

Message From The Firm

The Winds of Change Are Blowing

The expectations for plan sponsor responsibility are increasing. In the past, plan sponsors and fiduciaries were generally expected to review the investment and operating expenses of 401(k) plans to make sure that they were reasonable. Now, fiduciaries, such as plan committee members, are expected to understand and evaluate the revenue sharing and other payments being made by mutual funds, and their managers and affiliates, to a plan's providers and advisers. (I am using the term "revenue sharing" loosely to mean any payments made, directly or indirectly, by or through the plan's investments.) Fiduciaries who do not know the amounts of revenue sharing being paid from the investments in their plans are taking a chance of breaching their fiduciary duties. That is an unnecessary and unwarranted risk in today's environment.

Some fiduciaries are paying attention to revenue sharing and are negotiating a reduction in those amounts. Typically, the reduction takes the form of either a restoration of some of that money to the plan or the payment of other plan expenses, or both. When the money is restored to the plan, it must be allocated to the participants by the end of each year. I have attached a copy of a report on that subject prepared by Stephanie Bennett and myself.

The fiduciary responsibility for participant investing is also increasing. I believe that is primarily a function of the popularity of target maturity, or aged-based, funds, as well as of the fiduciary safe harbor given to qualified default investment alternatives (or QDIAs). From a legal perspective, any plan sponsor who is not using a QDIA as a default (for participants who don't give investment instructions) simply doesn't understand the legal protection given to those investments.

In addition to using target maturity funds, lifestyle funds, and managed accounts as

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401(k) Risk Management



By Fred Reish (FredReish@Reish.com)

I recently spoke at a retirement plan conference for large companies. My topic was risk management for 401(k) plans.

While preparing for the speech, I decided to take a different approach than most speakers on the subject. Instead of talking about recent law changes and court decisions, I decided to talk about how to design a plan, from the ground up, to minimize risk.

The first step is to focus on the benefits being provided to participants. If participants are receiving adequate benefits from a 401(k) plan, there is less chance of litigation. In a way, though, that answer begs the question. Adequate benefits are the output of a well-run plan and the real question is, how should a plan be designed and operated to provide that output?

The three key elements, or pillars, of a well operated plan are: high levels of participation; significant deferral rates; and quality investing by participants. If a plan succeeds in those three areas, it should produce substantial retirement benefits for participants.

A plan sponsor who wants to minimize risk and maximize benefits at the same time should:

1. Automatically enroll.
2. Automatically increase deferrals.
3. Automatically default into qualified default investment alternatives, or QDIAs.

Let me explain.

Automatic Enrollment

The national average for participation in automatically enrolled plans is about 90%. That is considerably higher than the two-thirds level of participation for non-automatically enrolled plans. (By the way, I define participation to mean eligible employees who are deferring into the plan.)

The dramatic increase in participation resulting from automatic enrollment, in and of itself, significantly reduces the potential risk of the employer and the fiduciaries, because it eliminates potential claims from people who did not get into the plan. Further, with automatic enrollment, any employee who does not participate has to affirmatively file an election to get out of the plan. So, on top of high levels of participation, there is written evidence from every employee who opted out that the employee did not want to be in the plan.

Because of those two factors—high participation in the plan and affirmative elections to be out of the plan—it seems virtually inconceivable that a plan sponsor could be sued over participation-related issues.

Automatic Deferral Increases

With automatic deferral increases, plan sponsors start employees at a deferral rate (usually 3% or 4%, but sometimes as high as 6%), and then increase the deferral rates 1% or 2% per year—up to a maximum that is often in the 10% to 15% range. Of course, employees can elect out of the automatic increases, but if they do

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Agreements With Service Providers: Participant Investment Advice



By **Bruce Ashton** (BruceAshton@Reish.com)

The Pension Protection Act of 2006 (PPA) facilitated the provision of investment advice to participants in 401(k) plans through a new prohibited transaction exemption. The exemption is aimed primarily at the adviser (referred to in PPA as a “fiduciary adviser”), but the new law—plus Department of Labor (DOL) guidance—also clarifies the role of plan sponsors and adds some requirements to be addressed by the employer in a service agreement with the adviser.

The new PPA exemption says that in offering investment advice to participants, the plan sponsor has to do the following:

1. Prudently select the adviser—this is not a new requirement, but the rules are somewhat clearer after PPA;
2. Obtain an acknowledgment from the adviser that it is a fiduciary to the plan;
3. Monitor the fiduciary adviser by following up on any complaints from participants—also not a new requirement;
4. Obtain a “compliance audit” report from the adviser on an annual basis.

At the same time, the PPA makes it clear that the plan sponsor is not responsible for any advice given by the fiduciary adviser.

In guidance issued earlier this year, the DOL said that to prudently select an adviser, the plan sponsor must take into account the adviser’s experience and qualifications, its registration under the securities laws and the extent to which the advice to be furnished will be based on generally accepted investment theories.

How does this impact service agreements? At a minimum, the plan sponsor needs to have a formal written contract with the adviser that covers the following (at a minimum):

1. Describes the services to be performed (*i.e.*, investment advice to the plan participants) and the specific individuals who will render the advice;
2. Describes whether or not the advice will be rendered by a computer model;
3. Describes how the adviser will be paid for its services and the source of such payments;
4. Contains an acknowledgment that the adviser is a fiduciary to the plan;
5. Contains the following representations and agreements:
 - a. a representation that the adviser’s services will comply with the PPA exemption (specifically, ERISA Sections 408(b)(14) and 408(g));
 - b. a representation regarding the adviser’s registration or licensing under applicable securities or other applicable laws—and if the adviser is a registered RIA, a copy of Part II of Form ADV or the adviser’s brochure;
 - c. a representation that the advice to be given will be based on generally accepted investment theories and prevailing industry practices;
 - d. an agreement that the adviser will provide to participants all of the information required by the PPA exemption; and
 - e. an agreement that the adviser will obtain the annual compliance audit required by the exemption and will deliver a report regarding

the results of the audit to the plan sponsor on a timely basis each year.

The agreement with the fiduciary adviser does not have to be elaborate—or even very long. Even though the adviser’s services will be provided only to the participants, the plan sponsor still needs to have some involvement, and that involvement should be documented in a proper service agreement. ♦

A Tip for Plan Sponsors

Here’s something that might help you out. Pull out a copy of your most recent 5500 Form and look at item 8a. Is “2F” one of the codes listed next to 8a? If not, you may have a problem. If it is, you may also have a problem.

If 2F is listed, it means that your 401(k) plan intends to satisfy section 404(c) of ERISA. By signing the front of the 5500, someone at your company (possibly the chair of the plan committee) has declared under penalty of perjury that the plan intends to comply with 404(c).

There shouldn’t be any problem if:

- the person knew what they were signing;
- the plan intends to comply; and
- a good faith effort has been made to satisfy the conditions for compliance.

On that last point, the Department of Labor (DOL) takes the position that, if characteristic code 2F is included on the 5500, the plan administrator (that is, the officers responsible for operating the plan—typically, the plan committee) must make a good faith effort to comply with the conditions.

On the other hand, if 2F is not on the 5500, in effect the fiduciaries have declared, under penalty of perjury, that the plan does not intend to comply. In most cases, that would be a serious mistake. That is because 404(c) is the provision of ERISA that protects fiduciaries from imprudent or inappropriate investment decisions made by participants. Otherwise, the fiduciaries could be liable if participants make bad investment decisions because, for example, some of the participants do not know how to invest properly.

Either way, make sure you know what you are signing. As a word of caution, it is a good idea to get legal advice about whether or not your plan intends to comply with 404(c) and, if so, how to go about bringing the plan into compliance.

Participants and 401(k) Expenses



By *Fred Reish (FredReish@Reish.com) and Stephanie Bennett (StephanieBennett@Reish.com)*



As you undoubtedly know . . . because of all the newspaper headlines, the House Education and Labor Committee is conducting hearings about the information that is given—and should be given—to plan sponsors and participants.

One of the most controversial issues involves fees and expenses. On one side, some experts are taking a libertarian approach and urging that legislation require that providers give participants complete information related to their 401(k) investments and the plan, including information on fees and expenses. On the other side, some experts—primarily from the financial services industry—are taking a paternalistic approach and arguing that the information should be limited.

The libertarian approach seems to be based on a belief that participants can, or will at some point in the future, be able to digest the information about fees and expenses—and make intelligent decisions. The paternalistic approach counters that participants are confused and have a hard time making decisions about participating in 401(k) plans—and that, if they are provided much more information, they will be overwhelmed.

There is some support for both sides of the argument. Many participants are able to handle all of the information about 401(k) investments and expenses. However, other participants may not be interested or may not have a good foundation of knowledge to evaluate the information. If my understanding is correct, the issue boils down to . . . do we adopt the libertarian approach and give all of the information to all the participants, knowing that some will handle it, but others won't, or do we adopt the paternalistic approach and limit the information to all participants?

Regardless of the outcome of that argument, I believe that, in due course, participants will be given one of the most important items of information that they need—and that it will be done without confusing them.

That one item is . . . a statement of the annual cost of the plan that is charged to their account. For example, if the combined investment expenses and expenses for operating the plan are 1.50% per year, and if a participant has a \$50,000 account balance, at the end of the year the participant would receive a notice (probably as a part of the annual benefit statement) that his account was charged a total of \$750 for the year (that is, 1.50% of \$50,000).

There are several reasons why a participant should know that information. The first is that the money in the account belongs to the participant. If the participant's money is going to be charged for management of the investments and administration of the plan, the participant should be told so in the most direct way. I cannot imagine a more simple, yet impactful, way of doing that.

Of course, if participants have not been told that they are bearing the costs of the plan (except, for the employer contributions), that disclosure could result in confusion and upset.

So, forewarned is forearmed. If plan sponsors have not been clearly communicating with employees about who is bearing the costs of the plan, now is the time to start that dialogue.

In my experience, many plan sponsors have not communicated as clearly as possible on that issue. On the other hand, participants are given information about the expense ratios charged to their investments—and, by and large, those expenses have been reasonable. So, the issue is not one of wrongdoing; instead, it is one of better communication.

Furthermore, in the past a dialogue about the cost of a 401(k) plan was not one of the higher priorities. However, now it is. This is the time for plan sponsors to address this issue, in an open and complete manner, with their employees.

The failure to openly, accurately and completely communicate on those issues could lead to litigation and possibly to fiduciary liability. A number of class action lawsuits have been filed in recent

years concerning fees, expenses and revenue sharing. In some of those cases, there are allegations that the fiduciaries failed to inform the participants about those matters. While it is too early to tell if those claims have traction, we now know that they have been asserted. As a matter of risk management, now is time to communicate with your employees about these matters. ♦

Message from the Firm

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default investments, every plan should include at least one of those categories of investments in its regular line-up. ERISA's investment principles are based on generally accepted investment theories, including modern portfolio theory. In effect, that means that ERISA contemplates that participants' accounts will be invested like well-designed portfolios. To the extent that plan sponsors, or their participants, don't understand those concepts, a plan is taking unnecessary risk. The best way to abate that risk is to offer professionally designed or managed portfolios, such as those mentioned above, to the participants.

Finally, automatic enrollment is being embraced much more rapidly than I had thought it would be. I thought that it would take a few years to take hold. Based on early data, it seems to be happening very quickly. For example, Hewitt Associates believes that over half of the largest plans will be automatically enrolling by the end of this year. Other providers are also reporting significant increases in the use of automatic enrollment.

On average, automatic enrollment produces participation rates of around 90%, which is about a third higher than non-automatically enrolled plans. As the concept takes hold, it will change the perspective on the appropriate level of participation, and employers will be expected to do more to increase the levels of participation.

The effect of these changes will be to impose additional responsibility on plan sponsors to educate themselves on expenses, revenue sharing, QDIAs, automatic enrollment, and so on. However, in my opinion, the changes will inure to the benefit of employers . . . because they will increase both the quantity and quality of employee participation in 401(k) plans. As a result, attentive and concerned employers will enhance the retirement plan experience of their employees and will, I believe, build a stronger bond with those employees.

-Fred Reish

Should Your Plan Roth?



By **Fred Reish** (FredReish@Reish.com)

I have been surprised by the lack of uptake on Roth 401(k) accounts.

As background, a Roth 401(k) account is one in which deferrals are made on an after-tax basis, rather than before tax. Under Roth, if you pay taxes on your deferrals, all of the benefits, both principal and income, come out tax free.

Based on the analysis I have seen, Roth 401(k) accounts will likely be “winners” for anyone who can afford to make the full 401(k) deferral (\$15,500 if you are under 50, and \$20,500 if you are 50 or older), and pay the taxes on top of that. And that analysis applies even if tax rates don’t go up; however, if they do, the advantage

is even greater. Who are those people? Obvious candidates are doctors, lawyers, and other professionals.

In fact, our law firm adopted a Roth feature at the earliest possible date, January 1, 2006. As a result, the participants who are making Roth deferrals now have almost two years of contributions, plus earnings, that will come out tax free at retirement.

I can understand why companies with hundreds or thousands of low- and moderate-paid employees may be reluctant to add the feature. HR and benefits people tell me that they are having a difficult time getting those employees to participate without adding another complex issue to the equation.

But, organizations with large numbers of high-paid employees should seriously consider adding a Roth feature to their 401(k) plans. This is the right time to do the analysis, since January 1 is a logical starting date for these deferrals.

As a word of caution, this article discusses only some of the issues for Roth. No one should make a decision on the limited information in this article. Instead, you should consult with a knowledgeable attorney or adviser to fully discuss and understand the pros and cons.

Also, I don’t mean to imply that only a few adventurous firms have added Roth to their plans. Vanguard recently reported that, by the end of 2006, 14% of the 401(k) plans that it studied had a Roth feature. Vanguard also reported that only 5% of the participants in those plans had elected to use the feature. That is not particularly surprising since the advantages are the clearest for the highest paid employees. ❖

DOL Testimony on Revenue Sharing

At a recent hearing of a Working Group of the DOL Advisory Council, Bob Doyle and Lou Campagna of the DOL testified on issues related to revenue sharing. Of particular interest were comments concerning the allocation of excess revenue sharing to participants. The following is a brief portion of the transcript on that subject.

Chairperson McCool: Assuming you have a two participant plan, two funds, both participants have an equal account balance, and there’s a fee for services, record keeping, et cetera, maybe 50 bucks each per head. The first person, Joe, is in a fund that ultimately generated \$60 of revenue share payments to the service provider, and Mary, the second participant, is in a fund that generates zero.

So what has been traditionally done, or at least is done oftentimes, is that that sum of the revenue share of \$50 if it’s applied to offset the cost charged the participants might be divided pro rata. In that case it would be split up 25 bucks each, 30 bucks each. I said \$60 of revenue sharing. It would be split evenly between those two participants even though the one

participant’s account technically didn’t generate any sort of revenue share.

So the question that starts to come to mind is as you start to get more transparency around this and sponsors are saying, you know, I’m not sure if that makes sense, should we be able to take that revenue share and effectively benefit a participant who really didn’t contribute any part of that?

Mr. Campagna: If they put that provision in the plan. If that was a plan provision that said that’s how it was going to be allocated, but if it wasn’t a plan provision then there may be issues associated with that.

Mr. Doyle: Keep in mind that if it’s in the plan [that is, if the plan had a provision specifying the method of allocation], the fiduciaries are subject to a fairly high standard of having to follow the terms of the plan to the extent it doesn’t otherwise violate Title I [of ERISA], . . .

Mr. Doyle: [If there was not a plan provision] . . . that would seem on its surface to be a rational way to allocate, to rebate the money to the account to which

it’s generated in terms of a fiduciary decision.

On the other hand, if the cost of doing that was such that it really didn’t make a lot sense to go through that exercise, you might nonetheless just go back to your per capita method of allocation as a fiduciary decision. So the fiduciary has to at least think about and I think as a threshold matter allocating it to the accounts that are generating the rebates.

But that’s not necessarily the end of the analysis. There are other factors that could come into play in determining what would be a prudent approach to allocation in that context.

RLRC Comment: The fiduciary duty to investigate revenue sharing, together with the emerging duty to recapture excess revenue sharing, is a hot topic in the 401(k) world. Once revenue sharing has been recaptured, though, that creates an issue about the allocation of the excess revenue sharing to participants’ accounts. Should the revenue sharing be traced back to its source and allocated accordingly? Or is a reasonable allocation method adequate? The DOL testimony is particularly helpful in that regard. In addition, the DOL has issued guidance on analogous issues. That guidance is instructive to plan fiduciaries and recordkeepers. ❖

Shifting Responsibility

By Fred Reish (FredReish@Reish.com)

The responsibility for the disclosure of 401(k) fees, expenses and revenue sharing is shifting. In the past, plan fiduciaries, such as committee members, have had the responsibility to investigate and learn about expenses and revenue sharing—and then to evaluate the reasonableness of those amounts. However, many plan sponsors have lacked the knowledge and resources to do the job properly. Unless those companies worked with experienced 401(k) advisers, they were unable to fulfill their legal duties.

However, part of that responsibility is shifting. New bills have been introduced in Congress and new regulations have

been proposed by the DOL to transfer the responsibility of employers to investigate revenue sharing to a responsibility on plan providers to disclose.

Many plan sponsors misinterpret these changes as creating new requirements. That is not the case. Fiduciaries have always had the responsibility to know about those payments. The only thing that has changed is that the burden of the fiduciaries has been partially relieved by an offsetting duty on providers to disclose.

However, once the new disclosure rules are in place, the duty for fiduciaries to evaluate the information will be more

obvious. In addition, fiduciaries have the duty to understand and consider any conflicts of interest, including those presented by external revenue sharing (*e.g.*, from unrelated mutual funds) or internal payments or credits (*e.g.*, related or “proprietary,” funds). For example, a bundled provider may make more money if affiliated mutual funds are used. That would be particularly true if the affiliated fund is a target maturity or lifestyle fund, since automatic enrollment defaults and investment education are driving more and more money to those options. Fiduciaries should evaluate the flow of that money and determine whether the total compensation to the provider and its affiliates is reasonable and whether the participants are protected against potential conflicts of interest. ❖

Risk Management

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not file an election, their deferrals will be automatically increased.

As a general rule of thumb, the goal for the combination of employee deferrals and employer contributions should be at least 12% to 15% per year. At that level, most employees will retire with meaningful benefits, and many employees will retire with adequate benefits (when defined as having income continuation of 75% to 80% of final pay, including social security). So, for example, if the employer contributes 3% of pay (either as a match or profit sharing contribution) and the employee defers 12%, the employee’s account will be “funded” at the rate of 15% per year.

As with automatic enrollment, there are two risk management advantages in automatic deferral increases. The first is that many, and perhaps most, employees will end up with substantial retirement benefits. The second is that, by and large, those employees who opt out will have

filed affirmative elections to stop the deferral increase program from working in their favor. With those two “defenses,” the odds are remote of an employer being sued or being liable for any potential fiduciary violation associated with the adequacy of deferrals.

Safe Harbor Investments

The new QDIA rules provide a fiduciary “safe harbor” for plan sponsors and their responsible officers and committees. The protection is so great that it is fair to say that there is no better protection in ERISA than for a participant who defaults into a QDIA. (The default investments that are “qualified,” or “QDIAs,” include target maturity or age-based funds, risk-based lifestyle or balanced funds, and managed accounts.)

In fact, the protection is so great that plan sponsors are better off if a participant defaults into a QDIA . . . than if the participant affirmatively elects to invest in the QDIA.

From a risk management perspective, plan sponsors would prefer that the largest possible number of participants

default into QDIAs. And, that is exactly what automatic enrollment does. Based on reports from advisers and consultants around the country, 75% to 95% of the automatically enrolled participants are defaulting into QDIAs. Stated slightly differently, 75% to 95% of the participants are invested in a way that the fiduciaries have no worries about potential liability for participant investing. And, if a defaulted participant decides to invest in a different way, he must file an affirmative election to invest differently.

Once again, there are the two advantages for risk management: a safe harbor investment and an affirmative election to invest differently.

Conclusion

I realize that plan sponsors and fiduciaries consider issues other than risk management. However, this article is intended to focus on just that issue. As a lawyer, I am confident in saying that, from a risk management perspective, the best possible plan is one which automatically enrolls, has automatic deferral increases, and defaults participants into QDIAs. ❖

Around the Firm

Speeches: Bruce Ashton and Joe Faucher co-presented "ERISA Litigation: What is the Nature of Recent Lawsuits, Who Are the Named Defendants & What Safeguards Minimize Your Exposure?" at the Center for Due Diligence Conference at Scottsdale, Arizona on October 2nd. Heather Bader-Abrigo, Stephanie Bennett and Pascal Benyamini co-presented an audio conference on "Domestic Partner Benefits in California: How to Decipher the Latest Rules and Administer These Benefits Correctly at Your Workplace" for the Employer Resource Institute on October 11th.

Quote: Fred was quoted in the article "Practitioners Question DOL Initiative on 401(k) Fee Disclosure" published in the September issue of *IOMA Managing 401(k) Plans*. Fred was also quoted in the article "Revenue Sharing Creates Confusion, Greater Clarity Needed, Speakers Say" published in the September 21st issue of BNA Inc., *Pension & Benefits Daily*.

Articles: Fred's column in the September issue of the *Plan Sponsor* magazine addressed the topic of "Expense Account." Nick White wrote articles entitled "IRS Compliance Project for 403(b) Arrangements: The Focus Is School Districts," "Ruling Encourages Caution About Promising Benefits During Employment Negotiations" and "Update on IRS Clarification Regarding The New Nonspouse Rollover Rules," published in the September issue of the *Pension Plan Fix-It Handbook*.

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Revenue Sharing

The following is from testimony prepared by Fred Reish and Stephanie Bennett for the DOL's Advisory Council. The Advisory Council posed several questions concerning revenue sharing and invited public response. This attachment includes the question on the allocation of excess revenue sharing to plan participants and reports on the responses by Fred Reish and Stephanie Bennett.

What, if any, guidance should the DOL issue with respect to the obligations of plan sponsors, trustees and other fiduciaries regarding the allocation of revenue sharing payments received by the plan from the service provider?

For purposes of determining how excess revenue sharing payments should be allocated to participants, we are discussing only those situations in which the revenue sharing payments are deposited into a plan. (For example, a large plan may collect all of the revenue sharing and pay service providers from those amounts. Alternatively, a mid-sized plan might require its recordkeeping to pay all revenue sharing in excess of the negotiated charges into the plan.)

There is no guidance directly on point regarding the allocation of revenue sharing payments; however, two DOL Field Assistance Bulletins (FAB) provide insight into the DOL's approach to allocation methods. While the FABs address other issues—the allocation of plan expenses and settlement fees, they shed light on the DOL's thinking about allocation methods. In Field Assistance Bulletin (FAB) 2003-03, the DOL provided guidelines for ERISA fiduciaries regarding the allocation of expenses in a defined contribution plan. The DOL advised that a plan fiduciary must be prudent in making a determination regarding the appropriate method of allocating expenses:

A plan fiduciary must be prudent in the selection of the method of allocation. Prudence in such instances would, at a minimum, require a process by which the fiduciary weighs the competing interests of various classes of the plan's participants and the effects of various allocation methods on those interests. In addition to a deliberative

process, a fiduciary's decision must satisfy the 'solely in the interest of participants' standard. In this regard, a method of allocating expenses would not fail to be 'solely in the interest of participants' merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method.

Thus, the guidance provides that the fiduciary must engage in a deliberative process in selecting a method of allocating expenses. The FAB acknowledges that the allocation method may differ based on the nature of the expense. Nonetheless, the allocation method must bear a reasonable relationship to the nature of the expense, "On the other hand, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and 'solely in the interest of participants' in selecting the allocation method."

For example, the FAB provides that the pro rata method (*i.e.*, allocations made on the relative basis of assets in individual accounts) of allocating expenses among participants would, in most cases, be equitable. However, it is not the only permissible method of allocation of expenses among participants. Another method is the per capita method (*i.e.*, expenses charged equally to each account, without regard to the amount of assets in the individual accounts). Thus, based on the guidance in the FAB, a fiduciary may employ a variety of methods for allocating expenses among plan participants; however, the decision involves analyzing the nature of the expense.

In FAB 2006-1, the DOL provided guidance on the allocation of mutual fund settlement proceeds. If the distribution plan does not contain a method for allocating the proceeds among participants, then the plan administrator must determine a method that relates to the impact of the market timing and late trading activities on the participant accounts. Plan administrators are permitted to weigh the costs to the plan and participant accounts and the ultimate benefit to participants when trying to determine how to allocate

settlement proceeds, taking into account matters such as the availability of plan records and the costs of different allocation methodologies. For example, the FAB suggests that it may be permissible to allocate the proceeds to current participants (rather than participants who participated in the plan during the relevant period (*i.e.*, when market timing/late trading occurred). In addition, the FAB acknowledges that in certain situations the amounts involved may be so small that the plan administrator might conclude that determining a method of allocating the amounts and the expense of actually allocating the amounts are not cost-effective and use the amounts to pay plan expenses.

The DOL and IRS should coordinate such that their rules are consistent on this issue.

Specifically, the IRS should recognize cost as a factor in allocation methodologies and include a *de minimis* exception, recognizing that there are instances where the cost of precise allocation outweighs the benefit that is being allocated.

Applying this guidance to the allocation of revenue sharing, fiduciaries responsible for allocating revenue sharing amounts among participant accounts need to be granted flexibility and discretion to determine whether, *e.g.*, a pro-rata allocation is appropriate or whether a more precise calculation can be done in a reasonable and cost-effective manner. While a straight-forward approach of allocating revenue sharing in proportion to account balances may seem to be the most reasonable manner of allocation, when one considers the variety of plans and revenue sharing arrangements, it becomes evident that flexibility is needed to determine the most appropriate manner. By definition, a method of allocation based on all balances at the end of year is not the most precise method, but the cost of doing precise calculations may be prohibitively expensive and administratively burdensome considering the amounts to be allocated. Thus, on balance it would seem that, in most cases, a pro rata allocation based on end of the year account balances is a reasonable method. But, it may not always be appropriate.

Consider, for example, two types of investments that often have the greatest divergence in revenue sharing (particularly for small plans)—stable value investments and an S&P

500 fund. (For example, it is not unheard of for a stable value investment to revenue share as much as 75 to 100 basis points per year, while a low-cost index fund may not revenue share at all.) In that case, if two participants have the same account balances, but one is invested entirely in the stable value vehicle while the other is entirely in the index fund, a pro-rata allocation based on account balances raises obvious issues for fiduciaries considering that one participant bore the entire cost of operating the plan through revenue sharing fees and the other participant did not. While this is an extreme example, the reality is that, for many small and mid-sized plans (and perhaps some large plans), the revenue sharing costs borne by participants for maintaining the plans may vary significantly. While that fact situation may raise fiduciary issues in its own right, our focus is on the prudent and equitable allocation of excess revenue sharing to the participants' accounts. Should it be allocated in proportion to the amounts charged to each participant to generate the revenue sharing? Conceptually, the answer is, yes, it should be. However, practically speaking, that may not be possible—at least at this time (although we are aware of one large plan that is doing exactly that).

Fiduciaries need guidance on this allocation issue similar to the guidance provided by the referenced Field Assistance Bulletins.

In recognition of the variety of revenue sharing arrangements, we recommend that any guidance on allocation methods for revenue sharing should build in flexibility and discretion so the fiduciaries may reasonably consider the material factors for determining the most appropriate method of allocation.

Finally, a tangential issue surfaces when considering the proper allocation of revenue sharing payments. That issue is—how long may that money remain in plan before it is allocated? Typically, when revenue sharing amounts are deposited into a plan they are initially placed into an unallocated account, sometimes referred to as a suspense account. Guidance in the form of a Revenue Ruling provides that, in general, money in a defined

contribution plan must be allocated to participants' accounts on an annual basis.¹ As a general statement of the qualification standards under the Internal Revenue Code, amounts held in a defined contribution plan must be allocated to participants' accounts on an annual basis unless there is specific authority allowing the money to be held unallocated beyond that time.² Since there is not specific authority for the creation of a suspense account for retaining recaptured revenue sharing payments (or similar revenues), those amounts must be allocated to participant accounts on an annual basis.

¹ Rev. Rul. 80-155 states that profit-sharing, stock-bonus and pension plans of the money-purchase type (*i.e.*, defined contribution plans) must provide for a valuation of investments held by the trust at least once a year in accordance with a method consistently followed and uniformly applied. In addition, Rev. Rul. 80-155 states that profit-sharing and stock bonus plans must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan.

² Note that there is guidance under sections 415 and 4980 of the Code that permit unallocated amounts to be held in a suspense account for forfeitures and amounts transferred from a terminating defined benefit plan to a defined contribution plan.

401(K) INVESTMENT ISSUES

What It Means to Be Prudent Under ERISA

Under ERISA, fiduciaries are required to be prudent. This has been said so many times, it is almost a cliché. Cliché or not, as one court has stated, the ERISA prudence standard is one of the highest duties known to the law.

[Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir. 1982)] But the practical application of that requirement is one of the law's most misunderstood concepts. What must fiduciaries actually do to act prudently?

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The prudent man rule is only 42 words long, but is the parent of scores of litigated cases and millions of words of analysis. Despite this volume of information, the rule still creates confusion and discomfort. That is doubly true in the context of participant-directed plans. In this column, we offer a primer on what it means to be prudent, focusing on the selection and monitoring of investments. (This is by no means a complete discussion of the concept of prudence, but the steps discussed in this column are some of the most important. Fiduciaries who fail to act prudently are personally liable to make good on any losses sustained by the plan, including lost earnings. [See ERISA Section 409.]

As stated in the prudent man rule, found in ERISA Section 404(a)(1)(B), fiduciaries must 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.

Note that the duty is described in terms of how a fiduciary must act, and not by the results a fiduciary must obtain. This is significant, for it highlights that the result of prudent behavior is not generally as important—at least from the legal perspective—as the process by which the fiduciaries arrived at the result. [See, e.g., *Liss v. Smith*, 991 F.Supp. 278 (SDNY 1998), at 297 and 300; the *Liss* case cites many of the relevant cases in

this area.] Because of this emphasis, the requirement is often described as procedural prudence, or a duty of the fiduciaries to engage in a prudent process.

The result is by no means irrelevant. The outcome of a prudent process is an informed decision (rather than a successful investment); however, an informed decision should produce investment results that help participants grow their benefits. For example, then-Circuit-Judge Antonin Scalia said, in *Fink v. National Savings and Trust Company*:

I know of no case in which a trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments . . . has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand. Similarly, I know of no case in which a trustee who has made (or held) patently unsound investments has been excused from liability because his objectively imprudent action was preceded by careful investigation and evaluation. [772 F.2d 951 (D.C. Cir. 1984), at 962]

He went on to explain: “in short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently.” [*Id.*] The second duty corresponds to the requirement to make informed and reasoned decisions. In the same vein, the court in *Howard v. Shay* [100 F.3d 1484 (9th Cir. 1996)] said:

To enforce [ERISA's fiduciary duties], the court focuses not only on the merits of the transaction [i.e., a reasoned decision on the merits], but also on the thoroughness of the investigation into the merits of the transaction [i.e., a prudent process to investigate the issues and facts]. [*Id.* at 1488]

Nevertheless, time and again the courts and the DOL have said that fiduciaries are not judged by the results they obtain—they are not guarantors of results—but their performance is measured by the

steps they have taken to get there. [See, e.g., *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), and *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984).]

The Prudent Process

The ERISA requirement of prudence applies to every fiduciary decision: The selection of investments; the selection of service providers, such as investment advisors, third-party administrators, and providers of participant education; and the decision to continue offering investments or using service providers (the phase known as "monitoring"). This is not just a "big plan" issue. In responding to concerns that its regulation under ERISA Section 404(a)(1), which requires fiduciaries to give appropriate consideration to all relevant factors in making investment choices, could "be read as establishing an impossible standard, especially for fiduciaries of small plans," the Department of Labor said that it would not "distinguish among classes of fiduciaries." [Preamble to DOL Reg. § 2550.404a-1]

To illustrate how the prudence requirement operates, look at the selection and monitoring of investments made available to plan participants in a participant-directed plan. Assume for this purpose that the investments to be selected are all mutual funds.

There are three key ingredients to the prudence process:

1. The duty to investigate;
2. The duty to maintain records; and
3. The duty to obtain expert assistance where necessary.

These three steps lead to the required outcome: An informed and reasoned decision.

Duty to Investigate

In describing the investment duties of fiduciaries, the DOL has said that the fiduciary must give "appropriate consideration to those *facts and circumstances* that . . . the fiduciary knows or should know are *relevant* to the particular investment or investment course of action involved." [DOL Reg. § 2550.404a-1(b)(1) (emphasis added)] In other words, the fiduciary must have available to it "facts and circumstances" related to the investments under consideration. What does the fiduciary have to do to consider the relevant facts and circumstances? At the least, the fiduciary should take the following steps:

1. Determine the Relevant Information: As stated in the DOL regulation, fiduciaries must consider

those facts and circumstances that are relevant to the selection of prudent investment options. The first step is to determine the information needed to make an informed decision.

This requirement is not limited to what the fiduciary knows, but extends to what he or she should know. This means the fiduciaries need to have the same information that would be used by a person who is knowledgeable about the particular issue.

In our example of selecting investments, this means that the fiduciaries need to have an understanding of the investments and services that are currently available in the investment marketplace for participant-directed plans. This field is evolving rapidly, and what was "state of the art" a few years ago may be out of date today. For example, a decade ago, who would have considered the importance of execution of transactions by the participants or the delivery of information to the participants, including investment advice, over the Internet? New services are constantly being made available from plan providers. New tools are available to help fiduciaries perform their jobs. New investment products that will better serve the needs of participants are being introduced.

The prudent fiduciary needs to examine the marketplace periodically to make sure that what he previously considered important continues to meet the needs of the participants. Although there is a value to stability and participants can be confused or put off by change, it is important for fiduciaries to know whether a service (for example, one that will better assist the participants with investing) might be available that would materially improve their chances of having adequate retirement savings.

2. Gather Information: Fiduciaries can only judge the appropriateness—the prudence—of an investment if they have at hand quantitative information, as well as qualitative information. Quantitative information includes historical performance, how that performance compares to benchmarks and peers, measurements of risk and volatility, and information regarding fees and expenses. Qualitative information includes information about the investment manager, including the investment provider's adherence to ethical and legal standards, manager turnover, and changes in investment philosophy or processes. The fiduciaries also need information

regarding the services that will be available to the plan and participants, how those services compare to those of other providers in the same market, costs and expenses of the services, and so forth. This list is not intended to be exhaustive or complete; it merely illustrates the breadth of the data that fiduciaries need to gather to fulfill the duty of procedural prudence.

In essence, fiduciaries must look at information about data that measures the past and present, and use it to evaluate the future, to decide if an investment option is likely to perform reasonably well in the future. Indeed, fiduciaries have substantive and procedural duties. The substantive duty is to look at the right data; the procedural duty is to look at it in the right way.

For small plans, as a practical matter, we believe investment providers must develop and distribute this information. We expect that the high-quality providers will "force" the marketplace to improve the decision-making process by providing their client plans with substantial assistance in this area.

3. **Examine and Evaluate the Data:** Merely having the data, having a file filled with paper and charts, is pointless if it is not reviewed. The DOL regulation on prudence, quoted previously, requires fiduciaries to give appropriate consideration to the relevant facts and circumstances. Fiduciaries can only do so if they review the information; however, they must do more than just review the information. The fiduciaries must understand and evaluate that information to determine how the particular investment will meet the requirements of the plan, test the data against the plan's investment policies, and determine whether the investment measures up to those standards.
4. **Understand the Costs:** While this has always been a critical issue for fiduciaries, in recent years there has been an increased focus on evaluating the fees and expenses for investments and services provided to a plan because of the impact they have on the participants' investment return. We need look no further than the DOL Web site to understand the significance of this issue. The DOL has published a number of brochures related to fees and expenses, most recently in May 2004. (See *Understanding Retirement Plan Fees And Expenses*, www.dol.gov/ebsa/publications/undrstndgrtrmnt.html.)

In evaluating costs, the fiduciaries should focus on three issues:

- Is the cost reasonable relative to the potential value of the service?
- Is the cost competitive with what is being charged by other providers?
- Is the service effective; that is, is it being used by the participants, is it working, and does it produce adequate results relative to the cost?

Duty to Maintain Records

Inherent in the duty to investigate is the need to document the process and be able to demonstrate that the fiduciaries actually took the steps required by a prudent process. Taking the investigative steps is important, but equally important is being able to prove it. For example, in its brochure "Meeting Your Fiduciary Responsibilities," published in May 2004, the DOL wrote: "Prudence focuses on the process for making fiduciary decisions. Therefore, it is wise to document decisions and the basis for those decisions." [<http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html>]

Duty to Use Experts

This third prong in the prudence process requires fiduciaries to obtain expert assistance when they do not have the knowledge, experience, or access to data needed to fulfill the duty to investigate. At the same time, it is important to stress that fiduciaries must prudently select and monitor their experts and may not rely blindly on the advice of they receive from them. [For a further discussion of this requirement, see *The Fiduciary Duty to Ask for Help*, Reish and Faucher, Autumn JPB 12.1:80-83.]

Fiduciaries must document the steps they have taken, retain the data that they have gathered, and record minutes of their evaluation and the decisions that were made.

Conclusion

Fulfillment of the fiduciary duty of prudence is measured by the steps taken—the process engaged in by the fiduciaries in meeting their obligation. These steps consist of the duty to investigate, the duty to obtain expert advice where needed, and the duty to maintain records. Fiduciaries must also make informed and reasoned decisions based on those steps. If ERISA fiduciaries meet these requirements, they should feel comfortable that they have acted prudently under ERISA's fiduciary standards. ■