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Adjusting to the Brave New World of 403(b) for plan sponsors

Regulatory Compliance, Fiduciary Due Diligence, and Trends in the 403(b) Industry

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Today's Speakers

Amy Pocino Kelly
Partner, Employee Benefits and Executive Compensation Practice

Jeffrey A. Levy, EA, MAAA
Practice Leader, Retirement Plan Services

Michael A. Webb, AIF[®], CRS, CEBS,
Vice President, Retirement Plan Services

A Brief Overview of the Final 403(b) Regulations – What's Changed?

Final 403(b) Regulations

- In 2007, the IRS issued final 403(b) regulations that generally become effective January 1, 2009.
- The final regulations memorialize past IRS guidance and add new requirements.
- Plans that fail to comply with the new requirements face disqualification.

Written Plan Document

- Beginning in 2010, 403(b) plans must be memorialized in a written document.
- The plan can consist of multiple documents that set forth the plan's eligibility rules, benefits, and material terms.
 - **For example, the plan can incorporate by reference the terms of a 403(b) vendor's annuity contracts.**
- All 403(b) plans need to be restated to comply with final IRS regulations by January 1, 2010.
- IRS has provided prototype language (Announcement 2009-34)

Eligibility

- The “universal availability” rule – with a few exceptions, 403(b) plans generally require that *all* employees be permitted to make salary reduction contributions.
- The final regulations narrow the list of exceptions.
 - For example, under the old rules employers could exclude collectively bargained employees from their 403(b) salary reduction plans. The final regulations do *not* allow such exclusions.
- There is a special transition rule to give employers time to make this change.

Controlled Group Test

- The final regulations also include new rules relating to applying the Internal Revenue Code's controlled group rules to tax-exempt entities.
 - **Generally, if an entity controls 80% of the directors or trustees of another entity (or there is an 80% or greater overlap of directors/trustees), both entities will be deemed to be members of the same controlled group.**
- *Very important!* – members of the same controlled group are subject to combined testing when applying the IRS nondiscrimination rules.

Nondiscrimination Testing

- 403(b) plans will now be subject to the same nondiscrimination tests that apply to employer contributions under Section 401(a)(4).
- This adds an additional level of complexity to maintaining a 403(b) plan where employer contributions are not a uniform match or percentage of compensation.
- 401(k)-type testing (known as Average Deferral Percentage, or ADP testing) on employee contributions is NOT required.

New Transfer Restrictions

- The final 403(b) regulations include new transfer restrictions. There are *two* types of transfers authorized by the final regulations:
 - Intra-plan transfers (i.e., a transfer of assets from one investment option offered under the plan to another investment option offered under the plan, identified as “contract exchanges” in the regs.); and
 - Plan-to-plan transfers (i.e., a transfer of assets from an investment option offered under the plan to an investment option offered by an unrelated 403(b) plan vendor).

Intra-Plan Transfers

- Most 403(b) plans permit participants to move contributions from one investment option in the plan to a different investment option offered under the same plan. Such transfers can be made on a tax-free basis provided that certain requirements are satisfied, including:
 - The successor contract is subject to distribution restrictions with respect to the participant that are not less stringent than those imposed on the contract being exchanged, and
 - The employer enters into an agreement with the issuer of the successor contract under which the employer and the issuer agree to provide each other with specified information.

Plan-to-Plan Transfers

- **Plan-to-plan transfers are more problematic because they involve coordination with vendors who have no relationship with the employer sponsoring the plan.**
- **The section 403(b) regulations impose new requirements on plan-to-plan transfers.**
- **For this reason, many employers do not permit plan-to-plan 403(b) transfers.**

ERISA vs. Non-ERISA Planning

- 403(b) programs, if “established or maintained by an employer,” are subject to ERISA.
- Being subject to ERISA includes:
 - **Form 5500 reporting and SPD disclosure requirements,**
 - **Fiduciary responsibility provisions, and**
 - **Enforcement provisions**

ERISA vs. Non-ERISA

- A Department of Labor “safe harbor” provides that a 403(b) plan will *NOT* be subject to ERISA if:
 - Participation of employees is completely voluntary,
 - All rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary,
 - The involvement of the employer is limited to certain optional specified activities, and
 - The employer receives no direct or indirect consideration or compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements.

ERISA vs. Non-ERISA

- The safe harbor allows the employer to engage in a range of activities to facilitate the operation of the program:
 - The employer *may*: permit annuity contractors (including agents or brokers who offer annuity contracts or make available custodial accounts) to publicize their products; request information concerning proposed funding media, products, or annuity contractors; compile such information to facilitate review and analysis by the employees.
 - The employer *may* enter into salary reduction agreements and collect annuity or custodial account considerations required by the agreements; remit them to annuity contractors; maintain records of such collections.
 - The employer *may*: hold group annuity contracts in the employer's name covering its employees; exercise rights as representative of its employees under the contract, at least with respect to amendments of the contract.
 - The employer *may also*: limit funding media or products available to employees, or annuity contractors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.

ERISA vs. Non-ERISA

- The DOL has said that a 403(b) plan will not become subject to ERISA merely because the written plan conforms to the new § 403(b) regulations by limiting employees to exchanges of contract funds only among providers who have adopted the written plan, or transfers from the program of a former employer to that of the current employer.
- Moreover, where an employer decides that it does not want to continue to perform the ministerial and administrative functions required under the § 403(b) regulations, the DOL does not believe that the employer's determination to terminate a 403(b) program in compliance with the IRS regulations will cause a program not otherwise covered by ERISA to become covered.
- But the question of whether any particular employer, in complying with the § 403(b) regulations, has “established or maintained” a plan so as to make it subject to ERISA must be analyzed on a case-by-case basis.

Dealing with Inactive 403(b) Contracts

Dealing with Inactive 403(b) Contracts

- **403(b) Compliance Deadline – January 1, 2009 – WAS NOT EXTENDED!**
- **Two key 403(b) decisions:**
 - **The Future: Plan going forward**
 - All active 403(b)'s – full compliance
 - **The Past: 403(b)'s inactive pre-2009**
 - Approach depends on the ERISA status and the date of contribution cessation

Dealing with Inactive 403(b) Contracts

- **Frozen ERISA 403(b) Plan:**
 - **Employer contributions and/or**
 - **Employer control/involvement**
- **ERISA – if ever, then always:**
 - **Full ERISA compliance required (i.e., Plan document, SPD, 5500, audit, testing)**
 - **Full 403(b) compliance required**

Dealing with Inactive 403(b) Contracts

- **Frozen ERISA Contract**
 - **Reason for freeze? (e.g., multiple plans due to company merger)**
 - **Possible course of action #1:**
 - Leave plan frozen and continue ERISA compliance / administration
 - Duplicity means additional expenses
 - Limits participants on investment options

Dealing with Inactive 403(b) Contracts

- Frozen ERISA Contract (cont.)
 - **Possible course of action #2:**
 - Consider merging frozen plan into new active plan
 - Merged on paper (employees may exchange assets to new provider within the plan)
 - Map assets to new provider where feasible (i.e., employer directed contracts, review surrender fees, etc.)
 - Employees benefit from due diligence on active plan (investment array, technology, etc.)

Dealing with Inactive 403(b) Contracts

- **Frozen Non-ERISA Programs**
 - **Rev. Proc. 2007-71: guidance to a degree**
 - **Critical question: when were contributions frozen?**
 - **Pre-2005: grandfathering opportunity**
 - No contributions made after 12/31/04
 - **2005-2008: good faith effort requirement for compliance**
 - Documented request for Information Sharing
 - Follow through on vendor responses (loans, etc.)

Dealing with Inactive 403(b) Contracts

- Frozen Non-ERISA Programs (cont.)
 - **Map to new ERISA provider**
 - Dependent on existing providers and contract language
 - Need to consider surrender fees
 - Legal counsel's opinion essential on employer authority to take this action
 - Converts formerly non-ERISA assets to ERISA

Dealing with Inactive 403(b) Contracts

- What are employers doing?
 - **Good faith effort**
 - **Limited Information Sharing Agreements (i.e., for frozen vendors – no incoming transfers/exchanges)**
 - **Careful communication to employees/participants**
 - The “go forward” plan post-2008
 - The status of the inactive 403(b)’s
 - Consideration to move assets to post-2008 provider
- **Legal counsel’s blessing prior to action**

Vendor Consolidation & Negotiation: Is it Worth the Effort?

Why Consolidate Vendors Today?

- Leverage purchasing power of the institution so that employees can obtain a benefit that is more cost effective than they could obtain on their own.
- The division of purchasing power among several vendors has a *negative* impact on pricing and plan features.
- Vendor enrollment packages encompass an overwhelming amount of material (basic information such as fees, loan provisions, etc. are frequently lacking).

Why Consolidate Vendors Today?

- Difficulty in complying with 5500/audits requirements for 2009 Plan year
- Difficulty in complying with new regulations using multiple vendors:
 - Regulations require that the employer (or a third party) is to coordinate vendor compliance with specific provisions, such as loan limits and hardship distribution restrictions.
 - If any vendor utilizes individual annuity contracts/custodial agreements, such arrangements may not allow for the plan level reporting required to comply with the 403(b) regulations.

Why Consolidate Vendors Today?

- **Too many investment options!**
- **Scientific studies have demonstrated that a large number of investments discourage participation.**
- **Consolidation would bring administrative simplicity (outsourcing), improved investment options, better education & communication services, and significant cost savings for participants.**

RFP Process for a 403(b) Program

- Request for Proposal (RFP) process frequently used to consolidate defined contribution plan into a single ongoing program
- Alternatively, RFP process could be used to solicit better offerings from present providers
- RFP process used to survey the marketplace and find the provider offering the best program for employees
- Lowest expenses possible for fund management and administrative services will be negotiated
- Review of outsourcing services provided by vendor, including document services, compliance, etc.

RFP Evaluation and Selection Process

- The most robust offerings of services negotiated (improved participant communication and education, internet access and modeling, etc.)
- Providers are selected through a screening process that identifies those capable of providing the most robust program based on number of lives, asset size, plan complexity, desired fund offerings, etc.
- Extensive RFP questionnaire is used to solicit information about administrative and recordkeeping capabilities, technology offerings, communication programs, experience with type of employer, and costs
- Responses are scored and providers rated with commentary for Board/Committee review
- Finalist presentations are scheduled for typically two to three providers

Establishing the Fiduciary Review Process

Why Review Fiduciary Practices?

- A focused review process helps to maximize investment results
- Establishes a process that helps protect the plan, participants and the organization by minimizing liability (especially important in today's environment of increased fiduciary scrutiny and a litigious society)
- Confirms that the plan is deriving value from fees paid to investment providers
- Helps ensure that the plan maintains compliance and competitiveness in the industry
- Creates a due diligence review process to ensure that informed decisions are made and consistent with prudent investment practices

Goals of the Due Diligence Process

- Overall monitoring of the investment performance of the funds, as well as the asset classes offered to participants, expenses of the funds, and the extent to which participants are diversifying their investments
- An analysis of the plan's participation, with a focus on ways that sponsors are changing their programs to increase participation
- A discussion on ways that the plan is communicated today, versus other approaches which have been successful in the industry
- Periodic review of the plan's operation, its provisions, and any applicable compliance requirements
- Other new trends in the retirement plan community

What is the Fiduciary Due Diligence Process?

- **Step 1 – Analyze Documents Utilized In Meeting Fiduciary Obligations**
 - Investment policy statement / committee minutes (if available)
 - Existing trust/recordkeeping/custodial/service agreements
 - Investment Fund Performance reports
 - Most recent due diligence files/monitoring procedures for funds
 - Review of plan provisions, compliance process & participation statistics
 - **Query: Are plan fiduciaries informed of their duties and responsibilities?**

What is the Fiduciary Due Diligence Process?

- **Step 2 – Review of Investment Diversification**
 - Is the number of asset classes consistent with the portfolio size?
 - Is there asset class duplication/omission among investment options?
 - Is the number of investment options offered appropriate for the plan?
 - Are plan participants making appropriate investment selections?
 - **Example: number of individuals (if any) invested solely in fixed income funds**

What is the Fiduciary Due Diligence Process?

- **Step 3 – Formalize the Process**

- Specific investment strategy for the program
- Duties / responsibilities of fiduciaries and all other appropriate parties
- Due diligence criteria for selecting/monitoring investment options
- Procedures for accounting/controlling investment expenses
- Process for a periodic review & discussion of plan administration and participation
 - **Draft/Update Investment Policy Statement?**

What is the Fiduciary Due Diligence Process?

- **Step 4 – Implementation of Investment Policy Statement**

- Are current investment options consistent with the plan's IPS?
- Is current investment provider structure, whether bundled or unbundled, consistent with policy? (comprehensive fee analysis)
- Are the investment vehicles appropriate for the plan size (are institutional shares appropriate?)
- If 404(c) safe harbor is being utilized, is the plan generally meeting the safe harbor provisions?

What is the Fiduciary Due Diligence Process?

- **Step 5 – Ongoing Investment Monitoring**
 - Establish process for periodic reviews (quarterly is best practice)
 - Fiduciary action steps
 - Placing funds on watch list/replacing funds that violate policy
 - Renegotiating service provider contracts to address fee issues
 - RFP is last resort, but often is the only method of obtaining best pricing from service provider

The Ongoing Due Diligence Review Process

The Investment Review

- **Many different analytical tools with different focuses:**
 - Morningstar
 - Lipper
 - Fiduciary Analytics
 - Fund Prospectuses
 - Moody's & S&P Ratings
 - Fitch & AM Best Ratings
- **What you want to know about the funds:**
 - Performance against standard benchmarks & other similar funds
 - The level of risk taken versus the return it attains
 - Cost of the fund versus others like it, and has there been style drift
 - Has there been any change in management recently or in the fund company
 - What global economic conditions exist & how do they interact with the fund

The Investment Review

- The process undertaken and the reports generated are coordinated to:
 - The Investment Policy Statement
 - Participant demographics
 - General organizational needs

Fiduciary Monitoring In Action

The Fiduciary Analytics Fiduciary Score™ for Mutual Funds



The Fiduciary Score™ represents the percentile rank as compared to its peer group. It is a useful tool for identifying a short list of funds that merit further research, but is not a recommendation. **It represents a suggested course of action and is not intended, nor should it be used as the sole source of information for reaching an investment decision.**

Fiduciary Analytics due diligence process for mutual funds consists of the following screens:

Track record: The fund should have a minimum three year history.

Assets in the fund: The fund should have at least \$75 million under management (total across all share classes).

Stability of the organization: The portfolio manager (or most senior manager) should have at least two-year tenure.

Holdings consistent with style: Minimum of 80% of fund's securities are consistent with the peer group's asset class.

Correlation to style or peer group: The fund's category and current style box should be the same.

Expense ratio: The expense ratio for the fund should be above the bottom quartile of the peer group.

Performance relative to assumed risk: The fund's Alpha and Sharpe Ratio should be above the peer group's median.

Performance relative to peer group: The fund's 1-, 3- and 5-year trailing performance should be above the peer group's median. (The exception is the fund that does not have a five-year track record.)

Fiduciary Monitoring

Fund Name	Ticker	Peer Group	FA Score 4th Qtr	FA Score 3 Yr Avg
PIMCO Total Return Admin	PTRAX	Intermediate-Term Bond	0	27
Loomis Sayles Strategic Income Y	NEZYX	Multisector Bond	0	0
Fidelity Inflation-Protected Securities	FINPX	Inflation-Protected Bond	57	16
AllianceBernstein Global Bond A	ANAGX	World Bond	0	5
Goldman Sachs High Yield	GSHAX	High Yield Bond	14	6
Fidelity Equity-Income	FEQIX	Large Value	14	23
Vanguard 500 Index	VFINX	Large Blend	8	15
Fidelity Growth & Income	FGRIX	Large Blend	83	74
Legg Mason Partners Large Cap Growth A	SBLGX	Large Growth	81	50
Pennsylvania Mutual	PENNX	Small Blend	0	8
Julius Baer International Equity A	BJBIX	Foreign Large Blend	24	4
Fidelity Freedom Income	FFFAX	Target Date 2000-2014	58	55
Fidelity Freedom 2000	FFFBX	Target Date 2000-2014	46	51
Fidelity Freedom 2010	FFFCX	Target Date 2000-2014	0	14
Fidelity Freedom 2020	FFFDX	Target Date 2015-2029	0	20
Fidelity Freedom 2030	FFFEX	Target Date 2030+	0	39
Fidelity Freedom 2040	FFFFX	Target Date 2030+	0	33
Pax World Balanced	PAXWX	Moderate Allocation	0	10
Fidelity Puritan	FPURX	Moderate Allocation	0	7

Information copyright Fiduciary Analytics and Morningstar as of 12/31/07.

Investment Commentary

- **Investment Monitoring Example – Fidelity Growth & Income**
 - **Possible Red Flags**
 - FA Score of 83 for the 4th Quarter
 - Performance relative to peer group in bottom quartile for 1, 3 and 5 years
 - Morningstar risk for 3 years is below average, low for 5 years
 - Fund underperforms index for one, three and five year periods



Investment Commentary

- **Investment Monitoring Example – Legg Mason Partners Large Cap Growth A**
 - Possible Red Flags
 - FA Score of 81 for the 4th quarter
 - Performance relative to peer group in bottom decile for 1 and 3 years, below median for 5 years
 - Morningstar risk for 3 and 5 years is above average
 - Fund underperforms index for 1, 3 and 5 year periods
 - Manager is Alan Blake, who has been in place for more than 10 years

Ongoing Due Diligence Monitoring

- **Participation & Education**

- Coordinated educational campaigns focused on today's employee: "sound bite" education, podcasts, focus groups...
- Use of plan utilization statistics (participants with 100% in fixed investments or in multiple target date funds, etc.)
- Participation improvement methods (automatic enrollment, simple enrollment, stepped-up enrollment, etc.)



- **Plan Administration & Compliance**

- Administrative issues (vendor concerns, contractual requests, participant complaints, etc.)
- Potential plan design modifications (changes in contribution rates, eligibility, vesting, etc.)

Ongoing Due Diligence Monitoring

- **New Legislative Implications**

- Pension Protection Act (default fund requirements, auto enrollment, etc.)
- 403(b) regulations (Plan document requirements, transfer restrictions, etc.)

- **Trends in the Industry**

- Annuity options
- Roth options

Benefits of a Due Diligence Review & Likely Plan Sponsor Considerations

The Benefits of Periodic Due Diligence Reviews

- **Due Diligence Process Plans Help Avoid Liability/Scrutiny by Establishing a More Definitive Process:**
 - Monitor investment and related management expenses;
 - Monitor performance and asset class appropriateness;
 - Derive value from fees

The Benefits of Periodic Due Diligence Reviews

- **Regularly Scheduled Committee Meetings Also:**
 - Provide forum to introduce best practices (trends in participant education, plan design, investment analytics, other innovative approaches to plan administration)
 - Allow for scheduled discussions to address difficult plan issues/decisions
 - Ensure adherence to a Due Diligence & Fiduciary Review process

Lack of Action Creates Risk; Procedural Prudence More Important Than Performance

Likely Plan Sponsor Considerations

- **Consider a Comprehensive Review of the 403(b) Program**
 - A detailed examination of existing vendor program(s) to understand all aspects of the offerings, and issues to address including compliance with new regulations
 - The review would especially focus on program investments and a comprehensive accounting of the dollar amount of all program expenses incurred
- **RFP Used to Consolidate to Single Provider or Maximize Current Program**
 - Comprehensive review of the 403(b) program typically helps focus the direction
 - Internal relationships may play a role in the decision making process
 - RFP helps ensure that program is competitive & obtains most “bang-for-the-buck”
- **Consider the Establishment of a Fiduciary Due Diligence Process**
 - The Investment Policy Statement is an integral part of the process
 - Establish a Committee with regularly scheduled due diligence meetings

403(b) Marketplace Trends

Recent Trends in the 403(b) Marketplace

- **Investments**
 - **Target Date Funds**
 - QDIA rules (default investments) have accelerated usage
 - Heavy equity focus throughout working lifetime today (the “Glide Path”)
 - Education even more important in volatile market environment
- **Annuity Offerings**
 - Older products generated concerns on annuity expenses and commissions
 - Newer offerings with somewhat lower expense levels, which strive to guarantee minimum level of lifetime income
- **Roth after-tax deferral offerings (increased implementation, still low usage)**

Recent Trends in the 403(b) Marketplace

- **Participation Initiatives**

- **Renewed Focus on Simple Enrollment**

- Check a box and sign campaign
 - Default deferral percentage & investment elections enacted for participant

- **Automatic Enrollment**

- Large increase in adoption rate, since garnishment rule issues eliminated; has waned in current economic climate however
 - Average deferral rates have been dropping as default rate typically is 3%
 - Use of automatic annual deferral increases has been picking up steam

Recent Trends in the 403(b) Marketplace

- **Communication & Education**

- Participant attention is more and more difficult to attract today

- Short, sound-byte forms of education becoming prevalent over long group presentations
- Crisp monthly, theme based financial educational approaches
- Quick lunch & learn programs

- Use of technology continues to increase

- Intranet/internet postings, seminars, and learning tools
- Email blasts
- Podcasts

Questions?

Amy Pocino Kelly, Partner
Morgan Lewis
(215) 963-5042
akelly@morganlewis.com

Jeffrey A. Levy, Practice Leader
Cammack LaRhette Consulting
(646) 839-8207
jlevy@clcinc.com

Michael A. Webb, Vice President
Cammack LaRhette Consulting
(646) 839-8232
mwebb@clcinc.com

Morgan Lewis