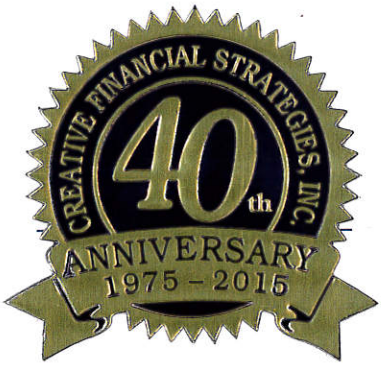

Staying on Course

A fiduciary handbook for retirement plan trustees

Written by Fred Reish, Esq., Bruce Ashton, Esq., and Joe Faucher, Esq. for Drinker Biddle & Reath, LLP

The information in this publication is based on information as November 1, 2012, and does not incorporate any changes or revisions to the law or applicable regulations that may have arisen after that date. The information is general in nature and is not intended to constitute legal advice on any particular matter. Nothing in this material creates an attorney-client or an advisor-client relationship.

FOREWORD

This handbook is written for you, as the owner or manager of a business that sponsors a 401(k) plan. The rules governing 401(k) plans are lengthy and complex. Without quality investments and capable advisors, it would be almost impossible to navigate those rules. Even with that help, the ultimate responsibility – and potential liability – for operating the plans and providing sound investments falls on the shoulders of the business owners and managers.

We have written this handbook with the benefit of years of experience in advising businesses that sponsor plans. Unfortunately, in many of those cases, we represented well-meaning people who inadvertently violated ERISA – the Employee Retirement Income Security Act, which governs the management of retirement plans. Through this handbook, their misfortunes provide valuable examples to you of the pitfalls which should be avoided and of the proper way to manage your company's 401(k) plan.

On a positive note, if your company's retirement plan is properly invested and administered, it provides a valuable benefit for your employees. The retirement plan story should have a happy ending. Our goal at Drinker Biddle & Reath, LLP in writing this book is to help you realize that ending.

I want to thank two ERISA attorneys in my firm, Bruce Ashton and Joe Faucher, who contributed their ideas and examples to this hard work and did much of the writing. The insights in this handbook reflect our combined experience of approximately 100 years of representing companies such as yours. Finally, I would be remiss if I did not thank the people at John Hancock who made the handbook 'come to life' through their hard work in the nuts-and-bolts of editing, formatting and printing the handbook. While their work was behind the scenes, it was invaluable in making this a useful resource for plan sponsors.

I hope our work helps you to better manage your company's 401(k) plan.

Fred Reish
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CHAPTER 1:
REAL PROBLEMS FOR REAL TRUSTEES

1. WHY SHOULD I READ THIS BOOK?

If you are an owner or officer of a business, particularly a closely-held business, and your business sponsors a qualified retirement plan, you should read this book.

The key people at closely-held companies must wear many hats: owner, officer, director, employee, "chief cook and bottle washer." When it comes to their tax-qualified retirement plans, the top people at companies – the decision makers – are ERISA fiduciaries because they make decisions about their plans when they serve as trustees, members of the plan committee, and members of the board of directors. Without an understanding of the responsibilities that go with those roles, fiduciary liability is just a heartbeat away.

"ERISA," the Federal law that regulates retirement plans, stands for the "Employee Retirement Income Security Act." It contains fiduciary laws that require more than common sense and good intentions: They hold you to a high standard. You must exercise the "care, skill, prudence, and diligence" of an experienced fiduciary in fulfilling your duties. A fiduciary must discharge his duties with the skill of a "prudent man" who is familiar with investing for retirement. So, as a fiduciary, you are responsible for what you "should know" about investments – as opposed to what you actually know. [See ERISA §404(a).]

More than one court has said, "A pure heart and an empty head are not enough." This handbook includes examples of how other owners and officers who served as good-hearted trustees and committee members have gotten into trouble, not because they had bad intentions, but because they didn't know the basic rules of fiduciary conduct.

Stop for a moment and think about Monday night football, Saturday afternoon hockey or Sunday afternoon baseball. How can you understand the game? First, you have to know what game is being played. Second, you have to know the rules of the game. Being a plan fiduciary can be compared to being a coach. You don't have to be able to play all the positions. But you have to make sure that you have a capable player in every position, and you have to know the rules. But unlike a sporting event, acting as a fiduciary is no game. If you violate your duties, you can lose your business, you can lose your house, and you can even lose your pension benefits.

However, you are not alone. By working with a knowledgeable advisor (like a financial representative or broker, third party administrator or accountant) and a quality 401(k) provider, your team can put together a winning 401(k) plan.

Violations of the fiduciary duties are called "breaches." As the following examples demonstrate, fiduciary breaches come in many forms – you can be too risky or you can play it too safe, but no matter how you breach, it can cost you.

2. EXAMPLES OF FIDUCIARY BREACHES AND THEIR CONSEQUENCES

Under ERISA, the officers or owners who choose the investments for a plan (such as a 401(k) plan) are fiduciaries. As investment fiduciaries, they are subject to ERISA's rules, including the requirements that they act:

- As knowledgeable and prudent investors
- For the exclusive purpose of providing retirement benefits
- In the best interest of the participants

A. FAILURE TO DIVERSIFY

There is an old saying that you shouldn't put all your eggs in one basket. A fiduciary has to decide how many eggs can go in one investment before it is time to get another basket. Because of the risk of large losses where investments are highly concentrated, ERISA encourages diversification. We have seen more than one plan incur substantial losses when the fiduciaries invested a large chunk of plan assets in a single investment or in a series of similar or related investments.

EXAMPLE: A law firm with several hundred employees sponsored a profit sharing plan. The investments were managed by a committee of senior partners. The firm's business manager periodically recommended investments to the plan committee and his recommended stocks did well. Because of that success, the committee over the years gradually turned more and more authority over to the business manager. It reached a point where the business manager was deciding on investments without consulting with, or even informing, the committee. Unbeknownst to the committee members, the business manager was amassing a large position in a thinly-traded company. At its peak, the

investment amounted to more than 80% of the plan assets. Then, unfortunately for the firm, the investment lost half its value in one day, costing the trust fund (and the participants) over $1,000,000 in losses. The business manager abruptly resigned and disappeared, leaving the committee "holding the bag." The U.S. Department of Labor (DOL) then arrived on the scene, insisting that the employees' accounts be restored – by making good on the losses, plus missed earnings. Since the DOL had a good case for failure to diversify (and for the failure of the committee members to do their fiduciary jobs), the firm settled. Fortunately for the firm's partners, about two-thirds of the losses were covered by a fiduciary liability insurance policy.

B. FAILURE TO GENERATE ADEQUATE RETURNS

Making sure that plan assets are safe from investment losses does not always mean that you have been prudent. For example, investing all of the plan assets in long-term Treasury bonds keeps the plan safe from loss – but that kind of investment may not provide a reasonable return for the participants. In ERISA cases, it isn't enough that an investment doesn't lose money. Rather, the fiduciary must establish an investment process to determine the prudence of the plan's investments, both initially and then on an ongoing basis. For example, do you have an investment policy statement or "IPS," written guidelines describing the investigation, evaluation and selection of the investments you make? Have you followed those guidelines in investing plan assets? The fiduciary who is 'procedurally prudent' generally does not wind up being a guarantor if the investment goes bad. Without 'procedural prudence' – the term used to describe the process of diligently investigating prospective plan investments and documenting the decisions – the fiduciary will have breached his basic duties and be responsible for making up any losses that result.

EXAMPLE: A corporation sets up a profit-sharing plan for its employees. The company is family-owned and the father serves as trustee of the plan. Because of a fear of fiduciary liability if the plan loses money, the father invests the plan in Treasury bills and money market accounts earning an average of 1%. During this same time period, statistics show that professional investment managers were earning an average of 5% per year with a mixture of stocks, bonds,

and cash. The father has exposed himself to potential liability from a lawsuit by participants or the DOL due to a fiduciary breach of failure to invest the funds as a "prudent" investor would have (or, alternatively, for failure to seek professional investment advice). The measure of damages would be the difference between the 1% actual earnings and the 5% "reasonable" earnings. Additionally, the father has exposed the family members on the board of directors to potential liability because it is their job to appoint a properly qualified trustee, to monitor his performance and to remove him if necessary.

In 401(k) plans, if a participant fails to direct the investments in his / her account, the investment fiduciaries – the officers who manage the plan's investments – must prudently invest the money for the participant. Some fiduciaries decide to invest money in "safe" investments, like money market funds. However, like the trustee in the example, they run the risk of breaching their duties by investing too conservatively to provide reasonable retirement benefits for their participants.

C. YOU CAN LOSE YOUR OWN RETIREMENT BENEFITS IF YOU DO NOT FOLLOW FIDUCIARY RULES

Generally speaking, your retirement benefits are protected from your creditors. Typically, the money you put aside for your retirement will be there to benefit you, regardless of any personal financial problems, including, in most cases, bankruptcy. But, if you breach your fiduciary duties and that breach results in a loss of plan assets, your benefits can be taken in order to make good on the loss. [See ERISA §206(d)(4)] More than one fiduciary has learned this lesson the hard way. It pays to know your fiduciary duties and to live up to them.

EXAMPLE: The principal owner of a manufacturing company served as the trustee of the company's profit sharing plan. A business acquaintance offered him the opportunity to invest in several partnerships. Because of the enthusiasm of the acquaintance and his assurances of large gains, the trustee invested several hundred thousand dollars of retirement plan money in the partnerships without seeking professional advice. The partnerships decreased in value over the years until several of the employees complained to the DOL about the losses is their accounts. The DOL investigated, determined that

the trustee had breached his fiduciary duties, and demanded that he personally restore the losses – plus missed earnings – to the plan. Since the trustee did not have sufficient liquid assets, the DOL agreed that he could reduce his personal account balance in the plan by the amount of the losses, and transfer that amount to the accounts of the other employees. After years of contributing to the plan, he lost half of his plan benefits.

D. USING THE PLAN MONEY TO BENEFIT THE COMPANY

ERISA includes a set of restrictions on using plan money to benefit the company or its owners (or other related persons). These are called the "prohibited transaction" rules and they prohibit the use of plan money to benefit persons who are closely related to the plan ("parties in interest"). It doesn't matter if the transaction is reasonable or even if it benefits the plan – it is absolutely prohibited.

Business owners often think that transactions which benefit the plan or the company – and which may even benefit the employees – must be okay, even if the transactions involve related parties. Unfortunately that's not the case. Even if the "prohibited transaction" seemed reasonable when it was entered into, it can result in substantial penalties and personal liability for the trustees and other plan fiduciaries.

EXAMPLE: A manufacturing company was having cash flow difficulties. To get past this problem, the CEO and CFO decided to have the company temporarily borrow from the plan. Since the CEO was the trustee and the CFO was on the plan committee, they quickly transferred the money and executed a promissory note from the company to the plan. To make the loan beneficial to the plan participants, they agreed to pay a rate of interest on the loan higher than the plan was currently earning on its other investments.

The company's financial situation deteriorated to the point where it was liquidated in a Chapter 7 bankruptcy. Both the CEO, as trustee, and the CFO, as a committee member, were fiduciaries to the plan. As fiduciaries, they were both personally liable for the losses resulting from the prohibited transaction. Further, both the IRS and the DOL imposed prohibited transaction penalties on them.

EXAMPLE: In similar situations, company officers have helped their companies' cash flow by holding onto employees' deferrals and using them in their businesses. But the law requires that companies deposit deferrals into the 401(k) plan as soon as possible, usually within a few days after they are withheld. The failure to make timely deposits is both a fiduciary breach and a prohibited transaction, resulting in personal liability and penalties.

3. CONCLUDING THOUGHTS

As these examples show, it is not easy to be a fiduciary. Transactions that appear fair to the plan may be prohibited. "Safe" investments may be too safe. Risky investments, even those that carry the promise of handsome returns, may also be imprudent. The key is procedural prudence. Go through a prudent process to understand and analyze the investments. Work with a good advisor and a leading provider.

Remember: You cannot know if a question is too foolish to ask until you have asked it and received an answer.

CHAPTER 2:
HANDLE YOUR EMPLOYEES' MONEY WISELY – THEY DEPEND ON IT FOR THEIR RETIREMENT

1. IDENTIFYING THE PLAN'S FIDUCIARIES

Q. Who are the fiduciaries of a plan?

A. ERISA defines fiduciaries both by what they do and by their positions. Someone is a fiduciary if he or she:

- Has the authority to make decisions about the management or administration of the plan or its investments. This includes any person or group (such as a trustee or plan committee members) that has been given the authority in the plan to make decisions about investments, service providers, distributions, loans, etc.
- Provides investment advice to the plan for compensation. This category could include investment advisor or financial representatives, who give individualized advice on the plan's investments based on the specific needs of the plan (or of the participants).
- Exercises any control over the plan assets. This category includes fiduciaries who are named in the plan document and it also includes anyone who actually makes decisions about investments. These people are called "functional fiduciaries" since they act as fiduciaries – even if they don't know it. The functional fiduciaries could include officers of a company who decide on the investments for a participant-directed plan, like a 401(k) plan, even if they aren't formally appointed to make those decisions.

Q. How can you know who the fiduciaries are?

A. To begin with, look in the plan document. Every plan must have at least one or more "named fiduciaries." The named fiduciary is the person, or group of people, or a company who is either specifically named as a fiduciary in the plan (for example, the trustee) or who can be identified by a procedure outlined in the plan (for example, how the members of the plan committee are selected).

But you also need to look at whether a person actually makes decisions about the plan administration or about the plan's investments, or in some other way takes control of the assets.

EXAMPLE: Under ERISA, employee deferrals belong to the plan as soon as they can reasonably be segregated from the general assets of the company – usually within a few days after payroll. If the president of a company directs the payroll department not to remit the deferrals to the plan, but instead to keep them to help the company's cash flow, the president has taken control of plan assets. By doing that – even though those plan assets have not been deposited into the plan – the president has become a functional fiduciary. And he has breached his fiduciary duty by using those assets for a purpose other than providing retirement benefits.

2. FIDUCIARY RESPONSIBILITIES

Q. What are my responsibilities as a fiduciary?

A. This is the first question you should ask if you want to minimize the chance of problems. If you don't know what you are responsible for, a legal mistake is just a step away. In order to do your job properly, you must know what the law requires you to do.

A. NAMED FIDUCIARY

First, let's look at the named fiduciaries. Typically, these fiduciaries (such as the trustee and the plan committee members) are selected by the board of directors of the company and can be replaced by the board. In making those appointments, the directors are acting as fiduciaries – the appointment of a fiduciary is a fiduciary act under ERISA. As a result, the selection of the trustee and the committee members must be done prudently, and their experience and qualifications must be considered. The minutes of the board of directors meeting should reflect the discussion of the responsibilities of those positions and the qualifications of the people. Once the fiduciaries have been selected, the board should periodically (at least annually) review their performance and decide whether to make changes.

B. EXPERTISE

Fiduciaries are not required to be experts in every area. They can hire outside advisors, such as attorneys, accountants, administrators, financial representatives or brokers and investment advisor. If fiduciaries act prudently in hiring and monitoring these advisors, they have fulfilled their duties in those areas.

For example, the fiduciaries should consider the qualifications of an administrator in working with a plan of their type and size. Many of the issues for a 2,500-employee 401(k) plan can be quite different than for a 25-employee plan – and vice versa.

Also, a trustee who does not have the experience or credentials to manage retirement investments can meet his responsibilities by selecting and monitoring a prudent range of well-managed mutual funds. This approach is commonly used in 401(k) plans. (The selection of 401(k) plan investment alternatives is discussed in more detail in Chapter 3.)

EXAMPLE: The board of directors of a distributorship company appoints its president as trustee of its profit–sharing plan. While the president is a successful entrepreneur, he has little education or experience in investing retirement money. Instead of hiring a qualified investment manager or selecting prudent mutual funds, he invests plan assets in speculative limited partnerships. In making those investments, the president/trustee does no independent investigation, but relies on representations by the salesman.

In this example, the president/trustee did not adequately investigate the investments, and therefore acted imprudently. As a result, the trust fund incurred large losses and the trustee is personally liable for the losses. The members of the board of directors also face claims of breach of their ERISA fiduciary duty to select a qualified trustee and to monitor his performance.

But what if the president/trustee's imprudent investments had resulted in gains, not losses? Under ERISA, imprudence is not measured by whether or not there was a loss from the investment. Under ERISA, there can be a fiduciary breach even without a loss. If, as a result of fiduciary imprudence, the plan's investments actually gain in value, but do not achieve the amount of gain that could have been earned if the fiduciary had been prudent, the fiduciary could still be liable for the amount of the "under performance" or the "lost" additional gain.

Courts usually compare what the plan actually earned on the errant investment to some other gauge of what the plan would have earned had the transaction not occurred. In analyzing this issue, courts may refer to: (1) the plan's other investments [Dardaganis v. Grace Capital, Inc., 889 F.2d 1237, 1243 (2d Cir. 1989) and Donovan v. Bierwirth, 754 F.2d 1049, 1056, 6 EBC 1033, 1039 (2d Cir. 1985)]; (2) national indexes, such as the Standard & Poor's 500 Index® [Dasler v. E.F. Hutton, Inc., 694 F.Supp. 624, 9 EBC 1862 (D. Minn. 1988)]; and (3) hypothetical portfolios proposed by expert witnesses [GIW Industries v. Trevor, Stewart, Burton & Jacobson, 895 F.2d 729 (11th Cir. 1990)].

C. ESTABLISH INVESTMENT POLICY PROCEDURES

Q. Are the investments designed to meet the plan's objectives?

A. That question presumes that you have determined the objectives of the plan so that you can decide on an appropriate way to accomplish them.

Successful entrepreneurs often accept a high degree of risk in order to make a large gain. Or, to put it another way, they want to hit an investment home run. That is exactly the wrong philosophy for investing employees' retirement assets funds. Preservation of capital is an important consideration. When you are an ERISA fiduciary, you need to be just as concerned about the *return of capital* as the *return on capital*.

D. ALLOCATE RESPONSIBILITIES FOR ADMINISTRATION AND OPERATION OF THE PLAN

Fiduciaries should document the allocation of responsibilities for the operation of the plan. Why take a chance that there is not a clear understanding of who is responsible for what part of the operation of the plan?

In most cases, a plan will use a number of advisors and service providers to help operate the plan. For example, these could include:

- The **financial representative** who helps with selecting the provider for the plan and may assist in enrollment meetings, employee education and answering employee questions about the plan's investments;
- The **plan provider** who provides services like the investments, participant account recordkeeping, the website and services like the 800 number that employees can use to change their investments; and
- The **third party administrator (TPA)** who assists in documenting the plan and the annual reporting to the government.

Generally, these advisors are not fiduciaries since they do not exercise any discretion or control over the plan or its assets.

A fourth type of advisor is an **investment advisor** (such as a registered investment advisor or RIA), who advises on the selection of the investments and who may also advise participants on their investment decisions. The investment advisor is typically a fiduciary to the plan.

It is important for the fiduciaries to understand the role of each type of advisor and provider, the services they will perform and the compensation they will receive, either directly from the company or the plan, or indirectly from others such as the plan's investments. The indirect payments, sometimes called "revenue sharing," are common and include, for example, funds paid by a mutual fund, or the mutual fund manager, to a plan provider and to an advisor. Revenue sharing often helps the plan by reducing the amount a service provider would otherwise charge for its services.

The services and compensation of each advisor and provider should be spelled out in a written agreement or in written disclosures. (Those agreements and disclosures are discussed in more detail in Chapter 5.) The fiduciaries should regularly review the performance of the plan's providers and advisors to make sure that the services are being properly performed, that the costs are reasonable, and that the plan's needs are being met.

3. EXCLUSIVE BENEFIT RULE

This rule requires fiduciaries to act "solely in the interest of the participants and beneficiaries." Fiduciaries cannot have divided loyalties when it comes to the plan.

Q. Can you be both a plan fiduciary and a corporate officer?

A. Yes. You can wear those two hats, but you cannot wear them in the same transaction.

EXAMPLE: The president of a company is offered a real estate investment that promises to return a significant profit. For the benefit of her company's shareholders, she has the company buy into the deal. She also puts up some of her own money and serves as the manager of the project. Finally, in order to invest enough to close the deal, the president, as trustee of the company's retirement plan, has the plan buy a minority interest. She has a conflict of interest given the different hats she wears, and she leaves herself exposed to the claim that she did not act solely in the interest of the participants.

A. AVOIDANCE OF SELF-DEALING

Some fiduciaries make the mistake of thinking that, if they do something for a noble purpose, it can't be a fiduciary breach. That isn't the case. Even if the fiduciary proves that he acted out of concern for the survival of the company – and thus saving the jobs of the employees – he can't act in a way that benefits the company at the expense of the participants' retirement benefits.

EXAMPLE: The CFO of a struggling printing company is being hounded by creditors. Some are even threatening lawsuits. Rather than deposit the employees' 401(k) deferrals into the plan, the beleaguered CFO decides to pay the creditors to keep them at bay. In doing so, the CFO has taken control of plan assets – the employees' deferrals – and has unknowingly become a fiduciary (a "functional fiduciary"). By not depositing the deferrals, he has breached his duties to the plan and is personally liable to make the plan whole.

EXAMPLE: The president of a company that distributes telephone equipment decides to set up a 401(k) plan. Shortly thereafter, the president talks to a loan officer at the company's commercial bank. The loan officer tells the president that, if the company gives the bank its 401(k) plan business, the bank will be able to give the company a lower interest rate on its commercial loans when they are renewed. The president reviews the information about the bank's 401(k) offering and decides that it looks reasonably good. Because of that, and because of the savings on the interest rate, the president places the company's 401(k) plan with the bank. The president has unknowingly entered into a transaction that is absolutely prohibited under ERISA … he used the plan money to benefit the company. As a result, the president has subjected himself and the company to governmental penalties.

B. FUNDAMENTAL FAIRNESS

The fiduciary rules have an overriding requirement of basic fairness. Fiduciaries cannot use the plan in an arbitrary manner. Remember, fiduciaries must protect the interests of participants, even if an employee behaves inappropriately.

EXAMPLE: Employees occasionally leave at inopportune times or under difficult circumstances. In some cases, companies have tried to "punish" those ex-employees by delaying or refusing to pay their plan benefits. The law does not permit companies to use ERISA plans to penalize employees. Those tactics can result in penalties, as well as the expense of attorneys' fees.

4. "PRUDENT MAN" STANDARD

ERISA requires a plan fiduciary to act 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."

One mark of a prudent person is that he acts in good faith. But good faith is not enough without procedural prudence. A prudent process requires that you gather the information needed to make a good decision, review it, consult with an advisor, if needed, and reach a reasonable decision. When the DOL investigates a plan (for example, because of an employee complaint), one of its first requests will be: *"Provide us with your file on this investment or that decision."* In asking that question, the DOL wants to know if you have gathered and studied the information necessary to make a prudent decision. The law expects you to combine good faith with a prudent process, for example, in picking the plan's investments. If you do that, then you have fulfilled your duty, even if the investment doesn't work out.

Prudence has two prongs: proper investigation and proper documentation. For example, when fiduciaries select investments for participant-directed 401(k) plans, they should investigate the funds and document that investigation in their files.

5. DIVERSIFICATION

ERISA requires that fiduciaries diversify the plan's investments to minimize the risk of large losses – unless under the circumstances it is clearly prudent not to do so.

The diversification requirement cannot be stated as a fixed percentage. It depends on the facts and circumstances of each case. If you are investing the plan's assets, you shouldn't invest an unreasonably large proportion in a single investment, in one type of investment, or in various types of investments all of which are dependent upon the success of one enterprise or the conditions in one locality. For instance, it rarely makes

sense to invest a large proportion of plan assets in multi-family residential real estate in one city. Instead, real estate investments should typically be diverse as to type (e.g., residential or commercial) and geographic location. Moreover, plan assets invested in real estate should constitute only a reasonable portion of overall plan assets. The same would be true of investing a large portion of a plan's funds in stocks or mutual funds in one sector, for example, technology. ERISA's rules are designed, at least partially, to minimize the risk of large losses and, as a result, plan investments must be well-diversified, except in rare cases.

EXAMPLE: The trustees of a profit–sharing plan delegated responsibility for investment of the plan assets to the sponsor's accountant. The accountant invested the plan's assets in speculative securities. In one case, almost all of the plan's assets were used to purchase high yield bonds. For a period of time, the plan enjoyed a substantial return on its investments. However, interest rates increased significantly, resulting in the collapse of the bond market and in a 50% loss in value on those investments. The participants sued and recovered the lost principal plus the earnings they would have had if the money had been invested prudently.

In participant-directed plans, the diversification requirement applies at two levels.

First, the plan must offer enough different types (or "classes") of investments to enable participants to balance the risk level and return potential of their accounts. Put another way, participants should have choices that are significantly different so that they can spread their investments among "safe" investments (like cash or bonds), which will typically have a lower rate of return but will present a small – or no – risk of loss, and some "riskier" investments (like stocks) that will offer the participant a higher potential return but will have greater risk of loss. The equity investments might include large and small company funds, growth and value funds, and domestic and international funds. The debt investments might include stable value or other guaranteed investments, government debt securities, and high yield bonds.

The second level of diversification applies to the investments themselves. That is, where a plan offers mutual funds, the funds should be internally diversified. This means, for example, that the plan would not offer – at least as the "core" investments – funds that invest in a single sector of the economy. Instead, the core funds should broadly invest across different companies and different industries. For a plan to be a "404(c)" plan

(discussed in detail in Chapter 3), it must offer a minimum number of well-diversified core funds.

This doesn't mean that the plan can't offer a single sector fund as an investment alternative – if the fiduciaries determine it is appropriate for the workforce – but it does mean that the plan should offer such a fund as only one of a larger number of alternatives.

6. COMPLIANCE WITH DOCUMENTS

ERISA requires a fiduciary to act in accordance with the plan documents and policies as long as they are consistent with ERISA's rules for fiduciaries. When a fiduciary fails to follow the terms of the plan, it often paves the way to a fiduciary breach.

EXAMPLE: The owner of a small manufacturing company was also trustee of its profit–sharing plan. When she came across an attractive real estate investment, she had the plan buy the real estate and allocate it to her account. Unfortunately, the plan did not provide for the allocation of specific investments to a specific participant's account. In other words, under the plan's terms, investments were "shared" by all of the participant accounts. Fortunately (or unfortunately, depending on how you look at it), the investment was not as attractive as it first appeared, and its value depreciated substantially. The plan was audited by both the IRS and the DOL and, as a part of the settlement, the owner/trustee was "*allowed*" to "*keep*" the losses in her account (in addition to paying a penalty). Had there been a gain, though, it would have been shared with all of the participating employees.

7. DUTY TO MONITOR INVESTMENTS

Making prudent investments is not the end of the process. A fiduciary also has a duty to monitor the investments on a regular basis. If you find that the plan's investments aren't working, you have to replace them or be prepared to explain why you did not.

At a minimum, the investments in a 401(k) plan should be reviewed – or "monitored" – annually. That process should include a comparison of the fund's performance and expenses against the appropriate benchmarks and the plan's investment policy. The materials that are reviewed, as well as your notes and conclusions, should be kept in "due diligence" files as proof of your compliance with ERISA's fiduciary rules.

Plan providers can help fiduciaries by regularly supplying reports and data on the investments. In fact, in selecting providers, companies should make sure that they will be getting information, at least annually, to use in the "prudent process."

A critical element of a prudent monitoring process is the use of knowledgeable advisors or financial representatives. The advisor can review and explain the materials received from the provider, as well as any additional information provided. As a standard practice, fiduciaries should meet with their advisors each year to review the plan's operations, services and investments.

CHAPTER 3:
HANDLING THE MONEY IN A 401(K) PLAN

1. PARTICIPANT CONTRIBUTIONS

Q. When do employee deferrals have to be put into the plan?

A. Employee deferrals to 401(k) plans must be paid into the plan as soon as possible after payday. Department of Labor regulations say that employee deferrals become "plan assets" as soon as the money can reasonably be transferred to the plan from the company's account. This rule means that the funds are subject to ERISA's fiduciary rules, even if they aren't deposited into the plan.

While there is an "outside" date for depositing deferrals of the 15th business day following the month in which the money was withheld, this is not a "safe harbor." In fact, the DOL has created a "safe harbor" for small plans (that is, plans with fewer than 100 participants). If the deferrals are deposited into a "small plan" within seven business days of payroll withholding, the DOL will automatically treat them as timely deposited. For larger plans, the deferrals must be deposited as soon as reasonably possible. In other words, large plans cannot take advantage of the seven-day safe harbor.

EXAMPLE: A company with a small plan did not pay attention to when it deposited deferrals in the plan. They were usually able to put the employees' deferrals in the plan within 7 days, but occasionally took as long as 30 days to deposit the money. The DOL investigated the plan and took the position that all of the deferrals should have been put in the plan within 7 days, since it had been able to do that in the past. The company had to pay interest and penalties on all of the amounts that were not deposited within 7 days.

It is important to note that if the company had a reasonable cause for the delay, it could have avoided the interest and penalties.

Q. What happens if you don't put the participants' deferrals into the plan on time?

A. If the deferrals aren't put into the plan on time, it is both a fiduciary breach and a prohibited transaction. As a result, the company and the 401(k) fiduciaries can be liable for both the amount of the deferrals and for any lost earnings on those amounts, in addition to taxes and penalties on the prohibited transaction.

EXAMPLE: As a matter of convenience, a company decides to send employee deferrals to the 401(k) plan only once a month. Prior to making that decision, the deferrals were sent to the plan provider twice a month, the day after payday. As a result of the change, some deferrals are being held by the company for more than two weeks longer than they were before.

This example illustrates a fiduciary breach. The company has already demonstrated that it can reasonably deposit the money in one day. If the DOL investigates the plan, it would look to the prior deposit history and assert a fiduciary breach and prohibited transactions, against both the company and the key officers.

Look at two possibilities:

1. The market goes up significantly during the month and the participants lose out on the rise in the market – in this case, the fiduciaries could be liable for the lost earnings; or
2. The company is hit with a big judgment in a lawsuit and the creditor seizes the company bank accounts. The fiduciaries are personally liable to replace both the lost deferrals and the missed earnings.

Some companies believe that they cannot deposit deferrals until all of the information needed to allocate the money to the participant accounts is available. However, allocating the money and depositing it into the plan are two different things. In order to satisfy ERISA's requirements, the money should, at the very least, be timely deposited in the plan's name until it can be properly allocated.

Q. What taxes and penalties are imposed on fiduciaries as a result of failing to deposit deferrals promptly?

A. The DOL may impose a 20% penalty on the any deferrals and any missed earnings that should have been paid to the plan, but haven't been. The IRS may also impose a 15% excise tax on the lost earnings and deferrals that were not (but should have been) deposited. The two penalties are offsetting.

Q. Who can be liable for the failure to put employee deferrals into the plan?

A. It's a long list: the company; the company's officers and directors; the members of the plan committee who administer the plan; the plan's trustees. Any officer who made the decision not to pay the employee deferrals to the plan can be liable as a fiduciary. This is because when a person exercises control over money that belongs to the plan, such as deferrals, that person becomes a fiduciary.

Q. What if the participant deferrals are used (or "borrowed") to pay the company's operating expenses instead of being paid to the plan?

A. The persons who decided that the company should hold on to the deferrals (usually, the company's officers) have breached their fiduciary duties and committed prohibited transactions. They will be personally liable for the principal amounts that should have been, but were not, contributed to the plan. They are also liable for the investment gains that would have been earned if the contributions had been put into the plan on time. Even worse, the officers who diverted the funds contributions may be criminally prosecuted.

Q. What if the company needed the money to stay in business?

A. The company's officers have still breached their fiduciary duties and committed prohibited transactions. No bad intent or evil motive is required to prove a fiduciary breach or a prohibited transaction. It is irrelevant that the motive for using the money in the business was pure and the intent was to help the employees keep their jobs.

Q. Can the members of the board of directors also be liable?

A. Yes, the directors can be liable because they also have fiduciary responsibilities. This can come about in two ways.

First, the board of directors typically appoints the trustee and other plan fiduciaries. This is a fiduciary function under ERISA and creates a duty to monitor the performance of the fiduciaries they have appointed. If employee deferrals are not paid into the plan and losses result, the directors may be liable for some or all of the losses, because they may have violated their duties by not properly supervising the fiduciaries they appointed.

Second, they can also be liable as "co-fiduciaries." ERISA imposes liability on a plan fiduciary for a breach by another fiduciary in several situations. This includes where the directors have knowledge of a breach by another fiduciary – for example, the failure to deposit the deferrals – but take no action to prevent or remedy the breach.

Q. The company indemnifies me; why should I care about personal liability?

A. While most companies indemnify their officers and directors from personal liability for acts done in the course of their duties, there are at least two reasons why this may not help. First, many companies only indemnify officers and directors for negligence – and don't cover intentional wrongdoing and/or criminal conduct, such as diverting employee deferral money. Second, the company may become insolvent or go bankrupt before it pays for the losses. In that case, the indemnification isn't worth much.

EXAMPLE: Key officers and certain directors of Enron were sued by plan participants and the DOL. Because of the bankruptcy of Enron, the personal estates of those officers and directors were at risk. As it turned out, the directors and committee members paid almost 90 million dollars to settle the case. While much of the settlement was covered by fiduciary breach insurance, these fiduciaries personally paid almost 2 million dollars.

2. SELECTING, MONITORING AND REMOVING 401(K) INVESTMENTS

Fiduciaries of participant-directed plans, like 401(k) plans, are responsible for choosing the investments for their plans. In a participant-directed plan, your duty is to select investments that allow your employees to create portfolios for retirement investing. To do that job, you need to have some understanding of your employees and their investment abilities, i.e., where they need help; do they need investment education; should the plan offer investment advice?

Your job is to assess whether each investment should be offered to your employees, given their investment abilities, the other types of investment being offered, and the investment help the plan is giving them.

Bottom line: You have to satisfy the prudent man – or knowledgeable investor – rule, with an eye to enabling your employees to accumulate retirement benefits. If an investment is not right for your employees, it should not be included in your plan.

Q. Do I have any legal responsibilities for selecting the investments that are made available to participants?

A. Yes. Even where the employees have the right to self-direct their accounts, the fiduciaries are responsible for investments selected for the plan. You can't be relieved of liability for picking – and keeping – the investments from which the participants choose. Therefore, you need to act carefully when choosing the investments.

Q. Do I have any legal responsibility to review the investments once the initial selection has been made?

A. Yes. In addition to prudently selecting the investments, you must monitor them to ensure that they continue to be suitable for the participants and appropriate for retirement investing. This means that you must periodically review the investments and compare their performance and expenses, among other things, against appropriate benchmarks. For example, you may decide that any fund which does not consistently perform in the top half of its peer group should be replaced.

Q. How do I satisfy the duty to monitor?

A. You and the other responsible plan fiduciaries should periodically gather information about the investments, including data for comparison with appropriate benchmarks, information on possible changes in investment style or objectives of each investment and so on. Then, the responsible plan fiduciaries should meet to review the information and to make decisions about the investments. If the performance of a fund has not been satisfactory compared to other funds in its investment category (or "peer group"), and there is no reasonable basis to believe that the performance will improve in the future, you should remove that fund and replace it with a better fund of the same category. Some 401(k) providers help with this process by supplying an analysis of the funds they offer. In addition, some of these providers will remove underperforming funds from their offerings, giving you support in meeting your fiduciary duties.

A good advisor is a critical part of this process. Your 401(k) advisor, including but not limited to your financial representative or consultant can help you analyze and understand the information from the provider. And, the use of an advisor is viewed as evidence of fiduciary compliance.

Once the data is analyzed, you should document your analysis and decisions in committee minutes or memos. These minutes and the backup materials should be kept in a "due diligence" file.

What do we mean by "periodically"? This can vary from plan to plan. The formal review process should be done at least annually. Some fiduciaries – particularly for larger plans – conduct the review semi-annually or even quarterly. Whatever the frequency, the important steps are to gather the appropriate information, perform the review, make decisions, take action where it is called for, and maintain proper records.

Q. Am I also legally responsible for properly selecting and monitoring the target date funds offered to the participants?

A. Yes. Fiduciaries are responsible for evaluating all of the investments chosen for the plan, including the target date funds, to make sure they are appropriate for the plan and the participants. However, target date funds are more complex than most other investments, since they combine different categories of investments (like domestic and international stocks, different types of bond funds, and cash). Also, the percentages, or

allocations, invested in those categories change over time, with the overall mix becoming more conservative as the targeted date approaches (which is called the "glide path").

Fiduciaries need to consider those allocations and glide paths, as well as the underlying investment funds. However, fiduciaries do not need to be experts on those issues. Instead, they can look to their providers and advisors for help. Even then, though, fiduciaries need to make an "informed" decision in the best interest of their participants.

Q. Do we have to remove underperforming investments?

A. Yes, as a general rule of thumb. Once you decide that an investment is not a good choice, it should be removed. However, if an investment underperforms for a period of time, it is not necessarily a bad choice. The question is whether it can be expected to perform reasonably well in the future.

Some plan sponsors prefer a middle ground. They tell participants that no new money can go into the underperforming investment, but the participants don't have to switch the money they have already invested in that fund. This is called "freezing," and some sponsors believe it is less disruptive to participants. That is a dangerous approach. Ask yourself this question: If the investment is not good enough for new money, how could it be a good for old money? In effect, once you determine that the investment does not meet the plan's fiduciary standards, you have also decided that it fails to satisfy the plan's standards to hold existing participant money.

Q. What should I do if we decide to change plan providers?

A. You should notify your employees of the change and take steps to ensure a smooth transition to the new provider. Participants must be notified, in writing, if there will be a "blackout period." A blackout period occurs if participants will not be able to direct the investment of their accounts or obtain loans or distributions from the plan for more than three business days in a row. (Fiduciaries should also notify people who have left employment and still have money in the plan.)

Some plans allow participants to make decisions – before the transfer to the new provider – about how to invest their accounts with the new

provider. Other plans "map" (or transfer) the participants' money into similar investments with the new provider. (See the QDIA discussion later in this Chapter.)

Fiduciaries should develop a "prudent process" for the change. An example of a prudent process would be: meeting with the old and new providers; preparing a conversion checklist and timeline that both providers agree to; and having both the old and new providers sign off on it. The fiduciaries should also monitor the conversion – that is, make sure that the steps occur as planned.

Q. When do I need to notify participants if there will be a blackout period?

A. Unless special circumstances exist, participants must be given written notices at least 30 days before the last day they can change their investments. For example, suppose a plan has a blackout period beginning on April 1. The last day participants would be able to change their investments prior to the blackout will be March 31. So, the blackout notice must be given to participants no later than March 1.

Fiduciaries may be penalized up to $100 per participant, per day, for failing to give blackout notices.

Q. Do I have any legal responsibility for the selection and monitoring of investments in 401(k) brokerage accounts?

A. No, at least not for the investments themselves.

Some plans let participants invest in virtually any stock, mutual fund, or other investment through personal stock brokerage accounts. These investments are made by the participant through a Personal Brokerage Account (PBA). Where participants are given this nearly unlimited range of choices, you are not responsible for the prudent selection or monitoring of the specific investments in the PBA.

However, you do have the duty to monitor the brokers, for example, verifying that they are following rules established by the plan for the PBAs, such as prohibition of margin accounts.

Further, the DOL provided the following guidance with respect to PBAs:

"Also, fiduciaries of such plans with platforms or brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan are still bound by ERISA §404(a)'s statutory duties of prudence and loyalty to participants and beneficiaries who use the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement, including taking into account the nature and quality of services provided in connection with the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement." [See Field Assistance Bulletin 2012-02R, Q&A-9]

In addition, some ERISA experts believe you need to consider whether PBAs are suitable for the participants. That is, given the investment sophistication of the employees (or the lack of sophistication), is it appropriate to offer unlimited investment choices?

Q. If our 401(k) plan offers company stock as an investment, do we need to monitor it also?

A. Yes. Company stock is governed by the fiduciary rules. As a result, fiduciaries must periodically review whether the company stock continues to be a suitable investment for retirement investing by the participants. In many cases, there is a presumption in favor of the fiduciaries that it is prudent to offer company stock as an investment option.

This could still mean removing the company stock as an investment if the company's prospects become bleak.

If the company is not doing well, the fiduciaries are in a difficult position. Removing the stock as an investment – and explaining why to the participants – would likely alarm the employees and possibly worsen the business condition of the company. As unenviable as this job may be, the fiduciaries nevertheless have the duty to monitor and to act on the results of their monitoring.

As a word of caution, the rules on company stock are, in important ways, different than the laws for other investments. Before putting company stock in a plan, you should consult with a knowledgeable benefits attorney. As the members of the Enron board and plan committee learned, company stock can be a dangerous investment.

Q. Does the plan need to have an investment policy statement (IPS)?

A. While the law is not clear, an IPS is valuable for the proper operation of a plan and for fulfilling the fiduciary duty to prudently select and monitor the plan's investments.

Some plan providers offer sample investment policy statements. Those materials are helpful in developing your IPS. In addition, your plan advisor can work with you to develop written investment guidelines appropriate for your plan.

Q. What should an IPS contain?

A. An IPS is a map for making decisions about the investments in your plan. The policy should describe: the categories of investments offered to participants; the criteria the plan will use for monitoring the investments, including the benchmarks the investments will be compared to; the benchmarks for investment expenses; the process for removing and replacing investments; and other duties for overseeing the plan's investment program.

3. PARTICIPANT-DIRECTED ACCOUNTS: ERISA §404(c)

Q. If participants are allowed to make decisions about how to invest their accounts, will the fiduciaries be responsible for their decisions?

A. No, if the plan satisfies the requirements of ERISA §404(c). That section says that fiduciaries won't be responsible for a participant's investment decisions if the plan satisfies the 404(c) conditions. However, that does not relieve you of all responsibility for the investments – because you still have the duty to prudently select and monitor the investment choices.

The DOL has adopted detailed regulations under 404(c) which list the specific requirements.

Unfortunately, many fiduciaries do not make an effort to comply with 404(c) and, as a result, unknowingly remain responsible for the prudence of the investment decisions made by participants. It is well worth the effort to satisfy those conditions and to obtain 404(c) fiduciary relief.

Some plan providers offer 404(c) compliance packages (including checklists and sample language). Take the time to read those materials. Then work with your advisors to go through the checklists, and to give your employees the required information.

Q. Can all fiduciary responsibility be transferred from the company, and its officers and directors, to the participants?

A. No, only part of the responsibility can be transferred. The duty to prudently select and monitor the investments and the service providers cannot be shifted from the company to the participants. However, if the company appoints an investment manager, as defined in §3(38) of ERISA, the responsibility for selecting and monitoring the investments can be transferred to the investment manager. But, the company must prudently select and monitor the investment manager.

Q. Why can't all fiduciary responsibility for the investments be transferred to the participants where they make the investment decisions?

A. The investments (for example, the mutual funds) offered by a plan are chosen by someone other than the participants, that is, by the company or its officers in their capacity as fiduciaries. Since the participants don't control that decision, they are not – and cannot be – legally responsible for it – or its consequences. The decision-maker – whether it is the board of directors, a plan committee, or a company officer – is the "investment fiduciary." In selecting the investments, and in monitoring them thereafter, the investment fiduciary can be liable for imprudent decisions for selecting bad investments or for keeping them in the plan.

Q. How can the responsibility for how the participants use the investments be transferred? In other words, how do I get 404(c) protection?

A. To transfer investment responsibility, the plan has to follow specific rules. These are found in the DOL regulation under ERISA §404(c).

Companies are sometimes told that they only have to do three things to comply with 404(c):

- Give the employees at least three investments choices
- Let the employees make their own decisions about the investments
- Let the employees change the investments at least once every three months

However, in reality, there is a list of specific conditions that must be satisfied (and, in addition, an additional list of mandated participant disclosures under ERISA's fiduciary rules [see discussion below]).

Some plan providers – mutual fund companies, stock brokerage firms, insurance companies and banks – have checklists and forms to help plan fiduciaries comply with 404(c). Those are useful tools, but they must be understood and applied in order to get the fiduciary protection.

Q. What are some of the most important steps I have to take to get 404(c) protection?

A. The first step – and one of the easiest to overlook – is that a plan must let the participants know, in writing, that it intends to comply with 404(c) and that, as a result, the fiduciaries will be relieved of liability for losses resulting from participants' investment decisions. This is often done in the summary plan description (SPD), but can also be done in a separate notice.

The 404(c) regulation also requires that the plan identify a fiduciary who is responsible for carrying out the participants' investment instructions. The "404(c) fiduciary" can delegate its duties. As a practical matter, in most 401(k) plans, the investment instructions are given over a voice response system or an Internet site maintained by the provider. However, participants must be told who the 404(c) fiduciary is and how to contact the fiduciary. Many plans pick the plan committee or a company officer (such as the head of human resources for a large company or the office manager for a small firm) to hold the position.

Q. How do I find all the requirements for getting 404(c) protection?

A. The 404(c) requirements are lengthy. As a result, the only way to make sure you comply is by working with an experienced benefits attorney or a consultant. However, some providers have materials to help you comply with 404(c), and a few have prepared step-by-step checklists for that purpose.

Q. Can I get 404(c) protection if my plan offers brokerage accounts?

A. Yes, so long as the plan meets the 404(c) requirements. However, as a practical matter, it may not be easy for brokerage accounts to satisfy those requirements. This is because it may be difficult for you to obtain the necessary information that you will need for disclosure purposes. For example, you will need to provide an explanation of any fees and expenses that may be charged against the brokerage account. It may be difficult for some broker dealers to provide these disclosures to participants.

Q. Can I keep 404(c) protection if we change one of the plan's investments?

A. Yes, if:

- your plan satisfied the 404(c) requirements before the change; and
- the current investment and the new investment are reasonably similar.

In addition, you will need to notify your employees of the change and provide to them a notice that identifies the new investment, the expenses that apply to the new investment, as well as where the participant can go to obtain additional information regarding the new investment. You should also give them the opportunity to pick the replacement for the proceeds from the removed investment. This notice must be provided to the participants 30 to 90 days prior to the effective date of the change, subject to certain exceptions. You should also notify former employees and retirees who still have money in the plan.

Then, if some participants do not select a replacement for the proceeds from the removed fund, you may map, or transfer, that money to the "reasonably similar" replacement fund.

Q. What if, when a participant joins a plan, the participant doesn't direct the investment of his or her account?

A. A common practice in 401(k) plans is that, if a participant fails to give investment directions, the participant's deferrals (and any matching or profit sharing contributions) will be placed in a "default" investment. Fiduciary protection is available if the plan uses a "qualified default investment alternative" or "QDIA."

For the QDIA, plans can choose age-based, or **target date funds**; a **balanced fund** (such as a lifestyle fund); or **managed accounts**.

Generally speaking, **target date funds** are based on the year a person is expected to retire. For example, a 2040 fund is intended to be used by a person who expects to retire close to 2040. When used as a QDIA, the fiduciaries will put a defaulting participant (that is a participant who failed to direct the investment of his account) into the target date fund that most closely corresponds to the plan's anticipated retirement age for the participants. For example, if the 401(k) plan has a 65 retirement age, and the participant will be 65 in 2039, the fiduciaries would typically use the 2040 fund as the QDIA for that participant.

A lifestyle or **balanced fund** is based on the degree of risk a person is comfortable with. Investments with greater risks (that is, with more stocks) are expected to have higher returns, but more volatility, than funds that are considered to have less risk (for example, with more bonds). Balanced funds, as the name implies, attempt to balance the level of risk and return. If a plan uses a lifestyle or other balanced fund as the QDIA, the fiduciaries should pick a default fund that would be appropriate for all of the participants in the plan. For example, if the employees in the plan are, on average, older, a more conservative fund would be used; if they are younger, a more aggressive fund could be used.

EXAMPLE: A real estate management company has employees that range widely in age, education, compensation and retirement needs. The fiduciaries – the plan committee – want to select a lifestyle fund that is appropriate for the demographics of their work force. After considering the make-up of their employees and getting input

from their advisor, the fiduciaries select the balanced lifecycle fund (consisting of about 60% equities, or stocks, and about 40% bonds). By considering their employee population, and its needs, the fiduciaries have satisfied one of the important QDIA requirements for the fiduciary protection for default investments.

For QDIA purposes, a **managed account** requires that an investment advisor sign on as a fiduciary to manage the investments for the participant. The investment manager must take the defaulted participant's age or anticipated retirement date into account in selecting the investments.

While fiduciaries are free to choose the type of QDIA (i.e., target date, balanced or lifecycle, or managed account), once that decision is made, they must prudently select and monitor the specific investments (or investment manager) used for that purpose, as described earlier in this Chapter.

If the plan does not use a QDIA, the fiduciaries are responsible for whether the default investment is prudent for the particular participant.

Q. If the plan uses a QDIA, are there any notice requirements?

A. Yes. The plan must notify participants about the default investment at least 30 days before their money is invested in the QDIA and annually thereafter. The notice must contain information regarding the QDIA, including but not limited to a description of the QDIA, the performance data of the QDIA, and the fees and expenses of the QDIA.

Q. If I change to a new plan provider, can I get fiduciary protection when the participants' money is moved to the new investments? How?

A. Yes, but only partial protection.

As the plan's investment fiduciary, you are required to prudently select the investments that the plan will offer on the new provider's platform. If you do that, there are two "safe harbors" for how you move the participants to their new investments:

(i) **QDIA default:** To get the benefit of the QDIA fiduciary safe harbor, you need to give the participants notices and information about

the new investments, and a reasonable time to select investments. If a participant doesn't turn in an investment selection form, the participant will be defaulted into the plan's qualified default investment alternative, or QDIA (which must be either a target date fund, a balanced or lifestyle fund, or a managed account). Properly done, that process will result in a safe harbor for the fiduciaries.

(ii) **Mapping:** The mapping process involves the same steps except that, if a participant doesn't turn in an investment selection form, the participant's account will be transferred, or mapped, into investments that are similar to what the participant had with the old provider. This approach is more complicated, since the safe harbor protection only applies if the plan satisfied all the 404(c) requirements before the transfer (see discussion earlier in this Chapter) and if the new investments are truly similar.

Q. Should we have one person on the 401(k) plan "team" who has the job to oversee 404(c) compliance?

A. Yes. The company officers, the plan provider, the consultant or advisor, the TPA, and the attorney all perform different functions. In most cases, none of them have been assigned the specific responsibility for making sure that all of the 404(c) requirements are met. Make sure that one of them, or someone else, is clearly assigned the job of being in charge of 404(c) compliance. Don't leave compliance on this important issue to chance.

Q. If I don't comply with the 404(c) requirements, have I violated ERISA?

A. No. The failure to satisfy 404(c) means only that the fiduciaries are not protected from imprudent investment decisions by the participants. But failure to comply with 404(c) is not a violation.

Q. What other information must be given to participants?

A. 404(c) requires that, in order to be protected for participant investment decisions, plans must also comply with the participant disclosure rules in the DOL's 404a-5 regulation, as well as the 404(c) requirements. Independent of 404(c), though, ERISA requires that participants be given the information specified in the 404a-5 regulation. Thus, while 404(c) is optional (in the sense that plan fiduciaries don't have to get its protections), the 404a-5 disclosures are mandatory. (Those disclosures are discussed in more detail later in this Chapter.)

4. PARTICIPANT EDUCATION AND INVESTMENT ADVICE

Q. What is the difference between participant education and investment advice?

A. If your 401(k) plan allows the participants to direct their own investments, you can – and most companies do – offer investment education to the participants. Surveys have found that investment education helps participants better understand investment concepts and results in employees making larger contributions to 401(k) plans.

A person who gives investment advice (as opposed to investment education) is a fiduciary. The main difference between advice and education is that advice involves specific recommendations that are based on the individual participant's needs, while education covers general information about saving and investing.

Q. Even though investment education is not specifically required, why are companies providing this service to their employees?

A. Many plan sponsors have become aware that some employees invest too conservatively, other employees make overly risky "bets" and some are insecure about making any investment decisions at all. Companies have tried to deal with those concerns by providing investment education and retirement planning.

Also, fiduciaries must act prudently and in the best interests of participants. As a result, it may be a problem to ignore the lack of investment knowledge of your employees. Once that problem is identified,

though, there are a number of ways to deal with it, for example, investment education, investment advice, and lifestyle funds.

Most often, the education services are provided by the plan's advisors and providers, but not directly by the plan sponsors. In selecting advisors and providers, the fiduciary should investigate the education services they provide.

Q. What types of investment advice can be provided to participants?

A. There are three types of investment advice that can be provided to participants:

(i) **Pure level fee advice** is provided by a person (a "fiduciary advisor") whose fees do not vary based on the advice given. Additionally, any fees received by affiliates of the fiduciary advisor may not vary based on the fiduciary advisor's advice. In other words, there is no financial incentive for a pure level fee advisor to favor one investment over another.

(ii) **Limited level fee advice** is where the fees of the fiduciary advisor and his employer or supervisor are level, but the fees of affiliates of the fiduciary advisor may vary, for example, the advisor might recommend affiliated mutual funds.

(iii) **Computer model advice**, as the name implies, is provided through an unbiased computer model. But the fiduciary advisor's compensation may vary depending on the investments recommended to and selected by the participant.

Because of the potential conflicts of interest, there are a number of requirements for limited level fee advisors and computer model advisors. Among the most important are:

- The arrangement must be approved by a plan fiduciary, such as the plan sponsor.
- The advisor must make disclosures to participants, including details regarding his compensation (and any fees earned by affiliates due to the advice) as well as the fact that it is a fiduciary.

- The advisor must also be "audited" annually to ensure that he is complying with the PPA.
- The recommended investments cannot be implemented without the approval of the participant.

Whether to offer investment advice to participants is a fiduciary decision. Therefore, it must be made prudently and it must be monitored by the plan sponsor.

Q. Are fiduciaries responsible for the advice given by fiduciary advisors to participants?

A. No. Fiduciaries will not be responsible for the investment advice given by fiduciary advisors. However, fiduciaries must prudently select and monitor the investment advisor to be used by participants. [See DOL Field Assistance Bulletin 2007-01]

Q. Is there any official guidance on the difference between investment education and investment advice?

A. Yes. The DOL has issued Interpretive Bulletin 96-1, which defines investment education. Broadly stated, investment education (as opposed to investment advice) can cover:

- Plan information
- General financial and investment information
- Asset allocation models
- Interactive investment materials

5. PARTICIPANT DISCLOSURES: ERISA §404A-5

Q. What other information do I need to disclose to 401(k) participants?

A. Under the ERISA §404a-5 regulation, plan sponsors are required to give the "eligible employees" (that is, those employees who have satisfied the plan's eligibility requirements and beneficiaries) certain information. The information required under the 404a-5 regulations includes information about:

- The plan's investments and how the participant can make and change the investments of his account;
- Any limitations on when a participant can make and change investments including any limits on transfers to and from any investment;
- A description of or reference to plan provisions that discusses the exercise of voting, tender or similar rights as well as any restrictions as they relate to any investments;
- The general administrative expenses that are charged to participant accounts (such as legal, recordkeeping and accounting fees) and how those expenses affect account balances;
- Individual administrative expenses (such as expenses related to domestic relations orders, loan processing and hardship withdrawals);
- Description of any self-directed brokerage accounts; and
- Information about the fees, expenses and historical performance of each investment.

There is also additional information that the participant may need to receive regarding the plan's QDIA (see above for more details on the QDIA notice requirements). Specifically, the DOL has issued proposed regulation that would require the disclosure of certain information regarding target date funds. For example, under the proposed regulation, the information required under the 404a-5 regulations may require an explanation of the target-date fund's asset allocation along with a chart or similar representation that illustrates the change in asset allocation

over time, including the point at which the investment will reach its most conservative asset allocation as well as other additional information.

Generally, this information must be given to the newly eligible employees (regardless of whether they are actually deferring) before they can first select their investments and annually thereafter.

In addition, participants must be given statements that show the dollar amounts of any administrative and individual expenses that have been charged to their accounts. As a practical matter, most plan providers will automatically include those amounts on the quarterly statements they prepare for the participants.

Also, plans will need to provide additional website information for participants who want more information about their investments. These websites will, in almost all cases, be developed and maintained by your plan provider.

While the rules may seem complex and burdensome, the reality is that plan providers will provide plan sponsors with most, if not all, of the tools necessary for satisfying them … so that plan sponsors can focus on their core businesses.

Q. How do I provide this additional information to the participant?

A. As a practical matter, most plan providers will prepare and provide this information to participants or provide them to plan sponsors for delivery to participants and beneficiaries. These disclosures can be sent out electronically so that plan sponsors and plan providers can work together to make sure participants and beneficiaries receive the required information.

Historically, the DOL and IRS have made it difficult to provide required disclosures electronically. This is because the rules for electronic delivery are complex. Now, the DOL has provided some alternatives for providing the 404a-5 disclosures electronically. Information regarding fees and expenses that may be disclosed in a participant's quarterly statement, can be delivered electronically in the same manner as the participant's quarterly benefit statement. For example, the DOL has indicated that providing participants with continuous access to benefits statement information through one or more secure websites satisfies the requirement to furnish the benefit statements. The 404a-5 disclosures that are provided

to participants on quarterly benefit statements may also be provided in the same manner. These websites will, in almost all cases be developed and maintained by your plan provider.

For all other disclosures under 404a-5, plan sponsors may utilize the DOL safe harbor method for electronic delivery or an alternative method. The DOL safe harbor requires actual receipt of the required disclosures. This is accomplished through the participant having access to electronic documents where the participant is performing his duties and such access is a integral part of his duties or the participant has consented to receiving the disclosures electronically. Alternatively, the DOL issued a transitional method for providing 404a-5 disclosures electronically requiring participants and beneficiaries to provide an e-mail address to receive the disclosures upon the receipt of certain notices (initially and annually). You must ultimately determine and work with your service provider to determine which method of delivery is most appropriate.

6. CHARGES TO THE PLAN AND THE PARTICIPANTS

Q. What expenses can be charged to the plan?

A. Generally speaking, any expense that is necessary for the operation of the plan can be charged to the plan, such as the cost of the annual administration and compliance with governmental reporting, the costs of making and changing investments, etc. In order to charge these expenses to the plan, the plan document must permit the payment of these expenses (or, stated slightly differently, the plan cannot prohibit their payment). If the plan says that the company will pay certain expenses, then those expenses cannot be paid by the plan.

However, any expense related to the company's decision to establish a plan, to change the design of the plan or to terminate the plan cannot be paid by the plan. Thus, for example, the costs of the consultants and attorneys who assist the company in making changes in the plan design would have to be borne by the employer sponsoring the plan.

What about the expenses of maintaining the plan's tax qualification? Both the company and the participants benefit if the plan remains qualified. Because of the benefit to the participants, the DOL has ruled that these expenses may be paid by the plan.

Companies need to be very careful when reimbursing the company for the services its employees provide to the plan. This is only permissible under very limited circumstances. The company should obtain expert legal advice because the risk and penalties are high.

EXAMPLE: An energy-related company had the plan reimburse it for the services its employees provided to the plan. The DOL investigated the plan and discovered the payments. The DOL took the position that these expenses should not have been reimbursed. More specifically, the DOL asserted that the payments to the company were fiduciary breaches and prohibited transactions. After lengthy contentions and expensive negotiations, the DOL required that the company repay most of these amounts, plus interest, to the plan.

Q. What expenses can be charged to an individual participant's account?

A. Reasonable expenses for operating a plan may be charged (or "allocated") to an individual participant's account if it is permitted (or at least not prohibited) by the plan document. If the plan is silent on how expenses are charged to participant accounts, the fiduciaries must act prudently when deciding how to allocate the expenses. Fiduciaries should have a good reason for deciding how the expenses will be allocated.

In addition, a participant's account can be charged for costs specifically attributable to that participant, for example, the expense of setting up and administering a participant loan.

Q. What is "revenue sharing?"

A. "Revenue sharing" is a term used to describe indirect payments made by a plan investment or provider to its other providers. Revenue sharing generally happens when mutual funds or their management companies pay other providers for the marketing or other plan services.

Plaintiffs' attorneys in recent lawsuits have described it as the "dirty secret" of the retirement plan industry. But revenue sharing is not necessarily detrimental to a plan's participants. It doesn't even necessarily increase a plan's overall expenses. For example, revenue sharing payments made to a recordkeeper from a plan's investments may reduce the direct costs that the plan pays for recordkeeping services, since recordkeepers usually reduce their fees as a result of the revenue sharing payments.

The main thing for fiduciaries to know is whether service providers are receiving revenue sharing or other indirect payments and to understand the effect those payments have on their plan. That is, they need to know if the revenue sharing payments increase the investment expenses, whether the service providers that receive revenue sharing payments reduce their direct compensation from the plan as a result and, if so, by how much. Then, the fiduciaries need to analyze whether the total compensation received by the service providers is reasonable.

Q. How do I know when the plan's service providers receive revenue sharing payments?

A. Until recently, it was largely up to fiduciaries to do their own investigation about the revenue sharing and other compensation their service providers receive. The DOL now requires – in its 408(b)(2) regulation – that all "covered service providers" disclose all of their compensation, in writing, before the contract is entered into. This includes both direct compensation (the compensation paid directly to the service provider by the plan) and indirect compensation (such as revenue sharing paid by, for instance, the plan's investments).

EXAMPLE: A mutual fund pays revenue sharing (for example, a subtransfer agency fee) to a recordkeeper for services provided to a plan, that is, keeping track of the amount of shares each person has in their account. This is a "fee" charged to the participants invested in those mutual funds and an indirect source of revenue to the recordkeeper. The recordkeeper is obligated to disclose the revenue sharing payments that it receives.

Q. How do I know if a service provider is a "covered service provider"?

A. The disclosure requirements apply only to service providers that enter into an arrangement or contract with the plan and reasonably expects to receive $1,000 or more in compensation, direct or indirect, in connection with providing "covered services" to the plan. These "covered services" include:

a. Services provided as a fiduciary, either to the plan or to an investment vehicle that holds plan assets and in which the plan has a direct equity investment, or as an RIA;

b. Recordkeeping and brokerage services provided to participant-directed defined contribution plans, if one or more designated investment alternatives will be made available in connection with such services; and

c. Most other services provided to plans, but only if the provider receives "indirect compensation" – that is, compensation from sources other than the plan or plan sponsor.

Q. What happens if the plan's covered service providers don't disclose their compensation in writing?

A. The DOL takes the position that a covered service provider who fails to properly disclose its compensation has committed a prohibited transaction and is at risk for having to disgorge that compensation.

Q. What do I need to do if the plan's covered service providers do not disclose their compensation in writing?

A. If you did not get the disclosures from a covered service provider, you must ask them for it in writing. Some covered service providers may be able to explain that they are not required to provide it (as there is an exception for some service providers), but they should tell you that in writing. If the covered service provider fails or refuses to give you that information, you must report them to the DOL and terminate their services to protect the participants in the plan. If these steps are not taken, you have violated ERISA by engaging in a prohibited transaction.

Q. Once I figure out what compensation service providers are receiving, what do I do with that information?

A. Fiduciaries need to determine whether the total compensation paid to their service providers is reasonable given the level of services. This requires fiduciaries to analyze the compensation and services provided in the marketplace and, if they determine that the compensation is unreasonable, to either renegotiate the terms of the contract or change service providers.

EXAMPLE: A TPA agrees to provide services to a plan in exchange for a flat fee plus a per participant charge, which is a reasonable charge. In addition, one of the mutual fund companies whose funds are offered by the plan makes a revenue sharing payment to the TPA. The TPA agrees, however, that the flat fee will be reduced by the amount of any revenue sharing it receives. The revenue sharing payments the TPA receives will therefore not increase its total compensation.

Alternatively, if the TPA keeps the revenue sharing payments without any offset, the fiduciaries will need to consider not only the direct payments the TPA receives from the plan, but the indirect revenue sharing payments as well. If the total of the direct and indirect payments exceed the compensation that would be paid to a competing TPA, the fiduciaries need to decide whether that additional compensation is warranted in light of the services provided. If there is no reasonable justification for paying the additional compensation, the fiduciaries either need to renegotiate the TPA's compensation or change TPA.

To evaluate the compensation of a service provider, fiduciaries should review the 408(b)(2) disclosures and get information about reasonable charges in the marketplace. One source is your plan's advisor. Another method is to use industry data to "benchmark" your provider's compensation … much the way that you benchmark investments. The 408(b)(2) disclosures and the information used to evaluate them should be kept with your plan records for at least six years.

Q. Is it permissible for providers to reimburse a portion of their fee to the plan?

A. Yes. Providers may return a portion of the fees they charge to a plan. These arrangements are becoming more common and are referred to as expense reimbursement accounts, ERISA budget accounts or PERAs (plan expense recapture accounts). A PERA might be used, for example, where a plan's assets have increased significantly since it was initially set up. Due to the growth of the plan, the revenue sharing paid to the provider now exceeds a reasonable amount. To adjust for that change, the provider agrees to establish an account for the benefit of the plan and to credit it with the amount that exceeds its reasonable charges.

EXAMPLE: A law firm sponsors a 401(k) plan. Because the assets in the plan have grown significantly, the provider credits the plan for the amounts above its total recordkeeping costs. The plan then uses a portion of the returned fees to pay for other services. For example, the fiduciaries could decide to use this amount to pay the plan's investment advisor or TPA.

CHAPTER 4:
PLAN DESIGN

Companies have many choices when designing their 401(k) plans. Generally, companies can design their plans any way they want as long as it complies with the tax laws. That said, plan design is critical to the success of a plan. Additionally, a good plan design can make a fiduciary's job a lot easier. This Chapter highlights some of the choices you should consider. As a word of warning, these questions and answers are intended to give you an overview. As a result, many details – including some important ones – have been left out. Before making any plan design decisions, you should consult with your advisors.

1. 401(K) DEFERRALS

Q. How much money can an employee contribute to the plan?

A. Generally speaking, employee contributions – called deferrals – can be up to $17,500 in 2013. This limit may increase in future years to reflect inflation. If the plan permits, employees who are at least 50 years old can defer another $5,500, called a "catch up." The catch up limit is also adjusted for inflation. [To view the most recent contribution limits and catch-up limits, go to http://www.irs.gov/Retirement-Plans/COLA-Increases-for-Dollar-Limitations-on-Benefits-and-Contributions]

Some employees may not be able to defer the maximum amount. That includes employees who own more than 5% of the company ("5% owners") or who earn more than $115,000 ("highly paid employees"). (The $115,000 amount is for 2013; it is periodically adjusted for cost-of-living.) The amount these employees can defer is based on the average amount deferred by the non-highly paid employees. (This is called the ADP limit.) However, 5% owners and highly paid employees will be able to defer the total amount if a safe harbor design is used. (See discussion later in this Chapter for additional information.)

Q. Are employees taxed when they make deferrals?

A. It depends. Employees are not taxed when they make traditional pre-tax 401(k) deferrals. However, the compensation used for Roth 401(k) deferrals is taxed.

2. ROTH 401(K) DEFERRALS

Q. What are Roth 401(k) deferrals?

A. Roth 401(k) deferrals are contributions made by employees where the employees have decided to be immediately taxed on their deferrals.

Q. Why would employees want to make Roth 401(k) deferrals?

A. When employees receive qualifying distributions of their Roth accounts, they do not have to pay taxes on either the amounts they contributed as Roth 401(k) deferrals or the earnings on those deferrals. In contrast, employees pay tax on both pre-tax 401(k) deferrals and their earnings when the money is paid by the plan. (However, the taxation can be delayed by rolling over into an IRA.) This tax savings can be significant.

Younger workers are often interested in making Roth deferrals because they expect to have large amounts of earnings – since their deferrals are likely to be invested for a long time.

Roth deferrals are also valuable to anyone who can make the maximum amount of deferrals and pay the tax on top of that.

EXAMPLE: A medical group has a number of high paid doctors who participate in the 401(k) plan. One of the doctors, age 55, has a $500,000 traditional account balance. He decides to switch to Roth deferrals because:

- He can afford to contribute the full deferral limit, and pay the taxes he incurs on that part of this salary;
- He believes that he will be in the top tax bracket in retirement and that tax rates will be going up; and
- He likes the fact that, if he ultimately rolls over into a Roth IRA, it will not be subject to minimum required distributions beginning at age 70½.

Q. How much money can employees contribute as Roth 401(k) deferrals?

A. The limit for Roth 401(k) deferrals is the same as for pre-tax 401(k) deferrals. The total amount of pre-tax 401(k) and/or Roth 401(k) deferrals that an employee can make in 2013 is $17,500. This amount is increased by the $5,500 catch-up contribution for employees who are at least 50 years old. (These amounts may increase in future years.) [To view the most recent contribution and catch-up limits, go to http://www.irs.gov/pub/irs-tege/cola_table.pdf]

Q. Do I have to allow workers to make Roth 401(k) deferrals?

A. No. The company can decide whether or not it wants to allow Roth 401(k) deferrals. That is, in order to have Roth deferrals, there must be a specific plan provision that permits it.

Q. Can I have only Roth 401(k) deferrals in my plan?

A. No. Plans that permit Roth 401(k) deferrals must also allow employees to make pre-tax 401(k) deferrals.

Q. Are Roth deferrals treated differently from pre-tax deferrals while they are in a 401(k) plan?

A. Generally no. While Roth 401(k) deferrals are in the plan, they are treated similarly to pre-tax 401(k) deferrals. But, a plan must keep separate records of Roth accounts and traditional accounts. Also, special rules apply when Roth 401(k) accounts are distributed.

3. AUTOMATIC ENROLLMENT

Q. What is automatic enrollment?

A. Under automatic enrollment, employees automatically make deferrals to the plan at a pre-set rate unless they elect a different deferral rate or elect to not participate at all.

For example, if a 401(k) plan automatically enrolls at a 4% deferral rate, employees will be put into the plan at that rate unless they elect a different rate or elect not to defer. (The 4% deferral rate is only an

example. Companies can choose the deferral rate for their plans. The most common rates are in the 2% to 6% range.)

The purpose of automatic enrollment is to make it even easier for employees to participate in the plan.

EXAMPLE: Jennifer has just started working for the XYZ Company. The company's plan includes an automatic enrollment provision. Jennifer is given information about the plan and an enrollment form. Jennifer is busy with work and doesn't turn in any of the forms. When she becomes eligible to participate, 4% is taken out of her paycheck and contributed to the plan as if she had elected to make deferrals. Of course, Jennifer can stop or change the deferral rate at any time.

Q. Do I need to worry about state laws that prevent me from withholding money from employees' paychecks?

A. No. ERISA provides that state laws cannot prevent a plan from using automatic enrollment. However, plans must notify employees of the amounts that will be withheld from their paychecks, as well as the opportunity to defer at a different rate or elect not to defer.

Q. What if employees complain about being automatically deferred?

A. Employees can have their money returned upon request. However, an employee must ask for his deferrals to be returned within 90 days after the first deferral was taken from his paycheck. (More precisely, the account balance is paid to the employee. The account balance is the total of the deferrals, increased by any investment gains or reduced by any losses.)

EXAMPLE: In the example above, Jennifer was automatically enrolled in XYZ Company's plan. After money has been taken out of her paychecks for two months, she realized that she was automatically enrolled in the plan. Jennifer immediately contacts Human Resources and fills out a form to have the money returned to her. The money in her account was invested in a lifecycle fund and experienced investment gains. The money that was withheld from her paycheck, plus the gains, are returned to Jennifer. Since Jennifer was not taxed on the deferrals, she must now pay taxes on them, as well as the investment gains.

4. INCREASING PLAN CONTRIBUTIONS

Q. What types of contributions can the company make for employees?

A. Companies can make contributions that are allocated to participant accounts based on an employee's compensation (known as profit-sharing contributions) and contributions based on the amount an employee defers (known as matching contributions).

There is a limit on the total amount of deferrals, profit sharing contributions and matching contributions that can be added to a participant's account in a year. For 2013, that limit is $51,000. This amount may change in future years for cost-of-living adjustments. [To view the most recent limits, go to http://www.irs.gov/Retirement-Plans/COLA-Increases-for-Dollar-Limitations-on-Benefits-and-Contributions]

Catch-up deferrals are not included in that limit. As a result, for 2013 a participant who is 50 or older can defer another $5,500, for a total of $56,500.

Q. Can we do anything to help employees make additional 401(k) deferrals?

A. Yes. Companies have a number of choices for increasing the amounts their employees can defer.

The starting point is to talk to your advisor and TPA to get ideas that are appropriate for your circumstances.

However, one idea is to restructure your matching contributions. There is some evidence that many employees will defer enough to get the full match.

EXAMPLE: MNO Company wants to get employees to defer more to the plan. It currently matches 50¢ on a dollar for deferrals up to 3% of pay. It decides to change the matching contribution to 25¢ per dollar up to 6% of pay. As a result, many of its employees increased their deferral rates in order to receive all of the matching contribution. In the example, the average deferred rates were increased without any increase in the overall cost of the matching contributions.

Another idea is to automatically enroll employees. If a plan automatically enrolls newly eligible employees at 4% or 5% of pay, it is only a matter of time until the deferral percentages of the rank-and-file employees increase significantly.

EXAMPLE: Assume that a plan has only a 40% participation rate for its non-highly-paid employees. As a result, the highly paid employees could only defer small amounts – because of the ADP test. The plan begins automatically enrolling newly eligible employees at 5% of pay. Within a few years, the average deferral rate for that group averaged over 4%, allowing all of the highly paid employees to fully defer.

Companies can also use a "safe harbor" design in their plans. By using a safe harbor, all employees (including the highly paid) can contribute the maximum deferral under the law.

Q. What types of safe harbor designs are there?

A. There are two types of 401(k) safe harbor designs – a traditional safe harbor and an automatic enrollment safe harbor. In both designs, companies must make either a matching contribution or a profit sharing contribution.

In the **traditional safe harbor,** the matching contribution must be equal to at least 100% of the first 3% deferred and 50% of the next 2% deferred. Thus, the highest matching contribution a participant would receive is 4% of pay – if the participant deferred 5%. The matching contributions are only made for participants who defer.

Alternatively, the company could make a 3% profit sharing contribution that employees receive even if they do not make any deferrals. Participants are 100% vested in these contributions.

EXAMPLE: JKL Company wants to enable its highly compensated employees to defer up to IRS's maximum dollar limits. To do that, it amends the plan to use the safe harbor method with matching contributions. The company makes a matching contribution for all participants. Joe is a participant in the plan who defers 4%. For Joe, JKL Company makes a matching contribution of 3.5% (dollar-for-dollar on the first 3% deferral, plus 50¢ on the next 1% deferral).

The **automatic enrollment safe harbor** is similar to the traditional safe harbor. However, the matching contribution alternative for the automatic enrollment safe harbor is less than the one for the traditional safe harbor. That is, plans that automatically enroll employees are only required to make a matching contribution of 100% of the first 1% deferred and 50% of the next 5% deferred. Thus, the highest matching contribution for a participant would be 3.5% of pay – if the participant deferred 6%. Alternatively, the company could make a 3% profit sharing contribution that employees receive even if they do not make any deferrals. This alternative is the same as the profit sharing formula for the traditional safe harbor.

The plan can provide that employees are not vested in the company contribution unless they have worked for the company at least two years.

EXAMPLE: Similar to the example above, JKL wants to create a safe harbor for the deferrals by its highly paid officers and managers, but instead decides to automatically enroll the employees and to use the automatic enrollment safe harbor with the matching contribution method. JKL Company would need to make a matching contribution for Joe's 4% deferral of 2.5% (100% match on the initial 1% deferral, plus 50% on the next 3% deferral).

In order to use the automatic enrollment safe harbor, employees who default (that is, do not elect a different percentage or who opt out) must have at least 3% of their pay deferred in the first year they are automatically enrolled. The percentage deferred must be at least 4% for the second year, 5% for the third year and 6% thereafter.

For both types of safe harbors, employees must be given written notices.

Q. What can we do to increase the amount of company contributions we make?

A. There are a variety of plan design techniques that can be used to increase the company contributions for a company's key employees. These methods are complicated and require the service of a knowledgeable consultant, like a TPA. For example, one method is called "cross testing." This method uses actuarial concepts to look at the amount of "benefit" the employees receive from the contribution. In our experience, cross-testing usually results in large contributions for key employees. As a word of caution, though, it only works where companies are willing to make significant profit sharing contributions for the rank-and-file employees – typically of 3% to 5% of pay.

CHAPTER 5:
DAY-TO-DAY HANDLING OF THE PLAN

This Chapter includes a number of frequently asked questions about the day-to-day operation of retirement plans. These questions are especially common for those sponsoring a plan for the first time, but we recommend this Chapter to any plan sponsor, regardless of how experienced.

1. ALLOCATION AND DELEGATION

Q. Can a fiduciary allocate and delegate his fiduciary responsibilities?

A. Yes. Fiduciary duties can be allocated among several fiduciaries and can also be delegated by one fiduciary to another. For example, a trustee can have the responsibility for holding and safeguarding the plan's assets, while the plan committee can have the responsibility for selecting the investments.

However, there are limitations on allocation and delegation. For example, no delegation or allocation can be made unless the plan document allows it. The exceptions, and the exceptions to the exceptions, are complex; as a result, these are treacherous waters and should only be navigated with expert advice.

2. INVESTMENTS AND INVESTMENT MANAGERS

Q. What is an investment manager?

A. ERISA defines the term "investment manager." It means any fiduciary:

a. Who is delegated the power to manage any asset of a plan;

b. Who ...

(i) is registered as an investment advisor under the Investment Advisers Act of 1940 or under state law (and has filed a copy of its state registration with the DOL);

(ii) is a bank, as defined in the Investment Advisers Act of 1940;

or

(iii) is an insurance company qualified to manage assets under the laws of more than one state;

and

c. Has acknowledged in writing that he or she is a fiduciary. [See ERISA §3(38)]

Note that the investment manager must acknowledge his or her fiduciary status in writing for the delegation to be effective.

Q. What is the advantage of having an investment manager?

A. If the plan's primary fiduciary prudently appoints an investment manager, and then prudently monitors its performance, the fiduciary will not be liable for the investment decisions of that manager. [See ERISA §405(d)(1); Harris Trust & Savings Bank v. Ameritech Corp., 832 F.Supp. 1169 (N.D. Ill. 1993); Lowen v. Tower Asset Mgmt. Inc., 829 F.2d 1209 (2d Cir. 1987)]

3. RELIANCE ON PROFESSIONALS

Q. Can I rely on professionals to help me with the operation of my plan?

A. Yes. Hiring competent professionals to help with, for example, calculating plan benefits, filing government forms, investing plan assets and amending the plan to comply with changing laws, and relying on their recommendations (after thoughtful consideration) is permissible – and advisable – under ERISA. Many courts have said that the use of competent advisor is evidence of a prudent process. (But the hiring and continued use of the advisor must be done in a prudent manner.) In fact, if you don't know how to operate a plan or manage its investments, the failure to hire professionals to help you could be an indication that you are not being prudent.

Other types of professionals (or "service providers") you might hire include:

- **Third party administrator (TPA):** Someone who performs the ministerial functions in the day-to-day administration of the plan. The TPA is not to be confused with the ERISA plan administrator, who is the fiduciary responsible for plan operations (and which is typically the plan sponsor). The TPA is usually not a fiduciary, because the TPA only performs ministerial functions, without exercising broad discretion or control over the plan.
- **Financial advisor or consultant:** A broker or investment advisor who assists fiduciaries in the choice of plan providers and in the selection and monitoring of the plan's investments.
- **Auditor:** A certified public accountant who audits a plan. Generally, audits are required for plans that cover 100 or more employees.
- **Legal counsel:** An attorney who advises you about the legalities of being a fiduciary, administering the plan, and managing the plan's investments.

Q. If you obtain help from an expert, are you immune from claims of fiduciary breach?

A. No. Over the years, the courts have ruled that obtaining an independent assessment from a financial representative or legal counsel is evidence of a thorough investigation, but it is not by itself a complete defense. As one judge explained, expert advice is not a "whitewash." [Donovan v. Bierwirth, 680 F.2d 263, 272 (2nd Cir. 1982)]

For example, in transactions involving assets that are hard to value, a fiduciary should do more than just hire a valuation expert. The valuation report should be studied by the fiduciary, and the expert should be questioned about the assumptions used and the validity of the data. The questions, and the answers to the questions, should be documented. If you can't understand what is being said, ask questions until you can understand the answers. Not asking the question, or not understanding the answer, can be the difference between winning and losing the lawsuit that may follow.

Q. Should you document the process?

A. Certainly. Make sure that you have a contemporaneous record of the steps you took to be procedurally prudent. Take notes. Keep minutes of meetings. Get your questions answered in writing. Keep these materials in a *due diligence or audit file*. Years later, when memories dim, your documents will show, for example, how you selected a competent independent consultant; how the advisor was supplied with and used accurate and up-to-date information; and how you reviewed the advisor's work and satisfied yourself that his or her analysis and conclusions were reasonable.

Q. What is an audit file?

A. When government agencies audit or investigate plans, there are certain documents that they usually request. (The IRS calls its investigations "audits." The PBGC calls them "audits," too. The DOL calls them "investigations." Whatever they are called, it is the government knocking at the door.)

Usually, the government wants to see the plan documents (including amendments), the trust documents (if they are separate from the plan), the summary plan description, the IRS determination letter for tax qualification, the investment guidelines or investment policy statement, plan loan guidelines, the fidelity bond, service provider agreements, minutes of any plan committee meetings, a list of the plan's assets, a record of plan transactions, the most recent annual filing with the government, and the most recent auditor's report.

The audit file should also include your *due diligence* documents. Those are the materials and data that you gathered for making fiduciary decisions, as well as the notes or minutes of your analysis, discussions and conclusions.

If you maintain an organized file with copies of all of these documents, you can be timely in your response to the investigators. Think about it. If it takes you weeks or months to put together these items, what are you telling the government about your plan?

Q. Who lets me know when I need to amend the plan? Who drafts the plan amendments? Who prepares the 1099Rs when participants get distributions from the plan? Who prepares the annual filing that the plan has to make with the government?

A. The short answer is, "it depends." Many of the tasks in running a plan do not have to be performed by a particular type of professional. The important thing is that these jobs get done – and done well. To make sure they do, you should have written agreements with your service providers that describe who is responsible for doing what. The agreements don't have to be long, they don't have to be in fine print, but they do need to cover all of the important tasks.

4. AGREEMENTS WITH SERVICE PROVIDERS

Q. Do I need written agreements with everyone who provides services to my plan?

A. ERISA does not require that agreements with service providers be in writing; however, it may be necessary to have written agreements for plan sponsors to show that they prudently evaluated and understood the terms of the arrangement.

But §408(b)(2) of ERISA does require that plan sponsors receive written disclosures about compensation, status and services from their service providers. Plan sponsors must review those disclosures and evaluate the reasonableness of their provisions, as well as any conflicts of interest that may be disclosed.

The DOL regulation under §408(b)(2) applies to the following service providers among others:

- Providers who act as fiduciaries;
- Registered investment advisor (RIA);
- Recordkeepers and bundled providers;
- Securities and insurance brokers; and
- TPAs, consultants and others who receive compensation from plan investments or other service providers.

Q. What would service providers need to disclose in the agreement?

A. Service providers would have to disclose the services to be provided, the direct and indirect compensation or fees to be received, and their status as either a fiduciary or a RIA.

Q. What types of compensation would service providers need to disclose?

A. "Compensation" is broadly defined in the regulation and includes money or anything of value (for example, gifts, awards and trips) received directly from the plan or indirectly – for example, revenue sharing payments from a mutual fund company. For example, if your plan pays your TPA directly, that is an example of direct compensation. Alternatively, if the expenses of the various investments in the plan that are paid by the participants are used to pay the plan's investment advisor, then this is an example of indirect compensation.

Q. What are the consequences if a service provider fails to make these disclosures?

A. If a service provider fails to make the disclosures required by the regulation, the arrangement will be prohibited. As a result, the service provider could be required to disgorge all of the compensation it received and to pay penalties to the government.

Q. Can I be held liable if a service provider fails to make the required disclosures?

A. Possibly, but the DOL has created an exception for fiduciaries who, through no fault of their own, don't receive the required disclosures from their service providers. To obtain that protection, the fiduciary must request the disclosures from the service provider. If the service provider refuses to provide you with the disclosures, you must report the service provider to the DOL within 30 days. However, if the service provider is unresponsive, you have 90 days to report the service provider to the DOL. You may report the service provider online by filing a Fee Disclosure Failure Notice at **http://askebsa.dol.gov/fdfn**. You will also be required take other steps such as terminating the service provider.

5. OTHER PRACTICAL HINTS ABOUT SERVICE AGREEMENTS

Q. Once I obtain information about the service provider's compensation, status and services, what do I do with that information?

A. The fiduciary's job is to determine whether the service provider's compensation is reasonable in light of the services being provided. That determination needs to be made when the service provider is initially hired and periodically thereafter. You may need help from your advisor to determine whether the compensation is reasonable.

Q. Who pays the service provider's fee?

A. If the plan is the client, either the plan or the plan sponsor can pay the fee. But if the plan sponsor is the client (and, therefore, has the obligation to pay), the plan cannot pay the fee and the plan sponsor must pay the fee. Be sure that the plan document does not have a provision that requires the plan sponsor to pay the fees because then the plan cannot pay the fee.

Also, your plan's investments make indirect payments (sometimes called revenue sharing) to your plan's providers and advisors, and your plan provider also may make payments to your advisor and/or TPA. (See Chapter 3 for additional information.)

Q. Can the plan pay all service provider fees?

A. No. The DOL takes the position that the plan sponsor must pay fees related to the decision to implement or terminate a plan or to amend the plan to increase or decrease benefits. The rationale is that these decisions are made for the benefit of the company and not as part of the on-going administration of the plan. However, the plan can pay for the cost of implementing the decision and communicating it to the participants, as well as the cost of amending a plan to ensure its continued compliance with legal requirements. (See the discussion of fees and costs in Chapter 3.)

Q. What must I do in deciding which expenses can be paid by the plan?

A. Fiduciaries have a legal duty to determine the *reasonableness* of the expenses being paid by the plan. This reasonableness limitation on 401(k) expenses is important because the payment of excessive expenses reduces the benefits for participants at retirement. Even seemingly small amounts of excess expenses can have a significant impact on a participant's retirement benefits.

EXAMPLE: The DOL provides the following example of how fees can affect a participant's account. Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7% and fees and expenses reduce your average returns by 0.5%, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5%, however, your account balance will grow to only $163,000. The 1% difference in fees and expenses would reduce your account balance at retirement by 28%.

Also, the costs of operating the plan must be reasonable compared to the value received. That is, fiduciaries do not need to choose the least expensive services or investments. However, they should make sure that the expenses are appropriate and reasonable compared to the value to the plan and the costs in the marketplace for comparable services.

EXAMPLE: A distribution company decides to establish a 401(k) plan for its employees. The president of the company is responsible for selecting the 401(k) provider. That decision is a fiduciary decision and, as a result, the president is acting in a fiduciary role. A president investigates three different providers for its plan. She picks the provider she reasonably believes will provide the best services for the plan, even though it is not the least expensive. For example, the provider offers effective enrollment meetings, resulting in high participation rates. The fiduciary has satisfied her duties under ERISA since she used a prudent process to pick the provider.

Significant focus has been placed on plan expenses by the media, government and participants. The DOL has indicated that fiduciaries need to understand both direct and indirect compensation paid to providers and advisors. Additionally, there are a number of highly publicized lawsuits where participants have sued plans alleging, among other things, that the fiduciaries entered into agreements with providers that caused the plans to pay unreasonable, excessive fees and didn't monitor the fees and expenses. Now, more than ever, fiduciaries should examine and understand all fees paid by their plans and all revenue received, directly or indirectly, by the advisors and providers.

Q. How can the agreement be terminated?

A. Regulations of the DOL require that a plan be able to terminate a service provider agreement with reasonably short notice and without a penalty. Service agreements include a termination provision which lets either party terminate on written notice.

Q. Can a fiduciary be liable for entering into an unreasonable arrangement with a service provider, even if the fiduciary receives no personal gain from the arrangement?

A. Yes. Remember that a pure heart and an empty head are no defense to a claim of fiduciary liability. An unreasonable arrangement or an unreasonable fee (such as excessive fees for average services) are prohibited by ERISA. The fiduciary who causes the plan to pay the charge or the fees from plan assets in those circumstances risks being liable for breaching his fiduciary duty.

If the arrangement with the service provider is not reasonable, or if the fee is not reasonable, or both, the payment of the fee is a prohibited transaction. A penalty must be paid to the IRS. The penalty is 15% of that part of the payment that was unreasonable. So, if the amount of the fee is $10,000, but a reasonable fee was $6,000, then the penalty is $600 ($10,000 - $6,000 = $4,000 X 0.15). If the $4000 excess is not paid back to the plan, there is an additional penalty of 100% of the $4,000, plus the $4,000 (with interest) overpayment must still be paid back to the plan.

EXAMPLE: A TPA agrees to provide services to a plan for a flat fee, plus a per participant charge. The TPA also receives fees (sometimes called "revenue sharing") from the mutual funds held by the plan. The combination of fees is twice what the average TPA would charge for comparable services. In this situation, the members of the plan committee who approved the arrangement may have committed a fiduciary breach, and the TPA may have engaged in a prohibited transaction because, even though the services are necessary, the fees are not reasonable.

6. INSURANCE COVERAGE OF SERVICE PROVIDERS

Q. Do service providers carry insurance?

A. They do in many, but not all, cases. You should ask if they are insured, and you should ask to see the policy and the declaration page that indicates the amount of insurance coverage. Among other things, make sure that the insurance covers the kinds of services that you are paying for.

7. PROHIBITED TRANSACTIONS

A. TYPES OF PROHIBITED TRANSACTIONS

The following types of transactions are generally prohibited:

- Transactions with closely related parties (for example, the company or its owners, or the service providers to the plan); and
- Self-dealing transactions by the fiduciaries.

Q. Who are closely related parties?

A. They are called "parties in interest," and they include (but are not limited to):

- Any fiduciary or employee of a plan;
- A party providing services to a plan;
- A sponsoring company;
- A relative of any of the above;
- A corporation or partnership, 50% or more of which is owned by those parties;
- An employee, officer or director or a 10% or more shareholder.

EXAMPLE: The wife and daughter of a majority stockholder of a company that sponsored a retirement plan are "parties in interest" to that plan.

Q. Who will help you guard against committing prohibited transactions?

A. These transactions can be hard to recognize. Look to your service providers to help you spot them and avoid them. Let them know you expect their help. And, if there is a questionable transaction, get the help of an experienced ERISA attorney.

B. EXEMPTIONS

Q. Are there exemptions from the prohibited transaction rules?

A. Yes, but this area is highly technical and fraught with peril. You should never have your plan engage in a transaction (e.g., a contract, loan, lease or sale) with a related person or entity without expert advice.

CHAPTER 6:
PROTECT YOURSELF, WHILE PROTECTING THE PLAN'S PARTICIPANTS

1. POTENTIAL LAWSUITS

Q. Who can file a lawsuit against me claiming that I breached my duty as a fiduciary?

A. First of all, if you read this handbook and take it to heart, you can reduce the chance of being sued in your capacity as a plan fiduciary. The universe of potential plaintiffs consists of the DOL, the participants and beneficiaries of the plan and other plan fiduciaries.

Q. If something goes wrong with an individual employee's account in the plan, can he sue me?

A. The United States Supreme Court answered this question in the recent, highly publicized case of LaRue v. DeWolff, Boberg & Associates. In LaRue, the plaintiff claimed that the plan fiduciaries failed to carry out his investment instructions, with the result that the value of the assets in his account were less than it otherwise would have been. LaRue's facts are somewhat unusual, since in the vast majority of 401(k) plans, participant investment instructions are communicated via "800 numbers" or the internet directly to the investment provider, whereas Mr. LaRue alleged that he gave the investment directions to his employer. The lower court held that Mr. LaRue was not entitled to recover damages, since damages under ERISA are only available for the benefit of the plan as a whole, and not to individual participants. The Supreme Court reversed that decision and paved the way for individual participants to sue.

2. INSURANCE

A. FIDUCIARY LIABILITY INSURANCE

Q. Can insurance be purchased to protect against fiduciary liability?

A. Yes. ERISA permits the purchase of fiduciary liability insurance. If the insurance is purchased with plan assets, the insurance policy must permit "recourse," that is, it must allow the insurer to try to collect any losses from the fiduciary (for example, the trustees or committee members), if the fiduciary has breached his or her duties. The fiduciaries may be able to purchase a "non-recourse rider," which covers the insurer's right of recourse against the fiduciaries. The non-recourse rider can be purchased for a relatively nominal cost. However, the premium for that rider cannot be paid with plan assets.

As a word of warning, don't confuse your fiduciary bond with fiduciary breach insurance. They are two very different forms of protection. The bond is very limited, covering only losses by theft and embezzlement, while the fiduciary insurance is much broader, covering breaches in making investments and overseeing the operation of the plan. (See the discussion of fiduciary bonds later in this Chapter.)

EXAMPLE: A doctor sponsors a profit–sharing plan for the benefit of her employees. She personally picks the plan investments, which are almost exclusively aggressive technology stocks. While the market is riding high, no one questions her investment choices. When the market collapses, her employees point the finger at her – as the plan's fiduciary – and argue that she should have been better in selecting, monitoring and diversifying the investment choices, and that she is liable for the losses. When she is sued, the doctor may be liable for (1) making the plan whole – that is, paying back the difference between the current value of the plan's assets, and what the value would have been if she had engaged in a more prudent selection of investments, (2) paying her own attorneys fees, and (3) if she loses, paying the participants' attorneys fees. A fiduciary liability insurance policy may allow her to avoid all or most of these expenses.

Q. Do any plan providers offer fiduciary protections to plan sponsors?

A. Yes. For example, some providers offer warranties to fiduciaries. Many fiduciaries are concerned about their legal responsibility and possible liability. To help companies manage that risk, a provider may offer investments that are selected and monitored in a way that meets or exceeds ERISA's standards. To do that, the provider would perform a qualitative and quantitative analysis of the investments and use generally accepted investment theories when deciding (i) which types of investments to offer and (ii) which specific investments will be included in the offering. The warranty may provide that: the investments are appropriate for long-term investors; the investments are a broad range of investment alternatives; and the funds are selected and maintained by standards that equal or exceed ERISA's standards for selecting and maintaining investments.

Fiduciaries should make sure that they understand the requirements to obtain the warranty and understand exactly what the warranty covers.

B. OFFICERS' AND DIRECTORS' INSURANCE

Q. Will my company's officers' and directors' insurance policy provide coverage in the event of a fiduciary breach?

A. Maybe, but maybe not. Check your policy and ask your insurer to tell you, in writing, whether your "D&O" policy will cover ERISA fiduciary breach claims. Many officers' and directors' insurance policies contain specific exclusions for ERISA claims.

3. BONDING

Q. What is ERISA's bonding requirement?

A. ERISA §412 requires that a bond be obtained to reimburse an employee benefit plan for losses resulting from fraudulent or dishonest acts by the people who handle the plan's money. The purchase of an ERISA §412 bond with plan assets is permitted.

Q. Who has to be bonded?

A. With certain limited exceptions, every fiduciary and every person who "handles" the money or other property of an employee benefit plan has to be bonded. For example, every employee who handles plan money must be bonded. (Certain entities such as banks, savings and loan associations, and insurance companies are exempt from the bonding requirement.)

Q. What does it mean to "handle" plan assets or property?

A. "Handling" of plan property and assets is not limited to actual physical contact. "Handling" occurs whenever the employee's duties present the possibility that the property or funds could be lost due to fraud or dishonesty.

Q. What is the required amount of the bond?

A. The amount of the bond must be at least 10% of the money or other property of the plan handled during the preceding plan year by the person or group that is covered by the bond. The bond cannot be less than $1,000, and it need not exceed $500,000. The Secretary of Labor may require a bond in excess of $500,000 under certain circumstances.

Q. Are there situations which might require a larger bond?

A. Yes, if the plan holds more than 5% "non-qualifying assets."

Under DOL regulations, plans with fewer than 100 participants are exempt from the requirement that the plan's financial statements be audited by a CPA. But this exemption is only available if at least 95% of the plan's assets are "qualifying plan assets." These include insurance company annuity contracts, mutual fund shares and assets held by a bank, insurance company, broker dealer or qualified custodian. Thus, for example, if the plan were to hold more than 5% of its assets in real estate, it would not be entitled to the exemption.

As an alternative to having a CPA audit of the plan, the plan sponsor may purchase a bond in an amount equal to the value of the non-qualifying assets. If the normal bond is sufficient to cover the non-qualifying assets, then no additional bond is required. But if the non-qualifying assets exceed the amount of the normal bond, then an additional bond would be required.

EXAMPLE: A plan has $6,000,000 in assets. Of this amount, $250,000 (less than 5% of the total assets) is invested in real estate. The bond would need to be $500,000 (the normal maximum bond required under ERISA). However, if $750,000 were invested in real estate, the plan would need to have a $750,000 bond. If all of a 401(k) plan's assets are invested in mutual funds or insurance contracts, an additional bond will not be needed, since those are qualifying assets.

CHAPTER 7:
WHAT OTHER QUESTIONS SHOULD I ASK?

Congress regularly changes the laws that govern retirement plans, and the DOL and the IRS keep issuing new regulations and rulings. From the time you started reading this handbook until the time you finished, there may have been a change in the law or regulations that affects your plan. One question you want to ask is, "Which of my plan professionals is responsible for keeping me up-to-date on changes in the law affecting the retirement plan?" If you do not know the answer now, ask your service providers and get the answer in writing. Here are some other questions that you may have, and the answers to those questions.

Q. Can participants borrow from the plan?

A. Yes, if the plan permits and with certain limitations. For example, the plan must have a written loan program; the loan amount can only be greater than $10,000 if 50% of the value of the participant's vested benefit exceeds that amount; the balance of all plan loans to a participant cannot be greater than $50,000; the loan must be repayable within five years (in most cases); and the loan must be adequately secured (usually by the participant's account balance). Of course, the plan's requirements for loans must be followed.

Q. Is there anyone who is not allowed to be a fiduciary?

A. Yes. Anyone who has been convicted of or imprisoned for certain crimes (such as embezzlement, extortion, robbery or murder) is prohibited from being a plan fiduciary or plan representative for a period of 13 years after the conviction or imprisonment.

Q. How does someone become a fiduciary?

A. You become a fiduciary by accepting a position that authorizes you to either exercise control over plan assets (for example, a trustee or an investment manager) or exercise discretionary control over plan administration (such as the plan administrator or a member of the committee which decides on the payment of participant benefits). When you accept the position, you become a fiduciary, even if you do not use your authorized power.

You can also become a fiduciary if you exercise control over the plan even if you were not appointed to do that. For example, if a person who is not authorized by the plan (or appointed under a plan procedure) begins controlling the investments, he or she becomes a "functional fiduciary" under ERISA. Another example of a functional fiduciary is a corporate officer who decides to use employee deferrals to pay company creditors rather than transferring the money to the plan.

Being a fiduciary does not depend upon whether you realize you are one. ERISA has a functional definition of fiduciary. This means the function you perform determines whether you are a fiduciary, even if you don't have an official title. On the other hand, if you do have a fiduciary title (for example, as trustee), you are an ERISA fiduciary even if you don't actually do the job.

Q. How does someone stop being a fiduciary?

A. The plan or trust document should have a provision that explains how a fiduciary resigns or how a fiduciary is replaced. Similarly, agreements with fiduciaries (for example, the investment manager) should have resignation/replacement provisions. Courts have ruled that resignation is itself a fiduciary act, so it must be carried out consistent with fiduciary duties. And, remember, being a fiduciary doesn't depend upon titles. If you perform a fiduciary function, you're a fiduciary for as long as you perform that function and until someone else replaces you. A fiduciary cannot abandon a plan.

If a fiduciary resigns without having a qualified replacement, the resigning fiduciary may be exposed to liability. For example, if you suspect that other fiduciaries may be breaching their duties, resigning is not a solution. You must first take action to protect the participants, and immediately alert the replacement fiduciaries of your concern. You should also consider notifying the DOL.

Q. Are there civil penalties for breaching fiduciary duties?

A. Yes. If you breach a fiduciary duty and are told to correct the problem by the DOL (in a lawsuit or an investigation), you may have to pay a civil penalty. The amount of the penalty is 20% of the amount recovered by the plan. This civil penalty is in addition to the payment necessary to remedy the breach. [See ERISA §502(l)]

Q. What happens if you commit a prohibited transaction, but correct the problem without intervention by the DOL or IRS??

A. You still owe an IRS excise tax to the government – 15% of the amount involved in the prohibited transaction. Failure to correct can result in an additional 100% tax.

Q. What happens if a participant asks for information about benefits and you ignore the request or you simply forget about it?

A. There is a civil penalty of up to $110 per day that you may have to pay if you do not respond to the participant's request within 30 days. This penalty may be imposed by a court even if you prevail in every other aspect of a participant's claim. The penalty is imposed against the plan administrator – i.e., the person named in the plan document as the plan administrator. If no administrator is identified, the company is the plan administrator.

Q. What happens if you do not timely file the plan's annual report (Form 5500) with the government?

A. The DOL may impose a civil penalty of up to $1,100 dollars per day for the failure or refusal to file the report. Additionally, the IRS may impose a penalty of up to $25 per day – to a maximum of $15,000 – for each untimely filed Form 5500.

Q. What happens if you take the plan's assets to pay the company's expenses because the company has fallen on hard times and you believe it is better to keep the company afloat so the participants will have jobs?

A. You can be fined or you can go to jail, in addition to having to pay the excise taxes for this prohibited transaction. You will also have committed a fiduciary breach and could be sued by participants or by the DOL.

EXAMPLE: The majority owner of a company served as president, chairman of the board and trustee of the company's 401(k) plan. When the business started having cash flow problems, the owner/president decided to help the company's cash flow by slowing down the payment of employee deferrals to the plan on a temporary basis. Unfortunately, the company's financial situation did not improve. Both the company and its owner ultimately declared bankruptcy.

In this example, after the company stopped operating, the former employees complained to the DOL that over $100,000 of their deferrals had never been paid to the plan. The DOL investigated, and when the owner refused to fund that shortfall, the DOL sued him for fiduciary breach. The owner settled with the DOL by transferring an amount equal to the missed contributions, plus earnings, from his account in the 401(k) plan to the employees' accounts. (Since liability from certain breaches of fiduciary duty under ERISA are not dischargeable in bankruptcy, the owner's personal bankruptcy did not protect him from this claim by the DOL.) Thus, he ended up with greatly reduced 401(k) benefits, along with the woes of his personal and corporate bankruptcies.

If the DOL had not fully recovered the employees' money from the president's account, the DOL could have sued the individual members of the board of directors for the losses, asserting that they failed to adequately monitor the performance of the president in his capacity as a plan fiduciary.

Q. What kinds of duties do co-fiduciaries have?

A. If the trustee does not adequately perform his or her duties, the fiduciaries who appointed him or her may have a duty to replace the trustee. For example, one of a trustee's duties is to collect the contributions from the company. If the company stops depositing employee deferrals into the plan, the trustee must take steps to collect those contributions. If the trustee sits on his or her hands, then the trustee may be liable for a fiduciary breach, and the members of the board of directors may be liable for not removing the trustee and appointing a new, more aggressive trustee.

In other words, the trustee of a 401(k) plan could have the duty to sue himself in his capacity as president of the company. And, if he doesn't, he could have the duty, as chairman of the board of directors, to act to remove himself as trustee and to appoint a new, more aggressive trustee to file the lawsuit. While that sounds ludicrous, it is, in fact, the law – and the law will be enforced by the DOL and plaintiff's attorneys.

Q. Are the fiduciary rules any different in a closely-held business, where the president of the company, the chairman of the board and the trustee of the plan are the same person?

A. Not really. Although this legal principle (one person filling multiple, separate roles) may seem artificial, it is not. In an audit or in litigation, the potential for liability is very real.

Q. What are the concerns of a co-fiduciary?

A. One concern is liability. For example, if the officers decide not to pay deferrals into the plan, the officers may become fiduciaries. When a fiduciary becomes aware of a breach by another fiduciary, ERISA requires that steps be taken to protect the plan and the participating employees. If the board does nothing to prevent the officers' use of the contributions for the benefit of the company, then the board's members may be liable for any losses that they could have reasonably prevented.

Being a fiduciary isn't easy, but it can be done, and done safely. Ask plenty of questions, and get answers to all of them. Follow the rules, and keep a record of what you did. You can survive with your reputation, your plan benefit and your estate intact.

Q. Is it possible to have a retirement plan and not get sued?

A. Yes, of course. Despite all of the horror stories we've told you so far, the vast majority of fiduciaries do not get sued, do not pay penalties, and probably do not regret the day they agreed to be fiduciaries. Retirement benefits are an important part of the compensation package for you and your employees. Fiduciaries are the watchdogs over those benefits. The law requires that the fiduciaries do their job in a prudent, or reasonable, manner. But the law does not require that the fiduciaries ensure the plan against problems or investment losses – just that they take prudent steps when handling the employees' retirement money.

THE DRINKER BIDDLE & REATH, LLP EMPLOYEE BENEFITS PRACTICE

The firm's retirement plan and benefits practice covers the full range of benefit issues: from single employer to multi-employer plans, from qualified plans to deferred compensation arrangements, and from consulting to litigation. The firm enjoys a national reputation for technical skills and practical advice. Our attorneys deliver these services in two practice groups:

Benefits Counseling: These attorneys advise plans and their sponsors, fiduciaries, and service providers on legal issues in the design, documentation, administration, investment management, and termination of qualified and nonqualified retirement plans and other benefit programs, such as health care.

Examples are:

- Counsel to private and public companies and fiduciaries on operational and fiduciary issues
- Representation of companies, plans and fiduciaries before all government agencies, including the IRS, DOL and PBGC
- Representation of service providers to plans, including advice on fiduciary and professional liability issues and technical support
- Counsel to companies on the design and operation of stock-based plans, including the transactional aspects of employer stock ownership plans (ESOPs)
- Counsel to tax-exempt and governmental entities on 403(b), 457 and qualified plans
- Advice to companies on the design and operation of non-qualified deferred compensation programs for executives, including funding vehicles for those programs

ERISA Litigation: Our attorneys litigate cases involving fiduciary breaches, prohibited transactions, service provider malpractice, valuation of plan assets, benefit claims and interpretation of plan documents.

Examples of our litigation practice include:

- Defending fiduciaries in connection with Department of Labor litigation
- Defending ESOP fiduciaries against participant claims relating to stock valuation
- Defending third party administrators and actuaries in professional malpractice and fiduciary breach cases
- Serving as expert witnesses in arbitrations and in state and federal courts on issues including the duties of plan fiduciaries, fiduciary status for providers to plans, document interpretation, and professional malpractice
- Prosecuting and defending ERISA-related claims in bankruptcy courts

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At the end of the day, you can take advantage of the work we're doing to help make sponsoring a qualified retirement plan work as smooth as possible.

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