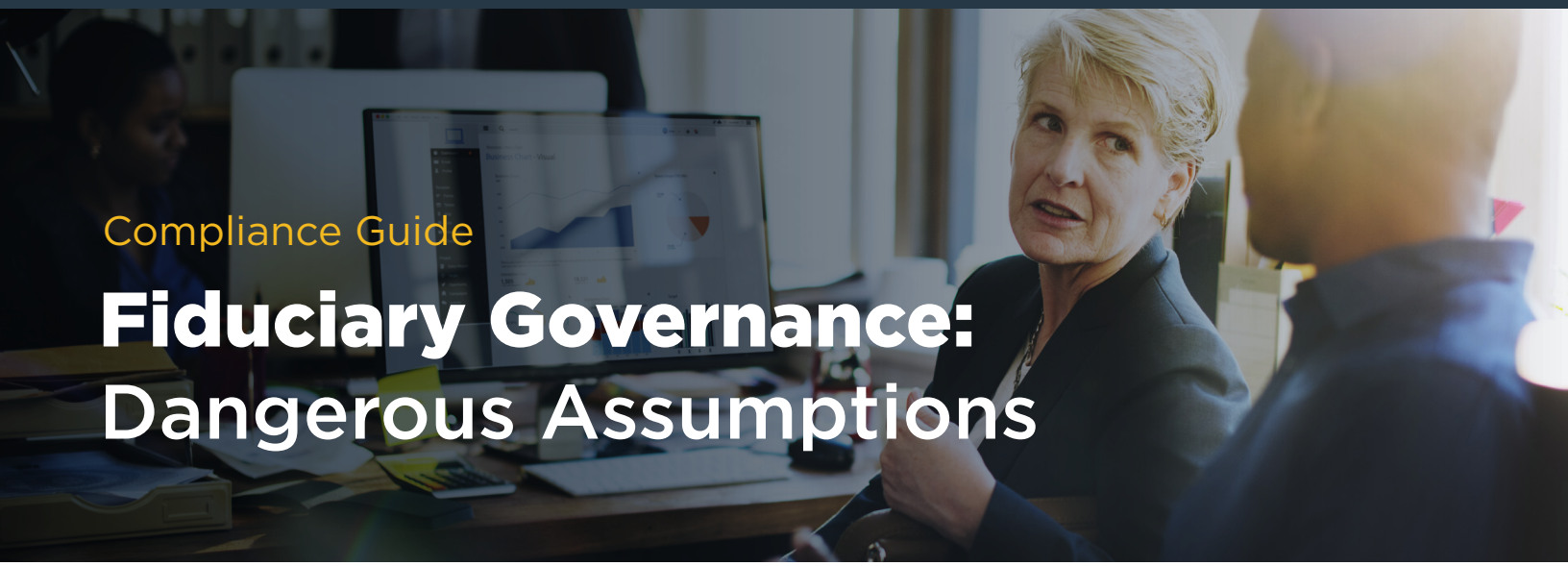

Compliance Guide

Fiduciary Governance: Dangerous Assumptions

Why Plan Oversight Is Important

When companies sponsor retirement plans, such as 401(k) and 403(b) plans, the officers and senior managers who make decisions about the plans' investments, providers, and administration are fiduciaries under ERISA—the Employee Retirement Income Security Act.

A number of courts have said that ERISA's fiduciary standard—the prudent man rule—is the highest standard known to the law. The point is that it is a demanding standard of care that requires that fiduciaries understand the issues they need to address and that they make informed and knowledgeable decisions about those issues.

This paper discusses five dangerous assumptions that some plan fiduciaries make. It then helps fiduciaries avoid the pitfalls of those assumptions by explaining the real issues and how to satisfy the requirements. Plan sponsors should seek advice from experience plan advisers, service providers and, where needed, attorneys.

Who Is Responsible?

Not all companies use the same approach to determining which of their officers or senior managers will be fiduciaries for the plans. Some will pick one person, for example, the CFO or Vice President for Human Resources, to make all the decisions about the plan. Others will appoint a committee of officers and managers to make those decisions. While a plan can be operated in a compliant manner with a single fiduciary or with a committee, this paper uses "plan committee" to refer to the plan sponsor fiduciaries.

Regardless of whether the retirement plan is managed by a company officer or a plan committee, the officer or committee members are fiduciaries and, as such, are held to the standard of the prudent man rule. ERISA explains that a fiduciary must "discharge his duties...solely in the interests of the participants and beneficiaries...for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses" of the plan. In performing those duties, the prudent man rule requires that a fiduciary act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims...".

Translating that legal language into conversational English, it means that the plan committee members must (1) act carefully, skillfully, prudently and diligently to perform their duties; (2) considering the "circumstances then prevailing" or, in other words, considering the investments, services, and information then available; (3) that a "prudent" person who is making decisions about retirement plans would consider; (4) and who is knowledgeable about the information and processes for making those decisions; (5) for selecting and monitoring the investments and services for a retirement plan, e.g., a participant-directed 401(k) or 403(b) plan.

Two aspects of that rule are particularly concerning. First, the "familiar with" phrase is sometimes referred to as the "prudent expert" rule. That is an overstatement in the sense that fiduciaries are not expected to be experts on all retirement plan issues. But they are expected to know when they are not familiar with the issues and considerations, and in those cases, they are expected to hire experienced retirement plan advisers to help make informed and knowledgeable decisions. Second, while some of the fiduciary issues are obvious (for example, fiduciaries must select and monitor a plan's investments), other decisions and issues are not (for example, does the plan have the appropriate share classes of the mutual funds that it holds). This paper addresses some of the assumptions that are common among fiduciaries, but that are not always correct. The foundation for making compliant fiduciary decisions is to start off with a good understanding of what is required.

Participant Deferrals: **Time Matters!**

The failure to take employee deferrals (and participant loan repayments) out of the company's bank account and to deposit them into the plan's trust on a timely basis is both a fiduciary breach and a prohibited transaction. That is because the Department of Labor's (DOL) position is that the money belongs to the employees—and not to the company and should be applied to their benefit as soon as reasonably possible. Once the money is in the trust, it is protected from the company's creditors and from possible misuse. In addition, the money should be invested for the employees' benefit to support their objectives of accumulating adequate retirement savings.

The bottom line of these rules is that the deferrals and loan repayment amounts must be paid from the company accounts into the plan's trust and invested as soon as reasonably possible.

From a technical legal perspective, if the money is not taken out of the company accounts and placed in the trust on a timely basis, the legal consequences are:

- The retention of the money by the company is a prohibited transaction because the plan sponsor is using the participants' money for its purposes. To correct the failure to deposit the money into the plan on a timely basis, the company must put the money into the plan, pay interest for the period that it was not in the plan, and pay excise taxes for the violation.
- The retention of the money is also a fiduciary breach because the failure to put the money in the trust exposed the participants' deferrals to possible loss and because the money wasn't invested for the benefit of the participants. The consequence is that the company (and the plan fiduciaries, e.g., the committee members) are liable for any losses, including any investment gains that weren't obtained, plus interest.

The critical point is that companies that sponsor plans, and their fiduciary committees, must put the money in the trust on a "timely basis." But that begs the question of, what is timely?

The DOL rules say that the outer limit is the 15th business day of the month following the month in which the money was withheld from the employees' paychecks. But the actual rule is that the money must be deposited into the plan's trust as soon as the money can reasonably be segregated from the company's bank accounts.

For small plans, there is a 7-business day safe harbor. That is, if the money is deposited into the trust within 7 business days after withholding, the DOL will not assert that the company didn't make a timely deposit. (A small plan is one with fewer than 100 participants.)

Larger plans do not get the benefit of that safe harbor. For larger plans, the expectation is that the money will be deposited sooner than that. The timing is often measured by the pattern that the company has established. For example, if a company regularly deposits the withheld amounts within two days after withholding, the DOL would likely challenge any payments delayed beyond that.

There can be exceptions, but never beyond the outer limit discussed above. For example, the DOL might approve delays due to major business disruptions (but probably wouldn't approve delays due to problems that could have been anticipated). Examples of exceptions that have been approved by DOL investigators include: a fire at the company that destroyed company records or made those records temporarily inaccessible, a cybersecurity attack, and a natural disaster that impacted the ability to transfer the money.

The timely deposit of deferrals and loan repayments is a priority for every Department of Labor investigation. It should be taken seriously.

Investment policy statements: **Legal or Best?**

There is not a legal requirement to have an investment policy statement (IPS). However, at least one judge found that it was a fiduciary breach to not have one.

In that case, the judge determined that, if the fiduciaries had an IPS and had followed it, they would not have made the imprudent investments.

But the general rule is that an IPS is not required. Even though not required, it can be a best practice to have and follow an IPS, and it can also be good way to reduce risk.

An IPS should be drafted as a "road map" for compliance with the prudent man rule for the selection and monitoring of a 401(k) or 403(b) plan's investments. The benefit of that IPS road map is that, if well drafted, a plan committee and its investment adviser can consistently follow the IPS process and criteria for selecting, monitoring, removing and replacing the plan's investments.

An argument against an IPS is that the plan fiduciaries, e.g., plan committee members, can inadvertently fail to comply with its terms and, as a result, possibly commit a fiduciary breach. To protect against that possible outcome, the IPS should be carefully drafted. Consider doing the following:

- Having an IPS and reviewing it at least once a year.
- When reviewing a plan's investments, review the IPS about the criteria to be used and the provisions for monitoring and removing an investment.
- Including a provision in the IPS that says that its guidelines are intended to help the committee members but that the IPS is not binding.

The investment "destination" for a 401(k) or 403(b) plan is to provide the participants with good quality, reasonably priced investments. A road map—an IPS—provides a good route to that destination.

Fiduciary Bonds & Insurance: **Does it Matter?**

The officers and committee members at plan sponsors may not know the difference between an ERISA fiduciary bond and ERISA fiduciary insurance. However, they are very different and the difference is critical.

An ERISA fiduciary bond is required by law. ERISA fiduciary liability insurance is not required but provides protection from lawsuits against the committee members and the plan sponsor.

An ERISA fiduciary bond protects against theft and embezzlement. The failure to obtain a bond could result in a claim for fiduciary breach, for example, if an employee steals money from a plan (e.g., employee deferrals) and that employee is not covered by an ERISA bond (which would cover the losses), the plan committee members could be individually liable for the losses to the plan. In that regard, an ERISA bond must cover every person who handles or has access to plan assets.

The bonds must be equal to at least 10% of the plan's assets, but not to exceed $500,000.

While ERISA does not require that fiduciaries have fiduciary liability insurance, plan committee members may want the protection it offers.

Fiduciary liability insurance protects plan fiduciaries, such as committee members, as well as the company, against claims of mismanagement of the plan and its assets, and other possible claims arising from their roles as plan fiduciaries. It also covers legal fees and litigation costs associated with fiduciary breach lawsuits.

Fiduciary Delegation: **How Much?**

A plan sponsor can never eliminate all fiduciary responsibility for its plan, and therefore can never avoid the potential of fiduciary liability by delegation of fiduciary responsibilities. However, some fiduciary responsibilities, and therefore potential fiduciary liability, can be transferred.

While plan sponsors and their committees can delegate fiduciary responsibilities to other third-party fiduciaries and non-fiduciaries, the ultimate responsibility for the operation of the plan remains with the plan sponsor and the committee members who serve as the fiduciaries. In that regard, plan sponsors have two primary fiduciary responsibilities—to manage the plan's assets and to administer the plan.

For plan administration, plan committees can delegate much of the responsibility to a service provider, for example, a third-party administrator (TPA) or a recordkeeper. However, in that case, the committee retains the responsibility to prudently select and monitor the service provider and to make certain administrative decisions. ("Administrative" decisions include approvals of participant loans and distributions, determining who is eligible to participate in the plan, and selection of a plan's service providers.)

The responsibility for many of the administrative decisions can be delegated to a so-called 3(16) administrative fiduciary—ordinarily a TPA who agrees to be a fiduciary administrator. But the plan committee retains the fiduciary responsibility to monitor the 3(16) TPA.

The responsibility to manage plan assets can be delegated in varying degrees, but the plan committee retains the duty to monitor the investment adviser.

One category of investment adviser is a 3(21) adviser—a nondiscretionary adviser. With a nondiscretionary adviser, the adviser makes recommendations to the plan committee, but the committee retains the responsibility for making the investment decisions and monitoring the investment adviser.

Another category of investment adviser is a 3(38) adviser—a discretionary investment manager, who makes the decisions about a plan's investments. In this case, a plan committee is not responsible for a plan's investment decisions but must monitor the investment manager.

While the plan committee retains the duty to monitor the investment advisers and other service providers, courts often say that the use of professional experts—such as a fiduciary investment adviser—is an indication that a plan committee has engaged in a prudent process to satisfy the fiduciary rules.

Some courts have also favorably noted that investment policy statements are evidence that a plan committee engaged in a prudent process.

Fiduciaries: **Responsible for What You Don't Know!**

While plan sponsors are experts about their own businesses, that may not carry over to the operation of their retirement plans. Does that mean that plan sponsors and their committees automatically have a fiduciary problem? Possibly. However, it doesn't need to be a problem.

Plan committees are not required to be experts on all plan issues and decisions. But they are expected to get competent help to learn what the issues are and how to address those issues.

Some of the decisions that plan sponsors have to make—but may not have expertise—include: determining the right share classes of the mutual funds for their plans; evaluating the revenue sharing paid to their service providers; determining when a mutual fund is no longer appropriate for the plan; determining if the fees charged by their service providers are excessive.

Fortunately, plan sponsors and committees are not expected to understand all of those issues. But they are expected to know that they don't know the answers and to engage knowledgeable advisers to help them.

However, committee members may not know if their plan's service providers are fiduciaries or commercial providers or about why that even matters. The fiduciary status of a plan's service providers is important since fiduciary advisers are held to the same standard of care as plan sponsors and, as fiduciaries, they owe a duty of loyalty to the plan and its participants. On the other hand, commercial providers do not owe the duties of prudence or loyalty to the plan and the participants. That means that non-fiduciary service providers can put their interests ahead of the plan and its participants.

As a result, plan committees should consider engaging fiduciary advisers to assist with their investment responsibilities and other duties, such as monitoring of the services and fees of the plan's service providers.

Concluding Thoughts

Misunderstandings and mistaken assumptions can be dangerous for plan sponsors and their plan committees. The first step to safely managing a 401(k) or 403(b) plan is to have correct information about the decisions that need to be made and the process for making those decisions.

Unfortunately, while some of the decisions are obvious, others are not. In that case, plan committees are not expected to know all of the questions or to have all of the answers. Instead, they are expected to know that they need help in identifying the decisions they need to make and in obtaining and considering the information needed to make prudent decisions.

This paper and the checklist are intended to be a starting point for helping plan committees and plan sponsors know about the five dangerous assumptions that could mislead them, and to address the actual issues in a compliant manner.

Put our global resources and local expertise to work for you.
Consult with your Retirement & Private Wealth Advisor to help you ensure fiduciary compliance.