# FIDUCIARY RESPONSIBILITY

## INTRODUCTION

Fiduciaries of defined contribution (DC) plans have come under increasing scrutiny in recent years, in part due to participant lawsuits filed against plan sponsors and the resulting media attention. The Internal Revenue Service (IRS) and Department of Labor (DOL) have also increased the number of plans they audit each year. Because significant consequences can result from a fiduciary breach, you are encouraged to focus on your fiduciary responsibilities and understand the standards of conduct that apply to every plan-related decision you make.

Under a participant-directed DC plan, much of the control and responsibility for participant investment outcomes is substantially shifted from the plan sponsor to the participant. The plan sponsor, however, remains fully and solely responsible for maintaining the plan, meeting regulatory requirements, educating participants, prudently selecting and monitoring both investment options and service providers, and controlling plan expenses.

NAGDCA created this Fiduciary Responsibility Brochure to guide you, a fiduciary of a governmental participant-directed DC plan, through the basic fiduciary responsibilities imposed upon plan sponsors. It provides a simple explanation of fiduciary standards of conduct. It is not a legal interpretation of your responsibilities under state or other applicable law, nor is it intended to be a substitute for the advice of your retirement plan attorney or other professional.

## THE PLAN FIDUCIARY

**Fiduciary Capacity -** A person acts in a fiduciary capacity when he or she handles money or property for the benefit of another. A governmental employer offering a defined contribution (DC) plan to its employees, herein referred to as the plan sponsor, handles money for the benefit of plan participants. Specifically, Internal Revenue Code §457(g) requires governmental 457(b) plan assets and income to be held in trust, or in custodial accounts or annuity contracts described in §401(f), for the exclusive benefit of participants and their beneficiaries. The obligation to make every plan-related decision prudently and with only the best interests of the plan participants in mind means it is essential for you to know and understand your fiduciary responsibilities.

**Plan Fiduciaries -** A fiduciary is a legal term that can be simply defined as anyone who:

- Exercises discretionary authority or control over plan assets, and/or
- Exercises discretionary authority or responsibility in the administration or management of the plan, and/or
- Gives or renders investment advice for a fee or other compensation.

Fiduciaries may include anyone who:

- Makes decisions regarding plan features and investments.
- Serves or is appointed to a Committee or Board responsible for the plan or its investments.
- Has responsibility to choose, evaluate and dismiss service providers.
- Has the authority to bind the employer/plan sponsor through plan-related contracts.
- Establishes policies and procedures for the plan, or has the ability to make exceptions.

Fiduciaries may be designated by name or function, and responsibilities may be delegated to others, but this does not remove fiduciary responsibility from the delegating fiduciary. Also, you do not have to make decisions to be a fiduciary; simply having the authority to do so makes you a fiduciary.

***Simply stated:* Fiduciary standards are put in place to protect against fraud, dishonesty and mismanagement of the plan and plan assets.**

**Non-Fiduciary Service Providers** – An individual's fiduciary responsibility is determined by his or her actions. However, those typically not determined to be plan fiduciaries include anyone who performs administrative functions, but does not have authority to make discretionary decisions for the plan such as those:

- Receiving contributions and applying them to participant accounts.
- Preparing and distributing communication and educational materials.
- Calculating benefits.
- Processing enrollment or contributions forms or documents.
- Applying adopted or established rules and guidelines.

## EMPLOYER VERSUS FIDUCIARY FUNCTIONS

Employers sponsoring a DC plan act in a dual capacity -- as the employer and as a fiduciary to the plan.

**Employer Functions -** Certain functions, known as "settlor" functions, are the responsibility of the employer and are not fiduciary in nature. You are acting in your employer capacity when you:

- Decide to offer a retirement plan to employees,
- Design the plan's benefits and features,
- Amend the plan to add or remove optional provisions, such as loans or Roth accounts, or
- Decide to terminate the plan.

**Fiduciary Functions -** You are a plan fiduciary when implementing the plan decisions made by the employer. Plan fiduciaries must focus on performing each of these duties solely in the best interests of plan participants, not for the benefit of the employer. Prudently performing each of the many duties required of fiduciaries will require a significant amount of time and effort, but will result in a well-maintained plan that benefits your employees. Things you do with your "fiduciary hat" on include:

- Establishing policies and procedures for the plan.
- Administering and operating the plan in compliance with the plan document by ensuring plan policies, procedures and forms match the plan provisions.
- Keeping the plan document compliant and updated for all required changes in law.
- Developing a formal written Investment Policy Statement (IPS) to detail the criteria you will follow in selecting, monitoring and replacing the plan's investment options.

- Monitoring the fees being charged by each investment option to ensure they are reasonable.
- Selecting and monitoring service providers, trustees, consultants and others who assist with the plan to ensure compliance with their contracts.
- Monitoring each vendor's fees periodically and benchmarking them to fees paid by plans of similar size and complexity.
- Creating and distributing participant communications to educate participants about the benefits of the plan and increase participation.
- Educating participants about the plan's investment options and providing the tools to help them save for a secure retirement.

## FIDUCIARY STANDARDS OF CONDUCT

**Duty of Loyalty -** Fiduciaries have a duty to act in the sole interest of plan participants and their designated beneficiaries. Fiduciaries may not engage in any "self-dealing" acts that serve personal or business interests. Plan fiduciaries subject to the Employee Retirement Income Security Act of 1974 (ERISA) must possess the "duty of care" and the "duty of loyalty" as outlined in the Department of Labor's (DOL) fiduciary standards. Governmental plan fiduciaries have similar responsibilities under state law and are cautioned to avoid conflicts of interest whenever making plan decisions.

**Ensure Plan Fees are Reasonable -** The duty of loyalty requires plan fiduciaries to ensure that the fees paid by the plan participants for investments and administrative services are reasonable and don't become excessive over time.

**Duty of Prudence -** Fiduciaries have a duty to act with the care, skill, prudence, and diligence a prudent person would use in similar circumstances (see your State's Uniform Prudent Investor Rule). Depending upon the expertise of your governing body, it may be prudent to retain investment experts to assist you in managing the plan's investments, including fund selection, monitoring, and oversight decisions.

**Establish Prudent Processes -** Plan fiduciaries are encouraged to develop a step-by-step process for prudently making investment and administrative decisions for the plan. Prudent processes should ensure your investment strategy is being properly developed, implemented, and monitored according to both legal and ethical obligations. Your chances of limiting your fiduciary liability will be increased if you put internal controls in place to assure prudent fiduciary procedures and then document compliance with those processes.

**Duty to Diversify -** Fiduciaries have a duty to diversify plan assets to minimize risk unless it is clearly prudent to do otherwise. Fiduciaries are obligated to provide diversified investment choices that have materially different risk and return characteristics so participants can diversify their individual accounts to minimize risk.

**Duty to Prudently Select and Monitor Investments** – One of the most important fiduciary functions for plan sponsors is the selection, monitoring and deselection of the plan's investment menu. Conduct regular investment reviews comparing your funds with those in their peer group and the benchmarks you have established for your funds. Compare the returns of the major asset classes, the expenses of each investment, the level of risk of the investment, continued adherence to the initial selection criteria as well as the standards each fund must meet in order not to be placed on a watch list or be replaced.

**Investment Policy Statement (IPS) -** Plan fiduciaries are strongly encouraged to adopt an Investment Policy Statement (IPS), which may be the single most important document to help you manage your fiduciary duty when making investment decisions. It should define the processes you have adopted for making investment-related decisions with respect to the plan. Identify the investment goals and objectives of the plan, establish how decisions will be made regarding the selection of investments and specify the procedures for measuring investment performance. Your IPS should govern the goals and objectives of the investment options and include the criteria to be used as your guidelines for monitoring and evaluating the plan's investment options, including a procedure for terminating and replacing any under-performing fund. Comprehensive Investment Management Agreements can aid in proper implementation and maintenance of the IPS guidelines.

**Duty to Follow Plan Documents -** Fiduciaries must act in accordance with an executed plan document and all other governing instruments established by the plan. All Internal Revenue Code (Code) provisions required to be in the plan must be included in the written document as well as all optional provisions being offered to participants. If your plan receives revenue sharing or other unallocated amounts into the plan's trust, your document should specifically address how those plan assets are to be used by the plan. Plans often use these unallocated amounts first to pay plan expenses and then allocate any remaining assets to plan participants.

Plan sponsors of individually designed qualified plans described in Code §401(a), including grand-fathered governmental 401(k) plans, are not required to seek an IRS determination letter. In fact, in Announcement 2015-19, the IRS expressed its intention to eliminate the staggered 5-year determination letter remedial amendment cycles for individually designed plans effective January 1, 2017. In addition, the scope of the current Determination Letter program would be narrowed beginning in 2017 for individually designed plans to initial plan qualification and qualification upon termination only. Thus, qualified plans will no longer be able to obtain on-going assurance that the plan continues to be qualified.

The IRS Announcement could cause specific concerns for governmental plans, particularly large ones, which are likely to have special issues in dealing with the changes proposed in Announcement 2015-19 because:

- Plans of governmental employers are subject to very different regulations than plans of private employers. Thus, most prototype plans (i.e., standardized plans designed to be used by numerous employers) do not fit their special circumstances.
- Governmental plans can often be modified only by state legislative action.
- The longer a plan is in existence, the more likely plan amendments will cause the plan terms to be different than the plan for which the determination letter was originally obtained.
- It will be increasingly important to consult with an attorney before making any substantial changes to a plan since IRS assurances as to its continuing qualified status may not be available.

The IRS is expected to issue a New Operational Compliance List on January 1, 2017 to address the "post-qualification letter" retirement plan world and plan amendments going forward.

Importantly, the determination letter program has never applied to eligible §457(b) plans. A plan sponsor wanting assurance from the IRS on the eligible status of its 457(b) plan must request a "letter ruling," commonly called a "private letter

ruling" (PLR). Changes to the determination letter process do not affect the IRS private letter ruling process.

**Operating the Plan in Compliance with Plan Documents** – Another major fiduciary function for plan sponsors, and a top IRS audit target, is administering the plan in compliance with the plan document. The written plan is your manual for operating your plan so all policies, procedures, forms and participant communications must conform to the plan terms. Be sure you understand how each plan provision is to be administered and develop a procedures/administrative manual to provide clear instructions for service providers and staff members and to help you monitor compliance with plan operations, including all processes outsourced to service providers.

## PARTICIPANT LAWSUITS

**Participant Challenges** – Some plan participants are challenging the prudence and competitiveness of plan investments. It only takes one disgruntled participant to cost the plan sponsor dearly in terms of fiduciary liability. Recent class action lawsuits place new emphasis on;

- fees charged by plan's investment options,
- fees charged by service providers and record keepers,
- allocation of fees to participants' accounts,
- allocation of revenue sharing, and
- the manner in which fees are communicated to participants.

**Issues Presented** – A few of the issues presented in these class action lawsuits include whether;

- plan fiduciaries acted prudently in selecting and monitoring plan investments and compensation arrangements,
- fees were reasonable or excessive,
- fees were properly disclosed, and
- fiduciaries who were determined to be acting imprudently in selecting "retail" or "proprietary" mutual funds resulting in unreasonable fees.

**Lessons for Plan Sponsors** – The courts have based their decisions more on whether the plan fiduciaries followed prudent processes when making plan-related decisions rather than on the particular decisions they made. In other words, plan fiduciaries must understand their duties, guard against conflicts of interest and act solely in the best interest of the plan participants in every plan decision. It is essential to follow your written IPS when selecting and de-selecting funds and to focus on the fees charged by each investment option.

Importantly, the U.S. Supreme Court has held unanimously that plan fiduciaries have an ongoing duty to monitor the investments they make available to plan participants. Another lesson learned from the court decisions is the responsibility of plan fiduciaries to prudently monitor your service providers' performance and fees and make changes when warranted.

Documenting your prudent decision making processes will also go a long way to limit your fiduciary liability. It is not a viable defense to argue that a decision was made solely in good faith, without due diligence. Plan sponsors are expected to obtain expert assistance and advice, if needed.

## STRATEGIES FOR LIMITING FIDUCIARY LIABILITY

**Reducing Complications** – To be successful, the plan must build the structure and framework necessary for prudent plan administration. A solid foundation must be laid before you can construct a winning plan design. Develop a clear direction and objectives for your plan so you can evaluate the effectiveness of your program. Focus on how to reduce your plan oversight obligations, limit your fiduciary liability and simultaneously improve the plan for your participants.

**Consolidate to a Single Record keeper** – Studies show that plans with multiple record keepers suffer at both the plan sponsor and participant level. Allowing more than one record keeper to offer products or services under your plan is a major complication that increases the time and effort you must spend exercising your fiduciary oversight over the plan. This duplication of providers requires you to monitor each one's investment lineup, services and fees individually and to determine that each provider's performance meets your expectations and that their fees are reasonable. Determining whether fees are reasonable can be more complicated if two providers offering essentially the same services to your plan charge different compensation. How can you argue that it is reasonable to retain a provider charging higher compensation for the same services?

Retaining a service provider is in and of itself is a fiduciary function. Consolidating to a single record keeper is arguably the best way to simplify your oversight functions and limit your potential fiduciary liability. You should use objective criteria to find a record keeper who offers a broad selection of reasonably priced quality investments, reasonably priced recordkeeping and administrative services appropriate for your plan design, and an effective participant communication program designed to meet the requirements of ERISA §404(c). You may decide to issue a Request for Proposal (RFP) to find the best provider for your plan based upon your objectives.

At the participant level, multiple record keepers have been shown to result in lower participation rates. Employees often procrastinate when deciding to join the plan if too many choices are required. Employees looking at joining the plan must also decide how much to contribute and what investment options to choose. Don't make it even more difficult for them to participate by adding another layer of decision making – which record keeper to choose.

Consolidating to a single record keeper does not, however, mean that you must retain a single institution to provide all plan services. Under a bundled approach, a single institution provides all plan services including recordkeeping, administration, the investment options and communications. Under an unbundled approach, two or more financial institutions are selected to provide different plan services. For example, you may choose one institution to provide recordkeeping and administration and another institution to advise you with respect to the investment options to be offered to the plan. The unbundled approach will make it easier to change one of the servicing providers if it fails to meet the service standards for the plan without having to terminate the other(s). Determining whether a bundled or unbundled approach is best for your plan is a fiduciary function.

**Limit Number of Core Investment Options** – Studies show a significant percentage of employees are overwhelmed by too many investment options in their DC plans. Confused employees might not join the plan at all or may select investment funds that are not well diversified. Some employees have even been known to throw up their hands and put an equal amount in each fund offered by their employer.

For plans with a single record keeper, revising the investment lineup may be the simplest and most effective action to help participants make better investment choices. By streamlining the investment lineup and eliminating asset class overlaps, you can significantly reduce confusion for employees and consequently improve participation and savings rates while helping them make more appropriate allocation decisions.

Ideally, an effective lineup would include professionally managed target-date options for those employees who are not prepared to deal with allocations and rebalancing over time; a streamlined core lineup that reduces participant confusion and limits the potential for taking unnecessary allocation risks; and a brokerage window for those participants wanting access to more sophisticated investments and have the capability to choose them wisely.

**Compliance with ERISA §404(c) -** State statutes governing governmental plans encourage participant education. Some states may even contain a provision similar to ERISA §404(c) which is designed to help plan sponsors limit their fiduciary liability. By advising participants of their responsibility to direct the investment of their accounts, and by providing them with sufficient information to permit them to make informed investment decisions, you, the plan fiduciary, may not be liable for any losses resulting from their individual investment choices. ***This is for informational purposes only and is not intended to be all inclusive of the requirements of 404(c) or provide guidance or legal advice upon which you may rely.*** Consult with your own attorney or other advisor for guidance on your particular situation.

Generally, in order to take advantage of the fiduciary relief available under §404(c) plan fiduciaries must satisfy a number of general conditions including:

- The plan must offer at least three diversified investment alternatives ("core funds") that have materially different risk and return characteristics so participants can diversify to minimize risk.
- The plan must permit transfers among these three core funds at least quarterly.
- The plan must give participants enough information to permit informed decision-making. The regulation is very specific about what information must be given to participants automatically and upon request, including regular and periodic disclosures of plan-related and investment-related information.
- Participants must be given the opportunity to give investment instructions to an identified plan fiduciary who is obligated to comply with those instructions.

When plans allow participants to direct their investments, fiduciaries need to regularly make participants aware of their rights and responsibilities under the plan related to directing their investments. This includes providing plan and investment-related information, including information about fees and expenses, which participants need to make informed decisions about the management of their individual accounts. Participants must receive the information before they can first direct their investment in the plan and annually thereafter. The investment-related information needs to be presented in a format, such as a chart, that allows for a comparison among the plan's investment options. If you use information provided by a service provider that you rely on reasonably and in good faith, you will be protected from liability for the completeness and accuracy of the information.

404(c) Relief for Defaulted Investments - Under the Pension Protection Act, fiduciaries are provided certain protections if they default participants into a qualified default investment alternative (QDIA). If plan sponsors wish to receive this limited protection, they should consider offering an investment option that qualifies as a QDIA according to the Department of Labor. Common QDIAs include balanced funds, target-date funds, and managed accounts.

## MONITORING PLAN SUCCESS BY EVALUATING RETIREMENT READINESS

Plan fiduciaries are not responsible for ensuring that participants make the right decisions about saving, investing and spending to have adequate savings to maintain their standard of living in retirement. Many sponsors, however, want their DC plan to serve as a vehicle for improving their employees' retirement picture. One area critical to effective plan governance is the accurate measurement of plan effectiveness. Surveys have shown that employers have a growing concern over retirement benefit adequacy and the financial well-being of their plan participants. DC plan sponsors are increasingly concerned about the ability of their employees to retire comfortably and in a timely manner.

As a practical matter, the more satisfied participants are with their plan, the less likely they will be to blame plan fiduciaries for a negative outcome. It makes sense, therefore, to monitor plan level retirement readiness, plan design, financial literacy and employee outcomes. Evaluate the current retirement readiness at the plan level by looking at the;

- overall rate of employee participation,
- median contribution rate,
- median account balance,
- your plan's demographics, and
- most popular investment alternatives.

Certain plan design features are proven to simplify employee decision-making and encourage plan participation. Two important ones, consolidating to a single record keeper, and limiting the number of core investment options, were previously discussed. In states where it is allowed, automatic enrollment can dramatically increase participation in the plan and studies show most automatically enrolled employees continue to participate in the plan. Automatically escalating the contribution amounts each year keeps contribution levels up and the resulting increased savings improves retirement readiness.

## DOCUMENT COMPLIANCE WITH YOUR PRUDENT PROCESSES

Plan sponsors should maintain all plan documents, executed amendments, meeting minutes and documentation of the processes used when making plan decisions. Maintaining these documents in a single location ensure they can be easily accessed for your review and for production in the event of an IRS audit or litigation. Documents that should be maintained in a fiduciary "filing cabinet" include:

- plan documents and any summary plan materials,
- trust agreement,
- plan forms, rules and procedures,
- service agreements,
- third party contracts,
- investment contracts,
- Investment Policy Statement, and
- all amendments to those documents.

## BREACHES OF FIDUCIARY DUTY

Depending upon the laws of your state, you may be personally liable if you are a fiduciary and you breach your fiduciary duties. Breach of fiduciary duty may also result in participant lawsuits. You may be considered in breach of your fiduciary duties if you;

- fail to comply with the exclusive benefit rule by entering into self-dealing transactions, such as using plan assets for your own or your company's benefit or accepting things of value from someone who may benefit from your actions,
- fail to exercise your responsibilities to the plan in a prudent manner., fail to prudently diversify the menu of investment options offered under the plan,
- fail to monitor the plan's investment options and replace funds as necessary pursuant to your investment policy, OR
- fail to provide participants with enough information to permit informed decision-making.

## Appendix A: Governmental Plan Fiduciary Responsibility Checklist

– The Governmental Plan Fiduciary Responsibility Checklist is designed to assist you in fulfilling your fiduciary responsibilities. You are encouraged to review the checklist at least annually as a due diligence exercise designed to keep you in compliance with your fiduciary responsibilities.

This Governmental Plan Fiduciary Responsibility Checklist is not guaranteed to be appropriate or sufficient for you and your plan and you are encouraged to consult with your counsel or other experts for all of your fiduciary responsibility and other plan related matters.

Neither NAGDCA, nor its employees or agents, nor members of its Executive Board, provide tax, financial, accounting or legal advice. This memorandum should not be construed as tax, financial, accounting or legal advice; it is provided solely for informational purposes. NAGDCA members, both government and industry, are urged to consult with their own attorneys and/or tax advisors about the issues addressed herein.

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## APPENDIX A

## GOVERNMENTAL PLAN FIDUCIARY RESPONSIBILITY CHECKLIST

This Governmental Plan Fiduciary Responsibility Checklist is designed to assist you in fulfilling your fiduciary responsibilities. You are encouraged to review the checklist at least annually as a due diligence exercise designed to keep you in compliance with your fiduciary responsibilities. It is not guaranteed to be appropriate or sufficient for you and your plan and you are encouraged to consult with your counsel or other experts for all of your fiduciary responsibility and other plan related matters.

**Plan Documents:**

- ☐ You maintain the IRS Determination Letter on your qualified 401(a) or 401(k) plan, (if you obtained one while the IRS program was in effect).
- ☐ You maintain the IRS Private Letter Ruling on your eligible 457(b) plan, if applicable.
- ☐ You amended your qualified plan for any required law changes by the due date in Rev. Proc. 2016-37 or subsequent guidance.
- ☐ You amended your 457(b) plan to include any new optional provision by the end of the plan year in which the provision is operationally put into effect.
- ☐ Plan trustees are properly appointed and your trust agreement is properly executed.
- ☐ Your written Investment Policy Statement (IPS) is up to date.
- ☐ Properly executed service provider contracts outlining their responsibilities and fees are maintained.
- ☐ Fiduciary liability or other insurance coverage has been purchased if deemed necessary.

**Plan Fiduciaries:**

- ☐ All fiduciaries are identified and understand their duties and fiduciary responsibilities via properly executed Board Charter.
- ☐ All fiduciaries have received sufficient training on the basic fiduciary standards of conduct and have completed ethics orientation
- ☐ Plan fiduciaries meet regularly to review plan investments and administration.
- ☐ You periodically review plan success metrics, such as participation rates, salary deferral rates, investment diversification, and retirement income readiness.
- ☐ You periodically review and consider changes to plan design, plan services and investment options as warranted to improve your plan's success metrics.
- ☐ No plan fiduciary has made plan decisions or used plan assets for his or her personal interests.

**Plan Administration and Operation:**

- All participant deferrals and loan repayments are invested in the plan as soon as administratively practicable after being deducted from employee paychecks.
- The plan is being administered in accordance with regulatory and plan document rules.
- Unallocated amounts in a plan account, if applicable, have been used to pay allowable plan expenses or have been allocated to participant accounts.
- Your policies and procedures for operating the plan and all processes outsourced to your service providers match the terms of your plan document.

**Plan Fees:**

- The fees being paid by the plan for the investment options are reasonable.
- You are receiving the same disclosure of service provider fees that are required to be provided to ERISA plans.
- You have determined the fees paid to third party service providers are reasonable.

**Monitoring Investments and Service Providers:**

The plan maintains and abides by a written Investment Policy Statement (IPS) when selecting, monitoring and making changes to the plan's investment menu.

The process of vendor selection and contract award is thoroughly documented.

Plan fiduciaries maintain a broad range of investment options for the plan.

You monitor all outsourced services performed by third parties to ensure compliance with your plan document, their contracts and performance standards.

**Employee Communications:**

- You have provided quarterly Participant Benefit Statements to participants.
- You have effective, easy-to-understand participant communications on all important aspects of the plan.
- You educate participants about the importance of saving for retirement and the basics of investing.
- You use ERISA §404(c) as a best practice to inform participants and limit your potential fiduciary liability.

**Documentation:**

- You document who your plan fiduciaries are and their responsibilities.
- You document each of your meetings, the results of your review and monitoring of investments and service providers, and the decisions made with respect to the plan.
- You maintain a due diligence file containing documentation supporting your fiduciary process and decision-making.
- You have all properly executed plan documents, contracts, agreements and all amendments thereto in an easily accessible "filing cabinet."