

Legal Obligations of Employers for 401(k) Plans

1. Background

A. After extensive investigation of 401(k) retirement plans throughout the country, the **Department of Labor** (DOL) has determined the following:

- (i) The cumulative effect of **high fees and expenses** substantially reduce the investment returns of retirement accounts;
- (ii) Many of the fees paid to financial service providers are **hidden** in bundled services and revenue sharing arrangements; and
- (iii) Employers are not **regularly monitoring** plan costs and investment options

B. The **General Accounting Office** (GAO) undertook a similar study and found:

- (i) Service providers have been assisting plan sponsors in the selection of investment options without disclosing **conflicts of interest** due to third party payments and other business arrangements;
- (ii) Service providers commonly structure their relationships with plan sponsors in a manner that **avoids** being subject to **fiduciary** obligations under ERISA; and
- (iii) Many plan sponsors **do not understand** that without a fiduciary relationship, service providers may provide biased recommendations.

2. Overview of 401(k) Plan Service Providers

A. *Recordkeeper*

- (i) Receives contributions from payroll deductions;
- (ii) Implements purchases and sales directed by participants;
- (iii) Provides web access and statements to participants; and
- (iv) Prepares periodic activity reports and provides web access for sponsor.

B. *Third Party Administrator*

- (i) Performs discrimination testing to ensure annual compliance with law;
- (ii) Prepares Form 5500 for IRS submission; and
- (iii) Assists with plan design.

C. *Financial Advisor*

- (i) Assists with development and maintenance of Investment Policy Statement (IPS);
- (ii) Recommends investment fund selections;
- (iii) Monitors investment funds and recommends changes;
- (iv) Provides participant education; and
- (v) Guides plan sponsor through ERISA compliance process.

D. *Bundled Services*

- (i) Functions are frequently bundled into one service contract; and
- (ii) Bundled plans do not receive all of the Financial Advisor services listed.

3. **Fiduciary Responsibilities of Employers under ERISA**

- A. Prudently select, monitor, and replace (when necessary) **investment options** offered to plan participants;
- B. Evaluate each service contract periodically for **reasonableness** (especially fees);
- C. Provide **sufficient information** so that participants can make informed decisions about plan investment options;
- D. Make **decisions** which reflect care, skill, prudence, and diligence;
- E. When necessary, engage independent professionals to provide **specific expertise**;
- F. Act based solely upon the **best interests** of plan participants; and
- G. **Document** all actions and decisions to demonstrate compliance with ERISA requirements.

4. **ERISA Requirements for Investment Fund Selections by Employers**

- A. The risk, return, cost, and asset class of **each investment** must be appropriate for plan participants;
- B. **Investment Policy Statement** (IPS) customarily utilized to document the investment selection and monitoring process;
- C. Employers **may not rely** upon the investment recommendations by non-fiduciary service providers;
- D. Each investment must be **monitored regularly** for continued appropriateness; and
- E. **Actively managed funds** require a more involved analysis than index funds.

5. **DOL Fee Disclosure Regulation**

- A. Most 401(k) plan service providers must deliver to employers each year a **written disclosure** containing:
 - (i) A description of the **services** provided to the plan;
 - (ii) The status of the provider as a **fiduciary** under ERISA (silence means no fiduciary status); and
 - (iii) The source and amount of all direct and indirect **compensation** received by the provider.
- B. Employers are required to determine the adequacy of the disclosures and promptly request in writing that service providers correct **disclosure omissions**;
- C. After 90 days, employers are required to **notify the DOL** of any service providers that violate the disclosure rule and in most cases terminate the contract;
- D. Employers are to review the disclosures and determine the reasonableness of **each contract** (including every mutual fund investment option available to plan participants);
- E. All contracts must permit **termination** on reasonably short notice without penalty;
- F. Unreasonable contracts must be **terminated**; and
- G. **Doing nothing** is the worst thing an employer can do.

6. Consequences of ERISA Violations

A. *DOL Fines, Penalties, etc.*

- (i) During DOL audits in 2013, over **75% of reviewed plans** were fined, penalized, or forced to reimburse plan assets for ERISA violations;
- (ii) The **average assessment** was \$600,000;
- (iii) Many audits were triggered by a complaint from a **disgruntled employee**; and
- (iv) DOL recently hired 1,000 new agents—most for assignment to investigate **ERISA compliance issues**.

B. *Civil Liability—Plan Sponsor*

- (i) Under ERISA, **one participant** can bring suit on behalf of the entire plan;
- (ii) A significant **wave of litigation** has developed asserting that sponsors did not diligently monitor plan fees and investment offerings;
- (iii) In 2008, the Supreme Court held that participants can also recover **investment losses** from plan sponsors;
- (iv) **Attorney's fees** can be awarded to a prevailing plaintiff under ERISA; and
- (v) While ERISA can immunize employers from liability for investment decisions made by plan participants, the DOL has asserted that employers remain liable for all losses resulting from the **imprudent selection and monitoring** of investment options.

C. *Personal Liability—Plan Fiduciaries*

- (i) Each employee or owner with decision making authority regarding a 401(k) plan is **personally liable** for ERISA fiduciary violations he or she conducts or permits;
- (ii) ERISA **prohibits** fiduciaries from being indemnified out of plan assets; and
- (iii) Indemnification by the plan sponsor typically **excludes** gross negligence or willful misconduct by individual fiduciaries.

7. **Transfer of Investment Selection Responsibility**

- A. Employers are permitted to **delegate responsibility** for investment selection and monitoring to a financial advisor;
- B. Under ERISA, **liability is transferred** from the employer (and plan fiduciaries) to the advisor;
- C. Employers (and plan fiduciaries) must **relinquish** all authority to select and monitor investments; and
- D. Financial advisor must **accept** discretionary authority and acknowledge status as an ERISA §3(38) fiduciary.