Best Practices for Retirement Plan Fiduciaries

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IU-84238 (4/13)

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Agenda

- Compliance Framework for Employee Benefit Plans
- What/Who is a Fiduciary?
- Basic Fiduciary Duties
- Delegation of Responsibilities
- Settlor v. Fiduciary Acts
- Limiting Liability
- Prohibited Transactions
- Correction Programs
- Action Steps

Compliance Framework

- Employee benefit programs must operate within a "***compliance framework***"
- The "compliance framework" consists of the laws and regulations which govern the establishment and ongoing operation of employee benefit programs for the benefit of employers and employees
- These laws and regulations are complex and constantly changing

Compliance Framework

- **The Employee Retirement Income Security Act of 1974 ("ERISA"), Department of Labor Regulations & guidance protect the rights of plan participants and beneficiaries**
  - To protect participants and beneficiaries, Section 404(a) ERISA sets ***standards of conduct*** for the individuals who manage an employee benefit plan and its assets
- The Internal Revenue Code, Treasury Regulations and Internal Revenue Service guidance allow tax-advantaged benefits for employers and their employees

Key Elements of a Plan

- Written plan document describing the structure of plan benefits and operation
- Plan must have a “named fiduciary” (identified by office or name, can also be a committee)
- Trust fund holding plan assets
- System for recordkeeping the flow of assets to and from the plan
- Explanatory documents for plan participants (SPD, SAR, blackout notices)
- Documents to provide information to the government (Internal Revenue Service, Department of Labor, Pension Benefit Guarantee Corporation)

What is a Fiduciary?

- Generally, a position of trust acting for the benefit of others with a high duty of care and loyalty

- Under ERISA, any person who exercises **discretionary** authority or control over plan assets or administration, or gives investment advice

Who is a Fiduciary?

- Employer/Plan Sponsor
- Plan Administrator
- Trustee
- Investment Manager

- Even if an individual does not hold a title or position associated with fiduciary status, his/her actions may cause him/her to be a fiduciary ("functional fiduciary")

Basic Fiduciary Duties

- Act solely in the interests of plan participants and beneficiaries with the exclusive purpose of providing benefits to them ("***duty of loyalty***") – avoid prohibited transactions

- Be prudent – act with care, skill, prudence and diligence of a person acting in a like capacity and familiar with such matters (the "***prudent expert rule***")

- Understand and follow the terms of the plan documents! (unless inconsistent with ERISA) – make sure documents are up to date as required by current law

- Diversify plan investments to minimize risk of large investment losses

- Pay only reasonable and necessary expenses

Co-Fiduciaries

- Individuals who serve as fiduciaries for the same plan
- All fiduciaries have potential liability for the actions of their co-fiduciaries
- If a fiduciary knowingly participates in another fiduciary's breach, conceals the breach or does not act to correct it, that fiduciary is liable as well
- A co-fiduciary is a fiduciary
- Delegation of duties and responsibilities among co-fiduciaries should be defined carefully in writing
- Distinctions among fiduciary positions should be strictly enforced
- A fiduciary should understand from whom and among whom his or her duties have been delegated—to whom he or she is accountable

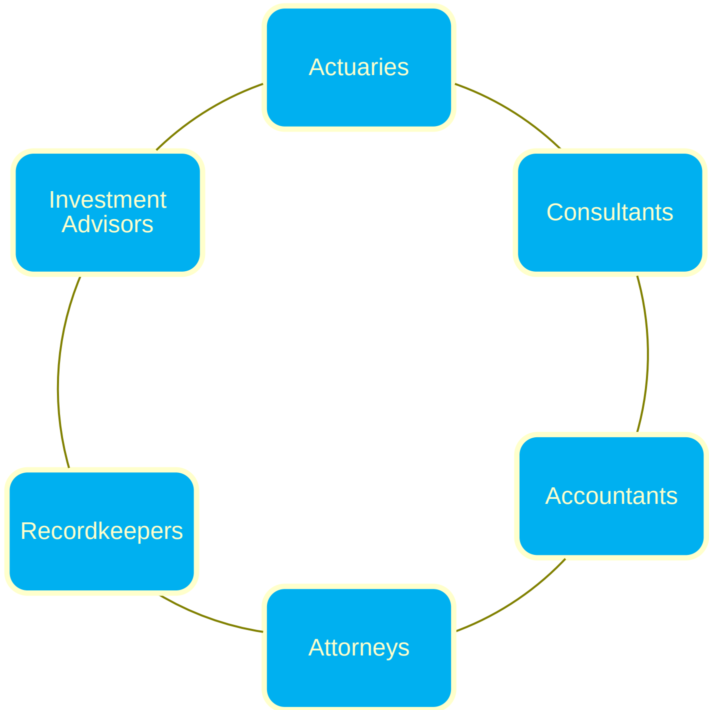
“Settlor” v. Fiduciary Functions

- Business (“settlor”) decisions are not governed by fiduciary rules
  - Plan establishment and design
  - Plan amendments (other than legally required amendments)
  - Decision to terminate a plan
- Expenses related to settlor activities may NOT be paid from plan assets
- ***Implementation*** of settlor decisions may be fiduciary acts governed by fiduciary rules

Delegation of Fiduciary Responsibilities

- A plan may contain procedures that allow a plan fiduciary to hire service providers to handle certain fiduciary functions
- Service provider may assume liability for its functions by agreement with the plan
- Despite this delegation, fiduciaries still retain duty to:
  - Ensure the service provider understands their responsibilities and has knowledge and information necessary to carry out their duties
  - Monitor performance on an ongoing basis

Role of Service Providers



- *Ministerial functions*
- *Act at the direction of Plan Fiduciaries*
- *No use of discretion*
- *Information provided in professional capacity*

Selecting Service Providers

- A fiduciary function
- Evaluate complete and identical information for a meaningful comparison
- Information to consider:
  - Information about firm (financial condition, experience with plans of similar size and complexity)
  - Quality of services (identity, qualifications and experience of persons handling the plan's account, recent litigation)
  - Description of business practices, existence of liability insurance
- Document, document, document

Monitoring Service Providers

- Establish and follow a formal process for review at regular intervals

- Verify that agreed-upon services are being provided at a satisfactory level through:
  - Review of provider’s performance
  - Review of reports provided
  - Audit actual fees charged
  - Review policies and practices
  - Follow up on participant complaints

- Document findings and any related decisions

- Remember that a fiduciary may be personally liable for a service provider’s failure to carry out its responsibilities

Fees

- Plan fiduciaries have a duty to ensure that fees and expenses paid by a plan are reasonable
- Decisions should be based on cost and quality of services
- When comparing fees of service providers know what services are needed and the associated costs
- Remember, all services have costs
- Know who is paying the fees (employer, plan, participants)
- Ask about additional compensation paid from plan investment vehicles

Plan Investments

- Fiduciaries have a duty to diversify plan investments in order to minimize risk of large investment losses

- Must understand investments relating to portion of plan assets over which fiduciary has discretion/control
- Adopt an Investment Policy Statement
- Hire an "investment manager" with discretion; or
- Hire service providers with expertise to provide necessary information to fiduciaries
- Be sure that where applicable, plan participants receive adequate investment information and education

Limiting Liability

- Understand, allocate and delegate responsibilities
- Follow statutory provisions that provide relief (e.g., ERISA 404(c) for participant directed account plans)
- Know the difference between “fiduciary acts” and non-fiduciary “settlor acts”
- Avoid “prohibited transactions”
- Maintain required bonding
- Consider fiduciary liability insurance
- Hire an independent fiduciary if needed

Participant Directed Investments – 404(c)

- 404(c) is an option which provides fiduciaries with a defense against certain participant claims
- Fiduciaries not liable for individual participant investment decisions if statutory requirements are met
  - Participants "exercise control" over investments
  - Must be able to choose from "broad range" of investments (at least 3 options)
  - Must be able to give investment instructions at least quarterly (more often if investment is volatile)
  - Must be given sufficient information to make informed decisions
- Fiduciaries are still responsible for selection and ongoing monitoring of plan investment options
- Qualified Default Investment Alternatives ("QDIA") provide 404(c) protection where participants do not make affirmative investment choices (automatic enrollment)

Prohibited Transactions

- A fiduciary cannot cause the plan to engage in a transaction that is directly or indirectly between the plan and a "***party in interest***"

- Purpose is to protect benefits promised to plan participants and beneficiaries

- However, exemptions from certain prohibited transactions do exist under ERISA ("statutory exemptions")

- Department of Labor may grant exemptions to classes upon application ("individual exemptions")

Parties in Interest

- Parties in interest are generally people or entities with a close relationship to the plan
  - Plan fiduciaries
  - Sponsoring employer (officers, directors, employees, 50% or greater owners)
  - Service providers (accountant, recordkeeper, attorney)
  - Relatives (spouses, ancestors, lineal descendants) of any of the above

Prohibited Transactions

- Causing plan to buy, sell or lease property to or from a party in interest
- Any loan or extension of credit to or from the plan and a party in interest
- Causing plan to receive goods or services from a party in interest
- Any use of plan assets to benefit a party in interest
- Self-dealing with plan assets for a fiduciary's own benefit

Statutory PT Exemption Examples

- Service Provider Exemption
  - Permits service contracts between parties in interest if:
    - Service is necessary
    - Contract is reasonable
    - Compensation received by service provider is reasonable
    - Service providers have furnished required 408(b)(2) disclosures to responsible plan fiduciaries
- Plan Loan Provisions
  - Allow participants to borrow from a plan if:
    - Available to all participants on a reasonably equivalent basis
    - Made according to plan provisions
    - Interest rate is reasonable
    - Loan is adequately secured

Class and Individual Exemption Examples

- Class exemptions apply broadly to specified transactions or a specified industry
  - Relief from excise taxes for correction of certain ERISA violations corrected under DOL correction program (VFCP)
  - To use this exemption, all potential violations must be understood and all conditions of the class exemption must be met

- Individual exemptions apply to a specific plan
  - Individual application to DOL is required
  - Example: plan owns a parcel of real estate and wishes to sell it to a party in interest
  - If the individual exemption is granted, all conditions of the exemption must be met

Bonding Requirements

- Plan <u>must</u> be covered by a fidelity bond
  - Lesser of 10% of plan assets or $500,000 ($1,000,000 if the plan holds employer securities)
- Covers fiduciaries and those who handle plan assets or other plan property
- Protects the plan against losses due to fraudulent or dishonest acts of those covered by the bond
- Different than fiduciary liability insurance

Fiduciary Liability Insurance

- Different from required ERISA fiduciary bonding
- Purchased at the option of the employer
- Provides protection to employer/sponsor and officers, directors and employees
- Coverage provided for breaches of fiduciary duties under ERISA (prohibited transactions, self-dealing, failure to diversify investments, conflicts of interest)
- Typically does not cover service providers
- Standard limits for most small to medium sized companies start at $1 million
- Available as both a stand-alone product or as an add-on to D&O coverage

Correction Programs

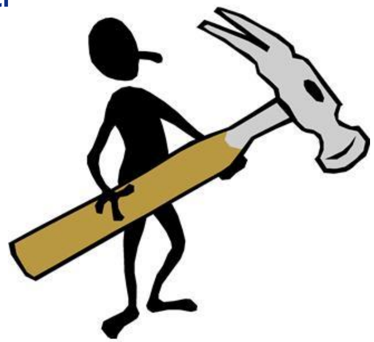
- ERISA or Internal Revenue Code violations discovered through DOL or IRS audit may result in penalties and, in extreme cases, plan disqualification

- DOL and IRS advocate voluntary compliance and encourage review plan operations for compliance

- DOL and IRS correction programs exist to help with voluntary correction with reduced fees and penalties

Correction Programs

- DOL Voluntary Fiduciary Correction Program (“VFCP”)
  - For correction of certain violations under ERISA (e.g., late deposit of employee deferrals, improper payment of “settlor expenses” with plan assets)



- DOL Delinquent Filer Voluntary Correction Program (“DFVCP”)
  - Correction of failure to timely file form 5500
- IRS Employee Plans Compliance Resolution System (“EPCRS”)
  - Correction of plan defects under IRS rules for tax-qualification (e.g., failure to adopt plan amendments timely, failure to perform plan coverage and nondiscrimination testing)

Action Steps for Plan Fiduciaries

- Verify all fiduciaries have been properly appointed, accepted and understand responsibilities
- Provide training for fiduciaries and anyone else who deals with a plan
- Establish and follow a "fiduciary structure" (meetings, decision making processes, monitoring of service providers and fees)
- Review and understand the plan document
- Ensure administration coincides with plan provisions
- Review investment policy statement and process for ongoing monitoring of plan investments
- Operate participant-directed investment plans in a manner that satisfies ERISA Section 404(c)

Action Steps for Plan Fiduciaries

- Communicate plan procedures for enrollment, plan transactions and investments to plan participants
- Hire experts where needed
- Monitor plan service providers on a regular basis
- Conduct periodic self-audits
- Use DOL and IRS correction programs where necessary
- Consider purchase of fiduciary liability coverage

Resources

- DOL Employee Benefits Security Administration
  http://www.dol.gov/ebsa/

- EBSA Fiduciary Education Campaign
  http://www.dol.gov/ebsa/fiduciaryeducation.html

- Internal Revenue Service – Retirement Plans Community
  http://www.irs.gov/retirement/index.html?navmenu=menu1