



Avoiding the Breach

Bringing Higher Education  
403(b) Plans Up-to-Date with Current  
ERISA Fiduciary Best Practices

# 403(b)

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For Financial Professional and Plan Sponsor Use Only



## 403(b) Plans and ERISA Fiduciary Best Practices Overview

Millions of Americans depend on their employer's retirement plan for their retirement security. With this in mind, the U.S. government has placed significant legal requirements on fiduciaries, who are the organizations and individuals entrusted with managing retirement plans and their assets.

Prior to the release of the final 403(b) regulations in 2007, many employers sponsoring a 403(b) plan did not devote a significant amount of time to complying with the regulatory requirements of the Employee Retirement Income Security Act (ERISA). ERISA provides guidelines for plan sponsors and their fiduciaries to follow in the management of a retirement plan and its assets. Employers who sponsor ERISA-covered 403(b) retirement plans need to understand the basic guidelines for their fiduciaries to follow to comply with these standards.

*The purpose of this paper is to assist employers, particularly those representing colleges and universities, in understanding when and how ERISA applies to 403(b) plans. Additionally, the paper will recommend best practices on how plan sponsors and plan fiduciaries can comply with fiduciary requirements. In particular, the paper will focus on areas where the application of ERISA fiduciary duties to 403(b) plans creates special situations that do not occur with 401(k) plans.*

Diversified Investment Advisors commissioned the Groom Law Group of Washington, D.C., a leading law firm in the specialized field of employee benefits, to prepare this paper as a guide for 403(b) retirement plan sponsors to make use of best industry practices that have been established for retirement plan fiduciaries.

### About Groom Law Group

The Groom Law Group has been at the forefront of developments in the nation's employee benefits laws since Congress passed ERISA in 1974, drawing

many of its attorneys from the federal agencies that regulate employee benefits and forging strong ties with key players in all three branches of government.

With nearly 60 attorneys dedicated to the employee benefits practice, Groom offers clients unparalleled coverage of issues and disputes arising from ERISA, the Tax Code, securities laws, HIPAA, COBRA, ADEA, and the many other laws that govern employee benefits. Working in nine different practice groups, Groom's attorneys build upon their diverse backgrounds to share a common understanding of employee benefits law that enables them to integrate their efforts across areas of specialization to produce the best results for their clients. The firm prides itself on offering state-of-the-art advice on best practices and emerging trends in employee benefits to a diverse group of clients across the country. Groom emphasizes a team approach to clients that assures responsive and efficient service. The authors of this paper, David Powell and Steve Saxon, are principals in the firm with many years of experience with handling 403(b) plans and advising ERISA fiduciaries, both from the perspective of the plan sponsor and the investment providers. To learn more, visit [www.groom.com](http://www.groom.com).

### About Diversified Investment Advisors

Diversified Investment Advisors, Inc. is a national investment advisory firm specializing in retirement plans. The company's expertise covers the entire spectrum of defined benefit and defined contribution plans, including: 403(b) and 401(k); 457; nonqualified deferred compensation; profit sharing; money purchase; cash balance and Taft-Hartley plans; and rollover and Roth IRA. Providing comprehensive plan administration, investment and communication services for mid- to large-sized organizations, Diversified helps more than 1.5 million participants save and invest wisely for and throughout retirement. To learn more, visit [www.divinvest.com](http://www.divinvest.com).

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## Introduction

With the release of the final 403(b) regulations by the Internal Revenue Service (IRS) in 2007, 403(b) plan sponsors must now operate their plans much more like 401(k) plans. One of the most crucial considerations for a 403(b) plan sponsor in light of the final regulations is the personal exposure he or she has to the Employee Retirement Income Security Act, or “ERISA.” Sponsors of 403(b) plans and plan fiduciaries are quickly learning that failure to comply with ERISA can result in personal liability for any breach in compliance.

While employers should not be overwhelmed by the prospect of complying with ERISA fiduciary best practices, they should be sensitive to its importance. Fortunately for those employers unfamiliar with the broad application of ERISA, there are a variety of safe harbors and exemptions that have evolved, providing some needed relief. Additionally, there are a select number of providers that have developed extensive expertise, along with cost-effective and efficient plan administrative capabilities, to support the ERISA requirements for 403(b) plan sponsors and fiduciaries.

If an employer has not yet taken steps with its 403(b) plan to comply with ERISA, the time to do so is now. There is no question that audits and compliance efforts by the IRS and Department of Labor (DOL) are ramping up. By not taking immediate action, any liability for past violations may only be compounded and extended to new fiduciaries. By taking action now, fiduciaries may be able to mitigate any exposure they may have.



## Background

### Brief History of 403(b)

To understand why many 403(b) plan sponsors need to begin addressing their obligations under ERISA, it helps to have a little history on how 403(b) plans came to be and why they have often operated with little attention to ERISA in the past. The simple answer is that 403(b) plans did not in fact start off as “plans.” The concept of a tax-exempt employer (usually a school) putting money aside into an annuity contract for an employee was first recognized in the 1942 income tax laws. These contracts were typically individual annuities, owned by the employees, usually teachers. They were, in essence, fully portable pensions. It was not until 1958 that for the first time the Internal Revenue Code (“Code”) section 403(b) was enacted for the purpose of putting limits on the amounts that could be contributed to such an annuity.

## **ERISA–1974**

When ERISA was enacted in 1974, the non-tax portion of that law did not distinguish between different types of plans such as 401(a) and 403(b) plans. But it did apply based on whether or not there was an “employee benefit plan.” And to have an employee benefit plan, there had to be an employer to sponsor the plan for its employees. The DOL recognized at the time that many 403(b) programs did not have significant employer involvement, and so issued a regulation in 1979 that provided a “safe harbor.” This safe harbor regulation indicated that a plan with little employer involvement, and consisting solely of salary reduction contributions, would not be treated as an employer-sponsored plan. Therefore, as a result, the plan would not be covered by ERISA. At that time, the Code required little employer involvement with 403(b) programs.

**Observation:** It is important to keep in mind that governmental 403(b) plans, and church 403(b) plans that have not made the election under Code section 410(d) to become subject to ERISA are exempt from ERISA whether or not they satisfy the safe harbor of the DOL regulation.

### **The Tax Code and the IRS Begin to Treat 403(b) Programs as Plans**

The concept of recognizing tax-sheltered annuities (TSAs) under a 403(b) program as a “plan” rather than as a “program” was not introduced into the tax law until the Tax Reform Act of 1986. *Subsequent tax legislation, particularly the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Economic Growth and Tax Relief and Reconciliation Act of 2001, added several provisions making 403(b) programs more like other qualified plans, in particular 401(k) plans.*

Making 403(b) programs operate more like plans, and not like loose collections of individual contracts, was a central purpose of the sweeping new regulations by the IRS. *The new 403(b) regulations were conceived as a result of the growing complexity of plan-based tax rules.*

The IRS had also begun to perceive, based on its audit experience, that continued treatment of contracts as the responsibility of the employee or of providers was contributing to wide-spread non-compliance. Employers and providers were not communicating with one another, and this lack of communication with respect to loans, hardships and other distributions was exacerbating noncompliance issues. Also contributing to the problem was 1990 Revenue Ruling 90-24, which allowed transfers from one 403(b) contract to another without any employer involvement or knowledge, and for which little compliance oversight was provided.

## **The Current Environment**

### **As New Regulations Require Plan Changes, Sponsors Begin to Reassess their Duties**

The new requirements for non-ERISA 403(b) plans in the final regulations received a lot of attention, especially now that these plans had to be in writing—previously only a requirement for ERISA-covered plans. However, the most important statement in the new regulations made the employer responsible for gathering all the contracts together—in effect administering the 403(b) plan—to comply with the Code. Of course, the employer could delegate that to others, such as a professional third party administrator or to a provider, but not to the participants themselves.

*Making sure that the plan’s administration is performed on a plan-wide basis, something rarely done by many plan sponsors before, has led sponsors to undertake a complete review of their 403(b) plans. This review extends to include audits of both investment products and provider services. And sponsors of plans subject to ERISA (as well as who are not) have also been assessing their fiduciary obligations with respect to making changes to those plans.*

## **The Shrinking DOL Safe Harbor—Creating More ERISA Plans**

Not only do the final IRS 403(b) regulations make the employer ultimately responsible for the plan's administrative duties (though those duties can be delegated), these regulations come at the same time that the DOL revisited its 1979 safe harbor guidance for such plans in a manner that many perceive has substantially narrowed the exemption. This has become a concern for many tax-exempt employers who sponsor 403(b) plans.

*Shortly after the final IRS regulations were issued, the DOL issued Field Assistance Bulletin 2007-2, which offered additional guidance on this safe harbor regulation. This particular FAB set about explaining whether compliance with the final IRS 403(b) regulations would necessarily mean the plan would be considered sponsored by the employer to the extent that it would be an "employee benefit plan." While the answer was essentially "not necessarily," and allowed that having a written plan document or terminating a plan would not in and of itself subject a plan to ERISA, it nevertheless set about creating conditions for the safe harbor that are very difficult to meet.*

The difficulty lies in two conditions of the DOL safe harbor which are now much harder to satisfy while still being able to comply with the final IRS regulations. The first condition stipulates an employer "could not, consistent with the safe harbor, have responsibility for, or make, discretionary determinations in administering the program."

*Examples of such discretionary determinations include processing distributions, making determinations regarding hardship distributions, and determining eligibility for or enforcement of loans and administering Qualified Domestic Relationship Orders (QDROs). This is not a new requirement. The DOL had previously issued advisory opinions to major 403(b) providers holding that the employer could not approve hardship distributions or loans and remain within the safe harbor. Therein lies the problem—if the employer cannot make those decisions, who can?*

The answer, prior to the final regulations, was that the provider could make those decisions. The provider, of course, commonly relied upon unverified representations by the employee. Under the final 403(b) regulations, when a plan utilizes multiple providers, the providers cannot rely on employee representations, but instead must depend on independent information. Currently, little information sharing between providers occurs in the marketplace. The use of a third party administrator to coordinate provider information might work to satisfy the IRS regulations. However, it is not clear whether the discretionary authority of such a third party administrator would be attributed to the employer, which would then flunk the DOL ERISA safe harbor. *Consequently, satisfying the IRS regulations without excessive employer involvement might only be possible if there were only one provider.*

That brings us to the second condition, which in fact conflicts with the first. The second condition regards the funding media or products made available to employees, including those made available by annuity contractors. In the preamble to those regulations in 1979, the DOL stated that "[i]t may be that in some circumstances it would be reasonable for the employer to limit to one the number of contractors who may deal with employees under the section 403(b) program." At that time, the DOL declined to specify a minimum number of contractors that would satisfy the rule. More recently, DOL representatives have informally indicated that placing a limitation on the number of providers because of administrative burdens and costs to the employer of multiple payroll slots might be harder to justify today than in 1979.

Consequently, an employer seeking to use the DOL safe harbor today is essentially attempting to thread a very small needle—leaving all the discretion to make loans, administer hardship requests, and address similar matters up to the providers, while trying not to limit providers in an impermissible way. Whether the sponsors are using the safe harbor to justify a single provider, or using multiple providers

sharing information, it is a tight squeeze to remove themselves from the process.

Some plans are finding that they may have flunked the safe harbor in other ways. For some, this may have occurred when they made a nonelective contribution at some point in time. The net result of all of this is that more 403(b) plans are concluding that they are in fact subject to ERISA, and hence must come to grips with the fiduciary duties that ERISA imposes.

### **New 5500 Filing Requirements in 2009**

One key requirement prompting sponsors of ERISA-covered 403(b) plans to review their fiduciary practices is the new Form 5500 annual reporting requirements. For the 2009 plan year, the DOL has substantially revised the Form 5500 for all plans and removed the special reporting rules for 403(b) plans. They now file the annual return on the same basis as a 401(k) plan. This includes the requirement that financial statements be filed for all 403(b) plans, and that large plans (generally over 100 participants) be audited by an outside accounting firm.

In addition, the American Institute of Certified Public Accountants (AICPA) has issued a four-page sample request for information to be used by auditors of 403(b) plans. This sample includes requesting investment policy statements and evidence of plan internal controls. The AICPA also recommends auditors ask questions about who reviews service provider activity and who performs due diligence when a service provider is changed. Consequently, plan sponsors can expect their auditors to begin asking questions about how they are fulfilling their ERISA fiduciary duties. Plan sponsors need to be ready to respond to these questions.

## **Overview of Fiduciary Duties**

### **Who Is a Fiduciary Under ERISA and Why Is It Important?**

If a plan is subject to ERISA, the plan must have

a “named fiduciary” identified in the plan document. *However, other persons can become fiduciaries by reason of exercising discretionary authority or control over the management or administration of a plan or the management or disposition of its assets, or by providing investment advice for a fee.* Thus, in addition to being named as a fiduciary in a plan document, a person may become a fiduciary and subject to fiduciary duties in fact, by exercising discretion over the administration or assets of the plan.

It is important for ERISA fiduciaries to know who they are and to comply with their duties. If a fiduciary breaches his or her fiduciary duty—and this includes if the fiduciary knows or should know that another fiduciary is breaching his or her duty—the fiduciary is expected to make reasonable efforts to remedy any breach, and may be held financially accountable for the losses to the plan resulting from the breach. Likewise, if a fiduciary, by reason of his or her failure to perform his or her administrative duties, enables some other fiduciary to commit a breach—again, the fiduciary is personally liable for the losses to the plan.

### **Overview of ERISA Fiduciary Duties**

ERISA imposes a number of duties on plan fiduciaries. A fiduciary is required to discharge his or her duties with respect to a plan:

- Solely in the interest of the participants and beneficiaries;
- For the exclusive purpose of (a) providing benefits to participants and their beneficiaries; and (b) defraying reasonable expenses of administering the plan;
- With the care, skill, prudence, and diligence that a prudent person would use;
- By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of ERISA.

Each of these bullet points is further elaborated on below. In addition, ERISA includes the concept of co-fiduciary liability, where one fiduciary may be liable for breaches committed by a second fiduciary under certain circumstances.

**Requirements to “Act Solely in the Interest” of the Participants and Beneficiaries and “for the Exclusive Purpose” of “Providing Benefits” and “Defraying Expenses”**

What this means, of course, is that plan fiduciaries cannot act in the interest of the plan sponsor, themselves, or anyone other than the plan participants and beneficiaries.



**Example 1:** The president of a college tells the human resources officer that their 403(b) plan has to use provider Z because the president is an old friend of the provider’s local representative and has some of his personal investments with provider Z. The human resources officer does so, making no effort to determine if provider Z is the best provider for the plan. Both the president and the human resources officer have breached their fiduciary duties because they exercised discretionary control over the investments of the plan (in fact, even if they are not named as fiduciaries in the plan document). They also did not act in the interest of the participants and beneficiaries, but rather in the president’s interest. If the plan has any losses (for example, the investments with provider Z underperform the markets, or the expenses are too high—and rest assured that plaintiffs’ lawyers can be quite creative when determining possible losses), they may both be personally liable to make up those losses.

**Example 2:** A college uses provider X for its 403(b) plan. Due to the new 403(b) regulations and the fact that the college has not surveyed the market or put their plan out to bid in a number of years, a committee appointed by the college decides to engage a consultant to help determine the best provider for their plan. A best practice fiduciary model is employed to review

providers, and a decision is made by the committee to hire a new provider, (provider Y), as the provider for all future participant contributions. In spite of the committee’s recommendation, senior administrative staff members decide not to go forward with the move to new provider Y. Instead, the staff decides to continue with current provider X, to the dismay of the retirement committee. The staff has made a fiduciary decision. If the decision to continue with provider X is found to have been imprudent (which it may not be, but in the absence of appropriate due diligence, may well be prone to second-guessing), should there be any losses to the plan by such a decision, the staff, by exercising investment discretion in fact, may be personally liable. The retirement committee members may be liable as well if, as co-fiduciaries, they knew of the breach of fiduciary duty but failed to take appropriate remedial action.

**Duty to Act Prudently and Diversify Investments—and How This Dovetails with Participant Choice**

A fiduciary must act “with the care, skill, prudence, and diligence that a prudent person 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.” This means that not only must a fiduciary act prudently, but he or she must act like a prudent person who is familiar with plans and investing—a “prudent expert.” Ignorance is no defense to a breach of the prudent person rule. *A prudent person does not personally have to be an expert, but if a question is in an area that the fiduciary is not familiar with, he or she must obtain expert advice.*

The fiduciary is also required to see that the plan’s investments are adequately diversified. However, in a defined contribution plan like a 403(b) plan, that duty may be modified by section 404(c) of ERISA, which generally provides that if a participant exercises control over the assets in his or her account, that participant will not be deemed to be a fiduciary. In addition, the person who is the fiduciary will not be liable for any loss which results from such participant’s exercise of control.

Plan fiduciaries are not completely off the hook for fiduciary duties over such assets, though, just because participants have a choice of how to direct their investments. Importantly, the DOL has made it very clear that 404(c) does not serve to relieve a fiduciary from his or her duty to prudently select and monitor any designated investment alternative offered under the plan. Thus, a 403(b) plan fiduciary must prudently select the providers offering annuity contracts and custodial accounts, along with the investments available under those contracts and accounts, and then must continue to monitor those investments.

**Example 1:** A human resources officer who is responsible for selecting providers for a college 403(b) plan picks the current provider because it is convenient to do so. He also doesn’t want to spend time or resources on a request for proposal (RFP) process. He does no review of whether this provider is actually the best provider for the plan. The officer may have breached his fiduciary duties by failing to prudently select the provider for the

plan. If any losses result, he may be personally liable for them.

**Example 2:** The human resources officer of a university who is responsible for selecting providers for a 403(b) plan reviewed possible providers for the 403(b) plan several years ago. Two providers were selected based on investment performance, fees, faculty/staff interests, and other criteria. These two providers have continued to be the plan’s providers since that time. However, no one since that time has reviewed the performance of those providers or the investments available under the plan. Several of the investments have been changed by the providers over the years, and some have performed extremely poorly by market standards and have high fees compared to similar investments of the same type and class. The human resources officer may have breached her fiduciary duties by failing to continue to monitor the investments and take appropriate actions after they were selected, even though the original selection may have been prudent at that time. That officer may be personally liable for any losses to the plan experienced by that inaction (for example, for excessive losses or fees). (Note: In some cases, the human resource officer’s ability to change investments offered by a selected 403(b) provider may be limited even though she may be monitoring them. We discuss this situation below.)

### **Use of Self-Directed Brokerage Options (SDBOs) in 403(b) Plans**

One idea that some 403(b) plans have implemented is borrowed from 401(k) plans, the “self-directed brokerage” option (SDBO). Under such an arrangement, the participant may allocate all or a portion of his or her investments into an account administered under the plan that allows the purchase of a wide array of mutual funds or annuities. *The 403(b) SDBO varies somewhat from a 401(k) SDBO because 403(b) investments are limited to mutual funds satisfying Code section 403(b)(7) and annuity contracts satisfying 403(b)(1). Publicly traded individual stocks, for example, are not available*

*in a 403(b) plan.* Interest in SDBOs on the part of 403(b) plan sponsors is sometimes driven by the desire to allow participants who have older contracts not available with the current provider to keep those investments. Of course, the plan administrator must still aggregate all of those mutual funds and contracts for compliance with Code section 403(b).

The ERISA duties for selecting and monitoring SDBOs, even in the 401(k) context, are not entirely clear. The hope is that ERISA section 404(c) would prevent the plan sponsor and plan fiduciaries from performing duties with respect to or shoulder liabilities for the investments the participant selects under the SDBO. The regulations under ERISA section 404(c) distinguish between “designated” investment alternatives, which would include the funds and annuities specifically selected by the fiduciary to be available under the plan, and other investment alternatives which might include the SDBO, and different rules apply to each. However, there is a lack of clarity regarding what it means to have “designated” an investment alternative. Questions arise as to whether selecting a SDBO is a fiduciary act, and whether consideration should be given to the financial sophistication of the plan’s participants when deciding to offer such an investment tool. Additional fees associated with implementing an SDBO may also be a consideration.

### **Avoiding Prohibited Transactions**

In addition to ERISA fiduciaries being subject to the duties outlined above, there is another area of fiduciary responsibility referred to as prohibited transactions that fiduciaries should be mindful of.

*Prohibited transactions under ERISA are certain transactions between the plan and certain parties closely related to the plan and certain acts of fiduciary self-dealing—even if it can be argued they are in the interest of the plan participants and beneficiaries. Certain strictly-construed exemptions exist, and the DOL can issue both class and individual exemptions in certain cases,*

*but we will not go into those exemptions in this paper, as they are usually not relevant to the plan sponsor of a typical 403(b) plan.*

Prohibited transactions between a plan and “party in interest” occur when a fiduciary, with respect to a plan, causes the plan to engage in a transaction that he or she knows, or should know, constitutes a direct or indirect:

- Sale or exchange, or leasing, of any property between the plan and a party in interest;
- Lending of money or other extension of credit between the plan and a party in interest [*an exemption to this rule generally permits plan loans to participants complying with the Internal Revenue Code requirements under Code section 72(p)*];
- Furnishing of goods, services, or facilities between the plan and a party in interest;
- Transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
- Acquisition, on behalf of the plan, of any employer security or employer real property, subject to certain exceptions.

In addition, there is a prohibited transaction if a fiduciary with respect to a plan:

- Deals with the assets of the plan in his own interest or for his own account;
- In his individual or in any other capacity acts in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan, or the interests of its participants or beneficiaries; or
- Receives any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

**Observation:** Normally, a 403(b) plan fiduciary would not be expected to engage directly in transactions with the plan that would obviously be prohibited transactions. This is because 403(b) plans generally must be invested in annuity contracts and custodial accounts held by a bank, trust company, or an IRS-qualified custodian. However, 403(b)

plan fiduciaries should be cautious that they do not deal with the assets of the 403(b) plan in their own interest or in order to receive some personal consideration. Examples of this might include receiving “kickbacks” from providers or their sales people, as would be the case where the fiduciary receives a personal gift from a provider in return for selecting them as a provider. These, too, can be prohibited transactions, and such amounts must be repaid, with interest.

Under any circumstances, prohibited transactions must be unwound as soon as possible and the plan made whole, which is often at great cost. They must also be reported on the Form 5500. Fortunately, one of the worst consequences, an excise tax under Code section 4975 that can be equivalent to 100% of the amount involved, does not apply to 403(b) plans.

## Fiduciary Best Practices

ERISA does not provide a list of concrete things fiduciaries must do. Rather, it is a principles-based regulatory system. That said, over the decades, “best practices” have developed that have become commonplace in the 401(k) world. These best practices are now becoming more common in 403(b) plans in much the same manner. Again, keep in mind that ERISA does not make any distinction between 403(b) plan and 401(k) plan fiduciary duties—ERISA just looks to whether the plan is subject to ERISA.

A large part of satisfying ERISA fiduciary duties is clearly identifying fiduciaries, and having those fiduciaries follow procedures which will guide them in acting prudently—what is often known as “procedural prudence.”

### **Appointment of a Fiduciary Committee**

Appointing fiduciaries to administer the plan and oversee investment decisions is critical. Those appointments should be consistent with the plan

document. A common best practice is to appoint a committee to oversee those duties. Though the fiduciary could be only one person or the employer itself, it is more common to have several individuals on the plan committee to divide up the duties, and to observe what is going on with the plan. In large employers, there may even be separate committees for administrative matters, such as overseeing employee communications, and handling benefit claims, or managing investment matters. The committee should have personnel who are familiar with pensions and investments. Providing the committee members some periodic education on the plan’s operation and on ERISA fiduciary duties is also considered a best practice.

**Observation:** Some plans name the employer as the named fiduciary. Such a plan may also provide that the duties can be delegated, which is typically what is actually going on. While permissible, note that it does not necessarily make it clear who has fiduciary responsibility for the plan in this case. For example, it may include board members and senior officers who are not aware of their duties.

Who to appoint to a plan’s fiduciary committee requires some thought. The goal should generally be to appoint the individuals who will be making the actual decisions, and thus will be the fiduciaries in fact. The idea here is that the best fiduciary decisions are made by people who understand they are fiduciaries and what their duties entail. In addition, one does not want to have a committee made up of people too senior or too busy to fulfill their duties, nor people so junior that they do not have the ability to make independent decisions.

### **Written Committee Charter**

Consistent with the idea of “procedural prudence,” a committee should have a written charter outlining its organization (chairman, secretary, quorum, etc.), responsibilities, how it operates and decides matters, how it conveys its decisions to others (such as by the secretary), and how often it meets.

## Periodic Committee Meetings

Once appointed, the committee should meet regularly. Once a quarter is common for most institutions, though special meetings may be held for good reason. Minutes should be kept of each meeting. The minutes should concisely cover all the important issues discussed.

## Investment Policy Statement

It is also a best practice to have an Investment Policy Statement (IPS). Generally, for a 403(b) plan, this does not identify specific investments; rather such a statement outlines the criteria for selecting and monitoring the providers and investment options. There is no standard form for an IPS, but a typical one will cover:

- Clear identification of the plan and the fiduciaries responsible for investments under the plan;
- Identification of the asset classes that are generally intended to be available under the plan (e.g., domestic large cap, domestic small cap, etc.);
- Selection criteria for a mutual fund or other investment to be added and/or removed from the plan, such as history, management, style, past performance, benchmarks and fees;
- Ongoing investment monitoring criteria, such as benchmarks and fees; and
- Use of investment consultants.

## Initial Evaluation of Investment Providers and Investments—the Request for Proposal Process

To fulfill the fiduciary duty to prudently select investment providers and their underlying investments, it is a best practice to do so in an organized and documented manner in accordance with the plan's IPS. A common question that arises is whether a formal Request for Proposal (RFP) process is necessary. While we do not believe an RFP is mandated by ERISA, the use of RFPs is common in 401(k) plans and especially by larger plans.



**Observation:** An RFP process does not need to be overly complicated. It is important to keep in mind that its purpose is to elicit clear information from possible investment and service providers regarding the services they will provide to the plan, along with their fees and other costs. To that effect, the RFP should provide prospective providers the existing plan documents and current Summary Plan Description (SPD) and plan information. The RFP should also be very clear about whether, in addition to investments, the plan sponsor is seeking administrative services, such as plan documents, SPDs, record-keeping, distributions, testing for IRS contribution limits and nondiscrimination testing, and preparation of 5500s (and whether they will consider respondents who provide only some of those services). It is common for sponsors to consider utilizing the RFP process to survey the market every 3 to 5 years.

Evaluation of the RFP responses is the most critical step in the process. Fiduciaries should review responses from providers carefully and select the provider that can provide products and services consistent with the needs of the plan.

**Example:** A university updates its plan document, selects a fiduciary committee that is knowledgeable in investing, adopts an IPS, and distributes an RFP. The university receives outside investment advice on the selection of the investments from a provider offering investment products. This process is well-documented. The committee continues to meet quarterly and review the performance of investments consistent with their IPS. The university in this case is following best ERISA practices.

### **Evaluating Investment Fees**

A significant amount of litigation and attention has been given by the DOL to fees charged by providers to participants and beneficiaries. Allegations have included fiduciaries not properly determining if their plan is obtaining services in line with the fees assessed by its providers, and whether or not, as a fiduciary, they could have selected other comparable investments at a lower cost to participants. While some of the allegations have perhaps tended to overemphasize the fees paid without proper attention to the services provided, the controversy has served to remind fiduciaries of their duty to understand the fees that the plan is paying. Additionally, in this situation, fiduciaries need to consider whether they can lower fees by obtaining comparable investments and services. Being aware of what fees are being paid (both directly and indirectly), taking them into account as a factor in making investment decisions, and documenting that is considered a critical best practice for fiduciaries.

### **Monitoring Investments**

*Not only does a fiduciary have a duty to prudently select the provider and the investments available under the 403(b) plan, fiduciaries have an ongoing duty to monitor those investments.* As a best practice, the fiduciary committee should meet at regular intervals and compare the returns of the selected investments with their “benchmarks.” The benchmarks should also be prudently chosen and evaluated from time to time. This process should be outlined in the IPS, and minutes of the meetings on this should

be kept. If concerns are raised about the performance of a particular investment or other issue, such as a change in management of the fund or “style drift,” the committee should investigate and take appropriate action. The committee should take action even if only to watch the investment until the next meeting. And the committee should also be prepared to follow up on any actions it decides to take, to best ensure that their direction has been followed. Any and all concerns addressed by the committee should be reflected in committee minutes.

### **Fund Mapping, Blackouts and Default Investments**

Though outside the 403(b) focus of this paper, 403(b) plan sponsors should keep in mind that ERISA provides guidance on a number of common transactions and decisions, and many providers have incorporated this guidance into their practices. Examples include fiduciary safe harbors arising out of the Pension Protection Act of 2006 when selecting “default investments” and the “mapping” of funds moved from one investment provider to another. ERISA also provides guidance on the regulations governing “blackouts” and their required notices when funds are moved. Fiduciaries of 403(b) plans should consult with their providers and tax and legal advisors regarding such practices.

## **Special 403(b) Problem Areas and How to Mitigate Them**

### **Fee Disclosure**

Though much of the litigation arising out of plan fees directly applies to 401(k) plans, some of the litigation has involved 403(b) plans as well. However, because ERISA compliance in the 403(b) markets has lagged behind compliance in the 401(k) markets, information on the fees for 403(b) products is at times unavailable or incomplete. Additionally, 403(b) plan fiduciaries are not always familiar with how to obtain this information and evaluate it. It is important, however, that 403(b) plan fiduciaries

begin to give ERISA compliance serious attention as part of their overall fiduciary best practice efforts.

### **Money in Contracts that Cannot Be Moved**

One of the more controversial issues in the 403(b) market is the consolidation of providers. This issue is in reaction to the enhanced administrative needs 403(b) plans have in light of the final 403(b) regulations. Another pressing issue is the question of holding investments in annuity contracts (and sometimes custodial accounts, though it is less often an issue under custodial agreements) that cannot be moved without the consent of the participant.

It is one of the longstanding quirks of 403(b) annuity contracts that they often do not allow employers much control over such contracts, unlike what you would find in a typical 401(k) plan arrangement. These contracts regularly indicate that money cannot be transferred to another 403(b) annuity contract or custodial account without the participant's consent. This condition is most often found in insurance company (annuity) contracts, though the employer should review relevant custodial account agreements as well.

This creates a dilemma for a 403(b) plan fiduciary. First, the fiduciary should consider whether this is consistent with the plan document in terms of who has the authority to determine plan investments. Does a conflict exist, for example, when a plan says the fiduciary committee selects investments, and an annuity contract does not allow the fiduciary committee to do so? IRS authority has suggested that the plan document should perhaps control (see, for example, IRS Ann. 2009-34), but it is not at all clear that the insurance company issuing the contract or the state insurance regulators charged with enforcing participant rights under insurance contracts will agree. A plan sponsor caught in this situation should consider his or her steps carefully. For example, how clear is the provision in the contract that the provider is relying upon to deny the employer direction without participant consent? And a corollary question is, if the committee under the plan has no authority over

the contract, does the insurance company become the fiduciary for the contract? Or is the insurance company just enforcing the terms of the contract? What is the position of the insurance company concerning these responsibilities? (This is something of an open issue).

In all of these areas the 403(b) market is still feeling its way through, so definitive answers for all situations may not yet be clear, but the process of deciding what to do as a fiduciary is of the utmost importance.

Some practical ways to mitigate this concern may include addressing the issue through the educational campaign on the new plan, making it as easy as possible for the participants to voluntarily move their monies to the new provider. However, the plan fiduciaries should be careful that education does not slip into investment advice, which would make them potential fiduciaries for recommending the investment change.

#### *Investment Education vs. Investment Advice:*

Investment education generally includes provision of plan-related information (e.g., information regarding the new investment options), general financial and investment information, generic asset allocation information and models, and interactive materials (such as computer programs) to review and compare the (generic) effects of different asset allocations. Investment advice, on the other hand, entails the regular (i.e., more than just once) provision of information describing the value of securities or other property, or making recommendations as to the advisability of investing in, purchasing, or selling securities or other property on the understanding that the advice will serve as a (not the) primary basis for the participant's investment decisions.

Also, in some cases, surrender charges and fees assessed by the previous provider may make it difficult or expensive for the participant to move monies to the new provider. Some practitioners believe that the employer could credit such

expenses back to the participants if they could be construed as “restorative payments” under applicable IRS regulations. The law in this area is not entirely clear, so an employer would need to consult with its own tax or legal counsel.

Some plan sponsors are designing their plans so that loans and hardship distributions are not available from those previous providers. This may encourage participants who want such a loan or hardship distribution to move their money to the current provider to obtain one. However, this raises a question of whether a conflict arises with the terms of the contract.

### **Monitoring 403(b) Contracts Over Which the Plans Sponsor Does Not Have Complete Control**

In many cases, both before and after the final regulations, because of the traditional structure of the 403(b) market, the employer may not have moved (and as described above, may not have been permitted to move) money from the previous provider to a new provider. And so the assets sit at the previous provider and are invested in whatever the provider offers under its contract.

Alternatively, the plan sponsor may have selected a new provider, but may not have much control over what is offered to the participants. The new provider retains the discretion over what funds are available once they are the investment provider to the 403(b) plan.

Both create a dilemma that usually does not exist in the 401(k) market. Is there a duty to monitor a current or legacy investment if there is nothing the fiduciary can do if he or she learns of an issue regarding that investment? One view might be yes—the fiduciary should monitor as well as try to move legacy investments into a position like that under a 401(k) plan where the fiduciary does control whether the assets will be invested with that provider and its funds.

Currently, though, that may not be a realistic approach with many 403(b) investment products.

Alternatively, the fiduciary may seek to clarify with the legacy or current providers involved that they will act in the interest of the participants and beneficiaries for any decision the provider may make. Even in that event, there is an argument to be made for continued monitoring to avoid potential co-fiduciary liability. The point here is that any issues that are detected with those investments should prompt the fiduciary to take appropriate reasonable steps. This may include making an inquiry of the provider and requesting additional information concerning the issue, or communicating the issue to employees.

### **Are Older Contracts Still Plan Assets Subject to ERISA Fiduciary Duties?**

A related concern is whether a plan fiduciary can take the position that it no longer has duties with respect to older contracts of terminated employees. The position would be based on the assumption that the contract represents amounts that have been distributed from the plan and are thus no longer ERISA “plan assets.” This is another area that currently is very unclear. The conservative approach would probably be to take a position that unless there has been a formal distribution of the monies in the contract to the participant or an IRA, or a rollover distribution out of the plan, the contract or account may not have been distributed, and should still be considered part of the plan, even if the participant has terminated employment.

For example, the mere fact that an employee may have terminated employment, and that the monies in his or her contract were transferred to another annuity years ago, may not necessarily mean that the contract is no longer part of the plan or subject to ERISA—even though IRS transition guidance may allow it to be treated as separate and apart from the plan for Code purposes. This is a rough parallel to the operation of a 401(k) plan under ERISA.

There is, however, some guidance under ERISA for treating certain contracts as distributed and no longer plan assets. Typically, this has been applied in the defined benefit qualified plan area, and we understand the DOL has the issue under consideration for 403(b) plans.

### **Best Fiduciary Practices for Non-ERISA Plans**

Even if a plan is not subject to ERISA, such as a church, or public college or university 403(b) plan, we believe it is prudent for the plan to follow ERISA-like fiduciary best practices voluntarily. In many states, there may be general fiduciary duties under common law or under statutes for charitable entities and for certain public retirement plans. How these might apply to a church or governmental 403(b) plan may be untested, but one does not want to be the test case.

As a general rule, therefore, being able to say “we performed to the same standard as if we were ERISA fiduciaries even though we are not” will be a much more defensible position in litigation than doing nothing. Adopting ERISA-like claims procedures in a plan document can also be protective, and perhaps afford more judicial respect for the reasoned decision of a fiduciary.

## Summary

Plan sponsors and fiduciaries of ERISA 403(b) plans should not panic if they have not taken the steps described above as best practices. But they should no longer feel comfortable with the status quo either. At this point in time, there may be some hesitation, but as employers grasp the implications of ERISA and their fiduciary duties, they are rapidly moving toward compliance. Adopting more 401(k)-like fiduciary practices among 403(b) ERISA plans is underway. This will mean determining who the fiduciaries are or should be for plan administration and investments, cleaning up the plan document, and selecting and monitoring all providers. In the 403(b) market, that may mean some hard decisions about prior providers, especially with respect to monies that cannot be moved or where the employer’s ability to affect investments is limited. It certainly means that fiduciary decisions need to be made in an organized manner with the interests of the participants and beneficiaries in mind, and not haphazardly or in the interest of the employer or others.

*This paper is to provide general information only, does not constitute legal advice as part of an attorney-client relationship, and cannot be used or substituted for legal or tax advice. Sponsors of 403(b) plans should consult their own tax or legal advisors with respect to their 403(b) plans. Any tax information contained in this paper is not intended to be used and cannot be used by any taxpayer to avoid penalties under the Internal Revenue Code, and such information cannot be quoted or referenced to promote or market to another party any transaction or matter referred to in this paper.*



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