OVERVIEW: RETIREMENT PLAN FIDUCIARY DUTIES, INDEPENDENT EDUCATIONAL ORGANIZATIONS

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Summary

The obligations of retirement plan fiduciaries have been described as the "highest duties known to the law." Recent regulations clarify that these duties apply if your organization contributes from its operating budget to a retirement plan, or otherwise exercises control, even if you previously viewed it as an individual retirement arrangement. Officers or committees charged with managing a plan and the investment of its assets—the plan's fiduciaries—must meet high standards of conduct. Plan fiduciaries should take appropriate steps to satisfy specific and general duties. For many educational organizations, establishing a prudent process is the single-most important step at this time.

Your organization's Fiduciary Duties.

Your organization's duties consist of *specific* and *general* duties. The *specific* duties require the trustee to administer the plan and decide the investments plan that the plan will make available, to follow the terms of the plan document (so long as that is consistent with the requirements of ERISA or state law, as applicable[i]) and to provide participants with diverse choices so as to minimize the risk of large losses.

The *general* duties are more broadly defined and relate to any fiduciary conduct, not only the carrying out of plan responsibility. General duties are:

- The requirement that all fiduciaries (regardless of the scope of their authority) act in the best interest of the participants, referred to as the "duty of loyalty."
- Fiduciaries must operate the plan for the exclusive purposes of providing benefits and paying reasonable expenses of plan operation. This is called the "exclusive purpose" rule.
- To arrive at plan decisions, they must follow a "prudent process."

In participant-directed defined contribution plans, including those established under Internal Revenue Code §403(b), the duty of loyalty requires fiduciaries to make decisions regarding the investments available and operation of the plan in order to support adequate retirement savings by the employees. Stated another way, the fiduciaries' role is to ensure that the plan is designed for success, *i.e.,* the plan is operated in a manner that facilitates employee participation, adequate employee deferral rates and appropriate allocation by participants to prudently selected and monitored investment options.

The exclusive purpose requirement–using plan assets to pay no more than reasonable expenses–relates closely to the duty of loyalty. Expense deductions from the investment accounts established by the plan fiduciary, in the name of individual plan participants, are a major factor in determining whether participants will accumulate adequate retirement savings. Fiduciaries must make certain that any expenses paid out of plan assets are reasonable in light of the services received.

Whether the fiduciaries are performing their duties well or poorly is judged under ERISA's prudence requirement. This rule requires fiduciaries to perform their duties with the care, skill, prudence, and diligence "under the circumstances then prevailing" 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." In light of the requirement that the fiduciary be "familiar with" the conduct of a retirement plan, this is sometimes referred to as the "prudent expert" rule.

Tie your organization's plan decisions to a Prudent Process.

The prudent expert rule describes the conduct expected of fiduciaries in carrying out the duty of loyalty and the exclusive purpose requirement and is, therefore, central to an understanding of fiduciary duties. Based upon our work with independent schools and other non-profits—large and small, nationwide—decision-making merits more detailed scrutiny:

- First, retirement plan fiduciaries must be careful, skillful and diligent in carrying out their duties.

- Second, ERISA fiduciaries must be "familiar with such matters" in conducting an "enterprise of like character and with like aims." Essentially, the fiduciary must have a level of expertise, specifically in the operation of a participant-directed retirement plan. The courts have expanded on this obligation to require that if the fiduciary is not "familiar with such matters," he must take steps to find experts to assist him in carrying out these duties.

- Finally, the duty is a dynamic one. That is, ERISA requires fiduciaries to take into account "the circumstances then prevailing" in operating the plan. This requires fiduciaries to periodically examine whether conditions that affect the operation of the plan and its investments have changed so that new decisions need to be made.

This last requirement of the prudent expert rule is referred to as the duty to monitor and is a cornerstone of fiduciary conduct. It requires 403(b) plan fiduciaries to make periodic re-evaluations of their decisions regarding the plan's operation and investments – often on a quarterly basis for the investments – and then, as circumstances dictate, to conduct a more wide-ranging reassessment of all decisions regarding the plan, from structure to investments to service providers to costs and compensation. This reassessment is especially critical during times of rapid change in provider capability, technology, the regulatory environment and the world economy. In essence, the duty to monitor means that fiduciaries may need to change their minds from time to time and remove and replace investment products, funds or service providers that no longer meet the objectives of the plan.

To assist fiduciaries in understanding how to act prudently, the courts and the U.S. Department of Labor (DoL) have indicated that the rule has two parts. First, in the context of investments, a DoL regulation says that fiduciaries must give "appropriate consideration" to those facts and circumstances that the fiduciary "knows or *should know* are relevant" [emphasis added] to the particular investment decision being made and then act accordingly. In essence, the DoL is describing the *process* in which fiduciaries must engage. They must determine the right questions to ask (so that they take into account what they *should* know is important), determine what is relevant to answering those questions, conduct an investigation to obtain the information and then evaluate the information (*i.e.*, give it appropriate consideration) in light of the needs of the plan they serve. This is referred to as *procedural* prudence. As described by the DoL, procedural prudence requires fiduciaries take into account what they already know and, in addition, what they should know about in making their decisions. This aspect of the prudence requirement emphasizes the need to obtain expert assistance when fiduciaries do not have the expertise or, sometimes, just the access to information, to conduct a proper investigation.

But there is a final step. Fiduciaries must "act accordingly." It is not enough to investigate and assess. In order to carry out their duties, the fiduciaries must make decisions that are informed and reasoned based on the information they have gathered and evaluated. This part of the prudent process is sometimes referred to as *substantive* prudence.

For example, consider the obligation to pay only reasonable expenses of operation, as one of the most important factors that need to be taken into account. The plan sponsor must first *gather* the expenses related to the investment options and the fees and compensation being received by service providers. Then the plan needs to *evaluate* those expenses and services by comparing to other, similar plans. Then, unlike sponsors of most other defined contribution plans, <u>a 403(b) plan fiduciary needs to factor in the specific terms of the plan's funding vehicle(s)</u> because many annuities, and some mutual funds, historically used in 403(b) plans have substantial contract-level limitations or encumbrances. Only after accordingly *negotiating* the contract(s) can the plan fiduciary reach an informed, reasoned decision whether fees are reasonable.

Wary fiduciaries should understand, as the DoL has stated, that "Prudence focuses on the process for making fiduciary decisions." The courts stress that the fiduciaries' conduct will be measured as much by *how* they carry out their duties as by the outcomes they achieve. While the final decision the fiduciaries make is clearly important, they don't always have to be right so long as they can demonstrate that their process in reaching the decision was prudent. In other words, fiduciaries have a "right to be wrong," to make choices that may ultimately prove to be wrong so long as this could not have been anticipated by a thorough and diligent investigation and on-going monitoring.

Conclusion

Fiduciaries bear heavy responsibilities under ERISA. Their actions may dictate whether or not participants in the plan they serve will be able to retire with adequate retirement benefits. In fulfilling their responsibilities, they must focus exclusively on what is best for participants for the sole purpose of accumulating retirement savings and engage in a prudent process of decision-making and periodic re-examination. And this means gathering and sifting data, considering what they know to be relevant today and what may turn out to be relevant tomorrow, and turning to experts to help them when necessary.

For more in-depth discussion of fiduciary duties and principles, please contact: <u>Richard (Dick) Shafer CEBS</u>, Executive Director, Well and Good LLC, telephone 608.256.9882. <u>Well and Good LLC</u> is registered with the Securities and Exchange Commission and provides investment advice only under the terms of a written, signed and dated Investment Advisory Agreement. The information in this overview is <u>not</u> intended to provide investment advice. Well and Good LLC does not furnish legal, tax or accounting advice.

April 2013

[i] ERISA (the Employee Retirement Income Security Act of 1974) applies to most retirement plans of independent non-profit organizations. If you consider yourself a "church plan" sponsor, state law may apply rather than ERISA. In describing plan fiduciary duties, many states use language very similar to ERISA.