Defined Pension and Defined Contribution Plans

Who is a 401(k) Fiduciary and What Does It Mean?

By:

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Having a retirement plan such as a defined benefit plan (aka pension plan) or a defined contribution plan (aka 401(k) plan) is a benefit that many companies provide to their employees. Although these are called "benefit" plans, they come with great responsibility for the Plan Sponsors and those inside the firms that oversee the "benefit". This responsibility is called a fiduciary responsibility and is defined by the Employee Retirement Income Security Act (ERISA). Although three agencies are charged with interpretation and enforcement, the Department of Labor (DOL) is the regulator that oversees the actions of the Plan Fiduciaries for a retirement plan.

So what does being a Plan Fiduciary of a Retirement Plan like a 401(k) mean? What are your responsibilities? What is your liability? Lots of questions and most of the time, your employer and your Service Providers do not give you any information on your responsibilities and your liabilities. And maybe you don't realize you are a Fiduciary, but that doesn't mean you do not have the personal responsibility and liability.

For many of the individuals filling the role of a Fiduciary for a retirement plan is a task they have been assigned and not necessarily one they volunteered to have. This role may come with your Company Job Title like Human Resources Director, Controller and/or as a management person with the most people under their direct supervision. True there are "named" fiduciaries, but even if no one told you that you are a Fiduciary for the "Plan", you may still be a Fiduciary under the Employee Retirement Income Security Act (ERISA).

Who is Not a Fiduciary?

To begin to understand what a Fiduciary is, we must first look at actions which are NOT considered Fiduciary actions.

These actions include:

1. Decision to establish a Plan (Seek ERISA Counsel on this)
2. Decision to determine the benefit package
3. Decision to include certain features in a Plan
4. Decision to amend a Plan
5. Decision to terminate a Plan (Seek ERISA Counsel on this)

Notice most of these decisions are made PRIOR to a Plan's creation. These are all business decisions made by the employer and thus not governed by the ERISA. When making these decisions, an employer is acting on behalf of its business and not the Plan or Plan Participants. Once the decision is made to implement those decisions then people helping to implement the Plan are considered fiduciaries. Once the Plan is created every action that takes place after this creation must be made exclusively for the benefit of the Plan Participant. Every action and decision that happens from this point forward falls under ERISA.

The first step after the creation of the Plan document is choosing who internally will implement the Plan and hire the appropriate third parties (if necessary). These types of decisions are fiduciary action.

Everyone involved in the Plan must fully understand who a fiduciary is, what are the duties, why this is important, and what happens if these duties are not fulfilled.

Who Is a Fiduciary?

The Department of Labor is not specific in who they define as a Fiduciary. They don't define a Fiduciary by title, but instead they determine if a person or entity is a fiduciary or not by looking at their duties. They state the key to making this determination is *"whether they are exercising discretion or control over the plan, acting solely in the interest of plan Participants and their beneficiaries, with the exclusive purpose of providing benefits to them."*[1]

A Plan's fiduciaries will ordinarily include the Board of Directors, trustee, investment advisers, all individuals exercising discretion in the administration of the Plan, all members of a Plan's administrative committee (if it has such a committee), and those who select committee officials.

A Plan Sponsor (employer) should document its selection (and monitoring) process, and should educate Board members, committee members, and all those working on their Plan on their roles and responsibilities.

[1]EBSA Meeting Your Fiduciary Responsibilities - http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html

Some fiduciary duties include:

- Deciding if all or any functions for the Plan will be done in house or will utilize third-party experts such as Investment Management, Trustees, and Record keepers
- Making sure loan applications for the 401(k) are properly reviewed and processed
- Checking or planning payout processing
- Processing trading instructions from a Plan Administrator
- Making sure 401(k) Participant contributions are invested in a timely manner

The Board of Directors/Trustees can mitigate their risk, but cannot eliminate their risk. They can delegate the day to day oversight to an individual or an Investment, Administrative or Oversight Committee, however, ultimate oversight still remains with the Board of Directors.

A Plan must have at least one Fiduciary (a person or entity) named in the written Plan. The named Fiduciary can be identified by office or by name. For some Plans, it may be an administrative committee or a company's board of directors.

The Plan Sponsor must also remember the DOL and the courts have also made it clear the named Fiduciary and other Plan Sponsor Fiduciaries can never completely delegate their Fiduciary authority. The Plan Sponsor always retains the responsibility of oversight and ultimately is responsible for the decisions of the third-parties hired including Fiduciaries. In a 1996 court case it was found:

> *"While we would encourage fiduciaries to retain the services of consultants when they need outside assistance to make prudent investments and do not expect fiduciaries to duplicate their advisers' investigative efforts,) we believe that ERISA's duty to investigate requires fiduciaries to review the data a consultant gathers, to assess its significance and to supplement it where necessary."*[2]

What Are the Fiduciaries Duties?

Where the DOL is a little less specific in defining by title what a fiduciary is, the Employment Retirement Income Security Act (ERISA) is very specific about what duties a fiduciary has towards the Plan and the Plan Participants. There are 3 (Three) Major Duties:

1. Exclusive Benefit Rule – The fiduciary must discharge duties with respect to the Plan for the exclusive benefit of the Participant and their beneficiaries. You must think first and foremost for the Participant and what is best for them. Not the company, the officers, or even yourself, but the Participants as a whole.

[2] *Unisys Savings Plan Litigation, 74 F. 3d 420 (3rd Cir.), (1996)*

2. Prudent Man Rule – A fiduciary must act "with the care, skill, prudence and diligence" under the circumstances then prevailing that a prudent man acting in a like capacity" would act. This rule is derived from the common law of trusts. This is an objective standard based upon how a person with experience and knowledge of a certain area would act in a given situation. If a fiduciary lacks the expertise for a certain area then the fiduciary must obtain expert help.

3. Diversification Rule – A fiduciary must diversify investments in order to minimize risk of loss unless it would be considered prudent to not diversify investments. This means that you need to give you Plan Participants investment choices for a 401(k) and for a Pension it would mean to have a variety of assets in the Plan.

On its surface, two of the rules (#1 and #3) appear to be straight forward. You must think and act exclusively for the benefit of the Plan Participants and make sure you diversify their investments. That makes sense, it is their Plan and it is the Plan Participants' money. You work for them and you should diversify and give them a variety of investment choices.

The Prudent Man rule, however, is not as straight forward. The duty to act prudently is one of a Fiduciary's central responsibilities under ERISA. It requires expertise in a variety of areas, such as investments. Lacking that expertise, a fiduciary will want to hire someone with that professional knowledge to carry out the investment and other functions. The courts in 1984 affirmed this when they found:

> *"The failure to seek outside counsel when "under the circumstances then prevailing ... a prudent man acting in a like capacity and familiar with such matters" would seek outside counsel, is imprudent and a violation of ERISA."*[3]

For investments, the Prudent Man standard is actually the Prudent Expert rule. The standard for participant-directed 401(k) plans is that of an investor who is knowledgeable about selecting investments for others to direct for the purpose of accumulating retirement benefits. The courts, in Donovan v. Cunningham, deemed *"a pure heart and an empty head are not enough."*[4] A separate court noted that ERISA's prudence standard "is not that of a prudent layperson, but rather that of a prudent fiduciary with experience dealing with a similar enterprise."[5]

Prudence focuses on the process for making fiduciary decisions. An employer should document its selection (and monitoring) process, and, when using an internal administrative committee, should educate committee members on their roles and responsibilities.

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[3] Katsaros v. Cody, 744 F.2d 279 (2d Cir.), (1984)
[4] 716 F.2d 1455, 1467 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984).
[5] Marshall v. Snyder, 572 F.2d 894 (2d Cir. 1978)

Why is a Fiduciary Important?

Because Fiduciaries act on behalf of Participants in a retirement plan and their beneficiaries, Fiduciaries have extra responsibility and liabilities as outlined by the government Fiduciaries are responsible for the monitoring, investing, and safekeeping of the retirement funds for each and every Plan Participant. The monies invested belong to the Participants and not to the Plan Sponsor (company).

What if I hire a "Co-Fiduciary"?

To obtain proper expertise, most any Plan Sponsors hire third-party/outside providers to manage the investments or act as a Plan Administrator for their 401(k). In some cases, these may be fiduciaries as defined by ERISA. ERISA statues name only 3 (three) types of "co-fiduciaries"[6] other than the Plan Sponsor Named fiduciaries:

- ERISA Section §3(21) Fiduciary – regarding investment advice
- ERISA Section §3(38) Fiduciary – regarding investment advice
- ERISA Section §3(16) Fiduciary – regarding plan administration

As you will note, Record Keepers, Third Party Providers, Payroll, and other providers are not listed as fiduciaries. Although they may ultimately be deemed a fiduciary due to their actions by the DOL or the courts, they are not fiduciaries named by ERISA.

When contracting with a Section §3(21), Section §3(38) or Section §3(16) Fiduciary, a Plan Sponsor must be careful and make sure the contracts and documentation clearly states the type of fiduciary service provider they have hired. Plan sponsors may believe (or are told) they have delegated all their Fiduciary duty to such a third-party fiduciary. It is, at most, a shared or "co-responsibility". The Plan Sponsor retains final Fiduciary responsibility including oversight on all vendors including "co-fiduciaries".

ERISA Section §3(21) Fiduciary

A Section §3(21) Fiduciary provides advice and recommendations to Plan Sponsors. They do not have independent authority to make and implement those recommendations. They do not have to declare themselves a fiduciary. Any individual can be a Fiduciary under Section §3(21) if they exercise any authority or control over the management of your Plan or the management or selection and investing of your Plan assets; if they render investment advice for a fee or have any authority or responsibility to do so; if they have any discretionary responsibility in the administration of your Plan, or are named in your Plan Documents. Outside of ERISA, these

[6] See ERISA §3(16), §3(21),, §3(38)

investment personnel may not be considered fiduciaries and may not fully understand its responsibilities.

ERISA Section §3(38) Fiduciary

A Section §3(38) is an "investment manager" and, by definition, is a fiduciary because they take discretion, authority and control of the Plan's assets. They have the authority to buy, sell and invest independently. ERISA provides that a Plan Sponsor can delegate the significant responsibility (and significant liability) of selecting, monitoring and replacing of investments to the Section §3(38) investment manager fiduciary. A Section §3(38) fiduciary can only be (a) a bank, (b) an insurance company, or (c) a registered investment adviser (RIA) subject to the Investment Advisers Act of 1940. Outside of ERISA, these groups are considered fiduciaries.

ERISA §3(21)	ERISA §3(38)
Investment Advisor Representatives (IAR)/ Broker-Dealers, 1940 Act Registered Investment Advisor (RIA), Bank, or Insurance company	1940 Act Registered Investment Advisor (RIA), Bank, or Insurance company
Assists in drafting IPS	Drafts IPS with assistance from Plan Sponsor
Does not have to state in writing co-fiduciary status	States in writing co-fiduciary status
Helps design initial fund menu	Builds initial fund menu
Provides documentation	Provides documentation
Provides monitoring	Researches and selects investments
Recommends changes to investment selections	Makes changes to investment selections

The degree of fiduciary responsibility of the Section §3(21) fiduciary is minimal. They assist and they recommend, but it is up to the Plan Sponsor to make the final decisions and take the majority of the fiduciary responsibility.

A Section §3(38), on the other hand, is a fiduciary outside of the ERISA environment. They are considered fiduciaries with each and every client. An RIA is held to same types of legal fiduciary standard through the 1940 Investment Advisor Act and must:

1. Act solely in the best interest of the plan sponsor, participants and beneficiaries of the plan
2. Avoid conflicts of interest or fairly manage them in the client's favor
3. Disclose all forms of compensation both direct and indirect

Remember even if you the Plan Sponsor hires a §3(21) or a §3(38) that in itself is a fiduciary act and as mentioned earlier the DOL defines a Fiduciary as to "whether they are exercising discretion or control over the plan, acting solely in the interest of plan Participants and their beneficiaries, with the exclusive purpose of providing benefits to them."

ERISA Section §3(16) Fiduciary – Plan Administration

There is one type of type of third-party co-fiduciary Plan Administrator under ERISA. This person/firm takes on the role of Plan Administrator and is named in the Plan Document. This, however, does NOT absolve Plan Sponsor Fiduciaries from overseeing this Plan Administrator and their activities. The Plan Sponsor's fiduciaries are ultimately responsible for all acts of their Plan and the service providers they hire, including a Section §3(16).

After you hire a §3(16) fiduciary, the Plan Sponsor will likely have amend their Plan Document and continue proper oversight of the provider. The §3(16) does not automatically assume all of the plan sponsor's duties. It is particularly important to identify the scope of services covered by the agreement with the §3(16) and identify any areas of overlap or repetition**.**

The duties of the Section §3(16) include:

Plan Management and Administration:

- Selection, evaluation and monitoring of Trustee, Service Providers and who provided the Plan Document
- Review and evaluation of all plan fees, fee disclosures and which fees the plan pays
- Delegation of responsibilities to other fiduciaries

Plan Operations Processes should include documented policies, procedures and practices for the Plan:

- Plan/Amendments documentation
- Timely and accurate reporting and disclosure to participants and regulators
- Distribution of benefits
- Loan Administration
- Qualified Domestic Relation Order

When hiring any "co-fiduciary", the Plan Sponsor is required to perform initial due diligence on them as to the scope of the services and the fee reasonableness. Your fiduciary due diligence should include an overview of expertise, qualifications, fee reasonableness, business profile, regulatory status, self-dealing, outside audits, financial stability, insurance and bonding. Remember hiring a Section §3(16), §3(21), or §3(38) is an affirmative fiduciary act by you as the Plan Sponsor and it must be made prudently and in accordance with ERISA's fiduciary standards for the quality of services and the reasonableness of the fees (if the fees are being paid for by the Plan Participants).

Remember even if you, the Plan Sponsor, hire a §3(21), §3(38), or §3(16) Co-Fiduciary, the act of choosing and hiring, in itself, is an affirmative fiduciary act. As mentioned earlier the DOL defines a Fiduciary as to *"whether they are exercising discretion or control over the plan, acting solely in the interest of plan Participants and their beneficiaries, with the exclusive purpose of*

providing benefits to them.[7]" The Plan Sponsor exercises continual control when they hire and when they retain the co-fiduciary. Because of this, you must continue oversight to make sure who you hire is following the Plan Document and is doing what is best for the Participants.

So What Happens If I Do Not Act Properly As A Fiduciary?

Failure to act as a Fiduciary will open the Plan, the Plan's fiduciaries and each individual fiduciary (you) to potential civil and even criminal liability. Plan Participants may bring civil action against fiduciaries in the event of a fiduciary breach, but only to "be made whole" for the Plan. They may only sue to recover personal damages. In certain circumstances, the Federal Government may bring criminal charges against individual fiduciaries.

It is logical to understand a Plan Sponsor may be held liable for failure to act properly, but a fiduciary may be also be held personally liable for losses caused by his or her breach of ERISA. They may also be held liable for another fiduciary's conduct as well. Some examples of one fiduciary may be held accountable for another fiduciaries responsibility include:

- Failing to satisfy one's fiduciary duties, which leads to another fiduciary committing a breach (including Section §3(16), §3(21), or §3(38))
- Overlooking or concealing the acts of a co-fiduciary
- Having knowledge of a fiduciary breach and doing nothing to report or remedy the breach.

A fiduciary may not claim ignorance of fiduciary conduct or knowledge within his or her oversight responsibility.

In recent years, lawsuits have become more prevalent against fiduciaries and Plan Sponsors. Depending on your Plan and the services that are provided, lawsuits can be filed by several different groups.

- Plan Participants (employees) and their beneficiaries, who are likely to sue for recovery of benefits or enforcement of their rights under ERISA
- The Department of Labor, to stop acts that violate ERISA and to collect civil penalties for prohibited transactions
- Third-party administrators
- The Pension Benefit Guaranty Corporation (this entity takes over for failed companies or pension plans)

An employer may also develop liabilities related to the Plan under the Internal Revenue Code. The requirements for a 401(k) Plan under the code range from technical testing mandates, such

[7] See ERISA §404

as not discriminating in favor of those employees considered to be "highly compensated," to failures to follow the terms of the Plan document. The latter failure is the easiest to remedy through periodic plan audits.

The most common fiduciary liability issues include:

- unacceptable choice of insurance company, mutual fund or third-party service provider
- failure to adequately fund a Plan
- failure to invest Participant contributions in a timely manner
- conflict of interest
- improper advice or counsel
- improper change in benefits
- improper amendments to the Plan document
- imprudent investment
- administrative error
- misleading representation
- lack of investment diversity
- incorrect benefit calculation
- prohibited transactions
- failure to file timely documents with the regulators

How Do I Protect Myself as a Fiduciary?

In the event of a breach, a fiduciary must act swiftly to report or correct the breach. The Plan must be returned to the state it was prior to the breach.

To safeguard yourself you need to consider and understand that YOU may also be taking on the risk of being personally liable in your role as a Fiduciary of a retirement plan.

1. Know who your Plan fiduciaries are and understand their roles.
2. Ensure that all of policies, procedures and practices are documented and have been put in place from the very beginning of the Plan.
3. Ask for qualified independent outside advice as soon as you think there is a problem or you are unsure about something.
4. Document, Oversee, Review, and Document
5. Understand all the costs of the retirement plan. Be skeptical, ask questions. Understand the true cost of recordkeeping and investment management.
6. Ask for a reconciliation of revenue sharing payments and any other Plan reimbursements.
7. Make sure the Plan is following any written documents. Are the Plan Service Providers and staff working on the Plan all following the Plan document and loan policy?
8. Look for conflicts of interest including prohibited transactions.

9. Does the Plan have an investment policy statement? Are investments being monitored and replaced if they are not meeting the policy requirements?
10. Rotate your committees or reassign responsibilities. This allows for a second set of eyes to uncover any mistakes or issues and allow for corrections.
11. Conduct regular annual compliance reviews or audits of the Plan Documents/amendments, policies, procedures, and practices.

Even if you think everything is okay ask for an independent Fiduciary to evaluate and assess what you are doing and how you are doing it. An Independent Fiduciary's "set of eyes" may not necessarily see things as you or your fellow Fiduciaries do.

Education is the first step in being a good fiduciary for a 401(k) Plan. A plan fiduciary must remember being a Fiduciary is critical because they are the eyes, ears, and the "protector" of each Plan Participant's monies. The ultimate job of a fiduciary is to keep the participant's monies as safe as the markets will allow. So a Fiduciary must learn what the duties are and how to carry them out in the most proficient and capable manner or risk personal liability.

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Ms. Castellani and Mr. Conrad have more than 50 years of experience working with ERISA Plan providers to deliver strategies and programs that help Plan Sponsors, Plan Fiduciaries and Plan Participants to understand and mitigate the complexities of making and documenting Plan decisions. For information as to how Akros or OTB can help you with your duties as a Fiduciary visit us at www.akrosinv.com or www.otbstrategic.com.

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