

# Ask Kidder.®

## PLAN SPONSOR and FIDUCIARY ALERT – Kidder Is Prepared!

Over the past few years through our Ask Kidder newsletters, we have kept you up to date on key regulatory changes such as new 408(b)(2) disclosure rules, enhanced reporting and electronic submission on IRS Form 5500s, enhanced participant disclosures under Section 404, and a proposed expanded definition of “fiduciary.” These rules have taken longer than expected to become effective and as a result many plan sponsors, fiduciaries, financial and tax professionals have become immobilized or partially immune to this upcoming event.

The changes made already and those that have yet to be implemented will forever change the way qualified plans (401(k), Profit Sharing, 403(b), Defined Benefit, Cash Balance) operate. They affect everyone involved with a plan including the plan sponsor, plan fiduciaries, trustees, Board of Directors, plan participants, investment providers/platforms, investment professionals, mutual fund companies, insurance companies and third party administrators.

The purpose of these multiple regulatory changes is to assist the plan sponsor and plan participant in making informed and reasonable decisions based on fully disclosed information. The Pension Protection Act of 2006 essentially declared that the 401(k) and 403(b) programs are the primary retirement vehicle for US taxpayers. Consequently, providing ways to improve the result produced most of this legislation and regulation.

The plan sponsor must now consider to a greater degree each component of the plan under the umbrella of “Fiduciary Governance”. The components of the plan include:

**1. Plan Design and Plan Document** – What plan design will satisfy the needs of the employer and participants? Most employers and many financial and tax professionals are not aware of the numerous plan design options available. They assume that their choices are limited due to the mass marketing of organizations that want to gather assets as opposed to building the right plan. Building the right plan design optimizes the chance of success as well as utilizes the company’s financial resources in the best possible way. One design example most plan sponsors are not aware of is you can have different allocation formulas for different employees or employee groups. Most plan sponsors want to provide a benefit but assume it must be equal. They are not aware they have flexibility to direct that

benefit to certain employees that may contribute more to the company’s financial success.

**Fiduciary Governance Note:** *With a plan design similar to our example you need to have a document that is drafted, regularly updated and approved by the IRS. While this plan document provides considerable value to the plan sponsor, it does not cost much more than a basic plan document. The plan design and document is not generally visible to a plan participant except via a Summary Plan Description (SPD), however it is the foundation and the brains of the plan from the plan sponsor perspective.*

**2. Plan Administration and Compliance** – Plan administration, compliance, testing and asset recordkeeping are not as easy as pushing a button. While those services seem to be a backroom operation, it is the heart of the plan. If your plan is not administered properly by experienced professionals with appropriate systems, security, procedures, policies and back-up, then your risk for non-compliance with the IRS and Department of Labor (DOL) increases. Is your provider focused on administration and compliance full-time? There are a lot of moving parts that need knowledgeable and experienced professionals that care about the outcome the client wants to achieve. Just like plan design has numerous options, how to administer a plan involves understanding multiple processes of plan administration and compliance, as well as the multitude of options that the IRS and DOL provide to satisfying the testing and compliance requirements of the regulations. Ongoing and regular continuing education is essential for professionals involved in the plan administration and compliance areas to provide the optimum results for a plan sponsor.

**Fiduciary Governance Note:** *Plan administration, compliance, testing and asset recordkeeping is also not something the participant sees. They and the plan sponsor want to know if it is accurate and timely. The interaction and effective consultative communication between the plan sponsor and provider is critical in maintaining the plan as an effective tool and benefit. When an issue develops at the employer/plan sponsor level, the Primary Administrator at Kidder is called immediately along with the CPA/attorney, and financial professional to review options and opportunities.*

Continued on Page 2

**NOTICE:** Any tax advice expressed in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of avoiding penalties imposed on the taxpayer by any government taxing authority or agency. If any such tax advice is made available to any person or party other than the party to whom the advice was originally directed, then such advice is to be considered as being delivered to support the promotion or marketing of the transaction or matter discussed or referenced. Each taxpayer should seek specific tax advice based on the taxpayer’s circumstances from an independent tax advisor.

**3. Investment Provider/Platform** -- This is where 80% to over 90% of plan costs exist. The participant usually views this as the plan. This includes the mutual funds or other investment options, the recordkeeping platform that allows for the daily trading and generates the participant statements, and the investment/financial professional assisting the plan sponsor in providing education and investment due diligence. This area has been impacted the most by the new laws and regulations. The plan sponsor needs to know what services are being provided by each group, what those services cost, if that cost is reasonable, and if any of these parties are serving in a fiduciary capacity. The new rules and regulations are designed to help the plan fiduciaries distinguish these costs.

The responsibility of the plan sponsor/plan fiduciaries is not to have the lowest cost plan, but to have the right plan at a reasonable cost. To do so, the plan sponsor needs to know what those fees are. In the past, many providers and financial professionals made it appear that there was little or no cost. There is *always* a cost. Now those costs will be visible in a consistent format so that the plan fiduciaries can make informed decisions. By providing this disclosure, it will be easier to compare services and costs.

The plan sponsor and plan fiduciaries must realize that putting all of these costs on a spreadsheet is *NOT* the solution, it is strictly a quantitative measurement and does not factor in complexity and qualitative measures such as effective communication and service.

Greater knowledge and ability to implement is also a qualitative measurement. An analogy to consider: what is the difference between going to a general medical practitioner or going to the Mayo clinic? It is a qualitative issue relating to a higher likelihood in providing the correct solution and generally involves greater specialization, expertise and experience. This higher quality sometimes comes with a slightly higher cost, whether it be the Mayo Clinic or an expert in providing qualified plan services, but it can produce positive results significantly out-weighting the additional cost. The plan sponsor needs to look at the qualitative issues as well and the quantitative.

Another qualitative issue relates to the type of funds selected. Certain fund types such as "actively managed" funds are generally more costly than "passive" funds such as "index" funds. Small company funds usually have higher expense ratios than large capitalization domestic funds, but they have historically generated higher long term returns. Consequently, while "passive" funds may be less expensive, increased returns may be achieved by higher cost "actively managed" funds.

**Fiduciary Governance Note:** *The issue of "fiduciary" under the proposed regulation, which is expected to become effective the beginning of 2012, will produce considerable change. Most investment platforms/providers will not serve in a fiduciary capacity. If they do, then they generally limit how the plan operates or the choices available. Many utilize a fiduciary warranty or guarantee. That is not the same as serving as a fiduciary. They are warranting or guaranteeing that if you use their investment choices, they will back you up in court. The warranties and guarantees generally do not address the issues of fee reasonableness.*

*Investment professionals will now have to decide whether they will affirmatively state that they are acting in a fiduciary capacity. In the past, they may have been serving as "broker" and were legally excluded from the definition as they were viewed as someone who processed transactions and did not provide advice. Under the proposed regulation, that is changing since investment selection of funds and platforms are generally directed/advised by the investment professional and is not just a transaction. Many of the broker/dealer firms are determining how to address that situation. A broker/dealer and its brokers' legal/financial exposure and compliance requirements in serving as an investment fiduciary under either Section 3(21) or 3(38) of ERISA has increased dramatically. These firms are now determining who should be allowed to service qualified plans and be allowed to wear the "investment fiduciary" hat.*

*Under this proposed definition change, part of the burden shifts to the plan sponsor. Specifically, an investment professional could affirmatively tell the plan sponsor that they are NOT serving as an investment fiduciary to the plan. If that were the case, under the proposed regulation the investment professional will also be required to say that the guidance/advice being provided is NOT impartial. In essence, they are telling the plan sponsor that everything they say may be biased.*

*Let's consider the scenario that participant Donny Trumps, a more sophisticated investor, is not happy with fund choices and asks about fees. He approaches the plan sponsor and asks how decisions are made and who do the plan sponsor/plan fiduciaries rely on for advice/guidance. He asks who the broker is on the plan and if they are a fiduciary? If the plan sponsor says they use broker B and that broker is not an investment fiduciary, then Donny Trumps (or his attorney) may respond with "So you are taking the advice/guidance from a party that specifically disclosed to you that the advice/guidance was not impartial? I thought your fiduciary responsibility was to look out for the best interests of the plan and participants?" A potential fiduciary issue has developed. Plan sponsors/plan fiduciaries will need to know whether the investment professional who is assisting them with*

Continued on Page 3

**NOTICE:** Any tax advice expressed in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of avoiding penalties imposed on the taxpayer by any government taxing authority or agency. If any such tax advice is made available to any person or party other than the party to whom the advice was originally directed, then such advice is to be considered as being delivered to support the promotion or marketing of the transaction or matter discussed or referenced. Each taxpayer should seek specific tax advice based on the taxpayer's circumstances from an independent tax advisor.

*such decisions will serve in an “investment fiduciary” capacity. With that said, there is no requirement relating to the investment provider/platform, mutual fund, third party administrator or CPA to be an “investment fiduciary” in their specific capacities. Those services are generally considered a “ministerial” function and not a “fiduciary” activity. They will still be expected to communicate whether they are or are not a fiduciary. They will most likely indicate that they are not acting in a fiduciary capacity since they are serving at the direction of the plan sponsor and not making discretionary decisions for the plan sponsor. Ministerial functions are still excluded from the definition of fiduciary.*

*As for Kidder, a separate and distinct entity has been created to assist financial/investment professionals and plan sponsors/plan fiduciaries with the investment fiduciary issue if they need such assistance.*

**4. Participant Education** – Participant Education can encompass group meetings, individual meetings, enrollment materials and website access. These services are usually provided by a combination of the plan sponsor, the investment professional, and the investment platform. While there is no specific requirement except for certain notices and communication, the goal is to provide sufficient information for the plan participant to make an informed decision. The more extensive the education program, the more cost involved especially if they involve face-to-face interaction such as with an investment professional.

If the plan sponsor desires reduced fiduciary liability under Section 404(c) there are additional required communications that need to be given to the plan participants. Under the new regulations, much of the required information will be provided by the investment platform provider. When that is not available, the information will come from the investment professional. Keep in mind that it is the plan sponsor’s responsibility to monitor the effectiveness of such communication.

The cost for these services are usually built into the investment professional fees described earlier. Depending on the size of the plan, the number of participants, the extent of the participant education, and the number of locations, the cost for the participant education can vary greatly. Cost may be tied to a percentage of assets, be a separate flat fee, hourly fee or a per participant dollar charge.

**Fiduciary Governance Note:** *The extent and scope of the participant education depends on the goals of the plan sponsor and what they want their plan to achieve. Successful participant outcomes can be achieved in a number of different ways and a specific participant education program can assist in achieving a particular outcome. Employee education is one piece of the*

*plan design puzzle, with appropriate investment platforms also being part of the equation.*

*From a fiduciary perspective, the plan sponsor needs to regularly measure the results of the participant education program and compare it to the cost of the program. A great part of that cost relates to the cost of the investment professional. Going forward, the cost of the “investment fiduciary” services for the plan sponsor, should be separated or specifically outlined as compared to the cost of the “participant education” services.*

**Fiduciary Benchmarking Comment** – As noted, the new regulations and rules are geared towards consistent and timely disclosure in order for the plan sponsor and plan participant to make informed decisions. It is both qualitative and quantitative in nature. While cost is part of the issue, a successful outcome for the plan and the participant is the goal. The right plan may potentially result in a higher cost program because it is administered correctly, utilizes appropriate investments to achieve the optimum returns and is supported by an effective education program. The fiduciary governance and investment due diligence oversight monitored by the plan sponsor and an investment professional (who is serving as investment fiduciary) will help to achieve the successful outcome.

Ultimately, the key is not to look for the lowest cost, but the most effective use of the dollars. To review the reasonableness, the plan sponsor should undertake a regular informal or formal fiduciary benchmarking of fees and services. Many programs in the marketplace focus only on fees or average fees. For larger plans or smaller more sophisticated plans, a deeper review of not only fees but the specific services provided should be considered and conducted every few years. Kidder has aligned itself with independent fiduciary benchmarking programs that are available for its clients.

**Conclusion:** The upcoming changes have altered the qualified plan landscape. While it has raised the level of compliance, the purpose is to help make better and more informed decisions. The qualified plan has become the main retirement savings vehicle so its importance has increased dramatically. Reasonable fees and successful outcomes via an appropriately designed and administered plan are vital to achieving the goals. Working with qualified parties and maintaining an appropriate fiduciary governance program will not only protect the plan sponsor from liability, but will help achieve the goals for the plan sponsor and plan participants.

Kidder is Prepared!