Morgan Lewis

webcast

Plan Sponsor Basics

Webinar 6 of 6

Fiduciary Issues for Retirement Plan Sponsors

Presenters:

Julie K. Stapel

Daniel R. Kleinman

October 15, 2013

www.morganlewis.com

Overview of Today’s Webinar

- ERISA Overview
- Fiduciary Status Under ERISA
- Fiduciary v. Settlor Functions
- ERISA’s Fiduciary Duties
- Additional Fiduciary Considerations

© Morgan, Lewis & Bockius LLP

ERISA Overview

What Is ERISA?

- Employee Retirement Income Security Act of 1974
- Enacted in response to high-profile plan sponsor bankruptcies and widespread corruption in the management of employee benefit plan assets
- Imposes very stringent standards on those with discretionary authority or control over employee benefit plans and their assets (i.e., fiduciaries)
- Includes very strict anti-conflict-of-interest rules (prohibits transactions with a wide range of parties involved with the plan unless an exemption applies)
- Allows both plan participants and the Department of Labor (DOL) to bring suit to enforce ERISA’s provisions

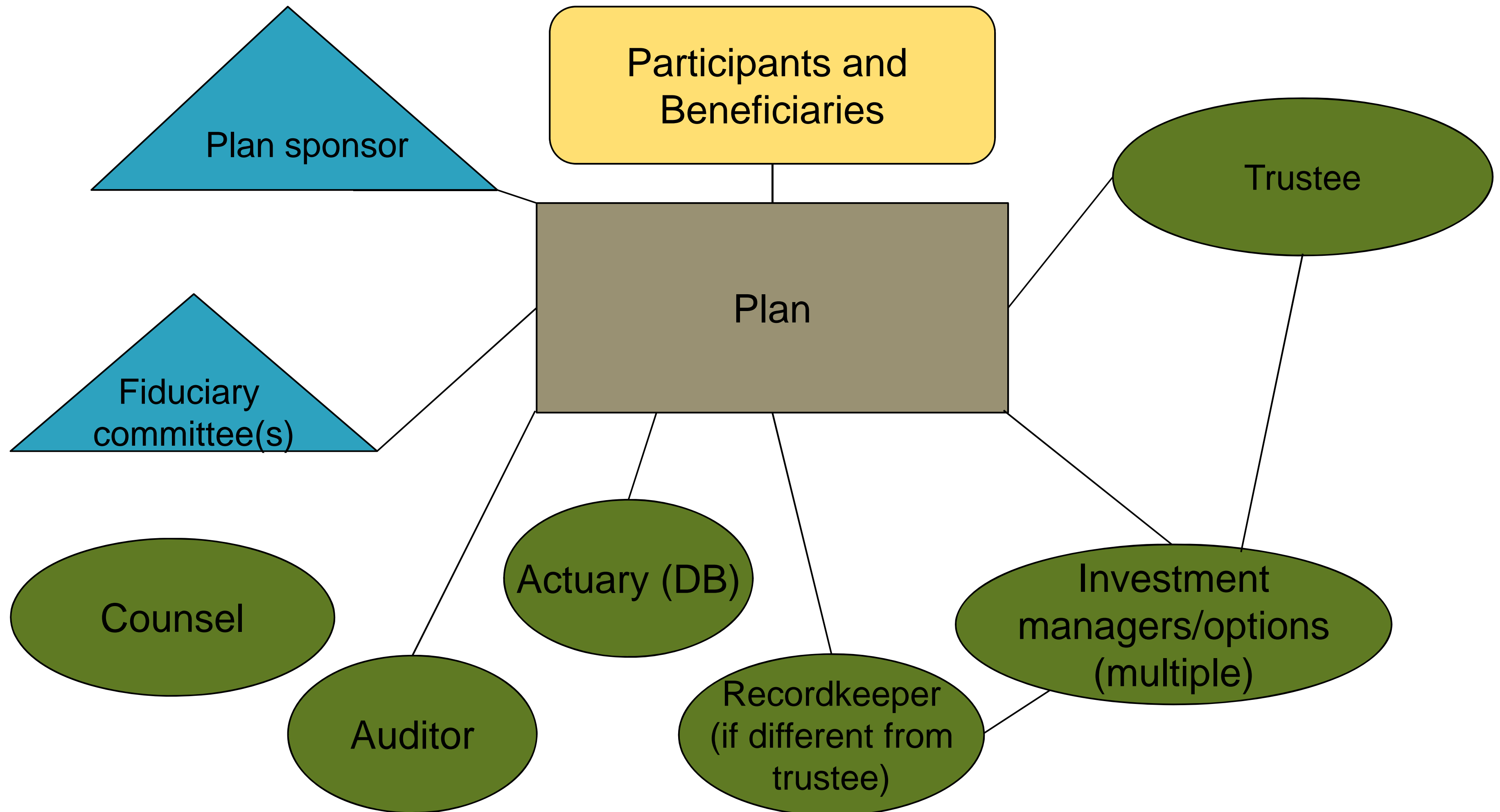
© Morgan, Lewis & Bockius LLP

What Plans Are Subject to ERISA?

- Governs all private sector qualified retirement plans and health and welfare plans
  - Defined contribution (DC) pension plans (401(k), profit-sharing, stock bonus plans)
  - Defined benefit (DB) pension plans (traditional pension, money purchase, cash balance)
  - Health and welfare plans
  - VEBA trusts
  - Severance plans (sometimes)
- But not “nonqualified” plans
  - SERPs
  - “Top hat” plans

© Morgan, Lewis & Bockius LLP

Plan Structure Overview



© Morgan, Lewis & Bockius LLP

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Definition of Fiduciary

- Under ERISA, the term “fiduciary” is broadly defined to include any person who:
  - Exercises discretionary authority or control over management or disposition of plan assets
  - Renders investment advice for a fee
  - Has discretionary authority or responsibility for plan administration
- Includes those named as fiduciaries in governing documents
- Includes those responsible for appointing other fiduciaries
- But a person can be a fiduciary even if not named as such in governing documents—based on function, not title

© Morgan, Lewis & Bockius LLP

Examples of Fiduciaries

- Committees assigned or exercising fiduciary functions
- Individual members of the committees and possibly investment and benefits staff who have discretionary authority or control over the administration and management of the plans
- The trustee (but only to a limited extent in the case of directed trustees)
- Managers of separately managed accounts of plans and collective investment trusts
- Some investment consultants

© Morgan, Lewis & Bockius LLP

Examples of Non-Fiduciaries

- Employers as “settlors”/plan sponsors (depends on governance structure)
- Recordkeepers
- Managers of mutual funds offered under 401(k) plans and managers of certain private funds under DB plans
- Attorneys
- Auditors
- Some consultants

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Named Fiduciaries

- ERISA requires each qualified plan to name one or more fiduciaries who have authority to control and manage the operation and administration of the plan—referred to as "named fiduciaries."
- Named fiduciary responsibilities can be split between two or more named fiduciaries.
- "Named fiduciaries" have the authority to appoint "investment managers" within the meaning of Section 3(38) of ERISA (discussed below).
- Considerations for who should be named fiduciaries—the sponsor? Committee(s)? Individuals?

© Morgan, Lewis & Bockius LLP

Plan Administrator

- ERISA requires each qualified plan to have an "administrator" with responsibility to oversee administration of the plan.
- If the administrator is not specified in the plan document, it is the plan sponsor.
- Considerations for who should be the administrator—the sponsor? A committee? An individual?
- Several legal duties fall on the plan administrator—especially disclosures.

© Morgan, Lewis & Bockius LLP

Delegation to Other Fiduciaries

- ERISA allows a named fiduciary to delegate responsibility to other fiduciaries.
- Internal delegations—fiduciary committees can delegate to others within the plan sponsor's organization.
- Delegation to a Section 3(38) "investment manager."
  - Used for discretionary asset managers, including managers of collective investment trusts (CITs).
  - Limits responsibility of the party appointing the investment manager to appointing and monitoring the investment manager (and not its investment decisions).

Delegation to Other Fiduciaries

- Fiduciaries can be appointed to serve different roles
- Section 3(21) fiduciaries vs. Section 3(38) fiduciaries
- For example, can appoint fiduciaries to:
  - Advise on overall fund selection (Section 3(21))
  - Take responsibility for investment option/manager selection (likely Section 3(38))
  - Manage a separately managed account or collective investment trust (likely Section 3(38))

© Morgan, Lewis & Bockius LLP

Managing Fiduciary Delegations/Service Providers

- RFPs/RFIs
- Periodic and systematic performance and fee reviews
- Use of standard agreements with investment managers and consultants as a risk-management tool
  - Can also save time and money in negotiating agreements
  - Help support consistent terms across service provider relationships
- Tools for monitoring performance

✓ Reporting

✓ "Watch list" procedures

✓ Periodic meetings

✓ Diligence and review

© Morgan, Lewis & Bockius LLP

Fiduciary vs. Settlor Functions

Fiduciary vs. Settlor Functions

- Settlor functions generally include the adoption, amendment, and termination of the plan.
- Officers of the plan sponsor may wear both "hats"—having both settlor and fiduciary responsibilities.
- In contrast to fiduciary functions, settlor functions can be carried out in the best interests of the plan sponsor.
- Fiduciary expenses can be charged against plan assets; settlor expenses generally cannot.

© Morgan, Lewis & Bockius LLP

What Decisions Are Fiduciary and What Decisions Are Not?

Settlor Actions

- Depending upon how plan is drafted, offering company stock as an investment option as provided by the plan document
- The decision to have auto-enrollment
- The decision to offer an early retirement window
- The decision to offer matching contributions or nonelective contributions
- The decision to terminate a plan

Fiduciary Actions

- The selection (and monitoring) of investment managers or investment options
- Negotiating contracts for services to be paid for with plan assets
- The payment of plan fees and expenses with plan assets (and the expenditure of plan assets generally)

Note that even when the decision may be a settlor function, carrying out that decision may turn into a fiduciary function.

© Morgan, Lewis & Bockius LLP

© Morgan, Lewis & Bockius LLP

Four Basic Fiduciary Duties

- Duty of loyalty (exclusive benefit rule)
- Duty of prudence (“prudent expert” standard)
- Duty to diversify
- Duty to follow plan terms

© Morgan, Lewis & Bockius LLP

Duty of Loyalty

- Duty of loyalty
  - A fiduciary must discharge his or her duties with respect to a plan:
    - *Solely in the interest of the participants and beneficiaries*
    - *For the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.*
  - Putting the fiduciary’s, company’s, or union’s interests ahead of plan participants and beneficiaries is a breach of duty.
  - Basically a conflict-of-interest rule—fiduciaries cannot have conflicting loyalties.

© Morgan, Lewis & Bockius LLP

Duty of Prudence—Prudent Expert

- Duty of prudence
  - A fiduciary must discharge his or her duties with respect to a plan:
    - *"With the care, skill, prudence, and diligence then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."*
  - Courts have interpreted the duty of prudence to be a "prudent expert" standard—what would a prudent expert do in a like situation? A fiduciary need not be the expert, but may need to consult an expert.
  - Good faith is not enough. "A pure heart and an empty head are not enough." *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

© Morgan, Lewis & Bockius LLP

Duty of Prudence—Procedural Prudence

- Duty of prudence
  - Duty of prudence does not require a fiduciary to guarantee outcomes, but rather requires use of a prudent process.
  - Sometimes referred to as “procedural prudence”—the ability to demonstrate that the fiduciary followed a prudent process in making a fiduciary decision.
  - A key factor in fiduciary decisionmaking.
  - Highlights the importance of documenting fiduciary considerations and fiduciary decisionmaking.

© Morgan, Lewis & Bockius LLP

Duty of Prudence—Procedural Prudence

- Under DOL guidance and fiduciary case law, process is paramount.
- Delegations of authority should be periodically and carefully reviewed.
- Document, document, document.
- Regular meetings of fiduciary committees
  - Meeting “books” and agendas
  - Resolutions
  - Minutes

© Morgan, Lewis & Bockius LLP

Fiduciary Training

- Good fiduciary risk-management tool
- Recent questions from DOL audit asking about fiduciary training
- Identified in litigation as a helpful fact in demonstrating compliance with fiduciary duties
- Required by some fiduciary liability policies
- Consider a policy to require training for new members as they join fiduciary committees, and periodically after that

© Morgan, Lewis & Bockius LLP

Duty to Diversify

- Duty to diversify
  - A fiduciary shall discharge his or her duties with respect to the plan
    - *"by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."*
  - "ERISA's duty to diversify is not measured by hard and fast rules or formulas." *In re Unisys Sav. Plan Litig.* (3d Cir. 1996).
  - Diversification is generally considered based on the plan's entire portfolio, so individual investment managers may not need to be diversified.

© Morgan, Lewis & Bockius LLP

Duty to Act in Accordance with Plan Documents

- Duty to act in accordance with plan documents and instruments
  - A fiduciary shall discharge his or her duties with respect to the plan
    - *"in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA]."*
  - Even if an act or investment otherwise satisfies ERISA, it could constitute a fiduciary breach if it is inconsistent with the terms of the plan documents—even if ERISA and the Code do not require that particular term to be in the plan documents.

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Duty to Act in Accordance with Plan Documents

- Duty to act in accordance with plan documents and instruments
  - Recent litigation has construed the phrase "documents and instruments governing the plan" broadly to include investment policy statements and other documents not generally considered the plan document.
  - Highlights the need for fiduciaries to review plan documents (and think about that term broadly).
  - Highlights the importance of consistency across plan-related documents.

© Morgan, Lewis & Bockius LLP

Consequences of Breach of Fiduciary Duty

- Breach of fiduciary duty
  - Personal liability for fiduciary breaches and losses (limits on exculpation using plan assets)
    - *Corporate indemnifications*
    - *Fiduciary liability insurance*
  - Obligation to restore profits received and opportunity costs
  - Other equitable and remedial relief (e.g., removal from fiduciary position) and additional penalties
    - *Monetary penalties to DOL equal to 20% of the recovery amount*
    - *Criminal penalties for failure to make 401(k) contributions, willful violations of reporting and disclosure requirements, kickbacks, bribes, and embezzlement*
    - *Reputation risk*

© Morgan, Lewis & Bockius LLP

Additional Fiduciary
Considerations

Safe Harbor for Participant Investment Elections

- Section 404(c) of ERISA
  - Applies to DC plans that permit participant-directed investments
  - Protection from liability for investment decisions made by participants if certain conditions are met
    - *Numerous detailed requirements (notice, opportunities to change elections, broad range of investment options)*
    - *May not relieve liability for prudent selection and monitoring of investment options*

© Morgan, Lewis & Bockius LLP

Safe Harbor for Participant Investment Elections

- Three primary components of Section 404(c) compliance
  - Offer a broad range of investment alternatives
    - *At least three*
    - *Each must be diversified*
    - *Each must have materially different risk and return characteristics*
  - Offer each participant a reasonable opportunity to give investment instructions
  - Provide each participant with specified information about the investment alternatives to allow the participant to make informed choices
    - *Same information as required by the Section 404(a) participant disclosures*

Safe Harbor for Default Investment Options

- Qualified Default Investment Alternative (QDIA) Rules
  - Like Section 404(c), apply to DC plans that permit participant-directed investments
  - Protection for "default" investments made in the absence of participant direction (e.g., auto-enrollment) under specific conditions
    - *May not protect from liability for prudent selection and monitoring of the QDIA*
  - Very useful safe harbor—can be used in any circumstance where there is no investment direction (such as rollovers) and can be used in mapping (without needing to establish comparability)

© Morgan, Lewis & Bockius LLP

Safe Harbor for Default Investment Options

- Primary components of QDIA compliance
  - The investment alternative is a QDIA
    - *Life cycle or target date funds*
    - *Balanced funds*
    - *Managed accounts*
    - *Not stable value or money market (subject to some grandfathering)*
  - The participant had the opportunity to direct the investment, but did not
  - Notice (prior to first default investment and annually)

© Morgan, Lewis & Bockius LLP

Participant Disclosures

- Section 404(a)(5) participant disclosures are a fiduciary duty
- Required to be provided by the plan administrator to 401(k) plan participants
- Initial disclosures were required by August 30, 2012
- Three categories of disclosures
  - General plan information
  - Plan administrative expenses
  - Investment information
    - *Performance*
    - *Fees and expenses*
    - *Other investment-related disclosures*

Revenue Sharing and ERISA Accounts

- Arrangements in which plan recordkeepers receive payments from investment providers for recordkeeping or other administrative services.
  - Sometimes referred to as "12b-1 fees," a reference to SEC Rule 12b-1, which governs some of these arrangements.
- Some or all of the recordkeepers' fees may be paid through revenue sharing.
- Plan fiduciaries should consider revenue sharing when evaluating reasonableness of fees.
  - ERISA requires service provider arrangements and fees to be reasonable.
  - Recent DOL Advisory Opinion.

© Morgan, Lewis & Bockius LLP

Revenue Sharing and ERISA Accounts

- Trend in recent years toward crediting revenue sharing directly to participant accounts rather than (or in addition to) paying recordkeeping fees and/or paying plan expenses directly
- Revenue-sharing amounts may be credited to an account for the benefit of the DC plan and then used to pay permissible plan expenses or be allocated to participant accounts, sometimes referred to as ERISA accounts
- Considerations for ERISA accounts
  - Plan asset status (see recent Advisory Opinion)
  - How to allocate to participant accounts (pro rata, per capita, based on funds participant has elected)
  - How to communicate it to participants

© Morgan, Lewis & Bockius LLP

Target Date Funds

- Target date funds are investment options in which asset allocations change over time to become more conservative as retirement nears.
- Regulatory focus on target date funds, as large amounts of assets flow into them after QDIA rules made target date funds QDIAs.
- Earlier this year, DOL issued "tips" for fiduciaries on target date funds.
- Special considerations:
  - How to monitor
  - Fees
  - Participant communication/education

© Morgan, Lewis & Bockius LLP

© Morgan, Lewis & Bockius LLP

Presenters

Julie K. Stapel
Partner
Chicago
312.324.1113
jstapel@morganlewis.com

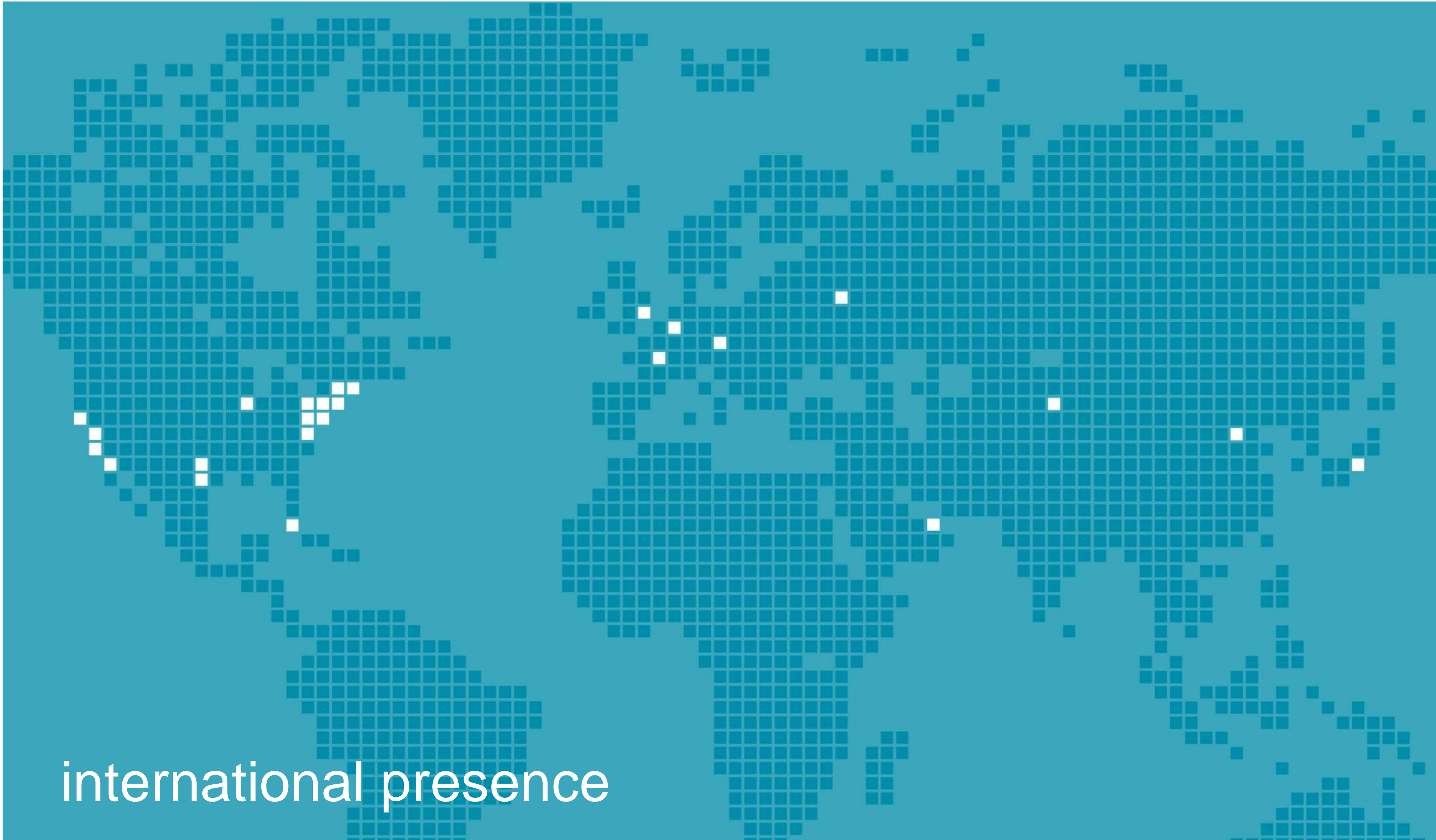
Daniel R. Kleinman
Partner
Washington, D.C.
202.739.5143
dkleinman@morganlewis.com

© Morgan, Lewis & Bockius LLP

DISCLAIMER

- This material is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2013 Morgan, Lewis & Bockius LLP. All Rights Reserved.

- **IRS Circular 230 Disclosure**
  To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see http://www.morganlewis.com/circular230.



Almaty Beijing Boston Brussels Chicago Dallas Dubai* Frankfurt Harrisburg Houston Irvine London Los Angeles Miami Moscow New York Palo Alto Paris Philadelphia Pittsburgh Princeton San Francisco Tokyo Washington Wilmington

*In association with Mohammed Buhashem Advocates & Legal Consultants