement. Examples of limited employer involvement include plans with no employer contributions, along with plans that do not select or limit employees' access to 403(b) fund managers.

Every other 403(b) plan is governed by ERISA. This means that the officials of the employer who administer the plan and select the investment options are "fiduciaries" under ERISA and are required to fulfill their duties at a level of care prescribed by ERISA. These include the requirement to act in the best interests of the participants for the exclusive purpose of providing retirement benefits and to fulfill those duties under a prudent man standard. Failure to properly fulfill these duties imposes personal liability on the fiduciary. If a fiduciary does not have the expertise to handle certain aspects of his or her responsibilities, the fiduciary may—indeed, may be required to—engage experts or others to assist in the process. The fiduciary must be conscious of the cost of the services and the relative value of those services, but may look to an advisor or service provider for, among other things, assistance in gathering and analyzing data, help in communicating with the participants, and advice and services regarding plan operations or investment options. While the fiduciary cannot rely blindly on the assistance of others, in some cases the use of service providers may be the most efficient way for fiduciaries to meet their obligations.

Plans subject to ERISA

Under the Internal Revenue Code, a Section 403(b) plan is a deferred compensation program for providing retirement benefits to employees of public schools and organizations that are tax exempt under section 501(c)(3) of the Code.[3] Under ERISA, an "employee pension benefit plan" is defined as: "any plan, fund or program...established or maintained by an employer...to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program—(i) provides retirement income to employees..."[4]

Combining those two definitions, unless there is an applicable exemption under ERISA, 403(b) plans are "employee pension benefit plans" and are thus subject to the requirements of ERISA, which means they must comply with certain reporting, disclosure and fiduciary requirements.[5]

A more detailed discussion of some of the fiduciary duties applicable to plans under ERISA is set forth in the next sections of this white paper.

Unless there is an applicable exemption under ERISA, 403(b) plans are "employee pension benefit plans" and are thus subject to the requirements of ERISA.

Exempt Plans

As noted, not every 403(b) plan is subject to ERISA. There are three exceptions.

Section 4(b) of ERISA specifically exempts "governmental plans" and "church plans." Thus, 403(b) plans established for employees of a public school or public school district or a public college or university are exempt from coverage under ERISA as "governmental plans," and plans established by a 501(c)(3) organization operating as a church would likewise be exempt, unless the church elected to be covered by ERISA. Absent some other form of exemption, however, 403(b) plans established by other tax-exempt entities are governed by ERISA.

The third exception is found in Department of Labor (DOL) regulations under ERISA. These regulations provide guidance on the application of the term "employee pension benefit plan." Under these regulations, the DOL indicates that, in certain circumstances, a 403(b) arrangement may not be considered to be "established or maintained" by an employer.[6]

Specifically, a 403(b) tax sheltered annuity or custodial account will not be treated as established or maintained by an employer if (i) employee participation is voluntary, (ii) only the employees can enforce their rights

under the plan, and (iii) employer involvement is limited.[7] An employer may, however, take various actions without having the plan be considered "established or maintained" by the employer, such as assembling information for participants, holding group annuity contracts in its name, acting as a representative of its employees in enforcing rights under the group annuity contract, administering the terms of salary reduction agreements, keeping records of its activities in so doing and limiting (to a degree) the number of service providers who may solicit salary deferrals from employees. On the other hand, the exemption would not apply if the employer were to select the 403(b) service provider,[8] make employer contributions to the plan[9] or have the responsibility for or make discretionary determinations (some of which are mandated by the 403(b) Treasury Regulations), such as authorizing plan-to-plan transfers, processing distributions, satisfying applicable qualified joint and survivor annuity requirements, and making determinations regarding hardship distributions, qualified domestic relations orders (QDROs), and eligibility for or enforcement of loans.[10] Thus, for example, if the tax-exempt employer made any contributions of its own funds, the 403(b) plan would automatically be fully and completely subject to ERISA.[11]

Absent one of these exemptions—that is, governmental plan, church plan or limited employer involvement—a 403(b) plan is subject to ERISA. This means that the various requirements of ERISA, especially the requirements related to fiduciary responsibility, will apply. Employers may find that, if examined by the DOL, the employer involvement exemptions may be difficult to meet.

Implications of being subject to ERISA

Officials responsible for a 403(b) plan are often unaware that their plan is governed by ERISA. Others often erroneously believe they fall into one of the exemptions already mentioned. As a result, these officials may not be aware that they are fiduciaries and have specific duties for the administration and investment options offered by the plan.

Under ERISA, a fiduciary is any person who has discretionary authority or control respecting management of the plan, who exercises any authority or control respecting management or disposition of assets of the plan, or who has discretionary authority or responsibility in administering the plan.[12]

ERISA's definition has been described as a "functional" one in that it defines a fiduciary by what the person does, though the definition also includes fiduciaries by reason of their status with respect to the plan. A trustee is always a fiduciary under ERISA. Similarly, the plan "administrator" (as defined in ERISA Section 3(16)(A)) is a fiduciary because it is named as such in the plan document. (Typically, the plan administrator would be the employer itself or the officers or plan committee members who make decisions about the plan.) But the definition also extends to, for example, members of the plan sponsor's board of directors who appoint the trustee and plan administrator, because they are exercising discretion over plan management through the selection of that fiduciary. In addition, officials of the plan sponsor who actually select the annuity service provider or select the specific investment option to be offered to participants are fiduciaries, because they are exercising control over the management of the plan's assets (even though they may not be named as a fiduciary in the plan document).

A fiduciary is any person who has discretionary authority or control respecting management of the plan, disposition of assets of the plan, or responsibility in administering the plan.

If someone is a fiduciary of a plan under ERISA—whether named as such or not—but fails to recognize that fact, what are the consequences? If that person happens to do a very good job—essentially, by accident—perhaps none, he or she is running an enormous risk. ERISA imposes personal liability on fiduciaries for failing to properly fulfill their duties. And ERISA imposes specific duties on fiduciaries (as discussed in the next section). Thus, an individual's failure to understand that he or she is a fiduciary, what the duties are and what steps need to be taken to fulfill them could become a trap for the unwary.

ERISA fiduciary duties

One purpose of this white paper is to provide an introduction to some of the most important ERISA duties of 403(b) retirement plan fiduciaries. The following discussion serves that purpose, but it is not an exhaustive treatment of the subject.

Section 404(a) of ERISA describes the primary duties of fiduciaries as follows:

"a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan..."

This means that officials of a plan sponsor must act without regard to their own personal interests or the interests of their employer, but solely for the benefit of the participants for the purpose of accumulating assets for retirement.

As a part of this duty, the fiduciaries must be attentive to the expenses charged for services and the expenses charged in connection with plan investment options. This latter issue is discussed in more detail later in this white paper.

Section 404(a) goes on to provide that the fiduciaries must act:

"(B) 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..."

Officials of tax-exempt entities may be familiar with the "prudent man" rule, but the ERISA version of the rule adds an element not found in the traditional standard. It adds the requirement that the fiduciary act with the care and skill of a person "familiar with" providing retirement benefits. This is sometimes referred to as the "prudent expert" rule, in that it requires both acting with care and having a knowledge level and a skill base.

Section 404(a) also requires the fiduciaries to act:

"(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this [ERISA]."

The latter requirement means that the plan must be documented (that is, in writing) and that the fiduciary must be familiar with the terms of the plan and follow those terms, except where doing so would be imprudent (that is, if it would require the fiduciary to breach his or her legal duties to the participants).[13]

A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries with care, skill, prudence, and diligence.

Investment Options

As stated earlier, the purpose of a 403(b) plan is to enable participants to prudently accumulate funds for their retirement. The job of the fiduciaries is to help them do so. As a part of that job, under ERISA the fiduciaries have a duty to prudently select, monitor, remove and replace the plan's investment options.[14]

The fundamental investment options concept underlying ERISA is the modern portfolio theory.[15] In the context of a participant-directed plan like a 403(b) plan, where the participants are able to select among investment options offered through a group annuity contract or custodial arrangement, this means that the fiduciaries have the responsibility to (i) determine the categories of investment options (or asset classes) to be offered by the plan, so that participants will have an opportunity to create diversified portfolios that balance return and risk, and then to (ii) select the specific investment options within those classes to be offered to the participants.

Under ERISA the fiduciaries have a duty to prudently select, monitor, remove and replace the plan's investment options.

The fiduciaries' job is not done at this point. They must also make sure that the investment options continue to be appropriate as time goes by.[16] This requires the fiduciaries to periodically monitor them to ensure that they continue to be suitable for the participants. If they determine, through monitoring, that an investment option is no longer one that should be made available for new contributions and for prior contributions directed to a particular investment option in the past, the fiduciaries have an obligation to act; that is, they need to remove and replace the investment options.

These are not simple tasks. They require, in the words of the DOL, that the fiduciary give: "appropriate consideration to those facts and circumstances that...the fiduciary knows or should know are relevant to the particular investment options or investment course of action involved including the role the investment options or investment course of action plays in...the plans' investment portfolio..."[17]

In effect, the fiduciary must act with investment sophistication, inasmuch as he or she must take into account information that a fiduciary *should* know is relevant for investing plan assets. In selecting and monitoring each investment option, the fiduciary must consider whether it satisfies the prevailing standards for selecting investment options for retirement purposes; whether the investment options, in the aggregate, cover a broad range of asset classes; and whether the investment options are appropriate vehicles for the employees covered by the plan. In other words, will the investment option lineup enable the participants to assemble portfolios of prudently selected investment options that

properly balance their risk and return needs? For a workforce with little investment experience, this may mean offering a limited array of investment options, including managed options such as lifestyle or lifecycle investment options. On the other hand, for a knowledgeable group of employees, it may mean that a large, varied and complex investment option lineup can be offered.

Within this broad framework, determining exactly what information is relevant—such as investment style, past performance, expense ratios, volatility, competency and ethics of the fund managers, etc.—requires some level of investment expertise. If the fiduciaries do not themselves possess this expertise, it is appropriate for them to turn to others to obtain the information and help in interpreting that data. One court acknowledged that the law "does not impose a rule that fiduciaries be 'experts' on all types of investments they make."[18] Both the DOL and the courts have said that:

"Where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors."[19]

To fulfill these requirements, fiduciaries can look to knowledgeable plan service providers that offer investment options and services designed to help sponsors satisfy their fiduciary obligations. Although fiduciaries may not rely blindly on the advice of others,[20] it is certainly permissible—even required—if the fiduciaries lack the expertise or access to necessary information to seek the help of knowledgeable persons.

ERISA provides two "safe harbors" for fiduciaries in connection with the allocation of retirement funds to participant accounts. The first relates to the selection of a default investment option in which the retirement funds will be invested if participants do not elect to allocate them in the account. The fiduciaries are protected from liability for losses on the default investment, so long as appropriate notice is given to the participants and the default option is a "qualified default investment alternative" (QDIA). QDIAs include risk-based lifestyle funds, target date lifecycle funds and managed accounts.[21]

ERISA provides two "safe harbors" for fiduciaries

1

Fiduciaries are protected from liability for losses on the default investment, so long as appropriate notice is given to the participants and the default option is a "qualified default investment alternative."

2

Fiduciaries are not responsible for participant decisions respecting the allocation of the retirement funds in the accounts, so long as the appropriate information is provided to the participants.

The second "safe harbor" is under ERISA Section 404(c), which provides that plan fiduciaries are not responsible for participant decisions respecting the allocation of the retirement funds in the accounts, so long as the appropriate information is provided to the participants. Under the DOL Regulations as in effect at the date of this white paper, there are approximately 20 items of information that must be provided to participants in order for this defense to fiduciary liability to be available.[22]

Expenses

A key obligation of fiduciaries is to act for the exclusive purpose of providing retirement benefits for the participants and *"defraying reasonable expenses of administering the plan."*[23] Implied in this requirement is the obligation of the fiduciaries to know the total expenses being charged by service providers for recordkeeping, administrative services, document preparation and investment management. All of these affect the investment return to the participants and, therefore, affect the growth of their retirement benefits.

But the obligation goes beyond merely knowing what is being charged. ERISA requires that the fiduciaries evaluate the reasonableness of the expense, as well as the quality of the services (or investment options) and their value to the plan and the participants. It means that the fiduciaries must understand what each service provider is being paid, even if the payment is "indirect" (for example, is paid by one service provider to another or by one—rather than being paid directly by the plan) and does not ostensibly increase the plan costs. Why? There are two reasons. First, under ERISA, it is a prohibited transaction—and thus a breach of fiduciary duty—for a fiduciary to permit a service provider to receive unreasonable compensation. In that case, the fiduciary would be required to restore any unreasonable payments to the plan. Second, at a more practical level, if a plan is overpaying for the services it is receiving, the participants' retirement benefits are being reduced because of the fiduciary's lack of attentiveness. Because of this impact on benefits, the payment of expenses is a primary focus of interest in DOL investigations of retirement plans. Further, the DOL is in the process of issuing guidance to require that plan service providers make full disclosure, in advance, of all services, fees they will receive and potential conflicts of interest they may have before a service contract is entered into.[24] In addition, for plans of more than 100 participants, the disclosure requirements in Schedule C to the Form 5500 (which will be applicable to 403(b) plans for plan years beginning in 2009) have been greatly expanded to include information regarding the fees received by service providers. Both of these developments should materially assist fiduciaries in obtaining full disclosure of all direct and indirect payments received by their service providers, including payments from any other entities or persons related to their plan or its other service providers, for both initial selection and subsequent monitoring purposes. Without this knowledge, fiduciaries are at risk of a breach of duty.

The DOL is in the process of issuing guidance to require that plan service providers make full disclosure, in advance, of all services, fees they will receive and potential conflicts of interest they may have before a service contract is entered into.

Again, fiduciaries may look to others for help in determining the amount and reasonableness of the costs of plan administration and investment options, since a service provider, advisor or consultant often has the information and the experience to ask and answer the right questions.

Reliance on Plan Service Providers

Under ERISA, it is appropriate for fiduciaries to look to third parties, including service providers and advisors, for the information or services needed to fulfill their duties. It is usually not appropriate, though, for the fiduciaries to look to the service provider to actually handle the fiduciaries' responsibilities. (However, in some cases, service providers will agree to serve as fiduciaries, typically for a limited and specific purpose.) In addition, some service providers may agree to serve as fiduciaries (or co-fiduciaries) for one or more of ERISA's investment requirements.

Conclusion

Officials of ERISA-governed 403(b) plans must understand that they are fiduciaries under ERISA and, as such, are required to perform specific duties according to the standard of a knowledgeable investor and a prudent person. Key responsibilities include: the selection and monitoring of the plan investment options, and knowledge about, and evaluation of, the direct and indirect expenses of the plan and its investment options and services. While fiduciaries can seek help for those duties, they cannot avoid them; and if they fail to perform those duties, they can be subject to personal liability for losses the participants suffer.

So, when it comes to selecting a competent service provider, what can the fiduciaries look to a non-fiduciary service provider to do?

A NON-FIDUCIARY PROVIDER CAN:

1. Assemble a broad lineup of investment options that satisfy generally accepted investment selection criteria.
2. Provide managed investment options to offer to participants (for example, lifestyle or lifecycle investment options).
3. Provide information to assist fiduciaries in monitoring the performance of the investment options against commonly accepted benchmarks.
4. Provide materials to educate fiduciaries on their responsibilities and services to assist in the performance of their duties.
5. Provide assistance with federal government-required tests and reports, including monitoring contribution limits and preparing Form 5500 annual reports.
6. Provide services, such as participant enrollment and investment education, to help employees with their investment decisions.
7. Communicate with fiduciaries and participants regarding changes in investment information and services.
8. Provide recordkeeping services, including internet and call center services for participant investment changes, other transactions (e.g., loans) and account information.

[1] The fiduciary and other rules imposed by ERISA are found in Title I of the law. The tax rules applicable to 403(b) plans are found in Title II of ERISA, which are codified in the Internal Revenue Code. References in this white paper to "ERISA" are to Title I, while references to tax rules are to the Code.

[2] These plans may be subject to fiduciary rules under state law, but that is beyond the scope of, and these exempt plans are not discussed in detail, in this white paper.

[3] Code section 403(b)(1)(A).

[4] ERISA Section 3(2)(A).

[5] This white paper does not address the reporting, disclosure or plan document requirements for 403(b) plans. However, plan documents will need to be updated before January 1, 2009, to comply with new Treasury Regulations. Further, the reporting requirements for these plans on Form 5500 is being greatly expanded for plan years beginning after that date.

[6] DOL Regulation Section 2510.3-2(f).

[7] DOL Regulation Section 2510.3-2(f) provides the following requirements in order for the exemption to apply:
(1) participation is completely voluntary for employees;
(2) all rights under the annuity contract or custodial account are enforceable solely by the employee, by a beneficiary of such employee, or by an authorized representative of such employee or beneficiary;
(3) the sole involvement of the employer, other than pursuant to paragraph (f)(2) above, is limited to any of the following:
(i) permitting annuity contractors (which term shall include any agent or broker who offers annuity contracts or who makes available custodial accounts within the meaning of section 403(b)(7) of the Code) to publicize their products to employees,
(ii) requesting information concerning proposed funding media, products or annuity contractors;
(iii) summarizing or otherwise compiling the information provided with respect to proposed funding media or products which are made available, or the annuity contractors whose services are provided, in order to facilitate review and analysis by the employees;
(iv) collecting annuity or custodial account consideration as required by salary reduction agreements or by agreements to forego salary increases, remitting such considerations to annuity contractors and maintaining records of such considerations;
(v) holding in the employer's name one or more group annuity contracts covering its employees;
(vi) before February 7, 1978, to have limited the funding media or products available to employees, or the annuity contractors who could approach employees, to those which, in the judgment of the employer, afforded employees appropriate investment opportunities; or
(vii) after February 6, 1978, limiting the funding media products available to employees, or the annuity contractors who may approach employees, to a number and selection which is designed to afford employees a reasonable choice in light of all relevant circumstances.
Relevant circumstances may include, but would not necessarily be limited to, the following types of factors:
(A) the number of employees affected,
(B) the number of contractors who have indicated interest in approaching employees,
(C) the variety of available products,
(D) the terms of the available arrangements,
(E) the administrative burdens and costs to the employer, and
(F) the possible interference with employee performance resulting from the direct solicitation by contractors; and
(4) the employer receives no direct or indirect consideration or compensation in cash or otherwise other than reasonable compensation to cover expenses properly and actually incurred by such employer in the performance of the employer's duties pursuant to the salary reduction agreements or agreements to forego salary increases described in this paragraph (f) above.

[8] In the Preamble to DOL Regulation Section 2510.3-2(f), the DOL indicates that in meeting the requirement that employees be afforded a reasonable choice among service providers under the relevant circumstances, "It may be that in some circumstances it would be reasonable for the employer to limit to one the number of contractors who may deal with employees under the section 403(b) program." The DOL goes on to state that the issue can only be decided on a case by case basis. In general, if the employer selects a single service provider, it will fall outside the limited involvement exemption unless it could be shown that there were significant administrative reasons why such a limitation were required.

[9] DOL Advisory Opinions 94-30A, 83-23A, and 80-11A.

[10] See DOL Field Assistance Bulletin 2007-02.

[11] We note that the Regulations establish a non-exclusive safe harbor for determining whether a plan is subject to ERISA. See Preamble to DOL Regulation Section 2510.3-2(f).

[12] ERISA Section 3(21)(A). One other category of fiduciary not relevant here is anyone who renders investment advice to a plan for compensation.

[13] Plan documents will need to be reviewed and updated to comply with the 403(b) Treasury Regulations on or before January 1, 2009.

[14] See, e.g., the Preamble to the Final 404(c) Regulation, 57 F.R. 46906, 46924, footnote 27.

[15] Laborers Nat. Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir. 1999); see also, DOL Interpretive Bulletin 96-1 and its Preamble.

[16] See the Preamble to the Final 404(c) Regulation, 57 F.R. 46906.

[17] DOL Regulation Section 2550.404a-1(b)(1). Some officials responsible for 403(b) plans erroneously believe they can simply allow participants to select among a multitude of service providers without consideration to a review or monitoring of the underlying investment option. This would not satisfy the fiduciary's duties.

[18] Harley v. Minnesota Mining and Manufacturing Company, 42 F.Supp.2d 898, 907 (D.Minn 1999).

[19] Liss v. Smith, 991 F.Supp. 278, 297 (S.D.N.Y.1998). See also DOL Regulation Section 2509.95-1(c)(6).

[20] ERISA Section 404(c)(5) and DOL Regulation Section 2550.404c-5. Note that this safe harbor would apply to both appropriately structured annuities and custodial accounts.

[21] See DOL Regulation 2550.404c-1. The DOL has proposed modifications to the information requirements that must be met in order for fiduciaries to obtain 404(c) protection.

[22] Bussian v. RJR Nabisco, Inc., 223 F.2d 286, 300-01(5th Cir. 2000).

[23] ERISA Section 404(a)(1)(A)(ii).

[24] Proposed DOL Regulation Section 408b-2.

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