403(b) Retirement Plans
New Rules, New Responsibilities

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Agenda

- Summary of 2009 regulatory changes
- ERISA, or not
- Fiduciary duties
  - Best practices
  - Plan fees
  - Investment selection and monitoring
  - What to look for in vendors

Employer Retirement Plans "Defined"

- Defined <u>Contribution</u> (DC)

  A work-based plan, such as a 401(k) or 403(b).
  - Employee chooses to participate
  - Employee bears the investment risk
- Defined <u>Benefit</u> (DB) – AKA a "pension"
  - Providing a fixed amount on a regular basis
  - The employer is responsible for investing

Most Common Defined Contribution Plans

- **401(k)**
  - Employees may make salary deferral contributions.
  - Employers may match contributions and/or have a profit sharing feature
- **403(b)**
  - Now, essentially like 401(k)s.
  - Available to employees of public educational institutions and 501(c)3 non-profit organizations

Recent Regulatory Giants

- **EGTRRA:** Economic Growth and Tax Relief Reconciliation Act of 2001
  - Many changes to retirement plans
- **PPA:** Pension Protection Act of 2006
  - Made EGTRAA Permanent
  - Went much further
- These two affected 401(k) and 403(b) plans

Pension Protection Act

Pension Protection Act of 2006

- Fourteen Titles; Over 62 Sections; 907 Pages
- Deals mostly with Defined Benefit Plans but…
- Also contains changes to Defined Contribution Plans and IRAs

PPA Made EGTRRA Permanent

EGTRRA, among <u>many</u> other things:

- Increased deferral and contribution limits
- Created the age-50 catch-up contributions
- Changed "top-heavy" rules
- Expanded portability, including rollovers to IRAs
- Added Roth IRA benefits to 401(k) and 403(b)

PPA Highlights
Effective 2009

Continued Roth 401(k) and 403(b)

- Post-tax contributions up to $16,500 (extra $5,500 for 50+)
- No required minimum distributions on rollover to Roth IRA
- Employer match would apply to both traditional and Roth contributions but the total amount would be considered as pre-tax

PPA Highlights
Effective 2009

New Rules for 403(b)s

- Faster vesting for some plans
- Allows for “hardship withdrawals” for plan beneficiaries
- Requires regular participant statements

Why New 403(b) Regs?

Issues:

- IRS audit failure rate was almost 100%
- Major concern - loans and hardship withdrawal documentation
- Desire was to operate 403(b) like 401(k) plans
- First comprehensive changes in 40 years
- Makes employers <u>accept responsibility</u>

403(b)
Written Plan Document

- Written documentation required
- Include eligibility, benefits, contribution limits, available contracts, distributions
- Current list of providers required (i.e., mutual funds, insurance companies, etc.)

Other 403(b) Requirements

- Salary reduction rules follow 401(k)
- ACP testing and eligibility under "universal availability" rules will be applied
- Deposits – as soon as administratively feasible but no longer than 15th business days
- Post-employment contributions allowed
- Clarification of "severance from service"
- Termination of 403(b) plans allowed

Subject to ERISA?

- Generally, 403(b) plans established or maintained by tax-exempt organizations are covered by ERISA Title I.
- Governmental and church plans are exempt.
- It is possible that some plans offered at legal services are not subject to ERISA

Becoming an ERISA Plan

The employer will be deemed to have control as the plan sponsor, and the plan will no longer be exempt from ERISA, if:

- The employer <u>exercises discretion</u> in:
  - authorizing plan-to-plan transfers
  - processing distributions
  - making determinations regarding
    - hardships
    - qualified domestic relations orders (QDROs),
    - participant loans
    - other matters

ERISA Advantages

- Certainty – a clear legal framework for defining obligations and duties
- Control over assets – allowing for protection and education of employees
- Control over the plan – Rather than the vendors defining the terms of the plan, the employer can have broader involvement

ERISA Advantages

- Pre-emption of state law
  - Eliminates the possibility of punitive damages, consequential damages and a jury trial
  - Generally limits reliance on oral statements that conflict with plan terms
  - Employers are given the benefit of the doubt in interpreting the plan, and usually any reasonable and consistent interpretation is upheld by courts

ERISA Disadvantages

- Greater employer duties and expenses
  - e.g., employers with more than 100 employees must have the plan audited by an independent certified public accountant each year
- ERISA disclosure obligations
- ERISA reporting requirements
- Claims procedures
- Fiduciary duties

Avoiding ERISA

- Employers can comply with the new 403(b) regulations, including the requirement to have a written plan document, without necessarily transforming a non-ERISA plan into an ERISA plan.
- However, the employer must continue to limit its discretion in the administration of the plan.

Avoiding ERISA

- An employer can:
  - Take steps to ensure the 403(b) plan keeps its tax-preferred status, and
  - Provide verifying information to plan investment providers,
  - Without crossing the line and becoming a "sponsoring employer."
- Difficult to remain non-ERISA after 2009 effective date of the IRS regulations.

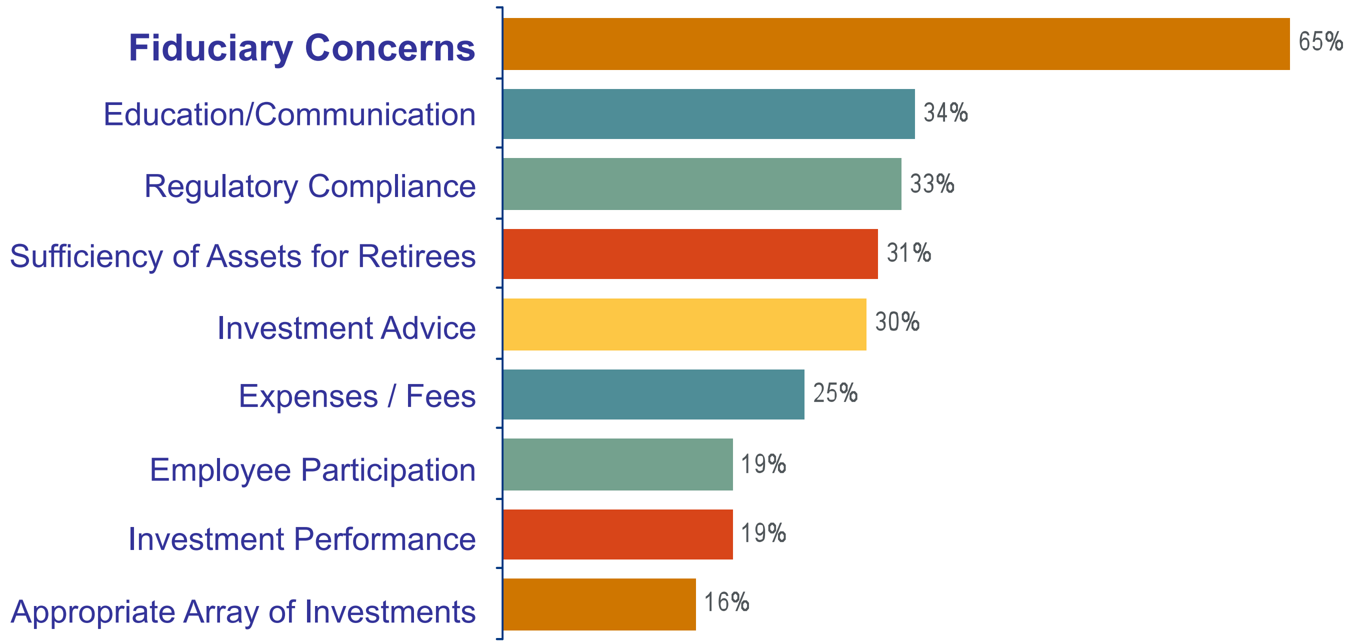
ERISA Bond Requirement

- Bond must be no less than 10% of plan assets
- Maximum required is $500,000, but higher limits available
- The bond guarantees that you will be able to pay any losses up to the face amount of the bond
- Pays in your stead in the event that you are financially unable to meet your obligations
- Can be purchased separately or, if limits are on the low end, added to office package policy
- "Crime" coverage, not liability coverage. Fiduciary liability is separate coverage usually added to D&O coverage

FYI: ERISA Bond Regs

- § 1112. Bonding, Requisite Bonding of Plan Officials
  - U.S. Code, TITLE 29, CHAPTER 18, SUBCHAPTER I, Subtitle B, part 4 , § 1112

Key Sponsor Issues:
Fiduciary Concerns Are #1



Source: IOMA's Annual Defined Contribution Survey 2008

What's a Fiduciary?

A person who:

- Occupies a position of special trust and confidence
- To whom power or property is entrusted for the benefit of another
- Having a legal relationship of trust and confidence to another, and
- Having a duty to act primarily for the other's benefit, e.g., a guardian, trustee, or executor

Personal Liability!

From the Department of Labor:

"Fiduciaries who do not follow the basic standards of conduct may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions."

Personal Liability for Whom?

- Fiduciaries can be named fiduciaries or "functional fiduciaries"
- Staff members can become "functional fiduciaries" if they perform functions of a fiduciary
- This can also include any Directors and Officers, whether or not they are formally named as fiduciaries
- Directors and Officers can be held personally responsible for ERISA-related fiduciary claims – **you should have a fiduciary liability endorsement on your D&O policy!**

Duties of a Plan Fiduciary

The DOL says Plan Fiduciaries are to:

- Act solely in the interest of plan participants and their beneficiaries, with the exclusive purpose of providing benefits to them;
- Carry out these duties prudently;
- Follow the plan documents;
- Diversify plan investments; and
- Pay only reasonable plan expenses

Ugly Fact

Employer-sponsored retirement plans lost nearly $4 trillion in value during the financial crisis, leading to a range of complex claims and causes of action.

Supreme Court Case 1

LaRue v. Dewolff , 2008

- Individual participants in a defined contribution plan may sue their employer or plan fiduciary under ERISA;
- For any impairment or loss of value in the individual participant's account;
- That is due to a breach of a fiduciary duty.

Supreme Court Case 2

Jones v. Harris, 2010

Allegation that a mutual fund advisor charged excessive fees:

- The Court held that
  - All relevant facts must be considered in determining the reasonableness of fees
  - Fees are too high when they are so disproportionately large that they could not be the result of arms-length bargaining

Court Case 3
Dist. Court, CD California

Tibble vs. Edison Int'l, 2010 Decision

Plan fiduciaries could have accessed funds with lower sales charges, but did not:

- The Court held that
  - The fiduciaries never pursued this
  - Relying on the investment advisor does not reduce fiduciary liability to operate prudently in the interest of plan participants
  - Damages included the difference in fund costs for participant, plus the lost earnings because of the higher charges

Top 10 Fiduciary Errors Part 1

- Not following the terms of your plan document regarding
  - the administration of loan provisions or
  - hardship withdrawals
- Failure to follow plan document eligibility and vesting provisions
- Improperly managing forfeiture accounts
- Not starting required minimum distributions (RMD) on time
- Not depositing contributions on a timely basis

Top 10 Fiduciary Errors Part 2

- Not providing required notices to participants (e.g., safe harbor notices or QDIA notices)
- Failing to obtain spousal consent
- Paying expenses from the plan that are not eligible to be paid from plan assets
- Not knowing (or making an effort to ascertain) if your plan fees are reasonable
- Not seeking the help of experts when you lack the expertise to make fiduciary decisions impacting the plan

Improving the Fiduciary Process

- **Identify all plan fiduciaries**
  - Whether they are named in plan documents or are "functional fiduciaries"
- **Establish procedures**
  - Create a paper trail to demonstrate compliance with ERISA rules
- **Consider adopting an Investment Policy Statement**
  - This provides fiduciaries with guidelines or general instructions concerning types of investments and investment management decisions
- **Conduct at least annual reviews**
  - This helps the plan and its fiduciaries stay current and in compliance

Understanding Plan Fees

Legal obligations under ERISA

- Decisions are to be made for the sole benefit of participants and beneficiaries
- "Fiduciaries who do not follow the basic standards of conduct may be personally liable…"

Source: U.S. Department of Labor (www.dol.gov)

Nature of Fees

Fees pay for services

- Plan setup
- Plan administration
- Investment management

Participants often benefit from

- Lower fees
- More services

Nature of Fees

Investment management fees are the largest charges assessed against plans.

Source: “Study of 401(k) Plan Fees and Expenses: Final Report,” Department of Labor, Pension and Welfare Benefits Administration.

Plan Fees

Analyzing the expenses of a plan is critical

- Plan costs affect bottom line for participants
- Expenses should be in line with the level and quality of services received
- Plan sponsors are required to know who is receiving money — how much and for what services

Fees:
Investment Product Expenses

Three main categories:

- Investment management fee:
  - Typically, 0.25% to 1.0% of assets in the fund
- Administrative expense:
  - Typically, from 0.05% to 0.40% of invested assets.
- Revenue-sharing:
  - 12b-1 Fees
  - Shareholder Servicing Fees
  - Sub-Transfer Agency Fees
  - Commissions
  - Mutual fund rebates

Types of Revenue Sharing

- 12b-1 fees:
  - For marketing and distributing the product.
  - Generally ranges between 0.25% and 1.0% of invested assets.
- Shareholder servicing fee:
  - Typically used by no–load mutual fund products, paid to TPAs for recordkeeping, annual administration, and education services.
  - Generally up to 0.25% of invested assets
- Sub-transfer agency fees (Sub-TA Fees):
  - For "omnibus" accounts, instead of individual participant accounts.
  - Typically, this fee ranges from 0.10% to 0.35% of invested assets.
- Commissions
  - Paid to a broker for servicing the retirement plan account.
  - Typically 0.25% to 1.0% of invested assets

Other Fees
Insurance Fees & Expenses

Variable Annuities, proprietary and non-proprietary:

- Mortality and Expense (M&E) Fees
- Insurance-Related Charges
- Surrender and Transfer Fees
- Typically range between 0.4% and 1.5% of invested assets.

Wrap Fees

- All-inclusive asset-based fee imposed on the value of total assets in an account.
- A catch-all that can be used to pay for plan services from compliance testing to trust reporting.
- May cover all the expenses with the exception of itemized fees and investment management costs, and will be in addition to the fees the investment products charge.

Participant Based Fees

Calculated as a flat charge per participants in or employees eligible for the retirement plan.

Traditionally, these fees pay for:

- Employee education and communication
- Typically in addition to annual base fee
- Fee ranges widely, from a few dollars to $40 per participant

Other Possible Fees

- Itemized service fees, typically paid by the plan sponsor. May include, among other service fees:
  - Loans, origination and maintenance
  - Form 5500 preparation
  - Distributions
  - Nondiscrimination testing
- Investment Advice Fees
- Outside Asset Fees
- Custody Fees
- Trustee Fees

New 408(b)(2) Requirements in July 2011

Relates to disclosure of fees

- Disclosure would be required for:
  - **Services:** A description of the services to be provided to the plan under the arrangement.
  - **Status:** As a fiduciary or investment advisor
  - **Fees:** Direct compensation, indirect, through third parties, to third parties etc.

Investment Choices
Best Practices

- Choice and balance
  - Managed portfolios?
  - Lifestyle funds?
  - Target date?
  - Choice among asset classes
  - Avoid participant confusion by limiting decisions
- Pay attention to fees!

Investment Choices
Best Practices

- Minimum 404(c) relief to sponsors for "bad decisions:"
  - Three distinctive options
  - Quarterly changes must be allowed
  - Sufficient information – meetings, website access, written information, etc.

Vendor Selection

- Hiring a retirement plan service provider is a serious fiduciary function
- DOL says you should obtain information about:
  - The company's financial condition
  - Experience with plans of similar size and complexity, including:
    - Qualifications of professionals
    - Recent litigation and enforcement actions
    - Firm's experience & performance record

Vendor Selection – Common Errors

- Not Shopping Around:
  - The 401(k) and 403(b) marketplace is very competitive and product offerings vary greatly. It pays to shop around.
- Confusing Sales People with Consultants:
  - Be careful about relying on them too much for objective information
- Reducing the Buying Decision to Only Cost:
  - Cost should never be your primary decision element, even though it is an important part of the buying decision
- Not Asking Enough Tough Questions

Vendor Selection – Areas of Focus

In an RFP, ask many questions in each of these areas:

- Fiduciary concerns
  - Litigation, compensation, conflicts of interest, quality controls, data integrity and backup systems
- Investments
  - Number of funds, information received, proprietary funds, open platforms
- Services
  - Enrollment support, ongoing service to participants, recordkeeping, 5500s
- Fees
  - Set-up fees, per capita fees, fees for transactions, loans hardships, plan amendments, etc.

Vendor Selection – Focus on Results, Not Just Features

- What is the benefit adequacy ratio (including social security benefits) of the plans that you recordkeep?
- What is the average participation rate of the plans that you recordkeep?
- What is the average deferral rate of the participants who are deferring into plans that you recordkeep?

From http://www.reish.com

Wrap Up

- 403(b)s are now in a new regulatory world
- IRS Audits are much more likely
- Fiduciary responsibilities are real and important – deal with it
- Regularly monitor your plan and your advisors

Information Sources

- Kerry Bandow: Kerry.Bandow@standard.com
- Sean Corry: sean.corry@SIGinsures.com
- 403bwise: http://www.403bwise.com
- 401(k)helpcenter: http://www.401khelpcenter.com
- DOL: http://www.dol.gov/dol/topic/retirement/index.htm
- EBSA: http://www.dol.gov/ebsa/erisa_enforcement.html
- IRS: http://www.irs.gov/retirement/index.html

Questions?

Thank You!