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White Paper

I think I'm a fiduciary

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Lately, the word on the street has been that retirement plan fiduciaries are being put under a high degree of scrutiny for their actions or, more importantly, their inactions. What follows will help you determine if you are a fiduciary and what to do if you are.

WHAT MAKES ME A FIDUCIARY?

You might ask yourself, "What makes me a fiduciary?" Well, in short, you become a fiduciary by title or by action, often relying more on the latter. The Employee Retirement Income Security Act (ERISA) defines a retirement plan fiduciary as a person or entity that does any of the following with regard to a retirement plan:

- Exercises control or authority over the management of the plan or the plan's assets
- Provides investment advice for a fee
- Has discretionary authority over plan administration

Usually, ERISA also requires that a retirement plan name a specific person, employee organization, or association as a fiduciary. In most circumstances, the plan sponsor has the authority to designate a named fiduciary, which then has the authority, control, and responsibility to manage the operations of the retirement plan. For example, a retirement plan specifically names certain trustees in the plan document as the fiduciaries. These named trustees would satisfy ERISA's fiduciary definition because they would have discretionary authority over the administration of the plan.

Plan sponsors can also name a directed trustee with the authority to perform limited functions for the retirement plan. These functions may include:

- Checking or planning payout processing
- Processing trading instructions from a plan administrator
- Having custody of plan assets
- Limited plan reporting

In carrying out these functions as instructed, the directed trustee is a fiduciary, but only in a limited capacity. The directed trustee's fiduciary liability is lessened by the fact that he or she merely reviews and determines the appropriateness of the instructions given by the plan sponsor.

Because of ERISA's broad fiduciary definition, plan sponsors are almost always fiduciaries to their plans, whether they assign other fiduciaries or not. In general, if the plan sponsor maintains a position of authority over the management of the plan or its assets, or oversees the selection of fiduciaries who will exercise control over the plan or plan assets, then the plan sponsor is a fiduciary. A plan sponsor that oversees the selection of a person or entity that offers investment advisory services to the plan also is a fiduciary.

Who is not a fiduciary?

Professional service providers typically are not considered fiduciaries if they offer:

- Legal services
- Accounting or auditing services
- Recordkeeping or third-party administration services
- Actuarial services

However, if (a) the services provided to the plan result in the service provider exercising discretionary control over the plan, the plan's administration, or the plan's assets, or (b) investment advice is provided for a fee, then the service provider is a fiduciary.

Who cannot be a fiduciary?

ERISA prohibits individuals or entities that have committed certain types of crimes from serving as fiduciaries.

These crimes include:

- Robbery, fraud, or embezzlement
- Grand larceny, perjury, or mail fraud
- Kidnapping, murder, or assault with intent to kill
- Violations of the 1940 Investment Company Act
- Labor-management-related violations
- Previous ERISA-related violations

OK, SO I'M A FIDUCIARY…WHAT NOW?

Fiduciary standards

Fiduciaries are required to act prudently and in the best interest of plan participants and beneficiaries when making decisions concerning the plan. When selecting plan investments, ERISA charges the fiduciary with diversifying the plan assets in a manner that minimizes the risk of substantial losses. Generally, a participant-directed plan must offer at least three distinct diversified investment options: a cash/money market investment, a bond-type investment, and an equity investment. By offering participants the right to direct the investment of their account balances, a plan can limit fiduciary liability with respect to losses arising from a participant's investment decisions under section 404(c). Finally, a fiduciary must assure that the operation of the plan is in accordance with a plan document, investment policy statement, loan policy, and QDRO policy.

ERISA holds any fiduciary responsible for a failure to report a known breach of duty by any other plan fiduciary. Some examples in which a fiduciary may be held accountable for another fiduciary's actions include:

- Overlooking or concealing the acts of a co-fiduciary
- Failing to satisfy one's fiduciary duties, which leads to another fiduciary committing a breach
- Having knowledge of a fiduciary breach and doing nothing to report or remedy the breach

If a fiduciary relies upon outside service providers such as professional investment advisors or recordkeepers, guidelines should be established to monitor their performance and to ensure that the third parties act prudently and in the best interests of plan participants and beneficiaries. Following the standard of procedural prudence, fiduciaries may want to consult experts regarding the selection and monitoring of recordkeepers and investment advisors.

Parties-in-interest and prohibited transactions

ERISA also provides guidance on the types of transactions that constitute a breach of fiduciary duty. The regulations also define a party-in-interest, who must not engage in specific transactions within a retirement plan, as:

- A fiduciary or counsel to the plan
- Persons or owners of corporations providing services to the plan
- The employer sponsoring the plan
- A relative of any of the above persons
- An employee organization whose members participate in the plan

A plan fiduciary breaches his or her duties by engaging in or allowing the following types of transactions between the plan and a party-in-interest:

- The selling, exchanging, or leasing of property
- The lending of money
- The furnishing of goods and services
- The transferring of plan assets, or using plan assets for a party-in-interest's or another individual's personal benefit
- The acquiring or holding of an employer security or employer real property with a value that is greater than permitted by ERISA

The Department of Labor (DOL) has the authority to grant exemptions to the prohibited transaction rules. Exemptions may be granted if the transaction is administratively feasible and in the best interest of the plan participants and beneficiaries. These exemptions may not be relied on in instances of self-dealing by a fiduciary.

Correcting a fiduciary breach

In the event of a fiduciary breach, the fiduciary should reverse the transactions that caused the breach and restore the plan to the same position it would have been in if the breach had not occurred. The fiduciary must also relinquish any profits arising from the transaction that resulted in a breach and is personally liable for any losses arising from the prohibited transaction. DOL has issued guidance on how plans may self-correct certain breaches. Plan participants may bring civil action against fiduciaries in the event of a fiduciary breach, but only to obtain equitable relief for the plan. They may not sue a fiduciary to recover personal damages. Even if the fiduciary breach does not result in a loss of plan assets, the plan may either suspend or terminate the fiduciary.

I'VE BEEN READING ABOUT SOME 401(K) LAWSUITS. AM I AT RISK OF GETTING SUED?

During September of 2006, a number of class-action lawsuits were filed against plan sponsors as well as other named fiduciaries of the retirement plans. The suits were against seven Fortune 500 corporations. The cases, in general, allege that the defendants (the plan sponsors and fiduciaries) had breached their fiduciary duties by subjecting plaintiffs (participants in the plans) to excessive fees and expenses that were not disclosed. The cases also detail that the expenses and associated revenue-sharing payments had reduced participant account balances, the basis for the claims.

What's revenue sharing?

It's probably a good time to define "revenue sharing." It can go by various names: shareholder servicing allowance, sub-transfer agent payments, expense reimbursements, etc. In short, revenue sharing is a payment from an invesment management company to a service provider or distributor when a retirement plan invests in one of their funds. This payment represents the portion of the fund's overall operating expense ratio that would be used by the fund's management company to pay the cost of servicing the individual shareholders. Since in a retirement plan the assets are held at an omnibus level and the recordkeeper deals with the individual participants on the fund's behalf, this portion of the expense ratio may be paid to the plan's recordkeeper. Used in this manner, revenue sharing should be applied to the costs of operating the plan–i.e., recordkeeping and accounting services, processing fund transactions, custodial/trustee interface services to the plan, providing enrollment materials, and statements and call center services to participants. From a fiduciary perspective, it is important that revenue sharing be fully disclosed to the plan sponsor and fully reconciled relative to the costs of operating the plan.

During 2007, a couple of the lawsuits were dismissed; however, plan sponsors and fiduciaries for retirement plans should take notice that their future actions will be under a higher level of scrutiny. In addition, in the U.S. House of Representatives, Rep. George Miller (D-Calif.) introduced for consideration the "401(k) Fair Disclosure for Retirement Security Act of 2007," which, if passed, would require that additional disclosure be made to plan participants related to their retirement plans. The act aims to:

- Require plan administrators to disclose all fees charged to the plan
- Provide information to help employees understand their available investment alternatives
- Require 401(k) plans to include at least one balanced-index type investment
- Require the disclosure of all conflicts of interest to plan sponsors
- Provide the DOL with more authority in the oversight of 401(k) plans

In general, plan sponsors (and fiduciaries) should take seriously their responsibilities to the retirement plans they are representing. It is their duty to understand their own responsibilities as well as those of other fiduciaries to the plan.

Some of the most common areas of exposure to risk are related to:

- Plan operations – Are human resources staff, your payroll provider, and plan recordkeeper following the direction of the plan document, IPS, loan policy, and QDRO policy?
- Plan oversight – Plan sponsors often establish committees to set policy without an understanding of their responsibilities as an employer or a fiduciary to the plan. Are the persons responsible for the plan aware of the service providers, fees and expenses, and roles of all of the parties involved?
- Investment policy oversight – Again, plan sponsors often set up committees to periodically review the plan investments. Are members of the committees following an investment policy statement, monitoring investments, and documenting decisions?

WHAT CAN I DO TO LIMIT MY EXPOSURE TO RISK?

The investigations of "late trading" and "market timing" by the mutual fund industry a couple of years ago started a wave of heightened awareness, followed by the lawsuits against plan fiduciaries in 2006. Going forward, we will most likely see requirements related to disclosure of fees, revenue sharing, and investment expenses. These items are the "hot" topics of the early to mid-2000s, which come in addition to the other items required of plan fiduciaries. Earlier this year Milliman published another paper focusing on one of the issues addressed in the lawsuits—fees.

As a plan sponsor (and a fiduciary), one of your duties is to understand the fee structure of all of your service providers.

If this is unclear, it is your responsibility to fully comprehend the real costs related to your service providers (record keepers, investment managers, and consultants). Hiring an independent consultant may help; however, it is your duty to understand their compensation structure and any compensation-sharing agreements they may have with other vendors and service providers. As a fiduciary it is your duty to look at any areas where exposures can occur.

In addition to fees, there are other areas where you should focus your attention. Following the recommendations below may help limit plan fiduciaries' exposure to risk.

1. Know who your plan fiduciaries are and what their roles are. Remember, you can be a fiduciary by title or by action, so having a general understanding of your role is important.

2. Wrap your hands around the cost of the retirement plan. Yes, we've all heard "It's free, trust me." Be skeptical, ask questions. Understand the true cost of recordkeeping and investment management.

3. Don't be afraid to ask for a reconciliation of revenue-sharing payments and any other plan reimbursements.

4. Make sure the plan is following any written documents. Are the plan recordkeeper, trust company, and staff working on the plan all following the plan document and loan policy?

5. Look for conflicts of interest. Are any of the plan fiduciaries involved in prohibited transactions with the plan?

6. Does the plan have an investment policy statement? Are investments being monitored and replaced if they are not meeting the policy requirements?

7. Rotate your committees. A good way to uncover things that may go uncovered for extended periods of time is to change committee members and reassign responsibilities.

8. Conduct regular compliance reviews or audits of the plan policies, procedures, and operations.

To read more about fee issues, go to www.milliman.com and search on "hidden fees."

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