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## Fee Disclosure Concerns and New Guidance for Fiduciaries

***WHAT YOU NEED TO KNOW***

- Since 2012, plan fiduciaries have been required to receive and evaluate detailed fee, expense and service disclosures from financial institutions and other plan providers.
- Fiduciaries face severe sanctions for failing to timely receive and evaluate accurate disclosures.
- The Department of Labor recognizes the difficulties fiduciaries have encountered to obtain and then understand the disclosures.
- It has proposed a new requirement on plan providers to make fiduciary compliance easier by requiring clearer and more direct disclosures.
- Now, before enhanced and vigorous Department of Labor audit initiatives commence, is the time for fiduciaries to comply.

For the full story, see page 2.

## Co-Editors of the *401(k) Advisor* -- Firm News

John C. Hughes and Jeff Mandell manage, occasionally author and are the co-editors of the monthly *401(k) Advisor, The Insider's Guide To Plan Design, Administration, Funding & Compliance*. For over two decades, New York's Wolters Kluwer Law & Business has published this widely-read and highly respected journal for the 401(k) industry.

Wolters Kluwer is showcasing Jeff and John's contribution in the Author Spotlight section of their home page: *www.aspenpublishers.com*. We thank our fellow experts and leaders in the field who contribute articles to the *401(k) Advisor*. Attached are two typical editions for your perusal (which include discussions on fee disclosures and contain articles authored by John and Jeff). Check it out!

# Fee Disclosure Concerns and New Guidance for Fiduciaries
## Jeffery Mandell, Esq.

### BACKGROUND

In 2012 the United States Department of Labor issued new final Section 408(b)(2) regulations requiring ERISA plan providers to furnish information to plan fiduciaries. These providers – most notably including the financial institutions in which the plans are invested, investment brokers and advisors, and third party administrators and recordkeepers – must provide detailed information describing the services they are providing and the fees and expenses attendant thereto.

Although the burden falls on the service providers to furnish this information, to the chagrin and surprise of many employers the direct risks of the Internal Revenue Service's and Department of Labor's ire fall on the employers and plan fiduciaries. The fiduciaries *must* obtain, understand *and* evaluate the requisite information or they have engaged in an ERISA "prohibited transaction." The employer's recourse for the service provider's failure to comply with the regulations is for the employer to report the provider and the plan to the Department of Labor, an action most employers would be wise to try to avoid.

### REASON FOR FEE DISCLOSURES

The Department of Labor issued its regulations because it believed that many plans were paying too much for plan services, that the employees and plan fiduciaries did not understand the fees they were paying, and that ultimately these marketplace factors significantly adversely affected the participants' investment returns. Much of the fees, in the nature of commissions, expense ratios, fund management, marketing, payments between plan providers and intrinsic costs of the investment funds, were neither known to nor available to be known to the consumers of most plans. Providers varied widely as to, and ERISA contained no uniform standard for, the legal sufficiency of disclosures.

Notwithstanding the burden of the new regulations and my general fervent objections to any new ERISA requirements, I believed that these DOL regulations would uniquely ultimately help employers and employees. Indeed, in my experience, and anecdotally from others, the DOL initiative already has helped to drive down prices in the marketplace without adversely affecting services.

***Service providers must furnish the disclosures, yet the direct risks of the Internal Revenue Service and Department of Labor sanctions, and of litigation, fall on employers.***

## EXPERIENCES WITH THE FIRST TWO YEARS OF DISCLOSURES

Innumerable employers throughout the country were and continue to be flummoxed in trying to comply with the regulations. The frustration, aside from generalized deserved annoyance with yet more ERISA rules, largely stems from the difficulty in obtaining the information that the fiduciaries are required to obtain, and obtaining it in a manner that is clear and intelligible. The requisite information often is very difficult to find among the pages of materials provided. The disclosures often do not contain the precise information for that specific plan that the regulations compel.

***Obtaining and identifying the required disclosures has proven very challenging.***

For example, many disclosures are couched in terms of stating fees within certain ranges, or that some fees and services will apply in some but not all circumstances. This leads fiduciaries and their attorneys to scratch their heads as to precisely what the charges are. Much of the information is contained in separate documents, turning us into taxed detectives following one trail after another, often hitting a dead end or requiring us to ask for that additional-not-yet-provided document where the required item of information will be found.

Often the list of investment funds, or the share classes, are downright incorrect. Sometimes the information is primarily or not at all even for the plan involved. Much of the noncompliance, as unquestionably errant as it sometimes is, is not readily apparent because of its fine print and volume. Very often the information is incomplete, missing key elements of what is required. Many providers that were required to furnish the disclosures insisted in good faith that they were not covered by the rules, which when countered by much fiduciary tenacity led them to ultimately conclude and acknowledge that yes, they needed to comply.

Fiduciaries reluctantly came to understand that their interest in the matter was not always aligned with the interest of some service providers, and that independent expert representation of the fiduciary was absolutely essential in order for the fiduciary to fulfill its legal obligation and thus ameliorate risk.

***The Department of Labor is aggressively seeking to enforce the new disclosure regime.***

## DEPARTMENT OF LABOR SERIOUSNESS

The Department of Labor, from the beginning of this initiative about ten years ago, has taken an unusually keen interest in enforcing the new regulations. Surprisingly, in our experience in recent audits the Department of Labor is actively looking at compliance. I say “surprisingly” because typically Department of Labor enforcement activities lag a new regulation by many years, but not so in this case. In this regard we have heard that

the Department of Labor will initiate targeted Section 408(b)(2) investigations in the second half of 2014.

## WHAT IS NEW?

The Department of Labor has taken note of the difficulties described above. It is not pleased that many fiduciaries face this uphill battle to comply. As a result, the Department just issued guidance to better enable compliance, called Proposed Regulations to Require a Guide to Assist Plan Fiduciaries in Reviewing 408(b)(2) Disclosures. The Department is proposing to amend the fee disclosure regulations to require service providers to furnish a guide along with the disclosures. It states, "[t]he guide must specifically identify the document, page, or, if applicable, other sufficiently specific locator, such as section, that enables the responsible plan fiduciary to quickly and easily find the specified information . . . The guide will assist responsible plan fiduciaries by insuring that the location of all information required to be disclosed is evident and easy to find."

## THIS MEANS THE FOLLOWING

This development is favorable, revealing, and worthy of note in several respects:

- It is more important than ever for employers and participants to understand the plan's fees and expenses (and the provider's services) which reduce the plan's, and thus the participants', performance. It will mean more money for participants' retirement.

- The change in regulations intends to make it easier, and therefore less expensive, for the plan fiduciaries to comply with the law.

- Employers that made a good faith effort to comply with the regulations should be able to pass the Department of Labor's scrutiny in the event of a plan audit for prior years.

- Fiduciaries likely effectively now have a window to shore up their compliance without the risk of the significant penalties the Department of Labor and Internal Revenue Service can impose for noncompliance.

***Fiduciaries that fail to heed the Department of Labor's alarms will be assuming significant risks.***

- Employers that largely ignored or continue to ignore the requirements (for example by relying merely on whatever information the service providers furnish) will not fare so well. The 2012 "good faith" standard for compliance was a one-shot, now expired lower compliance bar for only the first round of disclosures. Real compliance is now the legal standard.

***To satisfy 408(b)(2) and thus avoid a prohibited transaction, the fiduciary must conclude, based on the disclosures, that the arrangement with each service provider is reasonable and in the employees' best interests.***

### Evaluating the Disclosures and Documenting It

Once the disclosures are obtained and determined to be complete and accurate, arguably the hard part is over. Yet, there are additional critical compliance requirements. For example, the fiduciaries must conclude that the fees, expenses and services are reasonable in order to avoid the prohibited transaction. Fiduciaries are well advised to briefly document such matter, both the process and the conclusions, with which we routinely assist our clients.

It bears repeating that it is the employers and fiduciaries, not the providers, that have the most direct legal responsibility to comply. They carry the resulting risk of sanctions and litigation for noncompliance.

Compliance with Section 408(b)(2) generally is required annually, as well as in other circumstances, such as *prior to* a change in providers or investments. Fiduciaries are advised to independently understand the various circumstances when they are required to obtain new disclosures and the other conditions for satisfaction of these rules. Reliance on the providers to know these requirements and to act on them has proven to be misplaced.

### Litigation Threats

As a backdrop to the regulatory developments looms the unabated recurrence of litigation. Increasingly, class action suits are being filed that challenge the plan's investments, often resulting in large settlements, and often challenging the prudence of the plan's expenses and fees. These have received much press. The clearer the DOL's dictates for fiduciaries become, the stronger the case the DOL is making for plaintiffs against employers that do not heed the DOL's alerts.

### A Note Regarding Participant Disclosures

The disclosures discussed herein are commonly referred to as the service provider or the Section 408(b)(2) disclosures. These disclosures are different than the also new disclosures fiduciaries are required to provide to participants, which are often called the participant level or Section 404a-5 disclosures. These participant disclosures use some of the information required in the Section 408(b)(2) disclosures, but step up the level of disclosures by

***Fiduciary attention to the participant level 404a-5 disclosures is also compelling.***

requiring detailed information regarding the dollar amounts of participant fees and actual investment returns of the various plan investment funds.

Compliance with the Section 404a-5 disclosures were equally cumbersome and challenging, and no doubt compliance with those regulations will also be easier as developments continue. These disclosures are required quarterly for most plans, and at other times.

***The prudent fiduciary will with counsel document 408(b)(2) and 404a-5 compliance.***

Fiduciaries are equally encouraged to understand their responsibilities in these regards to minimize government action and litigation threats.

* * *

*We have advised numerous employers in complying with the regulations, made several presentations and written several outlines and articles regarding the subject matter.*

*If you wish to attend a training session or discuss your plan specifics, please contact Jeffery Mandell (jeff@erisalawgroup.com) or John Hughes (john@erisalawgroup.com) at 208-342-5522 or 866-ERISALAW.*

# 401(k) Advisor

THE INSIDER'S GUIDE TO PLAN DESIGN, ADMINISTRATION, FUNDING & COMPLIANCE

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## BRIEFLY



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# Determining Fee Reasonableness of a Defined Contribution Plan Recordkeeper

**Michael Viljak**

The determination of the reasonableness of fees has always been a core fiduciary function for ERISA plan sponsors. ERISA Section 408(b)(2) (and the associated regulations) has led to the increased scrutiny of this responsibility. The Department of Labor (DOL) has taken this step to solidify specific requirements for plan sponsors and service providers regarding the communication of fee information.

## Timing

The genesis of these regulations is found in proclamations by Phyllis Borzi, Assistant Secretary of the Employee Benefits Security Administration (EBSA). It is Borzi's contention that plan sponsors' monitoring of the reasonableness of fees, services, and contracts is not adequate. As a result, Section 408(b)(2) requires that plan sponsor fiduciaries receive explicit and transparent documentation of all aspects of fees and expenses relating to services rendered by plan service providers. The focus of this article is on these regulations as they pertain to a plan's recordkeeper (who also facilitates access to a plan's investment options).

## Progress Assessed

This well-intended action by the DOL has not proven to be a panacea, partly because the regulations offer no

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# Increased Focus on Brokerage Windows

**John C. Hughes, Esq.**

A popular feature in many 401(k) plans is the availability of brokerage arrangements, or "brokerage windows." In general, brokerage windows allow participants to invest beyond a plan's menu of funds, or "designated investment alternatives," chosen by the plan sponsor employer (or other plan fiduciary). Brokerage windows allow participants to invest in an individual stock and/or mutual fund not otherwise on the plan's list of investments. Sometimes plans offer only brokerage windows; that is, the brokerage window is not an option coupled with a menu of funds.

The use of brokerage windows has long raised several concerns including, for example, giving participants "too much rope," so to speak (thus resulting in an investment experience not as favorable as choosing from a menu of funds). Brokerage windows also

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# Timing of Partner Deferral Elections and Deposits

**William F. Brown, Esq.**

Due to regulatory focus, sponsors of 401(k) plans must pay careful attention to two basic rules: (1) the timing of a participant's deferral election, and (2) the timing of the deposit of a participant's deferral election into the plan. Adherence to these rules is particularly complicated when dealing with the partners in the partnership sponsoring the plan or members of an LLC plan sponsor that is taxed as a partnership. The rules are the same for both types of entities.

*Timing of the Deferral Election*. Section 1.401(k)-1(a)(3)(i)(A) of the regulations provides that to defer compensation to a 401(k) plan, a participant must make the deferral election before the compensation is available. For an employee, this means that the participant must make the deferral election before the pay date of the relevant compensation.

The same basic rule applies to partners, but this raises the question of when the partner's income is currently available. A partnership, and therefore the partners, does not know whether it has even had any income for a taxable year until the accounting for that year has been completed, which can be weeks or months after the end of that year. Section 1.401(k)-1(a)(6)(iii) of the regulations addresses this by stating that a partner's income is considered to be currently available as of the last day of the partnership's taxable year. Thus, a partner must make an affirmative election to defer income into the 401(k) plan before the end of the partnership's taxable year in order for the election to be timely for that taxable year.

Some partners take "cash advance payments," or "draws," during the partnership's taxable year. Payment of these draws do not cause a deferral election made near the end of the taxable year to be untimely, because the election is made after the compensation is currently available.

Section 1.401(k)-1(a)(6)(iv) of the regulations allow the partner to make 401(k) deferrals taken from the draws, so long as the deferrals are based on a reasonable estimate of the partner's earned income for the taxable year. The partner should be careful that the deferrals from the draws are not too large to exceed the deferral limit imposed by the plan or the partner's deferral election based on a percentage of compensation. Regardless, the deferrals based on the draws must be trued up to the partner's deferral election after the partnership determines the partner's actual earned income for its taxable year.

*Timing of the Deferral Deposit*. The Department of Labor has devoted considerable attention to the timing of the deposit of deferrals to a 401(k) plan. DOL Regulation Section 2510.3-102(a)(1) states that deferrals must be deposited in the plan's trust "as of the earliest date" on which the deferrals "can reasonably be segregated from the employer's general assets." Section 2510.3-102(b)(1) adds that "in no event" can this date be "later than the 15th business day of the month following the month" in which the employer receives the deferrals. The DOL interprets this regulation very strictly and will find violations in timing differences that many would consider minor.

In order to bring more certainty to this process for small businesses, the DOL added Section 2510.3-102(a)(2), which provides a safe harbor for employers whose plans have fewer than 100 participants at the beginning of the plan year. These small employers are deemed to have met the regulation requirements if the deferrals are deposited no later than seven business days following the date on which the

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# Supreme Court Upholds Plan's Contractual Deadline to File Lawsuits

**Marcia S. Wagner, Esq.**

On December 16, 2013, the US Supreme Court settled a split among the US Circuit Courts of Appeals and unanimously ruled in *Heimeshoff v. Hartford Life & Accident Insurance Co.,* No. 12-729 (US 12-16-13), that a plan provision which limits the time a participant can file a suit for benefit claims is enforceable under ERISA, so long as the time period is reasonable and even if the time limit begins to run before the plan has issued its final determination.

## ERISA Claims Procedures

Under ERISA Section 503, an employee benefit plan must provide certain required procedures for reviewing benefit claims. The first step of the process requires the plan to either approve or deny a participant's claim for benefits within 90 days after the participant files a claim for benefits (a shorter period in the case of disability and urgent medical claims). If a plan issues a denial of benefits, the participant may appeal within a specified time period. Upon appeal, should the plan issue a final denial of benefits, the participant may then file a legal action in federal court under ERISA Section 502(a)(1)(B) to challenge the denial. However, ERISA Section 502(a)(1)(B) does not provide a time limit within which such action must be brought, nor does it provide when such time limit commences.

In a previous Supreme Court case, *North Star Steel Co. v. Thomas*, 515 US 29 (1995), the Court explained that where a federal statute fails to provide any limitation period, the Court's longstanding and settled practice is to borrow the limitations period from the most nearly analogous state statute. For employee benefit plans, the state statute that governs written contracts will furnish the needed limitation period. Thus, employee benefit plans may be subject to different limitation periods depending on the applicable state of residence.

Rather than leaving it up to the applicable state statute, many plan documents contain their own plan-specific contractual limitation provision requiring participants to bring an action for benefit claims within a specified time period. For example, a plan may have a limitation period that requires a participant to file a claim in federal court within three years from the date the claim first accrues. The potential problem for participants is that, if the plan's internal review process takes two years to complete, the participant only has one year to file suit in federal court. The US Circuit Courts have been split on this issue as to whether a plan may specify a contractual limitations period that starts to run before the cause of action accrues (*i.e.*, before the plan's internal review process has been completed).

## A New Supreme Court Ruling

In the recent *Heimeshoff* case, Julie Heimeshoff, an employee of Wal-Mart Stores, Inc. and a participant in Wal-Mart's disability plan, submitted a claim for disability benefits with the plan's administrator, Hartford Life & Accident Insurance Company, after becoming ill. Hartford initially denied Ms. Heimeshoff's claim citing failure to provide satisfactory "proof of loss." Ms. Heimeshoff ultimately provided the additional documentation, but it was deemed unsatisfactory by Hartford and her claim was denied. Upon appeal, the denial was upheld and as a result, the plan issued a final denial of benefits. Having exhausted the internal review process under ERISA Section 503, Ms. Heimeshoff filed suit in federal court, within three years of the date of the final denial, but more than three years from the date of proof of loss.

The plan document provided that any lawsuit to recover benefits under ERISA's judicial review provision must be filed within three years from the date "proof of loss" is due. Hartford and Wal-Mart moved to dismiss Ms. Heimeshoff's claim on the grounds that it was filed more than three years after the proof of loss date. Ms. Heimeshoff argued that the plan's three-year limitation period should start to run on the date the plan issued its final denial of benefits, because participants are required to complete the plan's internal review process. The District Court granted the motion to dismiss. On appeal, the Second Circuit upheld the decision concluding that "it did not offend ERISA for the limitations period to commence before the plaintiff could file suit under 502(a)(1)(B)."

The Court relied on a prior Supreme Court decision from 1947, *Order of United Commercial Travelers of America v. Wolfe*, 331 US 586 (1947), 67 S. Ct. 1355, which held that a "contractual limitations provision is enforceable so long as the limitations period is of reasonable length and there is no controlling statute to the contrary" in upholding the District Court and Court of Appeals decisions. The Court noted that the plan's three-year limitation was quite common and reasonable in length, even in Ms. Heimeshoff's case where the internal review process took longer than usual and only left her with approximately one year in which to file suit.

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# Q&A

## Qualified Plan Minimum Coverage Requirements

**From an interview with Douglas S. Neville**

*Jeffery Mandell, Esq. co-editor of* 401(k) Advisor, *interviews Douglas S. Neville of Greensfelder Attorneys at Law, regarding the coverage requirements applicable to 401(k) and other qualified plans. Mr. Neville is an Officer in the Employee Benefits Practice Group who handles a variety of employee benefit issues involving qualified and nonqualified retirement plans, health and welfare arrangements, cafeteria plans, and executive compensation. He can be reached at 314-241-9090 or* dsn@greensfelder.com.

Internal Revenue Code (Code) provisions governing qualified plans and the regulations thereunder contain a number of requirements and limitations that are designed to ensure that qualified plans, including 401(k) plans, do not inordinately benefit highly compensated employees (HCEs) compared to nonhighly compensated employees (NHCEs). This Q&A discusses the basic rules of one such set of requirements—the minimum coverage requirements of Code Section 410(b) and the regulations thereunder.

**Q Let's start with HCEs and NHCEs.**

A The starting point for a summary of the Code Section 410(b) minimum coverage requirements is a brief discussion of HCEs and NHCEs. An HCE is defined in Code Section 414(q) as any employee who is either a five-percent owner during the year in question or the preceding year or had compensation in excess of a certain annual limit (currently $115,000) during the preceding year. If an employer so elects, any employee who is not among the top 20 percent of highest paid employees of the employer is not counted as an HCE. Certain former employees also can be treated as HCEs under the provisions of Code Section 414(q). Any employee who is not an HCE is an NHCE.

**Q What are the Code Section 410(b) basics?**

A Code Section 410(b) is designed to ensure that benefits under 401(k) plans and other qualified plans are available to a sufficient proportion of NHCEs. A qualified plan can satisfy Code Section 410(b) in one of three ways. First, the plan can meet the requirements by "benefiting" (see below) at least 70 percent of the employer's "nonexcludable" NHCEs. This is referred to as the "percentage test." Apart from a few special exceptions which will be discussed in a later question and answer, this is the simplest Code Section 410(b) test to pass.

The second way a plan can meet the Code Section 410(b) requirements is to benefit a percentage of nonexcludable NHCEs that equals or exceeds 70 percent of the nonexcludable HCEs who benefit under the plan. This test is commonly called the "ratio-percentage test." The following are two simple examples that demonstrate how the ratio-percentage test is applied:

> *Example 1*: Assume an employer has 10 nonexcludable HCEs and 20 nonexcludable NHCEs. Assume further than all 10 HCEs benefit under the employer's qualified plan. In order for the plan to pass the ratio-percentage test, at least 14 (*i.e.*, 70 percent) of the 20 nonexcludable NHCEs must be considered to be benefiting under the plan.
>
> *Example 2*: Assume the same facts as in Example 1, except that only five of the nonexcludable HCEs benefit under the employer's plan (rather than all 10 HCEs). In this case, the plan would have to benefit only seven of the nonexcludable NHCEs in order to pass the ratio-percentage test.

In Example 2 above, the number of nonexcludable NHCEs required to pass the test is cut in half because only 50 percent of the employer's nonexcludable HCEs benefit under the plan. In that example, the plan is required to cover only 35 percent of excludable NHCEs [70% × 50% of nonexcludable HCEs = 35%]. Thirty-five percent of the 20 nonexcludable NHCEs in the example equals seven NHCEs.

The ratio percentage is often expressed as a fraction which itself is comprised of two fractions—one fraction is in the numerator and one is in the denominator. The fraction is as follows:

$$\frac{\dfrac{\text{Nonexcludable NHCEs Benefitting Under the Plan}}{\text{Total Nonexcludable NHCEs Employer-Wide}}}{\dfrac{\text{Nonexcludable HCEs Benefitting Under the Plan}}{\text{Total Nonexcludable HCEs Employer-Wide}}}$$

If the result of the fraction (which is called the plan's "ratio-percentage") is 70 percent or more, the plan passes the ratio-percentage test for the relevant period. Although the test is slightly more complex than the percentage test, it is still a relatively simple way to satisfy Code Section 410(b).

**Q What about the average benefits test?**

A The third method for satisfying the Code Section 410(b) requirements is the most complicated of the three. However, it can provide more flexibility for employers that cannot satisfy either of the previous methods. This method is called the "average benefit test."

The average benefit test is beyond the scope of this summary of the basic Code Section 410(b) rules. It is needed for far less plans than the first two tests. However, to briefly summarize, the test contains two components, both of which must be satisfied in order to pass the test as a whole. The first component of the test is called the "nondiscriminatory classification test" in the regulations under Code Section 410(b). In order to satisfy this component, a plan must (1) use a reasonable method of classifying employees based on objective business criteria for purposes of identifying who is eligible under the plan, and (2) have a ratio-percentage that exceeds a safe harbor percentage established under a sliding scale. The sliding-scale percentage is based upon the percentage of the employer's NHCEs relative to the total number of employees employed by the employer. If the plan's ratio-percentage cannot meet the safe harbor percentage but exceeds a certain minimum threshold, the employer may still be able to pass the test by identifying facts which, taken as a whole, indicate that the plan's classification of employees is nondiscriminatory.

The second component of the average benefit test is called the "average benefit percentage test." This test compares the average "benefit percentages" of NHCEs and HCEs. The benefit percentage for each participant is determined by dividing the contributions to the participant by the participant's compensation. In order for a plan to pass this component of the test, the average benefit percentage of NHCEs must equal or exceed 70 percent of the average of the HCEs' benefit percentages. Various complicated rules apply in the performance of this test.

**Q You mentioned "nonexcludable" above. What is that?**

A couple of the terms used in the foregoing summary require explanation in order to understand the basic principles of Code Section 410(b). The first is the concept of "nonexcludable" employees. In counting HCEs and NHCEs for purposes of the percentages used in all three tests described above, certain employees may be disregarded and thus only nonexcludable employees generally are taken into account. Code Section 410(b) and related regulations identify certain types of employees who are excludable from the calculations in these tests. Excludable employees include those who have not met certain minimum age and service conditions (like age 21 and one year of service), certain union employees, and certain nonresident aliens. An employee who is not an excludable employee is a nonexcludable employee who is counted for Code Section 410(b) testing purposes.

**Q What does "benefiting" mean?**

A The second important term is "benefiting." The percentages in the above tests compare employees who are benefiting under a plan to a total number of employees. Whether an employee is benefiting under a plan depends on the specific type of plan being tested. In a profit-sharing plan, a participant generally is considered to be benefiting under the plan if the participant receives an allocation of employer profit-sharing contributions under the plan. A similar rule applies in defined benefit plans—if a participant accrues a benefit for the period being tested, the participant is considered to benefit under the plan. However, under 401(k) plans, the concept of benefiting is somewhat different. For purposes of determining whether a participant is benefiting for purposes of the elective deferral portion of a 401(k) plan, the rules only require that the participant be eligible to make an elective deferral contribution, regardless of whether the participant actually does so. Similarly, a participant generally is considered to be benefiting with respect to matching contributions under a 401(k) plan if the participant is eligible to make elective deferrals upon which matching contributions are based. The determination of whether the participant is benefitting for this purpose is again made irrespective of whether the participant actually receives an allocation of matching contributions, except in the case of a participant who does not receive a contribution because the participant failed to perform additional service that was required to receive the contribution. That is, if in the rare plan the participant must satisfy a condition to receive a match, then other roles apply to determine if the participant is benefiting.

**Thank you, Doug. The foregoing discussion covers just the basics of Code Section 410(b). Perhaps more detail on the concepts described above—as well as some advanced topics relating to coverage testing—can be provided in a later issue of *401(k) Advisor*.** ❖

# BENEFITS CORNER

**Submissions by William F. Brown**

## DOL Enforcement Lands Another Big One

Recently, the DOL's enforcement efforts have produced some impressive results. In the latest example, the DOL announced that it reached a settlement with Western Asset Management Company, a subsidiary of Legg Mason Inc., requiring it to restore a total of $17.4 million to employee benefit plans and other accounts. Western Asset also agreed to pay more than $3.6 million in penalties. The investigation, in conjunction with the Securities and Exchange Commission, revealed that Western Asset used assets of 99 benefit plans to purchase about $90 million of securities that were prohibited for purchase and ownership by ERISA plans. When management and compliance personnel learned of the purchases, they "failed to immediately correct the error or inform their clients," which violated the company's own policies. The securities were not sold for several months, resulting in "significant losses." The investigation also uncovered over 500 cross-trades involving ERISA-covered accounts over a three-year period. ERISA generally prohibits cross-trades "to protect employee benefit plans from an investment manager's conflicts of interest." These cross-trades involved "unfair pricing" that resulted in more than $6 million in losses for the affected plans.

## What Is the Most Common Match Formula?

Aon Hewitt has released its "2013 Trends & Experience in Defined Contribution Plans," which provides information from over 400 plan sponsors that employ over 10 million workers in plans totaling almost $500 billion in assets. Obviously, these would be considered large or very large plans. Perhaps the most interesting news is that the most common match formula is now $1 for every $1 of deferrals on the first 6 percent of compensation. Previously, a 50¢ match on each $1 of deferrals up to 6 percent was the most common. In addition, 98 percent of these plan sponsors provide some employer contribution to their defined contribution plan. Over half of the sponsors now include Roth deferrals in their plans, and almost 30 percent currently allow in-plan Roth rollovers. Sponsors also have been changing requirements to expand the employees who are eligible to participate in their plans and providing earlier opportunity to participate. Over three quarters of these plan sponsors now have immediate entry into their 401(k) plan. Almost 60 percent of the employers use automatic enrollment, but more than half of them set the default savings rate below the optimum level for the match formula. This results in higher participation rates, but lower savings levels. Eighty-six percent of the plans offer target date investments in their plans, and 75 percent of the sponsors offer at least one of the following tools to assist employees: Online guidance or advice, one-on-one financial counseling, and/or managed accounts.

## Who Sponsors the Most Generous 401(k) Plans?

Financial benefits research firm Brightscope has been compiling lots of information about 401(k) plans, and it has begun mining that data to provide different insights. Its latest effort involved an assessment of the most generous 401(k) plans based on company contributions to the plan, vesting schedules, and eligibility periods. Based on these criteria, the most generous plan sponsor was the New York law firm Sullivan & Cromwell LLP, and nine other major law firms were among the top 20 sponsors. Three of the top 10 sponsors were anesthesia medical groups. The NHL plan for its United States members was 15th on the list, and the NBA was 29th. UPS ranked 24th. The average account balance for the plans on Brightscope's most generous list was $470,014, almost five times the average account balance of all plans in its database. The average employer contribution to these plans was more than seven times the average employer contribution overall. The average participation rate in the most generous plans was over 96 percent, which points out that some employees will not participate in a 401(k) plan even in the most generous circumstances. No publicly traded company made Brightscope's list, but Brightscope suggested that has more to do with other benefits offered by those companies, outside their 401(k) plans.

## Sixth Circuit Permits Double Recovery

In *Rochow v. Life Insurance Company of North America*, 737 F.3d 415 (6th Cir. 2013), the Court of Appeals for the Sixth Circuit allowed a participant alleging denial of benefits from a benefit plan covered by ERISA to recover both the benefits and a disgorgement of profits under an equitable theory of unjust enrichment. In the words of the dissent, this is "an unprecedented and extraordinary step to expand the scope of ERISA coverage [that] undermines ERISA's remedial scheme." The plan in question provided disability benefits, but the court's reasoning could be applied to any case asserting a denial of benefits. It will be interesting to see if the Supreme Court accepts the inevitable appeal of this decision.

*Rochow* is also an example of the old adage that bad facts can make bad law. Daniel Rochow was the president of a company that offered its employees disability insurance. In 2001, he began to experience health issues that interfered with the performance of his duties. His employer first demoted him and then forced him to resign on January 2, 2002. In February

2002, he was diagnosed with a form of encephalitis, "a rare and severely debilitating brain infection." In December 2002, he filed a claim for long-term disability insurance that the defendant LINA, a subsidiary of CIGNA Group Insurance, denied on the grounds that his employment had ended before his disability began. Rochow appealed the denial, which LINA denied because he continued to work and was not disabled until after his employment ended. LINA also denied two subsequent appeals. Mr. Rochow died in 2008 without receiving benefits from the plan, and his estate continued the lawsuit.

The courts hearing this litigation were unimpressed with LINA's treatment of Mr. Rochow, characterizing it as "arbitrary and capricious," not "the result of a deliberate, principled reasoning process," and not made solely in the interest of plan participants and beneficiaries. The courts awarded his estate the benefits he was denied under ERISA Section 502(a)(1)(b) and granted disgorgement of profits under Section 502(a)(3) and the equitable principle of unjust enrichment. After reviewing relevant case law, the Court of Appeals concluded that both remedies were available. It contended that disgorgement of profits is not "punitive because it leaves LINA no worse off than it would have been had it paid benefits to Rochow when they were due as the law required." It also explained that such an award would "act as an incentive to ensure plan administrators act in the interest of the plan participants throughout the claims process." Otherwise, "insurance companies would have the perverse incentive to deny benefits for as long as possible, risking only litigation costs in the process."

As the result, LINA has to pay Mr. Rochow's estate all of the benefits, plus interest and attorney fees, and must also disgorge profits totaling $3.8 million.

In his dissent, Judge David McKeague objected, contending that ERISA is a remedial statute, designed not "to punish violators," but to place the participant "in the position he or she would have occupied but for the defendant's wrongdoing." Its aim is "to make the plaintiff whole, not to give them a windfall." Judge McKeague viewed the majority ruling as "a fundamental change in the interplay" of the ERISA provisions that "is not authorized by Supreme Court precedent." ❖

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➤ **Determining Fee Reasonableness**
*continued from page 1*

definition of "reasonable." Also, many plan sponsors may have misunderstood the full intent of the DOL by assuming that mere receipt and review of this data fulfills their obligation. This is not correct. Included in these regulations is the very specific responsibility for plan sponsors to use this fee data to document the process and result of their determination of the reasonableness of fees, services, and contracts.

The impact of Borzi's contention of nonperformance by plan sponsors is convincingly borne out in recent litigation where reasonableness of fees and services played a significant role. Court cases (*e.g.*, *Tussey v. ABB, Beesley v. International Paper*, and several others pending) generated awards/settlements in the $30 million plus range against plan fiduciaries. Increased litigation is all but assured by Borzi's declarations and ensuing 408(b)(2)'s statements regarding fiduciary responsibilities. Now that 408(b)(2) has provided fiduciaries with explicit instructions regarding their responsibilities, there is no excuse for nonperformance. This is welcomed news for class action law firms already active in this area. One firm specializing in fee-related fiduciary breach litigation is reported to have already generated $175 million in revenue over the past few years.

Based on off-the-record conversations with DOL representatives it appears they took a "wait and see" attitude during the first year of implementation to assess service provider and plan sponsor reaction. In year two, which began January 1, 2014, the DOL advises to expect increased audits and potential penalties for noncompliance. Some independent auditors have already begun asking questions during the annual plan audit as to how plan sponsors are responding to these regulations and are reporting their findings to the DOL in their annual audit filings.

## Determine Fee Reasonableness

To make the determination of reasonableness, it is necessary for the plan sponsor to review the 408(b)(2) disclosures provided by plan service providers and develop a clear and demonstrable working knowledge of a plan fees and components.

Defined contribution plan fees fall within three major categories: investment management, administration, and advisory. Pure investment management expense is always paid by the participant and is deducted from the investment's return. Administrative expenses and advisory fees can be shared with or paid by participants, the plan, or the company. In many cases, all are combined into a single asset-based charge. Included in this combined charge may be a revenue sharing component, which should also be reviewed for reasonableness.

## Revenue Sharing Defined

Let's dispel the myth about revenue sharing. Revenue sharing in itself is neither inherently good nor bad. It is simply a method of allocating expenses. For example, a Fidelity fund's cost may include fees for

marketing, administration, and shareholder services. If this same fund is offered through Prudential for use by its defined contribution plans, then Fidelity has one client, Prudential. Prudential assumes marketing, administration, and customer services for the 50,000 participants from plans who have invested in this Fidelity fund. As a result, Fidelity will share these fee components with Prudential, who will actually incur the marketing, administration, and servicing expenses. This is known as "revenue sharing."

Components of revenue sharing can include "12B-1" fees (marketing), "sub-TA" fees (administration), and shareholder services fees (participant service). If the combined revenue generated by all investments within a plan does not provide sufficient revenue for the provider to service a plan, an asset wrap fee also may be applied across all investments. All of these fees are asset-based so they are automatically deducted from fund returns. A plan may incorporate some, none, or all of these fee components. Many fund companies offer various share classes of each fund. These share classes differ only by the amount of revenue sharing they contain.

## The RFP

Armed with this knowledge, a plan sponsor can take the next step, which is to initiate a request for proposal (RFP) from competing recordkeeper providers. The process of soliciting and analyzing provider quotes is not a simple task and should be done with the assistance of an expert. This analysis is not as simple as comparing fees and "doing the math." There are many ways a provider can create the illusion of lower costs. Remember, the definition of prudence under ERISA is a heightened one of "prudent expert" requiring appropriate and documentable expertise. The DOL's expressed concern is that a non-expert, however well-meaning, "may not know what they don't know." Also, ERISA's procedural prudence process must be followed, as with all significant fiduciary decisions.

RFP responses should include an explicit and transparent statement of all fees and expenses, any restrictions, all services with contracts, and investment assumptions in order for the fiduciary to be able to document an equitable comparison and determination of reasonable expenses.

Investments offered to participants should be predicated on plan goals and participant demographics. Note that the DOL recently provided specific guidance on how target date funds should be selected and monitored. These should not be ignored when undertaking an RFP and the benchmarking of plan fees.

## Prudent Fiduciary Action

As plan fiduciaries review the offers of recordkeepers, they should understand that the DOL made clear that the fiduciary is under no obligation to select the lowest priced provider. Rather, there should be a comparison of services, investment opportunities, and other factors along with price. The general consensus in the ERISA community is that a price should be achieved within the range of the bidders. If an incumbent provider is priced high, they are typically willing to negotiate their fee to achieve fiduciary comfort.

Once this RFP exercise is complete and fee reasonableness and its process is documented, it should be followed up with an annual fee benchmarking. Another full RFP should occur every three to four years, or upon significant growth in assets. Whenever a change in provider is considered, a full RFP should be performed to document competitive comparisons.

An engaged fiduciary working with a qualified independent consultant will have no difficulty discharging this important and liability mitigating responsibility. ❖

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➤ **Increased Focus on...**

*continued from page 1*

have the potential to raise problems resulting from the inherent lack of plan oversight associated with such arrangements (*e.g.*, improper account titling or broker approved requests for in-service distributions when the plan does not provide for in-service distributions).

With the implementation of the Department of Labor's "404a-5" regulations regarding fee disclosure to participants in participant directed plans came a renewed focus on those concerns and others. After issuing the 404a-5 regulations, the DOL issued Field Assistance Bulletin (FAB) 2012-12, later reissued as FAB 2012-12R. FAB 2012-12R addressed issues relating to brokerage windows as they relate to the 404a-5 requirements (which remain quite vague). The FAB went on to hint that the use of brokerage accounts may be problematic from a fiduciary standpoint, and that the DOL intended to "engage in discussions with interested parties to help determine how best to assure compliance with these duties. . . ." Additional guidance has been anticipated and desired by the benefits community.

The DOL's 2013 regulatory agenda (issued in fall 2013) now identifies the brokerage windows issue as an item that the DOL will begin to further review by issuing a request for information. The request for information is expected to be issued in April 2014. The responses to the request, as well as the resulting guidance, undoubtedly will prove interesting given the pros and cons associated with the use of brokerage windows, as well as the confusion surrounding compliance with existing regulations such as 404a-5 and those under ERISA Section 404(c). ❖

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➤ **Document Update**

*continued from page 2*

employer either receives the contribution or would have paid the amount in cash to the participant.

If an employer fails to deposit deferrals in a timely manner, it is considered to have engaged in a prohibited transaction in the form of a prohibited loan from the plan to the employer. For many years, the DOL has required that late deposits be reported on the Form 5500, pertaining to that plan year. To remedy the problem, the DOL requires payment of the delinquent deferrals to the plan, of course, as well as payment of interest to the plan account of each affected participant. A plan sponsor can use the DOL's Voluntary Fiduciary Correction Program to obtain protection from a potentially more onerous DOL audit, and this process includes an interest calculator to determine the interest amounts owed to participants. In addition, the plan sponsor should file a Form 5330, with the IRS to pay the excise tax associated with a prohibited transaction. If the payment of the delinquent deferrals occurs in the plan year following the date that the deferrals should have been deposited, then the plan sponsor must file a Form 5330 for both plan years.

If the partner properly makes a 401(k) deferral election, when must the deferrals be deposited into the plan? The DOL rules on the timely deposit of 401(k) deferrals do not make any special provisions for partner deferrals. However, the preamble to the regulation states that a partner's elective deferrals become plan assets "at the earliest date" that they "can reasonably be segregated from the partnership's general assets after those monies would otherwise have been distributed to the partner" but no later than 15 business days after the month in which that would have occurred. This means that the clock for a timely deposit starts when the accounting for the partnership's taxable year has determined the partners' share of earned income for that year. As a practical matter, only the partnership's accountant knows when that actually occurs, so it would be difficult for the DOL to determine that date, absent some documentation of the accounting process. Nevertheless, it is prudent for the partnership to ensure that the partners' deferrals are promptly transferred to the plan once the partners' earned income is calculated to avoid any issues regarding timely deposit.

A different timing rule applies if the partner elects to make deferrals from draws; the clock starts to run on the date of payment of the draw from which the deferral is taken. For example, if the partner receives a monthly draw paid on the last day of the month, then that date starts the clock for the determination of a timely deposit of the deferral taken from the draw. ❖

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➤ **Legal Update**

*continued from page 3*

The Court also found that there was no controlling statute that prevented the plan's limitation provision from taking effect. Importantly, in reaching its decision, the Court emphasized the well-respected principle of enforcing plan terms as written in the context of an ERISA plan.

Ms. Heimeshoff argued that enforcement of the plan's contractual limitation period would undermine ERISA's required internal review process as participants would unwisely rush through the internal review process in order to preserve additional time for filing suit, and employers would attempt to prevent judicial review by delaying the plan's claim process. The Court rejected both of these arguments. The Court noted that to the extent participants fail to develop evidence during the internal review process, they risk forfeiting the use of that evidence in federal court. Likewise, employers have an incentive to proceed in an expeditious manner as the penalty for not meeting the deadlines in ERISA Section 503 is immediate access to judicial review for the participant.

## Recommendations for 401(k) Plan Sponsors

Even though a disability plan was at issue in *Heimeshoff*, the ruling applies to all ERISA plans, including 401(k) plans. Because the focus of the Court's opinion is on enforcement of plan terms as written in the plan document, plan sponsors of 401(k) plans should take the time to review the provisions in their plan documents relating to the claims process and the limitation period in which a participant may bring a legal action. Not only should the date the limitation period commences be examined but so should the length of the limitation period to determine if it is "reasonable." If the plan document does not have a limitations period, the plan sponsor may want to consider adding a three-year period or another reasonable contractual limitation period. ❖

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| Item | Statement | Status |
|---|---|---|
| **Erroneous arbitration ruling could not be vacated absent manifest disregard of law.** | ***Schafer, et al. v. Multiband Corp.*, CA-6, No. 13-1316, 1-6-14**<br>According to the Sixth Circuit Court of Appeals, an arbitrator's ruling invalidating indemnification agreements under an erroneous interpretation of ERISA and applicable precedent could not be vacated, as it did not constitute a manifest disregard of the law.<br>Two directors of a holding company, who also served as trustees of the company's ESOP and Employee Stock Ownership Trust, negotiated indemnification agreements that shielded them from liability for actions taken on behalf of the company. The indemnification agreements, however, did not protect the individuals from liability for "deliberate wrongful acts or gross negligence."<br>The holding company was subsequently sold. However, the purchasing company (Multiband) assumed the indemnification agreements with the individual trustees.<br>In 2011, the DOL charged the trustees with fiduciary breach for allowing the ESOP to purchase company stock at allegedly inflated prices. The trustees settled the suit with the DOL, declining to admit liability, but paying a penalty of $1,450,000 each.<br>The trustees requested indemnification of the penalties paid to the DOL. When Multiband refused the request, the trustees, pursuant to a mandatory arbitration clause in the indemnification agreement, filed an arbitration complaint.<br>During the arbitration proceeding, Multiband maintained that the indemnification agreements were void, as against public policy. The company cited ERISA Section 410(a), which states that any agreement that purports to relieve a fiduciary from liability for any responsibility, obligation, or duty under ERISA "shall be void as against public policy." However, ERISA Section 410(b) provides an exception that authorizes a plan to purchase fiduciary insurance, as long as the insurance permits recourse by the insurer against the fiduciary in the case of breach of duty by the fiduciary.<br>The arbitrator, while acknowledging that Sixth Circuit case law and ERaISA authorize indemnification agreements, noted the unique nature of ESOPs, and concluded that indemnity agreements do not fall with the statutory exception for insurance agreements and declared the agreements invalid.<br>The trustees filed suit in federal court seeking to vacate the arbitrator's decision. The court vacated the arbitrator's decision as a "manifest disregard" of law. The arbitrator's conclusion that ERISA does not authorize indemnification agreements was not a "mere error in interpretation," but "contrary to clearly established precedent."<br>On appeal by Multiband, the Sixth Circuit explained that, under the Federal Arbitration Act, an arbitrator's decision can be vacated if the arbitrator exceeded his or her powers. The court acknowledged the argument that the arbitrator exceeded his powers by manifestly disregarding the applicable law. However, the arbitrator, the court explained, did not manifestly "disregard" the law, but rather relied on a very broad "plain" reading of ERISA Section 410(a), while adopting a narrow and formal reading of the ERISA Section 410(b) insurance exemption. Accordingly, the judgment of the trial court was reversed and the case remanded. ❖ | **Clear errors of law, according to the Sixth Circuit, do not constitute the extraordinary circumstances that allow for interference with the efficient resolution of disputes afforded by arbitration.** |

# 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012

***EBRI Issue Brief,* December 2013, No. 394**

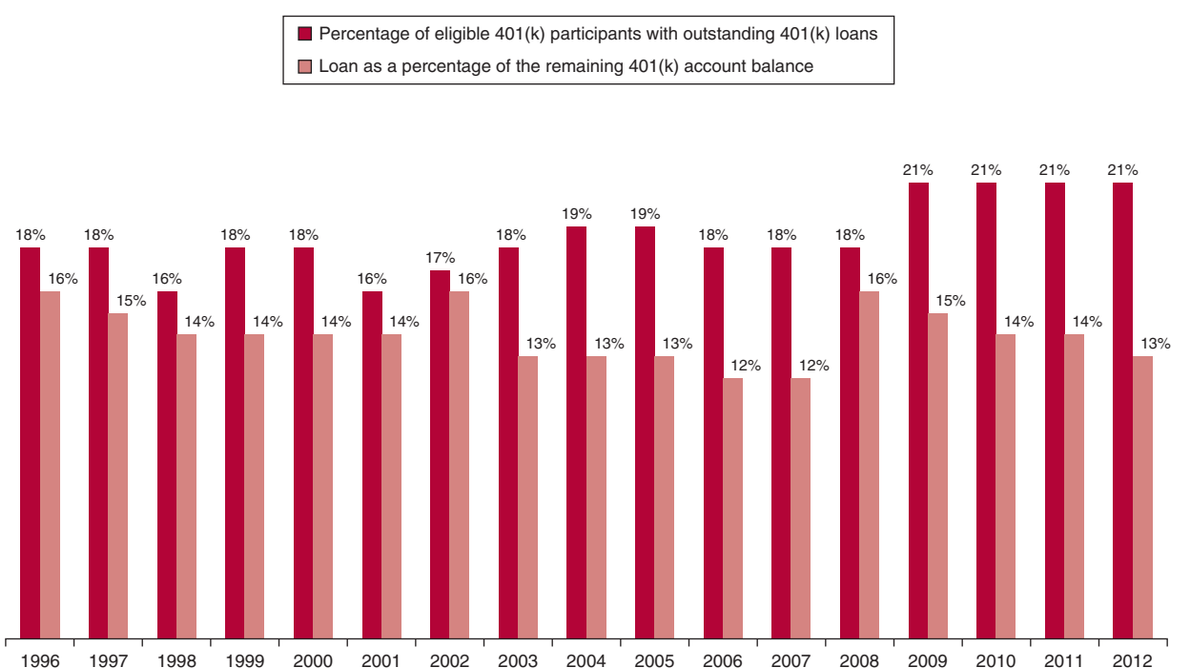
**Jack VanDerhei, Sarah Holden, Luis Alonso, Stephen Bass**

Fifty-nine percent of the 401(k) plans for which loan data were available in the 2012 EBRI/ICI 401(k) database offered a plan loan provision to participants. The loan feature was more commonly associated with large plans (as measured by the number of participants in the plan). Ninety-four percent of plans with more than 10,000 participants included a loan provision, compared with 35 percent of plans with 10 or fewer participants. Participant loan activity varied modestly by plan size, ranging from 20 percent of participants with loans outstanding in 401(k) plans with 11 to 2,500 participants to 24 percent of participants in 401(k) plans with 10 or fewer participants. Loan ratios—the amount of the loan outstanding divided by the remaining account balance—vary only slightly when participants are grouped based on the size of their 401(k) plans (as measured by the number of plan participants). Among participants in plans with 500 or fewer participants, the loan ratio was 15 percent of the remaining assets in 2012, while in plans with more than 5,000 participants, the loan ratio was 13 percent.

In the 17 years that the database has been tracking loan activity among 401(k) plan participants, there has been little variation. From 1996 through 2008, on average, less than one-fifth of 401(k) participants with access to loans had loans outstanding. At year-end 2009, the percentage of participants who were offered loans with loans outstanding ticked up to 21 percent and remained at that level from year-end 2010 through year-end 2012. However, not all participants have access to 401(k) plan loans—factoring in all 401(k) participants with and without loan access in the database, only 18 percent had loans outstanding at year-end 2012. On average, over the past 17 years, among participants with loans outstanding, about 14 percent of the remaining account balance remained unpaid. Department of Labor data indicate that loan amounts tend to be a negligible portion of plan assets.

The full text of the report can be accessed at *http://www.ebri.org/pdf/briefspdf/EBRI_IB_012-13.No394.401k-Update-2012.pdf.* ❖

**Figure 1: Few 401(k) Participants Had Outstanding 401(k) Loans; Loans Tended to Be Small, 1996–2012**




Source: Tabulations from the EBRI/ICI 401(k) Participant-Directed Retirement Plan Data Collection Project.

# MyRA Won't Solve Retirement Woes

**Martin J. Burke, Esq.**

In his State of the Union address, President Obama discussed a presidential memorandum directing the Treasury Department to create new retirement savings accounts for workers without access to employer sponsored retirement plans. The President deserves applause for his attempt to make retirement savings more accessible for workers. However, the changes he suggests are barely going to move the needle on United States's retirement security.

"MyRA" accounts permit individuals with less than $129,000 in income ($191,000 for married couples) to contribute to a MyRA account on an after-tax basis. These accounts will be treated almost identically to a Roth IRA, with the advantage of having no fees associated with opening or maintaining an account. Contributions to the account are invested in a Treasury bond with a rate of return equal to the Thrift Savings Plan Government Securities Investment Fund.

Workers can open a MyRA account with as little as $25 with ongoing contributions as small as $5 per payroll period. Workers would be able to contribute a maximum of $5,500 per year, plus an additional $1,000 if they are older than 50. Once the account reaches a balance of $15,000, workers are required to roll over the accounts to a Roth IRA.

While making retirement savings more accessible to the average US citizen is a laudable goal, the truth is that MyRA accounts will not be the answer to United States's retirement problems, and probably will not even become widely available.

The first barrier to the adoption of MyRA accounts is employer adoption of these plans. Even if there are no or minimal financial costs to allowing employees to defer into these accounts, the employer will still have the administrative hassle of setting up and implementing the payroll deduction. And even if there is not any traditional ERISA liability with setting up the accounts, employers would still have at least some liability if the contributions to the plan are handled incompetently. As I often advise my clients, adding additional moving parts increases the risk of errors. With no increased benefit for business owners, there is no compelling argument for employers to offer these accounts.

While there will not be any fees for the employees who participate in a MyRA account and there would be guaranteed returns, those returns would not be stellar. Since the investment option would be similar to the Thrift Savings Plan Government Securities Fund, returns will stay low. With a five-year average annual return of 2.69 percent, these funds cannot compare with the 18.63 percent five-year average annual return of an S&P index fund.

However, the biggest barrier to widespread adoption of MyRA will be the same reason low income workers do not save in employer sponsored retirement plans: They simply do not have the disposable income. Without the inertia of auto-enrollment in a 401(k), the incentive of employer matches, or even an immediate tax deduction, there is nothing in the President's proposal that will provide any significant movement towards Americans achieving a more secure retirement. ❖

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# 401(k) Advisor

THE INSIDER'S GUIDE TO PLAN DESIGN, ADMINISTRATION, FUNDING & COMPLIANCE

OCTOBER 2013 ◆ Volume 20, Number 10

## BRIEFLY



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Law & Business

# Setting Up a Retirement Plan Committee: How to Choose the Right Members and Run Efficient, Effective Committee Meetings

**Jania Stout, AIF**

Does your company have a retirement plan and the correct plan governance in place? Often, the best course of action for plan governance is a retirement plan committee. Maybe you think you do not really need one; after all, it is not legally mandated. Think again. The Employee Retirement Income Security Act (ERISA) requires that if you sponsor a qualified plan (*e.g.*, a 401(k) or 403(b) plan), your company must act as a *prudent expert* in managing the plan. The best way to document and demonstrate that prudence while cultivating expertise in plan management is to form a carefully structured committee.

The retirement plan committee can have fiduciary liability for the decisions it makes in reference to the plan. Many committees work with an investment advisor to monitor investment options. He or she can act as a consultant regarding plan compliance and provide assistance with the overall plan governance.

The committee may also conduct a periodic analysis of plan providers to ensure the company is getting the best possible deal, conduct fee analyses to ensure fees associated with the plan are reasonable and are properly disclosed to plan participants, take action to improve the retirement readiness of the workforce (by helping workers decide on asset allocation and goal retirement numbers, among other things), and monitor investment trends and legislation that might affect the fund and/or its participants.

A committee is only as good as its members, however, and those committee members will be more effective if they have some solid ground rules.

## Setting Up the Committee

Whether you are just forming a retirement plan committee or revising the structure of your existing one, the following questions should be key in your process:

### How Many Times a Year Should the Committee Meet?

Years ago, committees would get together for meetings just once or twice a year. Nowadays, more topics are covered in these meetings and the markets have continued to be volatile enough that a once-a-year review is not enough. The committee should meet at least twice a year, but quarterly is ideal. Even for small companies, meeting less than twice a year can result in investment priorities and documentation falling through the cracks. Quarterly meetings keep everyone's eye on the ball without being so frequent as to interfere with their other day-to-day responsibilities.

### How Many People Should Be on the Committee?

In most cases, a three- to five-member committee works best. As with committees of any type, having eight or even

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# From the Editor—Document Update, Document Update, Document Update

**Jeffery Mandell**

"Document Update" has been a permanent monthly column of the *401(k) Advisor* for as long as John Hughes and I have been editors (and for as long as I can remember before that). Given our view of the importance of the Document Update column, it is appropriate that we focus on the very obvious about document updates—update your document, update your document, update your document.

One may think, "Why in the world do you have to remind us of document updates?" After all, of all things ERISA demands, document updates must be one of the easiest, most straightforward requirements to satisfy. Yes, that is entirely true, but the truth is that documents continuously fail to be updated correctly and/or on time. A routine part of our practice is assisting employers or other plan sponsors whose documents are not in compliance. Even worse—often the plan was never even *established* on time or properly. Various forms have been prepared, the plan's trust has been established, contributions have been made, and annual reports have been generated, yet the legal plan document, for example, an executed adoption agreement, was never signed or dated, or dated on time, or simply cannot be found. One of ERISA's most basic, fundamental requirements is that there must be a written plan document. To make things even more ironic, most everyone in the business knows that requirement. Which raises the million dollar question: Why does the Internal Revenue Service (IRS) consistently find that the most common plan qualification failures it sees are plan document failures?

I think the reason for the failures, simple and perhaps without dispute, is the benefits marketplace, that is, the transactions between consumers (mostly employers) and the benefits providers. The solution is simple as a theoretical matter, but far from simple to actually mitigate the huge problem this has become. That solution is accountability and education. When a plan is established, *somebody* must be responsible and accountable for making the plan document compliant from the get-go and then continuously throughout the duration of the plan. This responsibility should be understood, and reduced to written evidence, by all parties and providers to the plan, and of course most notably by the plan sponsor.

With respect to education, both the IRS and Department of Labor (DOL) should be congratulated for their efforts. Nonetheless, and I believe through no fault of their own, such effort is not making enough of a mark. It will be to everyone's benefit if all providers to a plan remind employers that document updates will be required periodically throughout the life of the plan, and that there are strict, unbending deadlines for this work. Employers, in particular, must be aware of this ongoing requirement since the buck ultimately stops with them.

The employer should have absolute confidence that the party in whom it entrusts plan document compliance has the requisite advanced technical experience and knowledge. This agreed-upon provider will not only know the timing requirements with respect to each plan amendment, specific to that *specific plan*, but also must know the purpose of the amendment and its specific contents. The parties must recognize that most plan amendments (even volume submitter or prototype model amendments provided

*continued on page 8* ➤



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# IRS Comes Out with Same-Sex Guidance

**Marcia S. Wagner**

*Supreme Court Ruling*. In *United States v. Windsor* (June 2013), the US Supreme Court upheld a lower court decision declaring Section 3 of the federal Defense of Marriage Act (DOMA) unconstitutional. Section 3's definition of "marriage" as "a legal union between one man and one woman as husband and wife" was determined to violate constitutionally required due process and equal protection principles. With this decision, same-sex couples in states that recognize marriages between persons of the same sex clearly obtained marriage-based federal rights and benefits under the tax laws, including rights relating to 401(k) plans governed by the Internal Revenue Code.

The *Windsor* decision did not address the validity of Section 2 of DOMA, which gives individual states the right to recognize, or not recognize, same-sex marriages of other states. The effect of the decision on same-sex spouses who reside in states that do not recognize same-sex marriage was not clear, and awaited regulatory guidance. On August 29, 2013, the IRS issued the first installment of such guidance in the form of Revenue Ruling 2013-17 and two sets of frequently asked questions and answers.

*IRS Ruling*. The IRS guidance resolves the debate over the territorial scope of the *Windsor* decision by adopting a general rule respecting a marriage of same-sex individuals for federal tax purposes. This rule holds that if such a marriage was validly entered into in a state whose laws authorize same-sex marriages, it will be recognized under the tax laws even if the married couple resides in a state that does not recognize the validity of same-sex marriages. The IRS cited historical precedent as well as practical considerations for this decision. With regard to employee benefit plans, it noted the need for nationwide uniformity and pointed to the difficulty that employers would have in applying rules, such as spousal elections, consent, and notices, if the rules changed every time a same-sex couple moved to a state with different marriage recognition rules. The IRS ruling eliminates the need for plans to continually track the state of domicile of same-sex couples.

While the uniformity rule may make sense for many, it may lead to legal challenges under Section 2 of DOMA. It should also be noted that the uniformity rule applies to same-sex marriages contracted outside the United States in foreign jurisdictions having the legal authority to sanction marriages. Since Revenue Ruling 2013-17 does not purport to address the treatment of same-sex couples in domestic partnerships or civil unions, the uniformity rule has no application to these relationships.

*Effective Date*. The uniformity holding of Revenue Ruling 2013-17 is to be applied prospectively as of September 16, 2013. For example, in the case of a defined contribution plan providing for default distributions to a participant's spouse upon the participant's death, the plan must presumably pay the death benefit to a same-sex surviving spouse if the participant's death occurs on or after the effective date. The ruling does not, however, provide guidance with regard to the *Windsor* decision's application to employee benefit plans with respect to periods before September 16, 2013, although the IRS promises to do so in a manner that considers the potential consequences to all involved, including the plan sponsor, the plan, and affected employees and beneficiaries. Nonetheless, even if the IRS is true to its word, any rule it promulgates will not have the power to prevent certain parties, such as the surviving same-sex spouse of a deceased participant, from pursuing claims against a benefit plan or its sponsor.

*Specific 401(k) Issues*. Most plans subject to ERISA and tax-qualified retirement plans, other than government plans and non-electing church plans, must contain a number of provisions that hinge upon the marital status of the plan participant. With respect to 401(k) plans, these provisions may raise the following issues:

- *Spousal Death Benefit*. A retirement plan may not pay a death benefit to a beneficiary other than the participant's surviving spouse unless the spouse consents to the designation of a non-spouse beneficiary, and the participant's spouse is generally the default beneficiary if there is no beneficiary designation. A plan provision that automatically designates a surviving spouse as the plan beneficiary enables a 401(k) plan not only to avoid the need to pay benefits in the form of an annuity, as described below, but also eliminates the requirement to obtain spousal consent as a condition of granting a plan loan. As noted above, the *Windsor* decision and Revenue Ruling 2013-17 require a participant who has designated a beneficiary other than his or her same-sex spouse, or wishes to designate such an individual as his or her beneficiary, to obtain the consent of the same-sex spouse to the designation.
- *Spousal Annuity*. For those plans subject to the joint and survivor annuity rules, lifetime benefits in a qualifying joint annuity form will need to be offered to participants with same-sex spouses, and same-sex spousal consent will now be required for non-annuity benefit payments or annuity payments that do not provide for a survivor annuity to the spouse.

*continued on page 9* ➤

# Q&A

## Could You Provide These Documents to the DOL in Ten Business Days?

*John C. Hughes, co-editor of* 401(k) Advisor, *interviews Thomas E. Clark, Jr. of FRA PlanTools to discuss the recent excessive-fee investigations being performed by the DOL out of the Philadelphia office of the Employee Benefits Security Administration.*

*Tom is the Chief Compliance Officer of FRA PlanTools, a fiduciary consulting and technology firm. Tom is a former ERISA litigator, having served as legal counsel on prominent 401(k) excessive-fee cases such as* Krueger v. Ameriprise Financial, Inc., Nolte v. CIGNA Corp., Tibble v. Edison International, *and* Abbott v. Lockheed Martin Corp., *among others. Tom currently works with plan sponsors and service providers to implement solutions that reduce or eliminate risk as ERISA fiduciaries. Tom can be reached at (704) 247-7968 or* tclark@fraplantools.com.

**Q It has been reported that the Philadelphia office of the Employee Benefits Security Administration (EBSA), the investigative arm of the DOL, has recently begun investigations of retirement plans focusing on "excessive fees." Why is the DOL doing this now?**

A For at least the last five years, the DOL has been playing a long game regarding expenses and fees paid from the plan assets of qualified plans. What I mean by this is that the DOL has had three very public strategies for bringing the issue of fees to the surface. First, there were the new requirements for Schedule C of Form 5500s, which required an additional level of detail related to direct and indirect forms of compensation. Second, there were the Section 408(b)(2) regulations, which require covered service providers to provide detailed fee disclosures to responsible plan fiduciaries. Third, there were the Section 404a-5 disclosures that must be provided to plan participants explaining certain fees they are paying as participants of their plan. What we are now seeing is the DOL's fourth act.

**Q What do you mean by fourth act?**

A Never before has a DOL investigator had a cost- and time-effective method to review the fees being paid for services provided to a qualified plan. I can speak from the experience of litigating over a dozen excessive-fee cases that finding the actual fees paid by a plan is a time consuming process involving hundreds if not thousands of pages of documents to understand the total picture of all the different fees that can be (and are) charged. This process can take hundreds of hours, a resource the EBSA does not have when there are hundreds of thousands of qualified plans, a limited number of investigators, and limited monetary resources. With the new Section 408(b)(2) disclosures, the obvious benefit has been that plan sponsors have an easier resource to understand the fees being charged to their plans. The unobvious consequence is now the DOL does too, during their audit investigations.

**Q Who in the DOL is leading this effort?**

A It appears the Regional Director of the Philadelphia office of the EBSA, Marc Machiz, is leading the way. For those that do not know, Mr. Machiz was previously a partner at the ERISA plaintiffs firm Cohen Milstein Sellers & Toll PLLC before accepting his current post. It is not clear if and when this special focus on excessive fees will spread to investigations performed by other EBSA offices. Other audits do in fact ask about fees, but this special focus and publicity is something new.

**Q What issues will EBSA be looking at?**

A Mr. Machiz is reported to have provided the following six questions that they will be looking at as part of the investigation: What do the disclosures look like? What do the fiduciaries look at? Is there something that justifies the high fees? Is it the fault of the disclosures? Is it the fault of the service provider? Is it the fault of the named fiduciary/plan sponsor?

**Q What documents are EBSA requesting from plan sponsors?**

A Traditionally, in an EBSA audit, the documents requested from the plan sponsor include the plan documents and amendments, the trust agreement and amendments, summary plan descriptions, summary annual reviews, fidelity bonds, fiduciary liability insurance policies, committee meeting minutes, service provider contracts, plan financial records, and Form 5500s, among others. Now, the EBSA document request reads something closer to requests for production I previously drafted many times as an ERISA litigator. The list includes all documents regarding fees incurred by a plan, including documents showing all revenue sharing, finders' fees, commissions, soft dollars, 12b-1 fees, recordkeeping charges, sales loads, redemption fees, surrender fees, expense ratios, wrap fees, and monitoring and evaluation fees.

**Q Are there any other types of documents being requested?**

A The EBSA document request also includes a number of interesting topics such as those showing any advice received by an investment advisor, any fees charged by the plan sponsor itself, the names of all fiduciaries of a plan, and all efforts by a plan sponsor to comply with ERISA. These documents are obviously aimed at specific conflicts of interest involving the plan sponsor.

**Q After receiving the letter, how long does a plan sponsor have to provide the documents to the EBSA investigator?**

A The most troubling aspect is that the letters being received by plan sponsors are asking for the documents to be turned over in 10 business days. That is an incredibly short period of time. It may take that amount of time just to get a plan sponsor's ERISA counsel or in-house counsel caught up on any issues. It certainly does not allow enough time for any kind of meaningful review of the documents before being handed over.

**Q Is it feasible for a plan sponsor to actually be able to provide these documents in just 10 business days?**

A The practical reality is that the EBSA investigator will most likely work with the plan sponsor to develop a plan to deliver the documents. However, if a plan sponsor has a good process in place before they receive the letter from the EBSA, and one that I would argue is now required under the Section 408(b)(2) regulations, it should be a relatively straightforward task to provide the EBSA investigator with the documents they are requesting.

**Q What kind of process should a plan sponsor have in place before they receive the audit letter in the mail?**

A A plan sponsor needs to concentrate on two areas. First, the obvious area is to concentrate on good recordkeeping of any documents related to a plan. These include the types of documents listed above that the EBSA has traditionally asked for, such as the plan document and the summary plan description. These documents can be kept in a paper file or can be scanned and digitized. I recommend to my clients that they adopt whatever recordkeeping procedures for their plan that they already have in place for their business. If they like to store documents in paper, then store plan related documents in paper. If they like to scan documents, then scan and store plan related documents digitally.

Second, to have an established process to document all fiduciary decisionmaking. If the plan has named a committee as a fiduciary, then that committee should meet regularly and consistently document their decisions. This can often be accomplished with written meeting minutes, resolutions, and meeting agendas. Having one person be responsible for the process, often the committee secretary, is a good practice. Another good practice is to have the committee members review and vote on the meeting minutes and then package the minutes and all materials from the meeting together in one place.

The reason to document is simple. If it is not documented somewhere, then you may not be able to prove it happened. This is exactly what occurred in a Seventh Circuit decision a few years ago, where the plan sponsor of a multimillion dollar 401(k) plan could not prove they had made a decision regarding a plan investment.

Another important aspect of a properly established process is to keep plan-related documents for at least six years, if not longer. This is the statute of limitations under ERISA to bring claims against a plan fiduciary.

**Q Are there any technological solutions available to plan sponsors?**

A A number of providers, including my company, provide an online "vault" for plan-related documents of all types to be stored. These services are beneficial because they can provide an easy method of transferring documents between a plan sponsor and a service provider and they can show a time stamp as to when a document was stored, which can be useful if a plan sponsor must show when they performed a task.

**Q What other benefits exist in having an established process in place?**

A There are multiple other benefits to a plan sponsor from having an established process beyond responding to an EBSA audit. First, the most obvious is that if a plan sponsor has a process in place, then they know what is contained in the documents. This not only helps them understand any issues the EBSA may want to focus on before the audit, but understanding the plan allows it to be run well and have control over service providers and costs. Second, if the plan is large enough to be required to file an audit report with the Form 5500, having the documents in place can make the process much more efficient. Third, a plan participant is entitled to request a number of different documents and must be provided those documents within the statutory timetable, usually 30 days. If not, a plan sponsor can incur a daily monetary penalty. If the plan sponsor has an established process in place, this is unlikely to occur. ❖

# BENEFITS CORNER

**William F. Brown**

## IRS Explains Automatic Contribution Arrangements

There have been many studies recently that have concluded that 401(k) plans with automatic enrollment features can increase employee participation and participant savings rates. To assist plan sponsors' understanding of these features, the IRS has added an "Automatic Contribution Increases" page to the Retirement Plans section of its Web site. The page explains that if the 401(k) plan automatically enrolls employees, it can also automatically increase the salary deferral contributions of participants. A "basic automatic contribution arrangement" has the "most flexibility" because the plan sponsor can structure the contribution increases "to occur at any time, in any amount and based on any definition of compensation." The plan must state when the increases will occur, the amount of the increase, including any cap on the increases, and the definition of compensation that the plan will use. The page then explains that an "eligible automatic contribution arrangement" (EACA) has the same flexibility, but the employees must be informed of the timing and amount of the automatic contribution increases in an annual notice, and any contribution increase must be uniform, such as the same percentage for all employees.

A "qualified automatic contribution arrangement" (QACA) has notice and uniformity requirements that are similar to an EACA. In addition, a QACA must meet a minimum schedule of automatic contribution default percentages that start at 3 percent and increase 1 percent each year until the default percentage of 6 percent. The default percentage cannot exceed 10 percent, and the plan sponsor must make a minimum level of employer contributions each year. A plan that includes a QACA is exempt from the annual discrimination testing on participant deferrals and employer matching contributions. The Web page also includes a link to IRS Notice 2009-65, which has sample amendments to add either a basic arrangement or an EACA with automatic contribution increases. The Notice states that the sponsor can modify either sample to conform to the plan's terms and administrative procedures. Adoption of either sample will not result in a loss of reliance on a favorable opinion, advisory, or determination letter, and will not affect the pre-approved status of a master and prototype plan or a volume submitter plan.

## PBGC Considering Missing Participant Balances

One recurring problem for 401(k) plan administrators is the participant who fails to stay in contact with the plan, leaving behind a balance that remains the responsibility of plan fiduciaries. This is a particular problem when the plan sponsor is terminating the plan because all plan funds must be distributed. There are now private companies who will take responsibility for missing participant funds, but not all plan sponsors are comfortable with that option. For a long time, the Pension Benefit Guaranty Corporation (PBGC) has seemed like a logical option, but nothing ever came of periodic suggestions that the PBGC take on this role even though the Pension Protection Act of 2006 gave the PBGC authority to offer an optional program for defined contribution plans. The PBGC has again announced that it is considering this role and has sought comments on various issues, including the demand for this type of program and for a database of missing participants, the question of whether private-sector options exist for missing participants, and potential program costs and fees.

In response, the ERISA Industry Committee (ERIC), Plan Sponsor Council of America (PSCA), and the US Chamber of Commerce (the Chamber) sent in a letter encouraging the PBGC to implement this type of program. The letter provided some interesting facts regarding terminations of defined contribution plans. They estimate that 3 to 4 percent of these plans terminate each year, which works out to about 20,000 to 25,000 defined contribution plans terminating each year. They also note that service providers estimate that about half of these plans will have at least one missing participant when they terminate and that the majority of these accounts contain less than $3,000. That means that plan administrators of terminating defined contribution plans must collectively deal with at least 10,000 missing participants every year.

The letter asserts that "many plan fiduciaries" would be interested in participating in a PBGC program, particularly for smaller accounts, which have "historically been difficult to place with private sector IRA providers." In order to succeed, the program must handle the funds of missing participants properly, must charge reasonable fees that are comparable to private-sector fees, must not place significant administrative burdens on plan fiduciaries, and must provide an accounting of the PBGC handling of the funds of a missing participant who turns up. They added that the program should be optional and be in addition to any private-sector arrangements. In fact, the letter urges that the PBGC consider partnering with private-sector firms that provide rollover services for active and terminated plans.

Regarding a database of missing participants, the letter notes that plan sponsors are already required to provide information regarding separated participants with deferred vested benefits to the IRS, which in turn transmits it to the Social Security Administration. They urge the PBGC

to create a database using the information provided in these filings and not create additional, duplicative requirements.

Finally, the letter urges the PBGC to establish an acceptable program and then "encourage the DOL to provide fiduciary relief for plans that use the missing participants program." The letter writers argue that the PBGC should not delay creation of the program in order to obtain this relief from the DOL. ❖

➤ **Setting Up a Retirement Plan**
*continued from page 1*

more members can bog down decisionmaking and cause meetings to drag on longer than needed. Be sure to keep the roster at an odd number to allow for a tiebreaking vote. A deadlocked committee, after all, cannot get much work done.

**Who Should Be on the Committee?**

So you have settled on a committee of three—now it is crucial that you staff your committee with the *right* three people.

Typically, the CFO, comptroller, or someone from the financial side of the organization will serve as the committee chair. With a background in finance, this individual is likely to be a bit more skilled than others when it comes to reviewing investment funds and fees. The chair is responsible for organizing the committee and for keeping meetings productive and moving forward, but whoever takes the gavel should be someone who can fill the role of taskmaster.

The second key member on the committee might be your director of human resources or benefits manager. HR understands the benefit plans and can be very valuable with designing the strategy of the retirement plan. They have an important role relating to the organization and retention of employees. Committee members who care about the outcome will be more engaged and will generally conduct more productive meetings.

A third member of the committee could also be from finance or HR, or it could be a senior manager with the analytical skills to review funds and fees. Some organizations invite their inside legal counsel to sit on the committee. The most important qualities of a committee member are being able to attend the meetings consistently and having the desire to understand and monitor plan design and investments.

If your committee is going to be slightly larger, it should generally be populated with individuals whose responsibilities and areas of knowledge fall within the abovementioned categories of finance, human resources, and law.

## Not the CEO ...

The person you do not see on this list—and the person who will not be seen at the meetings of the most effective retirement plan committees—is the CEO. For starters, there is a fair amount of minutia that comes into play with retirement plan governance, and the details often fall below the level of requiring the boss's attention. The CEO is typically the hardest person to get to commit to a quarterly meeting for these discussions.

More importantly, with publicly traded companies, the CEO must avoid the practice (or even the appearance) of deploying insider information, and he or she must remain completely independent, which can sometimes be difficult when talking about the retirement plan. For example, if the plan offers an investment in company stock as an option, the CEO might know the company is getting ready to release earnings that would negatively impact the share price—and that type of information could be considered insider information for a committee discussion about using company stock as a matching option. Keeping the CEO (and any other executives who have inside information) off the committee will shield him or her from potential conflict-of-interest issues.

## ... And Not the Workforce Representative

Another thing you will not see here is a blanket call to invite an employee representative to fill a seat on the governance committee. In some cases it can be a real benefit to have the worker's voice at the table; unless the individual has a profound interest in investments and fund management, however, he or she is likely to require a fair amount of training to get up to speed with the technical know-how of the CFO or the head of HR.

## The Charter: Define the Structure of the Committee

The mission of the committee is to prudently monitor the plan and always do so with the benefit of the participants in mind. The best way to ensure that your committee has a defined structure that will stand the test of time—and the test of rotating committee members, which will inevitably happen—is to draw up a charter.

The charter should spell out as clearly as possible the roles, responsibilities, and duties of each committee member and those of the investment manager. It should lay out a framework for stewardship of plan documentation and maintenance of compliance requirements, and it should detail regular/annual training requirements for new and existing committee members. The charter might also call for an annual evaluation followed by a face-to-face meeting with the plan provider.

The charter should define the frequency of meetings. It should lay out clear expectations for the outside

investment advisor. The first and most important qualification for an investment advisor is that he or she acts as co-fiduciary of the retirement plan, and is willing to put that in writing. The charter should also describe how the committee will monitor any outside advisors.

Another function of the charter should be to define the structure of a typical committee meeting. Who should make motions and seconds, and how does voting proceed? Can matters be uniformly settled by a simple voice vote, or on some occasions will a roll-call vote be required? Will the committee follow Robert's Rules of Order, which offer guidance on strict parliamentary procedure? Or will a less staid set of rules be a better fit?

It is important to set out as much detail as possible at the outset, so the committee can do its work without getting bogged down in procedural questions. Conversely, the charter should not be so restrictive as to completely disallow flexibility in how the committee operates.

## Nonprofit Institutions and 403(b) Management

Until a few years ago, nonprofit entities were not exposed to fiduciary liability for their employee-investment retirement plans. With the rollout of final regulations in 2009, however, more 403(b) plans were brought under ERISA; 403(b) committee members now assume the same levels of liability they would in the for-profit sector.

Traditionally, the job of retirement investment management at most nonprofits has fallen to the nonprofit's board. There is a problem with that, however: Most nonprofit board members are not full-time employees of the organization—they are, instead, successful professionals in other lines of work. Because their roles on the nonprofit board are often centered on fundraising, operational guidance, strategic leadership, and community outreach, these members may not be focused on the fiduciary responsibility that comes with the governance of the organization's retirement fund.

A typical nonprofit board meeting covers a wide range of topics pertaining to the entirety of operations at the nonprofit, including personnel moves, capital projects planning, fundraising, marketing goals, educational programs, and budgeting. If the board is also responsible for managing the nonprofit's retirement plan, the plan has to compete with all those other issues for space on the agenda.

A plan committee comprised of executives and employees at the nonprofit, conversely, can take the time and care to focus entirely on the details of fund management. The committee can then report to the board of directors at whatever level the board is comfortable with, and the arrangement can be spelled out in the retirement plan committee's charter.

Having the retirement plan committee based at the organizational level will also serve to isolate the committee from the sometimes high turnover rate associated with nonprofit boards. It typically takes six months to a year for a new retirement plan committee member to get fully up to speed on all the ins and outs of retirement plan stewardship, so having that stewardship managed by a board that might see several members come and go every year is probably not the best option.

## The Best Practice for Prudent Expertise

Forming a retirement plan committee is not required by law. Nothing in ERISA specifically states that retirement committees must be formed. As we noted at the outset, however, ERISA requires the plan sponsor to act as a prudent expert, and with that requirement they may be exposed to fiduciary liability for their decisions and actions.

Managing a retirement plan entails making many important decisions. It also requires extensive documentation. It is a task best handled by a fully engaged committee of professionals, and since the sole purpose of a retirement plan is to provide the best possible outcomes for the plan's participants and beneficiaries, it only makes sense to deploy the best possible business strategy. ❖

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➤ **Document Update**

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by document providers) include design choices, some of which may be better for the employer than others. Those plan design decisions are often made at the plan provider level so that the employer itself does not know that other options were available with respect to that plan amendment. Finally, someone must be responsible to make sure the amendment is actually executed on time!

For our readers who are not aware of the importance of document updates, know this—all of the tax advantages of any ERISA plan depend upon strict compliance with the written plan document requirements. It is an "either/or," black or white proposition: A plan document is, or is not, in compliance.

The failure to establish a plan properly and keep the plan document current results in the following: (a) except for nontaxable employers, the employer loses its deductions for its contributions and the employees' contributions; (b) participants include their plan benefits in their taxable incomes; (c) employment taxes are owed on the contributions to the extent they were not otherwise applied (*e.g.*, for matching and nonelective employer contributions); (d) the plan's trust owes income taxes; and (e) the DOL, plan participants, or other parties can sue for recovery of benefits or further damages (including tax losses).

A most striking result that catches everyone's attention is that a plan document failure (or any qualification failure) is not barred by any statute of limitations. A missed amendment that occurred ten or twenty years ago or way back when, and discovered today, renders the plan illegal. The IRS can only collect taxes retroactively to open years (three, six, or in certain circumstances additional years), but the mistake could have happened decades ago. Between taxes, amending the various tax returns, penalties, and interest, the tax consequences alone are crippling.

All of which leads to the good news. Because the IRS sees plans fall out of document compliance every day, and because no one, including the government, wants to impose draconian tax consequences, the IRS has provided an easy fix through the Employee Plans Compliance Resolution System. For most missed amendments or plan document failures, EPCRS has a streamlined program which has an easier application and which very often has a reduced user fee. The employer must bring the plan document up to date, fix the prior deficiencies, and then the IRS will not impose the damage it could readily inflict.

It is important to note that the streamlined program and its reduced user fee are only available if the employer discovers the failure and fixes it before the IRS discovers the matter. If the IRS discovers the problem before the employer does and takes remedial action, then the IRS is completely in the driver's seat—its starting point for negotiating a penalty under "Audit CAP" is essentially the amount the IRS could collect if it were to disqualify the plan (as set forth above). ❖

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**➤ Legal Update**

*continued from page 3*

- *Plan Loans.* Many tax-qualified retirement plans that permit participant loans require spousal consent to any such loan. A same-sex spouse's consent will now be required unless the plan provides that the spouse is the participant's designated beneficiary.
- *Qualified Domestic Relations Order* (DRO). DROs requiring the payment of a participant's benefit to his or her same-sex spouse or their children will now be enforceable against the plan.
- *Hardship Distributions.* Under the hardship distribution rules applicable to 401(k) plans, the rules allowing such distributions for certain medical, tuition, or funeral expenses of spouses will now apply to same-sex spouses.
- *Required Minimum Distributions.* Under the minimum distribution requirements applicable to tax-qualified retirement plans, including 401(k) plans, spouses of deceased plan participants may delay the commencement of benefits for a longer period after the participant's death than non-spouse beneficiaries. Same-sex spouses will now be able to take advantage of this opportunity to defer payment of death benefits.
- *Rollovers.* A same-sex spouse entitled to receive a death benefit distribution from a tax-qualified retirement plan will now be able to roll over the distribution to an employer plan, as well as to certain other retirement vehicles, and will no longer be limited to making a rollover to an inherited Individual Retirement Account (IRA).

*Summary.* Many uncertainties remain as to the impact of the Supreme Court's decision, even after the IRS's recent guidance. Additional guidance addressing open questions has been promised, but may face resistance and/or challenge from employers, same-sex spouses, or relatives of the parties to a same-sex marriage based on Section 2 of DOMA or how the IRS resolves the issue of retroactivity. While this guidance is being developed, 401(k) sponsors and their advisors should now be considering the following actions:

- Communicating the Supreme Court's decision to employees;
- Identifying all past and present employees who are in a same-sex marriage;
- Identifying those plan provisions that may be affected by a changed definition of the terms "spouse," "marriage," and "husband and wife"; and
- Preparing plan amendments removing any requirement that the forgoing relationships be limited to members of the opposite sex. ❖

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| Item | Statement | Status |
|---|---|---|
| **Service Provider Was Not Fiduciary Subject to Liability for Allegedly Excessive Fees Assessed Plan Participants** | ***Danza v. Fidelity Management Trust Company, et al.*, CA-3, No. 12-3497, 7-29-13 [not precedential]**<br>According to the Third Circuit Court of Appeals, a service provider did not violate ERISA by charging plan participants an allegedly excessive fee for reviewing DROs because it was not a fiduciary at the time the fee structure was negotiated with the plan sponsor.<br>The Great Atlantic and Pacific Tea Company (A&P) and Fidelity Management Trust Company and Fidelity Investments Institutional Operations Company (Fidelity) negotiated a trust agreement under which Fidelity agreed to provide recordkeeping and administrative services for A&P's 401(k) plan. Included in the services to be provided by Fidelity was the review of DROs to ensure compliance with ERISA and the terms of the plan.<br>The trust agreement listed the fixed fees that would be charged to plan participants for various DRO review services. The fees ranged from $300 to $1,800.<br>A plan participant who did not use a DRO generated on the Fidelity Web site, but submitted a DRO prepared by an outside firm, brought suit alleging that the $1,200 he was charged for a DRO review was unreasonable and violated ERISA. Specifically, the participant alleged that Fidelity breached its fiduciary and co-fiduciary obligations and participated in a prohibited transaction. A federal trial court dismissed the action for failure to state a claim.<br>The participant alleged that Fidelity breached its fiduciary duty to plan participants by: (1) entering into an agreement to charge allegedly excessive fees and (2) collecting such fees. The appeals court, however, ruled that Fidelity, at the point it was negotiating fees with A&P was not a fiduciary of the plan and, thus, owed no duty to plan participants to defray the reasonable expenses of administering the plan.<br>The court conceded that at the point in time when Fidelity actually charged fees for reviewing DROs, it did have a fiduciary duty to the plan and its participants *with respect to the administration of services*. However, the court explained, Fidelity did not control the fee structure or have unilateral discretion to change the fee arrangement that was set forth in the agreement. Accordingly, Fidelity could not be held liable as a fiduciary for the allegedly excessive fee schedule.<br>The participant further asserted that Fidelity was a party in interest who received plan assets in violation of ERISA Section 406(a). The court, however, concluded that Fidelity was not a party in interest at the time the trust agreement was signed. Although Fidelity became a party in interest when it began providing services to the plan, it was not a fiduciary when the agreement was signed. Accordingly, the agreement did not constitute a prohibited transaction.<br>Finally, the participant advanced the novel argument that the disbursement of *any* fees by a fiduciary to pay itself for services rendered is prohibited. The court dismissed the argument, noting that the ERISA proscription of self-dealing does not subject service providers to liability for merely accepting previously bargained-for fixed compensation that was not prohibited at the time of the bargain. ❖ | **Service providers that are empowered with the discretionary authority to alter the terms of their fee arrangement with a plan may be subject as a fiduciary to liability for excess fees.** |

# The Impact of a Retirement Savings Account Cap

**Jack VanDerhei, PhD**

*The following is excerpted from Issue Brief No. 389, Employee Benefit Research Institute, August 2013.*

Earlier this year, White House officials unveiled the Obama administration's Fiscal Year 2014 budget proposal, which included a cap on tax-deferred retirement savings. Under the proposal, a taxpayer who accumulated amounts in specified retirement accounts in excess of the amount necessary to provide the maximum annuity permitted for a tax qualified defined benefit plan under current law would be (at least temporarily) prohibited from making additional tax deferred contributions or receiving additional accruals under any of those arrangements, although the taxpayer's account balances could continue to grow with subsequent investment earnings and market gains.

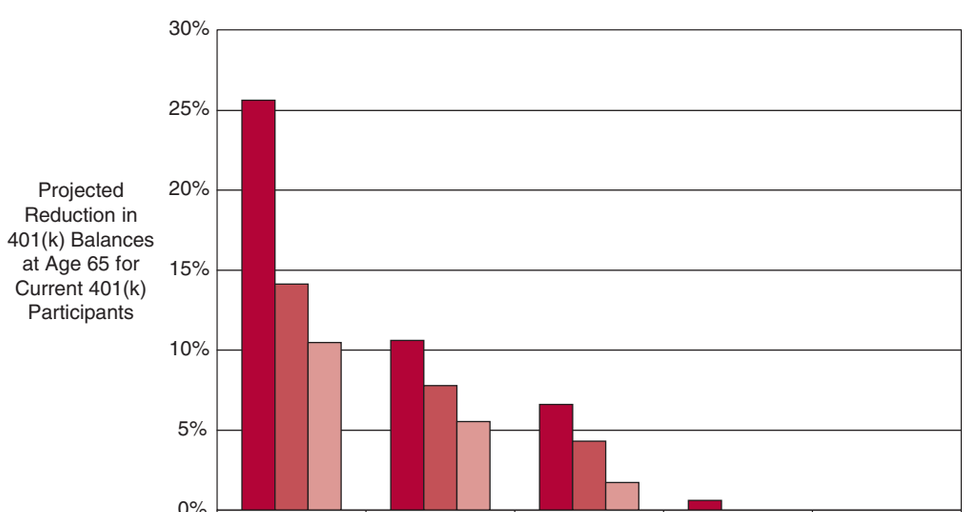
This Issue Brief provides an initial analysis of the potential financial impact on private-sector retirement benefits of the retirement savings account cap included in the Obama administration's FY 2014 budget proposal. It finds that although a very small percentage of current 401(k) participants with IRA accounts have combined balances sufficient to be immediately affected by the proposed limit, over time (and depending on the applicable discount rates, whether a defined benefit pension is involved, and the size of the 401(k) plan) the impact could be much greater.

Simulation results for 401(k) participants assuming no defined benefit accruals and no job turnover show that more than 1 in 10 current 401(k) participants are likely to hit the proposed limit sometime prior to age 65, even at the current historically low discount rate of 4 percent. When the simulation is rerun with discount rate assumptions closer to historical averages, the percentage of 401(k) participants likely to be affected by these proposed limits increases substantially: For example, with an 8 percent discount rate, more than 20 percent of the 401(k) participants are simulated to reach the limit prior to retirement.

When the impact of stylized, defined benefit account assumptions are added to the analysis, the percentage of 401(k) participants simulated to reach the proposed limits increases even more; in fact, for 401(k) participants assumed to be covered by a 2 percent, three-year, final-average plan with a subsidized early retirement at 62, nearly a third are assumed to be affected by the proposed limit at an 8 percent discount rate.

The full text of the Issue Brief can be accessed at: *http://www.ebri.org/pdf/briefspdf/EBRI_IB_08-13.No389.RetSvgsCap.pdf.* ❖

**Impact of Effective 417(e) Rate on the Projected Reduction in 401(k) Balances if the Provision to Limit the Total Accrual of Tax-Favoured Retirement Benefits from the FY 2014 Budget Proposal Took Effect Jan. 1, 2014**




| | 1st pctl | 5th pctl | 10th pctl | 20th pctl | 30th pctl |
|---|---|---|---|---|---|
| No Defined Benefit, 8% Effective 417(e) Rate | 25.6% | 10.6% | 6.6% | 0.6% | 0.0% |
| No Defined Benefit, 6% Effective 417(e) Rate | 14.1% | 7.8% | 4.3% | 0.0% | 0.0% |
| No Defined Benefit, 4% Effective 417(e) Rate | 10.5% | 5.5% | 1.7% | 0.0% | 0.0% |

**Source:** EBRI Retirement Security Projection Model® versions 1725, 1766, 1768. See text for assumptions and cavets.

# Administration's Plan to Worsen Retirement Inequality

**Martin J. Burke**

In F. Scott Fitzgerald's *The Great Gatsby*, between the commercial center of Manhattan and the money-eyed East and West Egg lies a narrow stretch of land "where ashes take the form of houses and chimneys and rising smoke and, finally … of men who move dimly already crumbling through the powdery air." Gatsby's lavish parties suggest a financial success that will never end, but the struggles of those living and working in the ashes of the successful foreshadow the collapse of excess just around the corner. Unfortunately, in the world of retirement plans, although some data suggest that America's retirement prospects are rebounding, diving below the headline numbers shows that inequality between the haves and have-nots is growing.

A recent study by the Economic Policy Institute reports the average size of retirement accounts has grown over the past two decades with aggregate savings rebounding since the start of the great recession. The number of people participating in an employer-sponsored retirement plan, however, has declined over that same period of time, while the median retirement savings for the top fifth of income earners has increased by 251 percent (adjusted for inflation) while remaining relatively stable for the rest of the country's earners.

The pattern of increasing benefits for some, but not others, repeats itself across several other differentiators. As an example, the retirement plan participation and savings account balances of college graduates grew much faster than did the balances of those without a college degree, with the same being true of white, non-Hispanic people when compared to black and Hispanic people.

A recent White House retirement plan proposal will only work to dampen the retirement prospects of the "have-nots." The White House plan would limit retirement contributions to an amount that would purchase a joint and survivor annuity of $205,000 at age 62. Under current market conditions, this amounts to approximately $3.4 million at retirement age. For a 25-year old, the dollar cap would be approximately $800,000. Under normal market conditions with historically average market rates, however, the account cap for a 25-year old would be $132,000.

With almost 52 percent of American society employed by small businesses, it is not difficult to envision a scenario in which the small business owner reaches the cap in his retirement plan, and thus no longer receives any benefit from sponsoring the retirement plan. Once the owner reaches this cap, he would derive no more personal benefit from sponsoring the plan, and would thus terminate, eliminating access to the employer based retirement programs for all of his staff. In fact, in a recent study by the Employee Benefit Research Institute, as many as 75 percent of small business retirement plans may have participants that will reach the cap, thus presenting the potential for a huge decrease in access to employer sponsored retirement plans.

It is this potential loss of employee access to employer sponsored retirement plans that will only further accentuate the divide between those who live large in East and West Egg, leaving the have-nots to continue to struggle in the valley of the ashes, without access to the methods in which to fund their retirement. ❖

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