DLA Piper Presents:

FIDUCIARY BEST PRACTICES

A collection of articles reprinted from DC Dimensions

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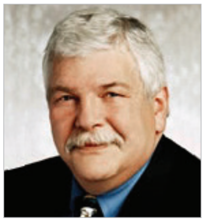

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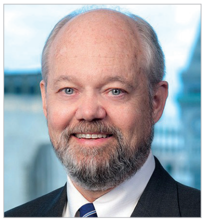

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Key Points about DOL's Proposed Fiduciary Definition

By **Ian Kopelman,** Chair, Employee Benefits and Executive Compensation Practice Group, and **Joseph Hugg**, Of Counsel, DLA Piper

The US Department of Labor has issued proposed regulations that will have a significant effect on those who recommend or market investment products and services to employee benefit plans and individual retirement accounts.[1]

The proposal would change the definition of a "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) to expand the class of persons and entities that would be subject to strict fiduciary duties and prohibited transaction rules under ERISA and the Internal Revenue Code. The new proposal follows an earlier similar proposal, which was withdrawn.

Explanation of Proposals

Proposed definition of fiduciary. Under the existing definition, a person (or entity) will be a fiduciary if the person provides investment advice to a plan or IRA (1) on a regular basis, (2) pursuant to a mutual agreement, arrangement, or understanding, written or otherwise, (3) the advice will serve as a primary basis for investment decisions, and (4) the advice will be individualized based on the particular needs of the plan or IRA. Under this definition, it has been widely assumed that brokers, insurance agents, and other persons selling investment products to plans and IRAs are not fiduciaries, although the DOL has noted that in some situations such persons may be fiduciaries. Also, sponsors of investment funds that do not hold "plan assets" generally have not been thought to be fiduciaries for plans and IRAs when they recommend an investment in their funds.

In contrast, the proposed regulation broadly defines fiduciary to include any person who provides the following types of advice in exchange for a fee, whether direct or indirect, to a plan, a plan fiduciary, plan participant, or beneficiary, IRA, or IRA owner:

1. For purposes of new DOL proposals and this summary, an "IRA" includes an individual retirement account, individual retirement annuity, Archer MSA, health savings account, and Coverdell education savings account.

1. A recommendation on the advisability of acquiring, holding, disposing, or exchanging securities or other property, including a recommendation to take benefits from a plan or IRA, or a recommendation as to the investment of securities or other assets to be rolled over or otherwise distributed from a plan or IRA.

2. A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA.

3. An appraisal, fairness opinion, or similar statement, whether verbal or written, concerning the value of securities or other property if provided in connection with a specific transaction.

4. A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in (1) to (3) above.

To result in fiduciary status, the advice must be provided pursuant to a written or verbal arrangement or understanding that the advice is specifically directed at the recipient for the recipient's consideration, but the advice does not have to be individualized for the recipient or provided on the basis that the recipient will in fact rely on the advice in making investment decisions. Also, the advice does not have to be provided on a regular basis to result in fiduciary status. Thus, one-time contacts with a plan or IRA may result in fiduciary status.

The requirement that the advice be provided for a fee, direct or indirect, would include compensation paid to affiliates of the person providing the advice in connection with the investment.

Finally, if a person dealing with a plan or IRA claims to be a fiduciary, the person would be treated as a fiduciary without regard to the above definition.

Consequences of fiduciary status. If a person is a fiduciary under the proposed definition, he or she will have to make investment recommendations that are in the "best interest" of the plans and IRAs, without regard to the fiduciary's financial or other interests or those of their affiliates. Also, such a fiduciary will be prohibited from engaging in certain transactions with the plans and IRAs. Most significantly, in the absence of a specific exemption, the fiduciary will not be permitted to recommend investments for which the fiduciary or an affiliate will receive fees or other direct or indirect compensation. That would constitute "self-dealing," a prohibited transaction.

Carve-outs and exemptions. How can anyone recommend and sell investments to plans and IRAs and still receive fees if the proposed definition of fiduciary becomes effective? The proposed regulation includes a number of "carve-outs" or exceptions from the definition of a fiduciary, i.e., situations in which the DOL does not believe fiduciary status is warranted. Also, proposed new and amended prohibited transaction exemptions accompanied the proposed regulation. Together, the carve-outs and the prohibited transaction exemptions cover many (but not all) typical investment situations, subject in most cases to stringent conditions and requirements designed to raise the level of protection for plans and IRAs.

Seller's carve-out. For plans with at least 100 participants or those with at least $100 million in assets, the proposed regulation includes a "seller's carve-out" that permits a "counterparty" to provide advice or recommendations to a plan in connection with a sale, purchase, loan, or other bilateral contract with the plan. To qualify for the carve-out, the counterparty must obtain a written representation from an independent fiduciary for the plan that the fiduciary is not relying on the counterparty to act in the best interest of the plan, to give impartial advice, or to give advice as a fiduciary. For plans with at least 100 participants that do not have $100 million in assets, the counterparty must also know or reasonably believe that

If a person is a fiduciary under the proposed definition, he or she will have to make investment recommendations that are in the “best interest” of the plans and IRAs, without regard to the fiduciary’s financial or other interests or those of their affiliates.

the independent plan fiduciary has sufficient expertise to evaluate the transaction and determine whether it is prudent and in the best interest of participants. The counterparty may not receive a fee from the plan or plan fiduciary for providing investment advice (as opposed to other services) in connection with the transaction. If this exception applies, merely making a pitch to a prospective plan client that is at or above the size thresholds—and receiving fees from the investment—will not result in fiduciary status for the counterparty.

Other carve-outs. The proposed definition of a fiduciary contains additional carve-outs, including exceptions for:

- Advice provided by swap counterparties.
- Advice provided by employees of a plan sponsor for no additional consideration beyond their regular compensation.
- Advice provided to participant-directed plans (but not to IRAs) by service providers that offer a "platform" or selection of investment vehicles, including general information but not recommendations, about the investment choices.
- Certain appraisals and valuation reports, including appraisals for investment funds and appraisals or valuation reports for purposes of plan reporting and disclosure.
- Advice that constitutes "investment education," although the education may not refer to specific investment products or investment alternatives by name.

As under current law, brokers, dealers, and banks that merely execute securities transactions and do not make recommendations would not be treated as fiduciaries.

Best interest contract exemption. This proposed prohibited transaction exemption applies to fiduciaries (under the new definition) of "retirement investors." A "retirement investor" is defined as including (1) plan participants and beneficiaries who make decisions (including rollover decisions) about their plan accounts, (2) non-participant directed plans with fewer than 100 participants, and (3) IRAs. The DOL said it intended this exemption to apply to "retail investors."

The best interest contract exemption is available only to "advisers," "financial institutions," and their affiliates and related entities, with respect to advice provided by the advisers. An "adviser" is an individual who (1) is a fiduciary with respect to a plan or IRA solely because of the provision of investment advice and (2) is an employee, independent contractor, agent, or registered representative of a financial institution. A "financial institution" is defined as including only a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker-dealer.

The exemption allows advisers and their related financial institutions to receive compensation for services performed in connection with the purchase, sale, or holding of an "asset" by the retirement investor as a result of the advice or recommendation of the adviser, if certain conditions are satisfied. The compensation may be direct or indirect, and may be paid by a third party. Without this exemption, the receipt of such compensation by a fiduciary with respect to an investment that it recommended would be a prohibited transaction.

The conditions for applying the best interest contract exemption are quite restrictive and go beyond existing practices. The advisor must acknowledge its fiduciary status in writing. In addition, the advisor must commit in a written contract to basic standards of impartial conduct (the "Impartial Conduct Standards"), as follows:

1. Act in the "best interest" of the plan or IRA.
2. Receive no more than reasonable compensation.
3. Do not make any misleading statements about the investments, its fees, or material conflicts of interest it may have.

The advisor must also disclose conflicts of interest, warrant that the advisor has adopted practices designed to mitigate the conflicts of interest, and disclose the costs of the advisor's services. The contract may include an arbitration provision but may not preclude class actions. Additional requirements apply if the advisor does not recommend a broad range of investments. Advisors must maintain certain data and make it available to the DOL upon request.

Advisors must notify the DOL in advance if they are relying on the best interest contract exemption. Thus, the exemption would provide no relief for an advisor that is inadvertently a fiduciary under the revised definition.

The most restrictive provision of the best interest contract exemption is the definition of the "assets" that qualify for the exemption. Under the exemption, an eligible "asset" includes only the following investment products: (1) bank deposits; (2) certificates of deposit; (3) shares or interests in registered investment companies; (4) bank collective funds; (5) insurance company separate accounts; (6) exchange-traded REITs (7) exchange-traded funds; (8) corporate bonds offered pursuant to a registration statement under the Securities Act of 1933; (9) agency debt securities as defined in FINRA Rule 6710(l) or its successor; (10) US Treasury securities as defined in FINRA Rule 6710(p) or its successor; (11) insurance and annuity contracts; (12) guaranteed investment contracts; and (13) equity securities within the meaning of 17 CFR 242.600 (generally, exchange-traded equity securities). Excluded from this definition is any equity future, put, call, straddle, or other option or privilege of buying an equity security from or selling an equity security to another without being bound to do so.

Outside the carve-outs and exemptions. If the proposals are implemented as proposed, brokers, investment advisors, insurance agents, and others in the financial industry who are involved with the investments of plans and IRAs will, at a minimum, be subject to additional compliance requirements that will affect their businesses.

Other exemptions

For a complete list of proposed exemptions, please consider reviewing our October 28, 2015, webinar with Dimensional Fund Advisors, which can be accessed at my.dimensional.com/tools/on_demand/172595/.

Principal transaction exemption. This proposed prohibited transaction exemption allows broker-dealers and other advisors to sell debt securities to plans, participants, and beneficiaries and IRAs in a principal transaction, i.e., the sale is out of the seller's own inventory. The exemption would require adherence to the impartial conduct standards that apply under the proposed best interest contract exemption. In addition, the exemption includes specific conditions related to the pricing of the debt securities, and the seller would be required to disclose to the purchaser the amount of compensation (e.g., a markup) it will receive on the transaction.

For brokers, investment advisors, fund sponsors, and others selling investment services and products that are not on the list of approved "assets" in the best interest contract exemption, it may take some time to determine whether they can continue to market services and products to retirement investors (i.e., small plans and IRAs), and if so, what alterations in current practices will be necessary.

Anticipated effective date. The DOL is expected to issue the final regulation and the exemptions, with a proposed effective date in 2016.

If the proposals are implemented as proposed, brokers, investment advisors, insurance agents, and others in the financial industry who are involved with the investments of plans and IRAs will, at a minimum, be subject to additional compliance requirements that will affect their businesses.

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Investment Policy Statements: Think Art, Not Science

By **Ian Kopelman,**
Chair, Employee Benefits and Executive Compensation Practice Group, DLA Piper

ERISA does not contain an explicit statutory requirement that each employee benefit plan maintain a written investment policy statement (IPS). Instead, the concept arises out of the fiduciary duty of prudence that applies under both ERISA and the common law of trusts and is referred to in interpretive bulletins issued by the US Department of Labor (see Interpretive Bulletin 94-2). In fact, a copy of the plan's IPS is usually requested as part of any DOL plan audit.

Investment policy statements are necessary to enable plan fiduciaries to satisfy their responsibilities under ERISA. However, they must be artfully drafted to ensure that they are not used by potential plaintiffs as justification for a breach of fiduciary responsibility allegation. The reason: Once written, investment policy statements become part of the documents and instruments under which the plan is established and maintained and thus must be followed [see ERISA Section 404(a)(1)(D)].

For example, in *Tussey v. ABB, Inc.*, a Missouri federal district court held that 401(k) plan fiduciaries were liable for more than $35 million in plan losses resulting from excessive fees due to a fiduciary breach that resulted in large part from the failure to follow the plan's investment policy statement. Thus, failure to follow an investment policy statement, once adopted, could be considered a clear demonstration of the fiduciary's imprudence and therefore a violation of ERISA.

Substantively, a properly drafted investment policy statement provides the plan sponsor and fiduciaries with a roadmap for the proper investment of plan assets. It also sets forth general investment objectives for the plan and investment options, standards for meeting those objectives, and a mechanism for monitoring the performance of plan investments. In addition, if the plan provides for participant direction of investments, the investment policy statement often is the most logical place to lay out the necessary compliance elements for Section

What's in an Investment Policy Statement?

A well-written IPS should:

1. Describe the purposes and general investment objectives of the plan.

2. Identify and allocate responsibilities among the fiduciaries and other parties responsible for selecting, monitoring, and managing plan investments.

3. Describe the asset classes to be offered and factors for selecting investment options, such as risk and return characteristics, expenses, and benchmark comparisons.

4. Describe any limits or standards for employee stock if included as an investment option.

5. Describe standards for investment performance and criteria for measuring performance.

6. If the plan permits participants to direct investments and is intended to comply with Section 404(c) (as most of today's plans do):
   - State that the plan intends to comply.
   - List the number of investment options offered under the plan and the asset classes for each option.
   - Describe in general terms the method and criteria for selecting options, including fees, and for monitoring and replacing funds, if necessary (to the extent the options are not included in the trust document).
   - Describe in general terms the investment education (if any) and financial information offered to participants in connection with investment options.
   - Describe any restrictions on particular investment options.
   - Describe the process and standards for selecting a qualified default investment arrangement.

7. Describe in general terms the process and criteria for selecting, monitoring, and, if necessary, replacing plan investment service providers.

8. Describe standards for accounting for and managing investment expenses.

9. Describe, in very general terms, that investment performance will be periodically reviewed, and describe the review process (including the possible but not mandatory use of outside investment consultants).

10. State that the IPS is also intended to serve as the plan's funding policy statement, thus satisfying the requirements of ERISA Section 402(b)(1).

404(c) protection from liability for participants' choices. It can also be a vehicle for outlining the overall purposes of, and funding policy for, the plan as well as the plan's fiduciary structure and allocation of investment responsibilities.

If the plan offers participants investment advice, the investment policy statement may include a description of the advice services and criteria and standards for the provider.

While virtually all practitioners agree that an investment policy statement is essential, not everyone agrees on how it should look or how detailed it should be.

It may be as short as three pages or as long as 10 (or more). Some believe that a short, general investment policy statement without specific guidelines might not provide the same level of fiduciary protection as a longer, more detailed one. However, this maxim only holds true for the fiduciary who follows the statement in all its particulars.

A long, complicated investment policy statement that plan fiduciaries do not follow can be used to assert a breach of fiduciary duty—even in cases in which a breach would not otherwise have been deemed to have occurred. A detailed investment policy statement can be a tool for fiduciary risk management and an operating manual for the plan's

Some believe that a short, general IPS without specific guidelines might not provide the same level of fiduciary protection as a longer, more detailed one.

Tussey vs. ABB, Inc.

The court ruled that:

"ABB Defendants violated their fiduciary duties to the Plan and its participants when they failed to monitor recordkeeping costs and negotiate for rebates. … ABB, Inc. also violated its fiduciary duties to the Plan when it continued to pay … an amount that exceeded market costs for Plan services in order to subsidize ABB's corporate services."

Source: US District Court, W.D. Missouri, Central Division, March 31, 2012.

fiduciaries, but this approach works as an indication of ERISA fiduciary compliance only if the plan's fiduciaries read the investment policy statement, keep it up to date, and follow it.

As evidenced by *Tussey*, a fiduciary who ignores and/or violates the plan's investment policy statement doesn't get any protection at all, and worse, may be deemed to have committed a breach solely because the IPS was not followed.

In this regard, it is important to remember that just because a policy or procedure is not included in the investment policy statement does not mean such a process or procedure can't be informally followed. For example, it may be deemed minimally prudent for the investment policy statement to require that plan investments be reviewed quarterly. However, it may also be determined that a better process would be to review plan investments more frequently—perhaps monthly.

A written investment policy statement that only requires quarterly review does not mean that the fiduciary could not or should not review investments more frequently. However, under such a general policy, if the investment fiduciaries were to miss a monthly review, that failure would not be deemed a prima facie breach of fiduciary responsibility. The issue would be one of prudence in fact.

However, if the policy statement did require a monthly investment review, a failure to review investments every month would per se constitute a breach, leaving as the only issue the amount of damages resulting from the breach—a very different issue than determining whether a breach occurred. For this reason, many practitioners recommend that an investment policy statement contain the minimal standards that will enable plan fiduciaries to demonstrate compliance with their prudence and other ERISA requirements, while leaving more stringent standards and processes to be put into effect informally.

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The Importance of Following an Investment Policy Statement

An IPS is only as good as the plan fiduciary's follow-through

By **Ian Kopelman,**
Chair, Employee Benefits and Executive Compensation Practice Group, DLA Piper

Early last year, a Missouri federal district court held that 401(k) plan fiduciaries were liable for more than $35 million in plan losses for excessive fees due to fiduciary breaches, which resulted in large part from their failure to follow the plan's investment policy statement (IPS). The case, *Tussey v. ABB Inc.*, is one of the first successful excessive fees lawsuits—and emphasizes the importance of having and following an investment policy statement.

Why an IPS is important

The Employee Retirement Income Security Act (ERISA) does not include a statutory requirement that each plan have a written IPS and did not create the concept of a formal, written investment policy. The concept arises from the fiduciary duty of prudence that applies under both ERISA and the common law of trusts, and is referred to in interpretive bulletins issued by the Department of Labor (DOL). Also, a copy of a plan's IPS is usually requested as part of any DOL audit of that plan.

A written investment policy provides specific guidelines and directions for the responsible fiduciary. Complying with the policy's requirements allows the investment fiduciary to demonstrate its prudence. Obviously, it behooves the wise ERISA fiduciary to adopt a written investment policy. Further, as the *Tussey* case illustrates, once an IPS has been adopted, it must be followed. Just as following the IPS is a way to demonstrate prudence, failing to do so can be a clear demonstration of imprudence.

For these reasons, it is generally agreed that while an IPS is not legally required by ERISA, it is key to ensuring compliance with the ERISA's fiduciary responsibility rules and minimizing the risk of fiduciary liability.

A properly drafted IPS provides the plan sponsor and fiduciaries with a road map for the proper investment of plan assets. It sets forth specific investment objectives for the plan and investment options, standards for meeting those objectives, and a mechanism for monitoring the

A properly drafted IPS provides the plan sponsor and fiduciaries with a road map for the proper investment of plan assets.

performance of investments and plan service providers. If the plan provides for participant direction of investments, the IPS often is the most logical place to lay out the necessary elements for Section 404(c) protection from liability for participants' choices. It can also be a vehicle for outlining the overall purpose of the plan and its fiduciary structure, and for allocating investment responsibilities.

What to include in an IPS

A well-written IPS should:

1. Describe the purpose and general investment objectives of the plan.

2. Identify and allocate responsibilities among the fiduciaries and other parties responsible for selecting, monitoring, and managing plan investments.

3. Describe the asset classes of investment options to be offered, and specific factors and criteria for selecting investment options, such as risk and return characteristics, expenses, and benchmark comparisons.

4. If employer stock is offered as an investment option, describe any limits or standards for its inclusion.

5. Describe standards for investment performance and criteria for measuring performance.

6. If the plan permits participants to direct investments and intends to comply with Section 404(c):

   - State that the plan intends to comply.
   - List the number of investment options offered under the plan and the asset classes for each option.
   - Describe the methods and criteria for selecting options, including fees, and for monitoring and replacing funds, if necessary.
   - Describe investment education and other information offered to participants in connection with investment options.
   - Describe any restrictions on particular options.
   - Describe the process and standards for selecting a qualified default investment arrangement.

7. Describe the methods and criteria for selecting, monitoring, and if necessary, replacing plan investment service providers.

8. Describe standards for accounting for and managing investment expenses.

9. Describe how often investment performance will be reviewed and the review process (including the use of outside investment consultants).

Other IPS guidelines

An investment policy statement may also include a summary of the plan's provisions, participant demographics, and/or overall administrative structure. If a plan offers its participants investment advice, the IPS needs to include a description of the advice services, and criteria and standards for the provider.

While everyone agrees that an IPS is essential, not everyone agrees on how it should look or how long it should be. An IPS may be as short as three pages or longer than ten pages. Some believe a short, general IPS without specific guidelines might not provide the same level of fiduciary protection as a longer, more detailed one. However, this only holds true for the fiduciary that follows the plan's IPS. As stated above, a long, complicated IPS that plan fiduciaries do not follow can be used to assert a breach of fiduciary duty—even in cases when a breach would not otherwise have been deemed to have occurred. On the other hand, while a detailed IPS can be a tool for fiduciary risk management and an operating manual for the plan's fiduciaries, this approach only works if the plan's fiduciaries read the IPS, keep it updated, and follow it. As evidenced by the *Tussey* decision, a fiduciary that ignores and/or violates the plan's IPS doesn't get any protection at all, and worse, may be deemed to have committed a breach solely because the IPS was not followed.

Conclusion

The Plan Sponsor Council of America and others offer free samples of 401(k) plan investment policy statements ranging from the general to the extremely detailed. In short, there is no excuse for a fiduciary's failure to take advantage of the potential protection offered by an IPS. Just remember that establishing an appropriate IPS for your plan means more than adopting a written statement. An IPS is only as good as the fiduciary's follow-through. A fiduciary that adopts an IPS and then fails to follow its rules could end up like the defendants in *Tussey*.

Excerpted and adapted from the July/August 2012 edition of *Defined Contribution Insights*, with permission of the Plan Sponsor Council of America.

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15 Tips for Fiduciary Compliance

By **Ian Kopelman,**
Chair, Employee Benefits and Executive Compensation Practice Group, DLA Piper

Part 4 of Title I of ERISA contains standards for fiduciaries' performance of their fiduciary duties. With the exception of specific rules relating to prohibited transactions, these standards are rather general and were in fact taken from the common law of trusts.

Since ERISA was adopted over 40 years ago, regulations and court cases have not issued many specific guidelines for fiduciaries.

The application of the standards to specific situations has generated confusion as well as trepidation among plan sponsors and in-house personnel for whom the role of plan fiduciary is only one of many responsibilities they perform for their employers. However, with a few exceptions, the standards are logical applications of the concept that fiduciaries should act with fairness, a basic level of expertise, in a manner calculated to provide retirement benefits to participants and beneficiaries, and without being subject to conflicting concerns.

Although fiduciary regulations and court decisions are often complicated, applying certain principles should help enable plan fiduciaries to achieve substantive compliance in virtually all cases.

To aid fiduciaries in their day-to-day ERISA fiduciary activities, I have developed a list of 15 tips:

1. Establish a Process and Follow it

ERISA doesn't require a fiduciary to always be right; ERISA requires him or her to be prudent, and for purposes of ERISA, prudence is a process. However, if the fiduciary doesn't follow it, a process doesn't demonstrate prudence or anything else (except non-compliance). So set up a reasonable process for decision-making, and make sure it is followed.

2. Put It in Writing

Rules governing the plan's operations should be in writing, but they shouldn't be too complicated. Following reasonable rules goes a long way toward demonstrating fiduciary compliance, but overly complicated rules tend not to be

> A key to avoiding any fiduciary breach is to make sure it is clear to the fiduciaries and third parties when they are—and are not—operating in their fiduciary capacities.

followed. Plus, non-compliance with plan rules and processes is a per se fiduciary breach.

3. Allocate Specific Responsibilities

Each fiduciary should know he or she is an ERISA fiduciary, understand what that means, and be familiar with the rules governing the plan's operations, including the allocation of responsibilities among various fiduciaries. For example, members of an investment committee are typically not responsible for administration, and members of an administrative committee are typically not responsible for investments. Making this clear may require education sessions for new fiduciaries and periodic reviews for the company's management and/or board of directors.

4. Know What is in Plan Documents

Each plan must be in writing. These documents, along with rules and guidelines for operation of the plan, govern the fiduciary's actions, and a failure to comply violates ERISA. Each fiduciary needs to keep copies of the plan documents and be familiar with their provisions. Since plan documents are updated periodically to reflect changes in the law and the plan's operation, a fiduciary also has to make sure he or she is aware of any changes.

5. The More Settlor Functions, the Better

Settlor functions, such as deciding to establish or terminate a plan or changing benefit formulas or distribution options, are not subject to ERISA's fiduciary rules. Establish clear distinctions between actions that are settlor functions and fiduciary actions that are subject to ERISA, even if the same individual or committee is responsible for both. It is possible to draft the plan so that the settlor functions are expanded, which limits the application of the ERISA fiduciary rules.

6. Meet Regularly and Keep Minutes of the Meetings

Responsible fiduciaries should meet periodically to review the plan's operations and investment performance. Their decisions and the reasons for them should be memorialized in written minutes, but the minutes should not be too detailed. Investment consultant reports and investment performance analysis documents supporting the fiduciaries' decisions should be included with the minutes.

7. Get Separate Written Service Agreements from Each Vendor

Service agreements should govern every relationship with an outside vendor, spelling out each party's obligations and requiring the vendor to indemnify each fiduciary and the company for liability or losses to the plan or participants resulting from the vendor's misconduct, negligence, or breach of the agreement's terms or ERISA. A vendor's liability should, if possible, not be subject to dollar limits. To the extent possible, the agreement should also limit the vendor's access to participants for purposes of cross-selling its services outside the plan.

8. Get Outside Help on Fees

If the plan is being charged fees for administrative, investment, or other services, let an independent third party make the initial recommendation as to whether billing the plan, as opposed to the plan sponsor, is appropriate.

9. Make Clear Who is a Fiduciary

Corporate officers or other employees frequently have fiduciary responsibility for a plan's operation. This responsibility can lead to real or perceived conflicts of interest. A key to avoiding any fiduciary breach is to make sure it is clear to the fiduciaries and third parties when they are—and are not—operating in their fiduciary capacities.

10. Avoid Decision-Making Conflicts

If a fiduciary has a real or perceived conflict, he or she should not make the decision. Each fiduciary should understand his or her rights and obligations to withdraw from any decision in which there is a conflict. If the plan sponsor has a real or perceived conflict, the record must demonstrate that the conflict did not impact the decision.

11. Know What Fees the Plan is Paying

A fiduciary can't conclude that a plan is getting what it is paying for when he or she doesn't know what the plan is paying and what the service provider is receiving. The fee disclosure rules developed by the US Department of Labor in the last few years should give the fiduciary access to necessary information, but it is up to the fiduciary to understand the information provided and determine if the aggregate fees are reasonable.

12. Know the Share Classes

Mutual funds typically offer two classes of shares: retail and institutional. Retail shares are the same class offered to individual investors. Institutional share classes are available to investors with larger amounts to invest and typically come with lower fees. Often, a plan will be invested in a retail share class even though it is eligible for an institutional class. Many recent lawsuits against plan sponsors and fiduciaries involve claims that participants were charged excess fees because the fiduciary failed to offer an available institutional share class. The plan should purchase the share class with the lowest cost unless there is a demonstrable and defensible reason to purchase a share class with higher costs.

13. Review Service Provider Selections and RFPs

The initial selection of a plan recordkeeper, trustee/custodian, and investment consultant or advisor is a fiduciary decision. However, fiduciary responsibility does not end there. Fiduciaries also must monitor the performance of the plan's service providers to determine if their selection remains prudent. Even if a service provider's performance is generally adequate, the fiduciary should periodically invite several service providers to submit proposals to determine if a different provider would be a less expensive and/or a better choice.

14. Review Participant Communications

Typically, recordkeeping services include drafting and distributing necessary or desirable (at least in the view of the recordkeeper) disclosures and other communications to participants. These communications often feature the plan sponsor's logo or letterhead, and participants view them as coming from, or at least endorsed by, the plan sponsor. The only way to control potential liability for any errors or misrepresentations in these communications is to carefully review and approve the language before distribution. Further, it should be made clear that the recordkeeper is the source of ancillary communications, such as investment education and a description of the recordkeeper's other services, and that the plan sponsor does not endorse them.

15. Check Plan Materials RE: DOMA

The US Supreme Court declared the Defense of Marriage Act (DOMA) unconstitutional in 2013, giving same-sex spouses all the spousal rights granted by ERISA. The plan document, procedures, summary plan description, and employee communications should all be reviewed to ensure they comply with this rule. Since prior plan documents and participant communications limited such benefits to opposite-sex spouses, new communications should be distributed to all participants and employees to avoid confusion, misrepresentations, and potential liability.

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Same-Sex Marriage Ruling: Key Questions and Answers

By **Ian Kopelman,**
Chair, Employee Benefits and Executive Compensation Practice Group, DLA Piper

Several months after the Supreme Court's decision in *United States v. Windsor*—which struck down Section 3 of the Defense of Marriage Act (DOMA)—plan sponsors and consultants are still struggling with the ruling's impact.

Recent guidance from the IRS on what constitutes a valid same-sex marriage for federal tax purposes answers a key question but leaves others unanswered.

IRS Revenue Ruling 2013-17

In Revenue Ruling 2013-17, the IRS interpreted the Internal Revenue Code ("the Code") as incorporating a general "state of celebration" rule recognizing the validity of a same-sex marriage if the marriage was valid in the state (including a foreign country) where it was entered into. The IRS ruling holds that for federal tax purposes:

1. The terms "spouse," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes a same-sex marriage.

2. The IRS adopts a general rule recognizing a same-sex marriage that was validly entered into in a state authorizing the marriage of two individuals of the same sex, even if the couple is domiciled in a state that doesn't recognize the validity of same-sex marriages.

3. The terms "spouse," husband," and "wife" don't include individuals in a domestic partnership, civil union, or other similar relationship recognized under state law that is not denominated as a marriage under state law, and the term "marriage" does not include such formal relationships.

For purposes of the IRS ruling, "state" means any domestic or foreign jurisdiction having the legal authority to sanction marriages.[1]

The IRS adopted a state-of-celebration rule—as opposed to a state-of-domicile rule—to avoid serious administrative concerns.

While the ruling is generally effective prospectively, affected taxpayers could rely on the IRS ruling as of September 16, 2013. Also, the IRS ruling and the *Windsor* decision do not apply for state tax purposes unless a state expressly adopts them.

IRS FAQs

In conjunction with Revenue Ruling 2013-17, the IRS issued "Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law" to explain the ruling's practical consequences:

1. A qualified retirement plan must treat a same-sex spouse as a spouse for purposes of satisfying the federal tax laws relating to qualified retirement plans. For example, if a qualified defined contribution plan provides that a participant's account must be paid to the spouse upon the participant's death unless the spouse consents to a different beneficiary (and the plan does not provide for any annuity forms of distribution), the plan must pay this benefit to the same-sex spouse.

2. The IRS intends to issue further guidance on how qualified retirement plans and other tax-favored retirement arrangements must comply with the ruling.

Interpreting the Guidance

Adoption of the state-of-celebration rule answers one of the biggest questions for plan sponsors. The IRS addressed a major concern for employers that sponsor qualified retirement plans in states that don't recognize same-sex marriage. In addition, the IRS guidance provides insight on (a) hardship distributions for medical, tuition, and funeral expenses for same-sex spouses; (b) spousal consent to a plan loan, if required; (c) rollover rights; (d) application of the minimum required distribution rules; and (e) qualified domestic relation orders (QDROs).

Still, a number of issues have not been resolved. One is how to apply the state-of-celebration rule if a foreign country's definition of a marriage conflicts with the IRS ruling that a domestic partnership, civil union, or similar relationship will not be treated as a marriage unless it is denominated as a "marriage" under law.

Additional guidance is needed for determining whether a court order assigning retirement plan benefits is

Recommendations for Plan Sponsors

- Review the terms of existing retirement plans, particularly the definition of a spouse, to identify provisions affected by the new rule and any amendments that may be required.
- Distribute employee communications on the impact of the new rules and how the state-of-celebration rule applies in identifying a spouse for retirement plan purposes. The communication should identify specific changes in plan operations that are effective immediately. Participants in same-sex marriages who want to name a non-spouse beneficiary should also be told they must file a new beneficiary designation with spousal consent for the designation to be effective.
- Before paying a death distribution to a non-spouse beneficiary, confirm that the beneficiary designation form includes spousal consent or that the participant was not in a valid traditional or same-sex marriage.
- Establish an administrative procedure for determining whether a same-sex marriage is lawful under the state-of-celebration rule.
- Review and revise plan participant communications.
- Wait for additional guidance before deciding whether any of the changes should be retroactive and require correction of some past plan practices or operations.
- Before determining that a court order assigning plan benefits to a same-sex partner is a valid QDRO, determine whether the state where the order was issued recognizes same-sex marriage and has sufficient jurisdiction over the participant.

a QDRO. *Windsor* and subsequent IRS guidance do not apply for purposes of state law, so states do not have to recognize a same-sex marriage for any purpose, including divorce. Because Section 414(p) of the Code provides that a valid QDRO must be made pursuant to a state domestic relations law, the potential federal-state disconnect can complicate the QDRO review process. The complication will arise when a participant subject to a purported QDRO lives in a state that doesn't recognize same-sex marriage. In such a case, the plan administrator has to determine whether the purported QDRO was issued by a court in a state that (a) recognizes same-sex marriage and divorce and (b) has sufficient jurisdiction over the participant to issue a divorce decree and, if required, a valid QDRO.

Finally, the IRS guidance fails to address the remaining key issue for plan sponsors—possible retroactive application of the requirements of *Windsor* and the IRS ruling. So plan sponsors remain in limbo on one of the most troublesome questions regarding compliance with the new rules.

1. Fourteen US jurisdictions currently allow same-sex marriage (California, Connecticut, Delaware, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont, Washington State, and Washington, DC), as do a similar number of foreign jurisdictions.

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Moving Beyond Fee Disclosure

Monitoring other areas of plan administration

By **Ian Kopelman,**
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Now that everyone (presumably) has survived the trauma of compliance with the final participant fee rules, and 401(k) plan sponsors and fiduciaries can turn their focus to other areas of plan administration, it seems like a good time to discuss two recent cases. Each case involves a familiar headache for plan sponsors and administrators, and, in each case, the plan administrator and service providers came out the winners because they followed the rules.

Transferring Participant Accounts to QDIAs

In *Bidwell v. University Medical Center, Inc.* (June 29, 2012), the Sixth Circuit Court of Appeals upheld a district court ruling that 401(k) plan fiduciaries did not breach their fiduciary duties when they included participant accounts with an existing affirmative investment election in the migration to a new qualified default investment arrangement (QDIA). In *Bidwell*, the plan administrator changed the default investment for its 401(k) plan to a target retirement date fund from a stable value fund after the DOL issued the QDIA rules. Because the plan administrator did not have records of which participants had affirmatively elected to invest in the stable value fund and which were investors by default, it sent the required QDIA notice of the change to all participants with 100% of their account invested in the stable value fund. The notice complied with all the DOL rules and informed participants of the deadline for making a new election in order to avoid a transfer to the new QDIA.

The *Bidwell* plaintiffs maintained they never received the notice and as a result did not respond by the deadline it specified. Thus, their accounts were transferred without their knowledge. They first learned of the transfer upon receipt of their quarterly account statements following the transfer and immediately switched their investments back to the stable value fund, but suffered significant financial losses in the interim due to market fluctuations.

Compliance Update: Advisor Background Checks

Duane Mattson, a senior compliance officer at Dimensional Fund Advisors, says plan sponsors that use a broker or advisor may want to try a free tool called BrokerCheck (http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/) to assist with background checks. Through BrokerCheck, investors and plan sponsors can obtain online background reports and learn more about broker qualifications. The report provides history on any reportable disciplinary actions or settlements, employment history, and registrations.

A BrokerCheck report for a brokerage firm contains:

- A summary that provides an overview of the firm and its background.
- A firm profile that describes where and when the firm was established, and lists the people and organizations that own controlling shares or directly influence the firm's daily operations.
- A firm history that details any mergers, acquisitions, or name changes affecting the firm.
- A firm operations section that lists the firm's active licenses and registrations, the types of business it conducts, and other details pertaining to its operations.
- A disclosure section that contains information about any arbitration awards, disciplinary events, and financial matters on the firm's record.

FINRA also maintains a BrokerCheck toll-free hotline at (800) 289-9999, open 8:00 a.m. to 8:00 p.m. eastern time.

The plaintiffs then sued for a fiduciary breach, arguing the QDIA safe harbor only applies to accounts that were invested by default, not to accounts for which an affirmative investment election is in place.

The Sixth Circuit rejected this argument and found that, based on the language of the DOL rules and their preamble, the safe harbor protected plan fiduciaries that required confirmation of prior investment elections from participants who wish to remain in the prior default investment fund.

Plan-Imposed Statute of Limitations on Claims

In *Foster v. PPG Industries, Inc.* (September 5, 2012), the Tenth Circuit Court of Appeals reviewed a case with facts far too familiar to most plan administrators. The plaintiff was a former 401(k) plan participant who, upon divorce, moved out of the marital residence but delayed notifying the plan's recordkeeper of his change of address for more than a year. During that period, the plan mailed information on how to establish a new user ID and password for the participant's account, marked "To Be Opened by Addressee Only," to the marital residence. William Foster's former wife, who remained at the residence, received the document and used the information it contained, along with Foster's Social Security number, to attempt to gain access to his account online. The plan's recordkeeper, in accordance with plan procedures, processed the password reset request and sent it to the "permanent address on file," i.e., the marital residence.

The former wife then created a user ID and password, as well as answers to security questions and beneficiary designation on Foster's account, changed the mailing address on the account to her PO box, and requested (and received) a series of withdrawals from the account. Around the time of the final withdrawals from the account, Foster called the plan recordkeeper and changed the address on file but did not inquire or receive information about his account balance. He did not learn of the withdrawals until the following January, when he received IRS Form 1099-R reporting the retirement plan distribution. He then contacted the recordkeeper and plan administrator and demanded that his account balance be reinstated. Mr. Foster's demand was properly treated by the plan administrator as a claim for benefits and reviewed in accordance with the plan's procedures, which complied with

ERISA. His claim was denied, and he filed suit in federal court.

On appeal, the Tenth Circuit upheld the plan administrator's denial based on the facts showing that the plan provided all participant disclosures required by ERISA, sent all newsletters and other plan information, including the account security information, to Mr. Foster's permanent address as shown on its records, maintained appropriate security procedures for accounts and distributions, and processed the requests for payment in accordance with those procedures.

In short, the court concluded, Foster's losses were due to his former wife's fraud, not an error by the plan administrator or recordkeeper.

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Employees vs. Independent Contractors

Misclassified employees present a risk for plan sponsors

By **Ian Kopelman,**
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In an effort to save money, many companies elect to treat workers as independent contractors rather than employees. This saves the company cash because payments to independent contractors are not subject to tax withholding or employment taxes (such as FICA), and independent contractors are not eligible for benefits. However, if an audit by a government agency finds that the workers classified as independent contractors are actually employees, the employer's liability for back taxes, penalties, and claims for benefits may far outweigh potential savings. In the past, many companies viewed the potential for a finding of misclassification as an acceptable risk. They may want to reconsider that view.

Worker Misclassification: A Hot Topic

Worker misclassification has become a hot topic in Washington and state capitals. The issue was the subject of Congressional hearings and proposed legislation. The IRS launched a payroll tax audit initiative focusing on misclassification and introduced a voluntary compliance program for employers. The DOL hired 100 additional agents for an enforcement initiative. Finally, in September, the DOL and IRS entered into a memorandum of understanding permitting them to share information and coordinate their enforcement activities. According to the DOL press release, the memorandum "will improve departmental efforts to end the business practice of misclassifying employees in order to avoid providing employment protections." A number of states signed similar agreements with the federal agencies.

The increased scrutiny inevitably means that some companies will have to reclassify some independent contractors as employees and pay the resulting back taxes and penalties. These issues are the focus of the government agencies. But these companies also face potential claims for wages, retirement benefits, and welfare benefits (such as health insurance) retroactive to the date of reclassification. In short, the liability resulting from a reclassification after an audit could be a disaster for the company. The best way to avoid such a disaster (or at least minimize liability) is to review relationships with independent

Worker misclassification has become a hot topic in Washington and state capitals.

contractors now to confirm that they aren't misclassified employees.

Determining Misclassifications

There are numerous formulations of the test for determining if a worker is correctly classified. Most of these are based on the IRS approach, which considers a number of different factors and is applied case-by-case based on the facts of each situation. As a general rule, however, an individual worker is an employee if the company has the right to direct and control how the worker performs his or her services. The fact that there is a written agreement in place that states that the worker is an independent contractor is not enough to prevent a finding of misclassification.

If an employer concludes that a government audit would find that some or all of its independent contractors are misclassified, it can reclassify the affected workers as employees or change the terms of the relationship. If it chooses to prospectively reclassify the workers as employees for employment tax purposes, it may be able to substantially reduce its liability for the prior misclassification by filing an application with the IRS under the voluntary compliance program established last year. However, participation in the program only addresses liability for employment taxes. It provides no protection from claims for benefits.

An employer can address potential liability for benefit claims by misclassified employees in two ways. The first and most obvious way is to make sure workers are correctly classified and include any reclassified workers in the benefit plans prospectively. The second is to make sure that the eligibility and administration sections of each plan include certain provisions. To date, the majority of courts addressing misclassified employees' claims for retroactive benefits have decided in favor of the employer based on the plan's specific terms. The courts have denied retroactive benefits when the plan's terms specifically provided (a) that independent contractors were not eligible for benefits and (b) that the plan administrator had the authority to interpret the terms of the plan in its sole discretion.

This language provides a basis for denying retroactive benefits to misclassified employees because a plan may exclude employees as long as it satisfies the Internal Revenue Code's minimum participation and coverage standards, and a plan administrator with complete discretion to interpret the plan's terms has the right to determine if an individual employee meets the plan's eligibility requirements. Under these circumstances, a court will defer to the administrator's determination unless it finds that it was arbitrary and capricious. Plan sponsors with a significant independent contractor workforce may want to bolster their argument by revising a plan's eligibility provision so that it excludes independent contractors, regardless of whether they have been determined to be employees for other purposes by a government agency.

Finally, it should be noted that while this column and most of public concern about the issue of misclassification focuses on the consequences of misclassifying an employee as an independent contractor, the opposite situation is also problematic. Misclassifying independent contractors as employees eligible to participate in a benefit plan means that some participants aren't actually employees. If non-employees are participating in a retirement plan, the plan is operating in violation of its terms and the Internal Revenue Code.

Conclusion

No matter what a particular company's situation may be, it is clearly time to take a second, or even third, look at how it uses independent contractors and to take steps to minimize potential liability—before the government shows up on the doorstep.

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The Best Defense Is a Good Offense

Plan sponsors can minimize fiduciary liability with adequate fiduciary education and certification

By **Ian Kopelman,**
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As pointed out in a recent column published by the PSCA, an in-house or named fiduciary of an ERISA plan is never completely free from fiduciary responsibility for the plan—and the potential personal liability that comes with it. The smart fiduciary takes steps to minimize that liability. As the old saying goes, the best defense is a good offense. In this case, that means the in-house/named fiduciary of the plan has a full understanding not only of the fiduciary responsibility rules, but also the rules of ERISA and the Internal Revenue Code that govern the operation of qualified retirement plans and the investment of plan assets. The fiduciary that fully understands the plan rules is in the best position to fulfill its fiduciary responsibilities and minimize its liability.

As previously explained, a plan's in-house/named fiduciary can delegate some or all of the day-to-day responsibility for a retirement plan, but it always retains responsibility for the following:

- Appointing the trustee.
- Appointing investment managers.
- Investing plan assets.
- Selecting plan service providers.
- Monitoring the performance of all of the above on an ongoing basis.

Under ERISA, the in-house/named fiduciary's actions in fulfilling these responsibilities must be:

- For the exclusive benefit of plan participants and their beneficiaries, and for the purpose of defraying expenses of administering the plan.
- Prudent, which means they must be done with the care, skill, and diligence that would be exercised by a reasonably prudent person who is familiar with such matters.
- In accordance with the plan documents, unless the documents themselves are not in compliance with the terms of ERISA.

Meeting these responsibilities with respect to the selection of plan service providers and other plan fiduciaries may seem fairly straightforward, but a plan's in-house/named fiduciary is also responsible for monitoring the performance of the service providers and fiduciaries it selects. This means that even if the selection was prudent, the in-house/named fiduciary will have breached its ERISA fiduciary responsibility if it does not terminate the relationship with a service provider or fiduciary when a failure to perform makes continuing the relationship imprudent. Further, under ERISA's co-fiduciary liability rules, an in-house/named fiduciary that acts in good faith and complies with all ERISA requirements still may be liable for the acts or omissions of a co-fiduciary if:

- It knows the person committing the act or omission is a fiduciary with respect to the same plan, participates knowingly in the act or omission, and knows the act or omission is a breach of fiduciary duty.
- Its breach of ERISA's rules enabled the subsequent breach by a co-fiduciary.
- It knows of a breach by a co-fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.

It is generally agreed that, in order to manage its potential liability, a plan fiduciary needs a paper trail demonstrating it acted prudently. However, it is difficult, if not impossible, for an in-house/named fiduciary to satisfy the responsibilities described above, meet ERISA's fiduciary standard, and avoid liability if it doesn't understand the rules of ERISA and the Internal Revenue Code governing qualified retirement plans.

Once an in-house/named fiduciary understands the rules that apply to plans, it can avoid fiduciary breaches by:

- Formulating (and periodically reviewing) a formal written investment policy statement.
- Performing adequate due diligence in selecting plan fiduciaries and other service providers.
- Periodically auditing the performance of those service providers.
- Reviewing the performance and relative expenses of plan investments.
- Terminating other plan fiduciaries and service providers when their performance makes it imprudent to continue the relationship.
- Understanding and complying with ERISA's reporting requirements.

Fortunately, understanding the rules governing qualified retirement plans does not mean the in-house/named fiduciary needs to become a compliance expert. That can take years. However, an understanding requires more than reading the statute or a couple of articles. The best and most efficient way for the in-house/named fiduciary to gain the knowledge it needs is to get help from compliance experts by taking advantage of educational programs, such as those offered by the Profit Sharing/401k Council of America (PSCA).

The in-house/named fiduciary of an ERISA plan faces a difficult problem. It has significant fiduciary responsibility under ERISA, which can't be completely relieved by delegation to another fiduciary. If the actions of the in-house/named fiduciary don't meet ERISA's fiduciary standards, it faces significant liability. However, it can't be confident that its actions meet ERISA's standards without understanding the applicable rules.

Further, the in-house/named fiduciary needs to be able to demonstrate that it took steps to make sure its actions and decisions meet ERISA's fiduciary standards.

Conclusion

Fortunately, this problem can be addressed. A fiduciary education program can provide the in-house/named fiduciary with a basic knowledge of the rules of ERISA and the Internal Revenue Code with only a small time investment. That basic knowledge minimizes the potential for failure to meet ERISA's fiduciary standard. Completing a formal education program offers an additional advantage beyond gaining the necessary understanding of the rules. If the program offers a certificate of completion, it provides hard evidence that an in-house/named fiduciary who participates in the program has taken action to fulfill fiduciary obligations under ERISA, and it minimizes potential fiduciary liability.

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