

ASPPA
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Workshop 21

**Key Fiduciary Issues for
401(k) Plans**

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Where Are We and Where Are We Going?

- 401(k) plans are now the primary retirement vehicle in America.
- But they were designed to be supplemental, or secondary, plans.

Where Are We and Where Are We Going?

The shift to participant-funded and participant-directed plans has led many employers to believe that they have little responsibility for the **success** of the plans.

Yet, the law is clear . . .

Where Are We and Where Are We Going?

In managing their 401(k) plans, ERISA imposes a duty on all fiduciaries to discharge their duties:

“ . . . for the exclusive purpose of providing benefits to participants and their beneficiaries; . . . ”

ERISA §404(a)(1)(A)(i).

Fiduciary Responsibility

A fiduciary must discharge his duties . . .

“. . . 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. . . .”

Requires a prudent process.



"If we take a late retirement and an early death, we'll just squeak by."

• •

➤ **Change of focus from features to results.**

Exclusive Purpose and Adequacy of Benefits

Fiduciaries are required by ERISA to engage in a prudent process and to determine the issues and facts relevant to the prudent operation of their plan. That includes:

- Providing retirement benefits.
- The quality and suitability of the investments.
- The quality of participant investing.
- The plan's level of participation.
- The rates of deferral.

Top Fiduciary Issues

With that introduction, the Top Fiduciary Issues in 401(k) plans are:

- Benefit adequacy
- Investments
- Investing
- Participation
- Deferral rates
- Expenses
- Disclosure and reporting for expenses

THE FIRST STEP: Adequacy of Benefits

The primary focus will be on whether plans are actually providing adequate retirement benefits.

Advisors and providers will be asked for statistics of “success” for the plans they work with.

THE SECOND STEP: Plan Investments

- ▶ The options, in the aggregate, must constitute a broad range
- ▶ Each investment option must be prudently selected and monitored

A Broad Range of Investments

The 404(c) regulations provide that:

A plan offers a broad range of options where a participant has “a reasonable opportunity to materially affect the potential risk and return . . . at any point within the range normally appropriate for the participant. . . .”

Modern Portfolio Theory.

Selecting Asset Classes and Styles

- How many are needed for benefit purposes?
- How many are appropriate for benefit purposes?
- Can a plan have too few? Too many?

THE THIRD STEP: Participant Investing

Industry studies show that many, and perhaps most, participants are making serious mistakes. One study has shown that over a quarter of the participants invest in only one or two asset classes—hardly enough to constitute prudent and diversified investment portfolios.

Consequence: Participant “investing” will rival investments.”

THE THIRD STEP: Investing

Fiduciaries are responsible for the prudence the participant investment decisions . . .

. . . unless the plan complies with the requirements in the 404(c) regulation.

THE THIRD STEP: Investing

Judge Harmon, in her September 30 Enron ruling, concluded that:

“If a plan does not qualify as a 404(c) [plan], the fiduciaries retain liability for all investment decisions made, including decisions by the Plan participants.”

In re Enron Corporation Securities, Derivative & ERISA Litigation, 284 F. Supp. 2d 511 (S.D. Tex. 2003) (“The Enron Court Order”).

THE THIRD STEP: Investing

Even if a plan satisfies the 404(c) requirements, fiduciaries continue to have responsibilities, for example:

If a plan offers investment education, as most do, fiduciaries have the duty to prudently select the investment education provider and to monitor the quality and effectiveness of its services.

See, e.g., DOL Interpretive Bulletin 96-1.

THE THIRD STEP: Participant Investing

In order to engage in a prudent process to monitor the participant investing and the investment-related services, fiduciaries will need information and data about:

- Actual investment activity
- Industry benchmarks
- Set reasonable goals

Employee investing in Investment Policy Statement.

THE THIRD STEP: Participant Investing

Congressional and DOL activity: Fiduciary safe harbor for defaults into “multi-asset class” investments

Likely consequence:

- Use of age-based funds as defaults
- Addition of age-based funds to most plans
- Use of those funds as initial investments

Safe Harbor Default Investment

UPDATED

The PPA amends ERISA §404(c) to extend its protections to “default investment arrangements.”

The new 404(c)(5) conditions the relief on:

- a default by the participant;
- satisfying a notice requirement; and
- an appropriate default investment.

Effective for plan years beginning after December 31, 2006.

Safe Harbor Default Investment

UPDATED

The DOL is directed to issue a regulation providing guidance on the “appropriateness” of default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.

The regulation must be issued within six months of enactment (or February 13, 2007).

Investment Advice

UPDATED

To increase participant access to investment advice, the PPA amended 408(b) to create a statutory exemption for revenue from fiduciary advice, if certain conditions are satisfied. The amendment is effective January 1, 2007.

The new 408(b)(14) and 408(g) cover (i) advisers whose fees do not vary depending on the investments selected, and (ii) advisers whose fees do vary—if a qualifying computer model is used.

THE FOURTH STEP: Participation

The fiduciaries have the duty to prudently implement the plan's enrollment and eligibility provisions and to monitor its service providers in those areas.

However, this responsibility has not been fully defined by ERISA, the DOL or the courts.

THE FOURTH STEP: Participation

Fiduciaries should also consider the impact of a DOL regulation that provides that all eligible employees are considered “participants”—and, therefore, the fiduciaries must also act prudently with regard to the non-deferring employees. (DOL Reg. §2510.3-3(d))

Risk Management “moat.”

THE FOURTH STEP: Participation

As a result, the fiduciaries should consider at least the following:

- Analysis of information regarding non-participants
- Review of existing programs and services and their effectiveness
- Understanding of available programs and services (*i.e.*, “easy enrollment”)
- Set goals for improvement

THE FOURTH STEP: Participation

Plan sponsors, in their “settlor” role, should review their plan design to determine whether changes would improve participation, for example, the use of automatic enrollment.

According to the *Plan Sponsor* magazine, the top priority for employers is to increase the level of participation.

THE FOURTH STEP: Participation

Congressional activity: Legislation on automatic enrollment, including pre-emption of state payroll withholding laws, and safe harbor plans.

Industry developments: Easy, or quick, enrollment and mandatory return of forms.

Automatic Enrollment: Generally

UPDATED

In some states payroll withholding laws have inhibited the expansion of the use of automatic enrollment.

The PPA amends ERISA, effective immediately, to preempt State laws which would directly or indirectly prohibit or restrict the inclusion in any plan of an “automatic contribution arrangement.”

Automatic Enrollment: Generally

UPDATED

The law imposes certain requirements:

- The automatic deferrals must be invested in “safe harbor” investments to be defined in a new DOL 404(c) regulation.
- A notice must be given to eligible employees of their rights under the arrangement.
- The DOL may, by regulation, establish additional requirements.

Automatic Enrollment: Generally

UPDATED

“Eligible” automatic plans may allow a participant to withdraw his deferrals (called “erroneous automatic contributions”), without penalty, within 90 days of the date of his first deferral.

- Adjusted for earnings.
- Included in taxable income in year received.
- Matching contributions are forfeited.
- Not counted for ADP testing.

Effective for plan years after 12-31-07.

Automatic Enrollment: Safe Harbor

UPDATED

The PPA also amends the Code to create a new 401(k) safe harbor design for automatically enrolled plans.

The new safe harbor is called a “qualified automatic contribution arrangement.”

The provision is effective for plan years beginning after 12-31-07.

Automatic Enrollment: Safe Harbor

UPDATED

Contributions:

- Like the regular 401(k) safe harbor design, this arrangement requires either a safe harbor match or a safe harbor profit sharing contribution.
- However, it also requires a minimum level of automatic deferrals.

Automatic Enrollment: Safe Harbor

UPDATED

Required deferral contributions:

- In the first year for an employee, the deferral must be at least 3%.
- Second year: at least 4%.
- Third year: at least 5%.
- Fourth year and after: at least 6%.
- The automatic deferral rate cannot be more than 10%.

Automatic Enrollment: Safe Harbor

UPDATED

Employer safe harbor contributions:

- Matching:
 - 100% of first percent.
 - 50% of next 5%.

or

- Profit Sharing: 3% of compensation.

Satisfies ADP, ACP and top heavy.

Automatic Enrollment: Safe Harbor

UPDATED

Coverage: the arrangement must cover all eligible employees, except any previously eligible employee who made an election to defer or made an election to not participate.

Vesting: employer contributions must be 100% vested after two years of service.

THE FOURTH STEP: Participation

Obviously, eligible employees who do not defer will receive little, if any, in the way of retirement benefits. However, it is less obvious that employees' retirement benefits are most affected by . . .

THE FIFTH STEP: Deferrals



Deferral rates
Asset allocation
Rebalancing
Age-appropriate changes
Performance of individual funds

DC Plans Missing the Forest for the Trees, Putnam Investments, August 2004.

THE FIFTH STEP: Deferrals

Adequacy of deferrals:

Based on reasonable assumptions, a 30-year-old making \$50,000 must defer (in combination with a match or profit sharing contribution) approximately how much in order to have an adequate retirement benefit, in combination with social security at 65?

1. 7%
2. 10%
3. 13%
4. 17%
5. 20%

THE FIFTH STEP: Adequacy of Deferrals

As with any fiduciary duty, the starting point is to engage in a prudent process--to understand:

- the needs of the participants;
- the current status of the plan;
- possible methods for improving; and
- set goals for improving

THE FIFTH STEP: Deferrals

Fiduciaries can improve the level of deferrals in a number of ways:

- redesigned enrollment forms:
 - defaults
 - automatic increases
- financial education
- targeted communications

THE FIFTH STEP: Deferrals

The plan sponsor, as the settlor, can help with this task through the plan design, for example:

- structure of the matching contribution
- setting the initial deferral rate (e.g., 5%)
- automatic deferral increases (e.g., to 10% or even 20%)

THE FIFTH STEP: Deferrals

Congressional activity: Legislation on automatic deferral increases

Industry developments:

- re-designed enrollment forms
- financial education and gap analysis
- targeted communications

THE SIXTH AND SEVENTH ISSUES

The last two issues:

- ▶ Expenses
- ▶ Disclosure and reporting

go hand in hand. Expenses are a significant issue because excessive costs can materially reduce the level of benefits. In turn, front-end disclosure and after-the-fact reporting create the transparency needed for the competitive marketplace to drive down costs.

Expenses: Legal Standard

The fiduciary responsibility rule in ERISA §404(a)(1)(A) provides:

“A fiduciary shall discharge his duties . . . for the exclusive purpose of:

- (i) providing benefits to participants and their beneficiaries; and
- (ii) defraying **reasonable expenses** of administering the plan. . . .”

Expenses: Legal Standard

Under ERISA §408(b)(2), the prohibited transaction rules permit:

“Contracting or making reasonable arrangements with a party in interest for . . . services necessary for the establishment or operation of the plan, **if no more than reasonable compensation is paid therefor.**”

Expenses: Fiduciary Responsibility

As explained by the DOL, the primary plan fiduciaries are required to know and evaluate the compensation paid:

“ . . . the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to [the provider] is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by [the provider] in connection with the investment of Plan assets. **The responsible Plan fiduciaries therefore must obtain sufficient information** regarding any fees or other compensation that [the provider] receives with respect to the Plan's investments . . . **to make an informed decision** whether [the provider's] compensation for services is no more than reasonable.”

Expenses: DOL Activity

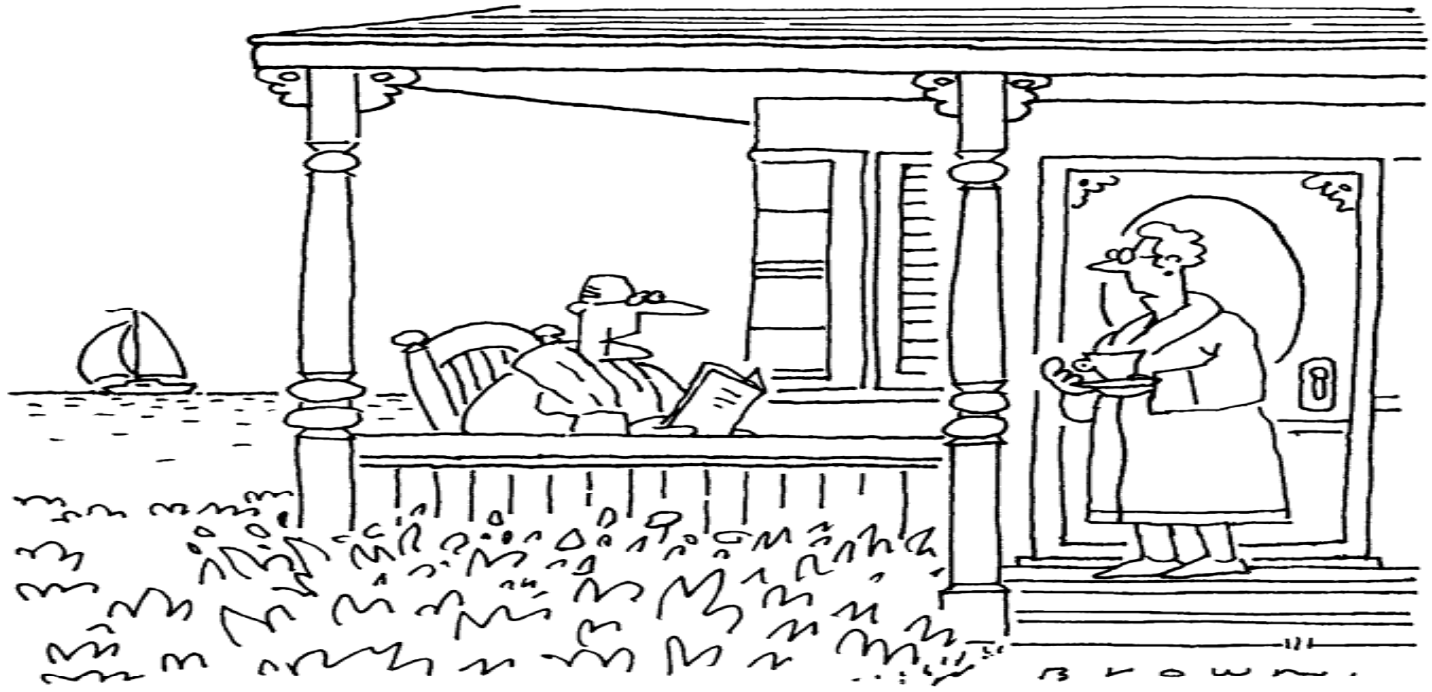
DOL activity:

- Point of sale disclosure to fiduciaries for advisors and providers (whether or not either is a fiduciary) (408(b)(2) project)
- Revisions to Form 5500 (reporting)
- Revisions to 404(c) regulation (participants)

Parting Thoughts

In my experience, fiduciaries are not sued for what they do . . .

. . . instead they are sued for what they do not do.



" The best part of growing old is not having to invest for the long term . "

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