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FiduciarySource® Guide

Helping plan sponsors understand their fiduciary duties

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Introduction to the T. Rowe Price Fiduciary Guide

Fiduciary duties and responsibilities are a growing responsibility for workplace retirement plan sponsors. To help you meet these challenges, T. Rowe Price is committed to providing high quality education that reflects the latest and best thinking in this area. Through its **FiduciarySource®** program, T. Rowe Price offers our Fiduciary Guide to plan sponsors. This valuable resource provides a basic overview of fiduciary responsibilities applicable under the Employee Retirement Income Security Act of 1974 ("ERISA").

This guide is an introductory fiduciary resource for defined contribution retirement plan sponsors and their employees working with the plan(s). It streamlines complex fiduciary topics into an easy-to-understand format. The goal is to help plan sponsors determine who their plan's fiduciaries are, and what basic duties those fiduciaries have. This material can help lay the foundation for the development of good fiduciary practices, such as asking the right questions, creating a process for decision making, and seeking help from experts when needed.

The emphasis is on providing general principles, not specific formulas. Readers should recognize that there is no "one-size-fits-all" when it comes to fiduciary best practices. What may be appropriate for a large retirement plan sponsor may be very different when compared to a retirement plan sponsored by a small business with fewer resources.

This guide can't tell you everything you will ever need to know about being a fiduciary, and it can't take the place of legal advice regarding what to do in a particular situation. You should seek counsel for specific issues as you encounter them.

To provide the best thinking from diverse perspectives, each chapter of our Fiduciary Guide has been authored by an ERISA expert with distinct points of view and extensive experience representing plan sponsors and educating them on their responsibilities.

If you are already familiar with the basics of "who" and "what" in relation to fiduciary responsibility, but you have a special interest in a particular topic (e.g., litigation), the material is designed so you can turn directly to chapters and selected topics.

We sincerely hope you find this resource helpful as you scratch the surface of a complex but increasingly important responsibility—a responsibility which is designed to help safeguard the retirement security of you and your coworkers.

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My role as a fiduciary and basic fiduciary duties

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Purpose of the fiduciary rules

Introduction and key concepts: Congress passed the Employee Retirement Income Security Act of 1974 (ERISA), as amended, after more than a decade of discussion, investigation, and negotiation. Recognizing that the "well-being and security of millions of employees and their dependents are directly affected by" employee benefit plans, the law states that one of its purposes is to "protect" plan participants and beneficiaries (collectively, "participants") by "establishing standards of conduct, responsibility, and obligation for fiduciaries." By establishing a fiduciary relationship between plan overseers and participants, and by imposing personal liability on fiduciaries who breach their duties, ERISA creates a framework that demands careful oversight by fiduciaries and fidelity to participants. Employee benefit plans are as important today as they were in 1974, and the fiduciary structure required by ERISA continues to protect participants.

This chapter outlines the fiduciary standards to help you understand and satisfy your duties. Five key concepts to understand at the outset are:

- ERISA defines "fiduciary" in ***functional terms***, meaning it focuses on the activities performed. A person's job title, intent, or knowledge are irrelevant when determining if an individual is a fiduciary under the functional definition.
- Every plan must have at least one ***named fiduciary*** to ensure that participants can identify a fiduciary.
- Fiduciaries are required to comply with high standards of conduct, which are referred to as ***fiduciary duties***.
- Fiduciaries who breach their duties have ***personal liability*** for losses resulting from the breach.
- Certain transactions, known as ***prohibited transactions***, are so fraught with the possibility of wrongdoing that fiduciaries must avoid these transactions, unless an exemption applies.

Who is a fiduciary?

Functional definition

Because ERISA's fiduciary duties apply only to fiduciaries, it is important to understand who is a fiduciary. A person is a fiduciary "to the extent" that he or she:

- "exercises any discretionary authority or discretionary control" over the management of the plan;
- "exercises any authority or control" over plan assets;
- receives compensation for providing investment advice; or
- "has any discretionary authority...in the administration" of the plan.

The definition of fiduciary is intentionally broad, and it focuses on the functions of an individual. A person will be considered a fiduciary if he or she exercises discretion or has discretionary authority over plan administration, assets, or investments. Plan assets receive heightened protection because discretion is conspicuously absent from the definition. An individual need only exercise authority or control over plan assets to be a fiduciary.

Case study: Functional definition of fiduciary

ACME Corporation has established a 401(k) plan. A participant in the plan with a vested account balance of $50,000 has terminated employment and submits a distribution request form to the Human Resources Department. The Human Resources director decides not to process the distribution because he suspects the employee is going to bring a discrimination claim against ACME Corporation, and he wants leverage over the employee.

The Human Resources director is a fiduciary by virtue of his exercising discretion over whether or not to make the distribution from the plan. The functional test does not depend on the director's job title, intent, or even knowledge concerning ERISA fiduciaries. It does not matter what the director's motive is for taking this action. It is what the director does that matters. Note that the director also could be treated as a fiduciary without exercising discretion because this matter involves plan assets, and he need only exercise authority or control over the assets to be considered a fiduciary.

Named fiduciary

ERISA's broad functional definition of fiduciary should ensure that every plan has a fiduciary. However, Congress went further, and ERISA requires that every plan identify at least one fiduciary, the "named fiduciary," who is responsible for overall administration of the plan. A primary reason for requiring a named fiduciary is to unambiguously identify for participants who is responsible for operating the plan.

Special care should be given to the selection of the named fiduciary or fiduciaries. It can be an individual or an entity, including the company sponsoring the plan. Many plan sponsors name a committee or an individual by title to be the named fiduciary.

There is no single "right" answer to the question, "Who should be the named fiduciary?" It generally depends on the size and needs of the plan sponsor. A sole proprietorship is more likely to name an individual, and a large corporation will commonly appoint a committee (a typical committee could include individuals from the Human Resources, Finance, and Legal Departments). What is critical is that the named fiduciary be identified clearly and that the person or entity serving as the named fiduciary understands their (or its) responsibilities.

Plan documents typically provide that, unless a person or entity is specifically named, the "default" named fiduciary will be the employer. If the plan document does not identify the named fiduciary, ERISA provides that the named fiduciary will be the plan sponsor, which is also usually the employer. Therefore, it is important to understand what it means to have the employer as the named fiduciary. If the employer is a corporation, courts will likely treat the corporation's board of directors as the named fiduciary because the board has the ultimate authority and

There is no single "right" answer to the question, "Who should be the named fiduciary?" It generally depends on the size and needs of the plan sponsor.

responsibility over the company. This can put the board in the undesirable position of serving as a plan fiduciary (in addition to its duties to shareholders), which could expose board members to unwanted liability for plan administration and potentially hamper the board's ability to make business decisions for the company.

Allocating and delegating fiduciary responsibilities

While there must be at least one named fiduciary, there can be more than one fiduciary. A plan document may provide for the allocation of fiduciary duties among named fiduciaries and, further, for named fiduciaries to delegate fiduciary responsibilities to other individuals or entities who are not named fiduciaries.

If the plan document allows for the allocation and/or delegation of fiduciary responsibilities, you must follow the plan documents carefully in order to successfully allocate and/or delegate responsibilities, and you must carefully select and monitor the appointed fiduciary because appointing a fiduciary is a fiduciary act.

As with many fiduciary acts, when it comes to allocating and/or delegating fiduciary responsibilities, there is no such thing as "set it and forget it." Fiduciaries must continually engage in meaningful oversight of those to whom responsibility has been delegated. As one court colorfully described it, "good old-fashioned 'kicking the tires' of the appointed fiduciary's work is required."

Case study: Allocation and delegation

ACME Corporation sponsors a 401(k) plan. The plan document states that the plan sponsor shall be the named fiduciary unless it appoints other persons or entities. The plan document also provides that named fiduciaries may appoint other fiduciaries to assist in operating the plan.

ACME's board of directors decides it is not in the best position to manage the operation and administration of the plan. Therefore, it names an Administrative Committee, responsible for plan administration, and an Investment Committee, responsible for overseeing the investment of plan assets. Members of each committee consist of employees of ACME appointed by the board of directors, and both committees must report to the board periodically.

The Administrative Committee engages a recordkeeper to assist with the administration of the plan, and the Investment Committee engages an investment adviser to assist with selecting and monitoring the investment funds that will be offered to plan participants.

ACME's board of directors is a fiduciary with respect to its oversight of the two committees. It must carefully select the committee members, and it should routinely monitor whether or not the committees are performing their duties (and remove and replace committee members if necessary). If the board of directors properly appoints and monitors the fiduciaries, it will generally not be liable for any losses resulting from their fiduciary decisions. Similarly, the committees must diligently select the recordkeeper and investment adviser, and they must monitor the performance of (and fees charged by) those service providers. When allocating or delegating fiduciary responsibilities, a fiduciary cannot simply set it and forget it; it must monitor the service providers to ensure they are fulfilling their responsibilities and take action if they are not.

Other fiduciaries:

Trustees and investment managers

In addition to functional fiduciaries and named fiduciaries, you should be aware of two other common plan fiduciaries. First, trustees holding plan assets are always considered fiduciaries, although the scope of their duties can be limited if they are either directed trustees or the authority to manage assets has been delegated to investment managers. Most trustees of retirement plans are directed trustees with limited fiduciary duties.

Second, investment managers are always fiduciaries. Investment managers are defined as registered investment advisers, banks, or insurance companies who have discretion to invest plan assets. Investment managers are distinguishable from nondiscretionary investment advisers (who are fiduciaries under the functional definition because they provide investment advice for a fee). Investment managers have discretion over the investment of plan assets, whereas investment advisers are typically not able to make or change investments unilaterally.

> When making settlor decisions, the person making the decision can do what he or she believes is in the best interest of the employer, but when a person is making a fiduciary decision, he or she must do what is in the best interest of participants.

Common fiduciaries

A defined contribution retirement plan's fiduciaries typically include:

- individuals exercising discretion;
- investment advisers;
- all members of an administrative committee or investment committee (if committees have been appointed);
- those who select committee members or fiduciaries; and
- the trustee.

Accountants and attorneys are usually not considered fiduciaries unless they are exercising discretion over plan administration (which would be unusual).

Fiduciary acts, ministerial acts, and nonfiduciary acts

Fiduciaries are responsible only for fiduciary acts, which generally require the exercise of discretion over some aspects of plan administration or investments. A person would not be considered a fiduciary if they are performing purely ministerial functions (such as processing forms and handling routine, day-to-day plan operations) for the plan that do not require the exercise of discretion.

Importantly, fiduciaries are not responsible for what are commonly referred to as "settlor" decisions. These decisions include establishing a plan, determining the design of the plan, amending the plan, and terminating the plan. When making settlor decisions, the person making the decision can do what he or she believes is in the best interest of the employer, but when a person is making a fiduciary decision, he or she must do what is in the best interest of participants. Once a settlor decision has been made, subsequent acts to implement the decisions and administer the plan may be subject to ERISA's fiduciary rules.

Case study: Settlor vs. fiduciary acts

ACME Corporation decides to establish a 401(k) plan to help it recruit and retain employees. ACME decides that the plan will provide an employer matching contribution. After several years of sponsoring the plan, ACME decides that the matching contribution is too expensive and decides to eliminate the match going forward. ACME's decisions to establish the plan, offer a matching contribution, and subsequently eliminate the matching contribution are all settlor decisions. None of those decisions is a fiduciary decision and, therefore, can be made based on the best interest of the employer.

While the matching contribution is in place, ACME's Payroll Department calculates the matching contribution for each participant based on the plan formula. There is no discretion exercised in performing the match calculation. This work by the Payroll Department would likely be considered ministerial and, therefore, not a fiduciary act.

By contrast, once the plan is established and operating, the plan fiduciary overseeing administration of the plan must ensure that the plan is operated in accordance with its terms and ERISA. For example, the fiduciary may monitor and confirm that matching contributions are calculated in accordance with the terms of the plan. In addition, the fiduciary may help ensure that an accurate summary plan description (SPD) is distributed to participants, and when the plan is amended to eliminate the matching contribution, participants receive a summary of material modifications (SMM) or updated SPD describing the change.

Four core fiduciary duties

ERISA imposes high standards of conduct on plan fiduciaries, sometimes referred to by courts as the "highest known to law." The four core fiduciary duties under ERISA are:

- The duty of loyalty, which requires the fiduciary to act "solely in the interest" of participants and with the "exclusive purpose" of providing benefits and defraying reasonable expenses of plan administration.
- The duty of prudence, which requires the fiduciary to act with the care, skill, prudence, and diligence of a prudent person who is knowledgeable about the pertinent issue. Specifically, this duty requires a fiduciary to discharge its duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."
- The duty to diversify the plan's investments to minimize the risk of large losses.
- The duty to follow the terms of the plan document, provided the terms are consistent with ERISA.

Loyalty

The duty of loyalty is the cornerstone of ERISA's fiduciary obligations, and fiduciaries can inadvertently violate this duty by mistakenly placing their own self-interest or the interest of the employer ahead of the participants.

Case study: Loyalty

ACME Corporation's Administrative Committee, the named fiduciary, is conducting a search for a recordkeeper for its 401(k) plan. The recordkeeper will provide custodial services, a participant website, and other services necessary to run the 401(k) plan. The Committee intends to use plan assets to pay the recordkeeper's fee.

Two vendors bid for the work, and both are well qualified and offer the same services. One vendor's fee is more expensive, but it offers to provide ACME Corporation with free payroll services if it is chosen.

The Committee would likely violate its duty of loyalty if it chooses the more expensive vendor because it would be requiring the 401(k) plan to pay more than is necessary for 401(k) plan services in order to obtain free payroll services that benefit ACME Corporation. This type of breach can easily arise if a fiduciary does not understand its duties or confuses who it is acting for—the participants, not the employer.

Prudence

The duty of prudence requires a fiduciary to act in manner consistent with that of a prudent person acting under similar circumstances. Prudence is determined at the time the decision is made, rather than in light of the ultimate success or failure of the decision or with the benefit of hindsight. Fiduciaries are judged on the quality of the process they followed in reaching a decision, rather than the outcome of the decision.

Courts generally hold fiduciaries to a "prudent expert" standard—meaning that if the fiduciary lacks the necessary expertise to handle an issue, it must obtain the expertise through the use of independent advisors. Courts have made clear that documentation—such as meeting minutes, notes, and reports—is the best evidence that a fiduciary has engaged in a prudent decision-making process.

Case study: Prudence

ACME Corporation's Investment Committee is responsible for selecting the investment fund menu offered to participants in the ACME 401(k) Plan.

None of the Investment Committee members are investment professionals. Accordingly, the Committee relies on an investment adviser to assist in choosing and monitoring the menu of investment funds. The Committee receives regular reports from the investment adviser, which it reviews diligently, and the Committee regularly meets with the investment adviser to "kick the tires" by asking questions and reviewing the investment adviser's recommendations. The Committee documents its meetings and decisions.

One of the funds selected by the Committee does not perform well. Although the fund has underperformed, a court will not use hindsight to second guess the Committee's initial decision because it engaged in a prudent process in selecting the fund. However, the Committee must continue to prudently monitor the fund on an ongoing basis and determine whether or not to keep or replace it.

Diversification

A fiduciary who has investment duties has a duty to diversify investments in order to minimize the risk of large losses. Although this is an important fiduciary duty, it typically presents less risk to fiduciaries overseeing defined contribution retirement plans, such as 401(k) plans, that offer a broad array of investment funds and allow participants to decide which investments to choose. In participant-directed plans, a fiduciary generally will not be held liable for losses experienced by participants who exercise control over the investment of their accounts; however, the fiduciary has a continuing responsibility for selecting and monitoring the investment funds offered to participants.

Case study: Diversification

Assume ACME Corporation's Investment Committee is responsible for investing employer discretionary contributions under the ACME 401(k) Plan, and it decides to invest 100% of those assets in a single guaranteed investment contract (GIC) issued by one life insurance company that was itself invested in risky assets. The GIC promises to pay interest annually and return the principal amount after five years.

Approximately three years after making the investment, the life insurance company is placed in conservatorship. The 401(k) plan loses nearly all of the value of its investment in the GIC. Participants in the ACME 401(k) Plan sue the Investment Committee for breach of duty to diversify assets to minimize the risk of large losses.

The Investment Committee is at risk of having violated its fiduciary duty to diversify plan assets.

In an actual case with similar facts, the court found that investing 75% of plan assets in a single investment violated the diversification rule when considering the known risks of the life insurance company and the needs of the profit sharing plan in that case. There is, however, no bright line percentage (e.g., 60%, 70%, or 80% of assets) that will automatically trigger a violation of the duty to diversify plan assets. It is based on the facts and circumstances of each case.

Follow plan terms

One of the most important questions a fiduciary can ask is, "What does the plan document say?" Fiduciaries must follow the plan terms and other governing documents (unless they are inconsistent with ERISA). Therefore, before making a decision, fiduciaries should confirm that the decision is consistent with the plan terms and any other governing documents.

Case study: Follow plan terms

As noted in the initial case study, ACME Corporation's director of Human Resources was acting as a functional fiduciary when he decided not to process the terminated employee's request for distribution of his $50,000 account balance.

The terms of the ACME 401(k) Plan clearly provide that termination of employment is a "distribution event," and terminated employees are entitled to request and receive a distribution of their vested account balance.

In this situation, the director of Human Resources, acting as a fiduciary, is likely to have violated the fiduciary duty to follow the terms of the plan.

Personal liability

To help ensure that participants are protected when fiduciaries breach their duties, ERISA provides that fiduciaries who breach their duties are personally liable for any losses to the plan. Importantly, ERISA authorizes participants, the U.S. Department of Labor, and other fiduciaries to bring lawsuits seeking to hold a fiduciary personally liable. This is significant because it demonstrates the array of parties with the ability to hold a fiduciary accountable. In addition, courts are authorized to award attorney's fees and costs to participants or fiduciaries, and that can help those parties bring lawsuits.

Due to the risk of personal liability, fiduciaries should consider obtaining fiduciary liability insurance and indemnification protections from the plan sponsor.

> In participant-directed plans, a fiduciary generally will not be held liable for losses experienced by participants who exercise control over the investment of their accounts; however, the fiduciary has a continuing responsibility for selecting and monitoring the investment funds offered to participants.

Prohibited transactions

In addition to complying with ERISA's general fiduciary standards, fiduciaries must avoid causing the plan to engage in certain transactions with a "party in interest." Congress created these prohibited transactions because of the risk they present for unfair dealings with the plan. Parties in interest include fiduciaries, service providers, the employer, employees, officers, directors, certain owners, and relatives.

Prohibited transactions include:

- selling or exchanging any property between the plan and a party in interest;
- lending money between the plan and a party in interest; and
- furnishing services between the plan and a party in interest.

Importantly, the prohibited transaction rules are "per se" prohibitions and cannot be entered into even if the transaction would benefit the plan. In addition to the party-in-interest prohibited transactions, fiduciaries are precluded from engaging in self-dealing prohibited transactions, which prohibit fiduciaries from using plan assets for their own benefit, acting on behalf of a party whose interests are adverse to the plan, or receiving personal compensation from any party doing business with the plan.

Excise taxes, civil penalties, and, in certain cases, criminal penalties can be imposed against a fiduciary for breach of the prohibited transaction rules.

Congress recognized, however, that the prohibited transaction rules are very broad and could ban transactions that are necessary or beneficial to operating a plan. For example, plans require service providers in order to function properly and yet, the prohibited transaction rules would preclude such services. Similarly, loans between a plan and a party in interest are prohibited; however, many plan sponsors want a plan design that allows participants to borrow money from their individual account under the plan. Accordingly, there are several statutory and regulatory exemptions from the prohibited transaction rules.

> In addition to complying with ERISA's general fiduciary standards, fiduciaries must avoid causing the plan to engage in certain transactions with a "party in interest."

The most common exemptions are:

- contracts for services, provided the services are necessary and only reasonable compensation is paid from plan assets;
- plan loans to participants, provided that loans are available to all participants on a reasonably equivalent basis, made according to the terms of the plan, charge a reasonable interest rate, and are adequately secured;
- exemptions for dealings with banks, insurance companies, and other financial institutions; and
- exemptions for the provision of investment advice with respect to participant-directed accounts.

Conclusion

In enacting ERISA, Congress recognized the importance of retirement plans and other benefit plans and the need to protect participants against the intentional and inadvertent misdeeds of those responsible for administering the plan. One of the most important protections ERISA offers is the fiduciary structure required for operating plans and managing plan assets. Fiduciaries are subject to high standards, and the following practices can help you satisfy your duties:

- Understand when you are acting as a fiduciary and know the basic fiduciary duties that require your compliance.
- Engage independent consultants to assist if you do not have the necessary expertise.
- "Kick the tires" continually. You cannot "set it and forget it" with respect to the service providers you engage or the fiduciaries you appoint.
- Establish a sound process for overseeing the operations of your plan, which may include appointing committees or individual fiduciaries. Document your actions in writing.
- Monitor all service provider fees paid from plan assets to ensure that they are reasonable.
- Check the plan terms and confirm that they are consistent with the actions you are contemplating.

Understanding and complying with the fiduciary rules will not only protect you as a fiduciary, it also can result in better administration and overall plan performance.

T. Rowe Price would like to recognize Kenneth F. Ginder for his contributions to authoring this chapter.

KENNETH F. GINDER

Partner, Verrill Dana, LLP

Kenneth F. Ginder handles matters in all areas of employee benefits, including retirement plans, welfare plans, fringe benefits, and executive compensation. He regularly counsels clients on fiduciary obligations under ERISA, and on income and employment tax issues associated with all areas of employee benefits. Ken has significant experience representing clients in Internal Revenue Service (IRS) and U.S. Department of Labor (DOL) audits. Ken has represented many clients before the IRS under its Employee Plans Compliance Resolution System (EPCRS), and before the DOL under its Voluntary Fiduciary Correction Program (VFCP) and Delinquent Filer Voluntary Correction Program (DFVCP). He also spends a significant amount of time advising clients on their nonqualified deferred compensation plans, incentive compensation plans, and welfare benefit plans including the Affordable Care Act (ACA), Consolidated Omnibus Budget Reconciliation Act (COBRA), and Health Insurance Portability and Accountability Act (HIPAA) issues.

Overseeing investments 2

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Overseeing investments

One of the most important aspects of your retirement plan that requires care and attention is the plan's investments. As a plan sponsor, it is critical for you to understand who has fiduciary responsibilities with respect to your plan's investments, what those responsibilities are, and how they may best be discharged. Of course, the answers to these questions can vary depending on the specifics of your plan, and getting professional advice tailored to your plan from a qualified expert may be useful. This chapter provides some basic guidance concerning the who, what, and how of fiduciary oversight of plan investments.

Who is a fiduciary with respect to the plan's investments?

Whether a person is a fiduciary of a plan depends upon the *functions* performed for the plan and not the person's *title* or *position*. So while a plan's fiduciaries may ordinarily include discretionary trustees, investment advisers, and named fiduciaries such as investment or administrative committees, others may have a fiduciary role if they have decision-making power for the plan.

When it comes to the plan's investments, most defined contribution plans are set up so that the participants themselves can decide how to invest their plan accounts. Nonetheless, plan fiduciaries do have responsibility for choosing the investment options that will be made available to participants.

Fiduciary roles with respect to plan investment options can vary. Some plan sponsors decide to appoint an investment committee that is given decision-making authority with respect to the selection and oversight of plan investments. But not everyone who serves as a fiduciary is an expert in investments. For this reason, the plan fiduciary or fiduciary committee may decide to hire an investment adviser to provide professional advice. If the plan fiduciaries retain the decision-making authority, they can and should consider the professional advice, but they are still responsible for investment decisions for the plan. That said, plan fiduciaries may choose to outsource their decision-making authority to an "investment manager" fiduciary as contemplated by ERISA § 3(38). A 3(38) investment manager fiduciary assumes full responsibility for investment decisions for the plan and must be someone with the requisite qualifications, such as a registered investment adviser (RIA). If you decide to go this route, it is important that your delegation of authority to the 3(38) investment manager fiduciary be in writing and be clear as to what specific duties are being delegated. A plan fiduciary may also hire a 3(38) investment manager who will make available to participants account management services. Under such arrangement, individual participants can elect to turn over the management of their plan account to the 3(38) manager, who will invest that participant's account among investment options available to the plan in accordance with an asset allocation strategy. Even when you hire a 3(38) investment manager to select, monitor, and make changes to plan investments or to provide managed account services to plan participants, you as the plan sponsor are still responsible for selecting that professional and for overseeing their performance.

What are the fiduciary's responsibilities with respect to plan investments?

The basic responsibilities of an investment fiduciary are selecting and monitoring the investment options that are made available under the plan and the oversight of any plan investment managers. As the Supreme Court confirmed, ERISA requires fiduciaries to monitor *all* designated investment alternatives in the plan. *Hughes v. Nw. Univ.*, 142 S. Ct. 737, 740-42 (2022).

Meeting these responsibilities requires a plan fiduciary to engage in an informed and thorough evaluation of the plan's needs. Every plan is different, and there is no one-size-fits-all approach. The Supreme Court has acknowledged that the circumstances ERISA fiduciaries face will implicate difficult trade-offs and that there is a range of reasonable judgments fiduciaries may make based on their experience and expertise. You may want to consider, for example, what your employee-participants look like. For example, what is the average age of your participants? Do you have a large older population that is nearing retirement? What are their education levels? Are they sophisticated when it comes to finances and investments? With these kinds of considerations in mind, a fiduciary can look at the options available in the marketplace when making initial investment selections. But keep in mind that there are many available options, and there is no single, correct choice for any or all plans.

In evaluating the available options in light of your plan's needs, you may find it useful to understand some basic concepts about investments, including the *types of investment vehicles* that are available to retirement plans, *asset classes* and *management strategies* to choose from, and the costs associated with the available options.

Types of investment vehicles available to retirement plans

There are several different types of investment vehicles available to retirement plans, depending on the plan's needs and its size.

- **Mutual funds:** Mutual funds are a popular choice for retirement plans. A mutual fund is a pooled investment vehicle managed by a professional asset manager that invests in an array of securities such as stock, bonds, money market instruments, and similar assets, depending on the fund manager's strategy. Investors purchase shares of the fund, and the shares are valued on a daily basis, which means that investors are generally free to sell their shares. Mutual funds are registered with and overseen by the Securities and Exchange Commission (SEC) and are subject to certain disclosure requirements. As a result, publicly available information about a mutual fund's investments, performance, and fees is readily accessible, as are tools—such as Morningstar.com—that can help investors to compare a mutual fund with other comparable funds.

> Meeting [fiduciary] responsibilities requires a plan fiduciary to engage in an informed and thorough evaluation of the plan's needs. Every plan is different, and there is no one-size-fits-all approach.

- **Commingled pools:** A commingled pool is a type of collective investment vehicle that combines assets from several sources to reduce the cost of managing each account separately, which may result in lower costs to investors compared with other investment vehicles. Examples of commingled pools include insurance company separate accounts or collective investment trusts. The investment objective or style is set by the investment manager, and access to these investments may be subject to higher investment minimums than mutual funds. Commingled pools are non-registered investment vehicles, which means that they are not subject to the same regulatory oversight as mutual funds, and information about their investments, performance, and fees generally is not required to be publicly available. While the commingled pool's manager will provide some disclosures to investors, the disclosures may not be as extensive as mutual funds are required to provide, and it may be more challenging to get information about other commingled pools with which to compare.
- **Separate accounts:** A separate account is an investment portfolio managed by a bank or an investment firm on behalf of a single plan sponsor. This structure may allow for more control on the part of the plan sponsor with regard to the separate account's investment strategy, but it also requires the sponsor to enter into a variety of service arrangements to obtain investment management, custodial, accounting, and other services for the separate account. Separate accounts tend to have high minimum investment requirements but lower investment management fees than other investment vehicles. Separate accounts are non-registered investment vehicles, and information about their investments, performance, and fees generally is not publicly available and presents some of the same benchmarking challenges as commingled pools.
- **Employer stock fund:** A employer stock fund is a fund that enables plan participants to invest in the employer's company stock. These funds can be structured in different ways, but typically the fund is primarily invested in shares of the company but may also hold some cash in order to ensure liquidity (the ability for investors to get out of the fund quickly, where permitted). Given the unique nature of these types of funds, there are special considerations that plan sponsors should keep in mind when their plan offers an employer stock fund, which are discussed further below.
- **Self-directed brokerage account:** A self-directed brokerage account offers plan participants the ability to make investments outside of the plan's menu of investment options. Through a brokerage "window," a participant may invest their plan account directly in investments such as stocks and mutual funds.

Asset classes, management styles, and asset allocation vehicles

The investment vehicles described above are available in many different varieties, depending on the types of assets that the vehicle invests in and the management style and allocation strategies used by the fund manager.

- **Asset classes:** An asset class is a category of investments that share particular characteristics. The main asset classes are: equities (stocks), fixed income (bonds), cash equivalents (money market and stable value investments), real estate, and commodities. However, within each of these classes you will find a variety of options.
  - Examples of stock funds include U.S. stock funds (e.g., Blue Chip Growth or Mid-Cap Value) or international and global stock funds (e.g., Asia Opportunities or Emerging Markets Stock).
  - Examples of bond funds include U.S. bond funds (e.g., Short-Term Bond or Inflation Protected Bond) or international and global bond funds (e.g., Emerging Markets Bond or Global High Income Bond)
- **Management style:** When investing in a particular asset class, a fund manager may utilize either "active" or "passive" management strategies. There are different costs associated with each type of strategy, which will result in different fees for the investors.
  - An *actively managed fund* is a fund for which the fund manager employs a strategy of actively analyzing and selecting investments with the goal of outperforming the market. The fund manager will have a stated investment objective and will utilize different analyses and trading strategies to attempt to achieve above-market returns. Actively managed funds will likely have higher research and trading costs than passively managed funds, resulting in greater overall expenses. The active fund manager's objective is to produce superior returns, even after fees are taken into account.
  - A *passive fund* is a fund for which the fund manager is trying to achieve a return for investors that is comparable to the return of the overall market or a particular index, such as the Standard & Poor's 500 Index. A passively managed fund (or index fund) can usually operate at lower costs than an actively managed fund, resulting in lower overall fees to the investors.

Some investment managers combine the use of different asset classes and management styles, along with a dynamic allocation strategy, to provide one-stop shopping for investors in the form of an asset allocation vehicle. An *asset allocation vehicle* invests in different asset classes over time in order to achieve a diversified investment portfolio that is geared toward either a target risk profile (such as conservative, moderate, or aggressive—sometimes called a "lifestyle" fund) or a target retirement date (such as 2040 or 2060—sometimes called a "target date" or "life cycle" fund). These vehicles can be structured as mutual funds, separately managed accounts, or commingled pools and can utilize active and/or passive investment strategies. Typically, asset allocation vehicles are structured to have an asset allocation strategy that changes over time, either to maintain a specific level of risk (in the case of lifestyle funds) or to decrease risk as the investor moves closer to retirement age (in the case of target date funds). Managed account providers that plan sponsors can elect to make available to their participants utilize a similar strategy in determining the asset allocation for a particular participant, depending on the participant's age or other factors.

Fees associated with plan investment products

The fees associated with plan investments are one component of a plan's overall expenses. Fees for investment management and other related services typically are assessed as a percentage of the assets invested in the fund (e.g., 0.50%). This is called the fund's *expense ratio*. The expense ratio may also be expressed in "basis points" (one basis point is equal to 1/100th of 1%). For example: 0.50% = 50 basis points. These asset-based fees are deducted directly from investment returns and apply to all investors.

The total *expense ratio* for an investment option may reflect different component fees, including investment management fees, shareholder servicing fees, or other fees. Fund expense ratios typically compensate the fund's management company for a variety of services, such as investment management, diversification, liquidity, communication, educational services, and administrative and recordkeeping services. However, when a fund is offered in a retirement plan, a portion of the fund's total expense ratio may be available to help offset the plan's administrative expenses. In this regard, revenue generated in connection with plan *investments* can be used toward plan *administration*.

For instance, when a fund is offered in a retirement plan, it is often the case that other service providers, such as the plan's recordkeeper, provide services in connection with the plan's investment in that fund that would otherwise be performed by the fund or its service providers. For example, individual account statements that show a participant's investments are typically provided to participants by the plan's recordkeeper and not the fund's transfer agent. As a result of this arrangement, the fund avoids the expense of such services, which it would otherwise incur, and either the fund or its transfer agent may agree to pay a portion of its fees to the plan recordkeeper as compensation. These *administrative fee payments* by the fund or its service

providers to the recordkeeper are sometimes referred to as "revenue sharing." Administrative fee payments are part of—and not additional to—the fund's total expense ratio, which highlights the importance of considering the plan's total fees when reviewing for reasonableness.

The amount of administrative fee payments available in connection with a plan's investments may depend on the *share class* of funds that the plan uses. Plan fiduciaries who select mutual funds for their plans should be aware that mutual funds may offer multiple share classes. Each share class represents a different investment option in the mutual fund. For example, a mutual fund may have a "retail" share class that is available to all investors, and an "institutional" share class that has a minimum investment requirement and is available to institutional investors such as large retirement plans. The total expense ratio for each share class may be different and may result in different administrative fee or revenue sharing payments available to pay the plan's recordkeeper for administrative services. In this regard, the availability of different share classes may allow for flexibility in the plan's fee arrangement. Fiduciaries will want to consider the impact to the plan's overall fee arrangements of selecting investments in a particular share class. Some providers offer revenue credits or rebates to the plan that can be used to offset plan expenses. Such arrangement may provide further flexibility when funds with these payments are utilized.

Case study

Choosing the share class with the lowest expense ratio may not necessarily reduce plan expenses and may have some unintended consequences. Consider this scenario:

A plan has $200 million in assets under management and offers an array of actively managed and index mutual fund options with a range of expense ratios. Some of the funds pay administrative fees to the plan's recordkeeper, generating sufficient revenue to cover the plan's administrative expenses, resulting in no per-participant recordkeeping fee assessed to individual participant accounts. The fiduciaries receive advice that they should be reducing plan expenses by moving to investment vehicles that do not generate revenue sharing. Focused exclusively on the expense ratios of the funds, the fiduciaries take steps to eliminate certain mutual funds from their plan, only to learn that doing so may require that the plan add a per-participant recordkeeping fee.

Fiduciaries are not judged by the results that they achieved for their plans, but rather on whether they acted prudently in making investment decisions.

How does a fiduciary discharge its responsibility with respect to plan investments?

While plan fiduciaries are expected to act prudently in selecting investments for their plan, the good news is that investment decisions will not be judged based on hindsight. For example, choosing an investment that ultimately performs poorly due to unforeseen market conditions should not, in and of itself, result in legal liability. Fiduciaries are not judged by the results that they achieved for their plans, but rather on whether they acted prudently in making investment decisions. In other words, the *inputs* to the fiduciary's decision-making are more important than the *outcomes*. This puts a premium on the *process* that you use to make investment decisions for your plan.

A good process will be thorough, consistently applied, and well documented. Documentation of your decision-making process should make clear what information was considered and what decisions were made. For example, a good fiduciary process in overseeing a plan's investments may include:

- Understanding the plan document, which may set forth investment objectives or mandates for the plan.
  - In addition to the plan document, investment fiduciaries should understand and consider any investment policy statement (IPS) that has been implemented for the plan. Although ERISA does not require it, some plan sponsors elect to establish an IPS that sets forth the plan's specific goals and objectives. The Department of Labor (DOL) has described an IPS as a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions. An IPS may describe the plan's investment structure and enumerate criteria and procedures for selecting, monitoring, and replacing investment options in the plan.
  - There is no requirement that a plan sponsor utilize an IPS. However, should the sponsor choose to adopt an IPS, it is important that the IPS be carefully drafted. A "detailed road map" approach to drafting an IPS may provide comfort to decision-makers wanting clear direction on their selection and monitoring responsibilities. On the other hand, a less formal "framework" approach may help to avoid overly restrictive policy terms or policies that are too difficult to follow.
  - Some sponsors who adopt an IPS elect to include review criteria to assist the fiduciaries with their evaluation of plan investments. Review criteria can be general or can be specific metrics against which to evaluate a fund's performance. While ERISA does not prescribe specific

review criteria to be utilized by fiduciaries, where adopted, they may include comparing the funds with benchmarks and/or peer universes over specific periods of time (e.g., 1-, 3-, 5-, and/or 10-year performance). Above all else, it is important to remember that discretion is a hallmark of the fiduciary function. This means that best practices will allow the fiduciaries to apply their judgment in reaching conclusions about plan investments.

- Consider this scenario: A plan's IPS requires the plan's investment committee responsible for monitoring plan investment options to remove an investment option based on specific performance metrics. Such inflexibility precludes the fiduciaries from considering other inputs such as market context and participant demand for the investment and impedes the fiduciaries' exercise of their reasoned judgment.
- The sponsor may benefit from input from the plan's consultant or any investment fiduciaries in drafting the IPS. If an IPS is adopted, it is important that the IPS is considered and followed by the plan's investment fiduciaries and that the fiduciaries document their consideration of the IPS in making investment decisions for the plan. But it is equally important to remember that ERISA fiduciaries may only follow the dictates of plan documents (which may include any IPS) where doing so would otherwise be consistent with their fiduciary obligations.

- Meeting regularly to discuss and review the plan's investments and keeping notes or minutes of such meetings.

Case study

Taking minutes of fiduciary meetings may seem commonplace, but it can be a key component of defending fiduciary actions down the road. Consider this scenario:

A sponsor offers a range of investment options in its 401(k) plan and maintains an investment committee to oversee the plan's investments. The committee is composed of personnel from the company's human resources, finance, and treasury functions. The committee meets quarterly, reviews voluminous materials concerning the plan, monitors existing investments, and selects new funds for the plan, from time to time. As the company evolves and personnel turnovers occur, the fiduciary committee also changes.

A lawsuit is filed challenging the selection of investment options as many as six years prior. The fiduciaries at that time have long since left the committee and are not equipped to answer questions about particular fund selections based on their own memories. But the committee has a long-standing practice of keeping reasonably detailed minutes, so the materials considered, any alternatives evaluated, and the basis for the fund selection at issue are available for review.

- Periodically reviewing the plan's investments, comparing the performance, expenses, and volatility of the plan's investment options with appropriate peer group and index benchmarks.
  - For example, if a plan offers mutual fund options, plan fiduciaries can utilize publicly available information to compare the funds' performance and fees with those of their respective categories as identified by Morningstar. The plan's service providers may also provide information that can assist with comparing the plan's investments with appropriate benchmarks, as may any investment consultant or adviser that the fiduciaries may elect to hire.
  - When evaluating investment expenses, keep in mind that fiduciary prudence does not require the selection of the cheapest available option. What is important is that the fiduciaries consider reasonably available alternatives (including alternative share classes of funds) and the impact on the plan's overall expenses. For example, there may be instances where the selection of a fund share class with a higher total expense ratio is the right choice for your plan in light of the administrative fee payments that will be made to your plan's recordkeeper, which may avoid the need to assess other fees.

Documentation of your decision-making process should make clear what information was considered and what decisions were made.

- Applying special considerations when it comes to default investment options, target date funds, employer stock funds, and specialized funds.
  - **Qualified default investment alternatives (QDIAs):** A plan may utilize default investment options for plan participants who are automatically enrolled in the plan and do not make affirmative elections as to how their plan accounts should be invested. Under DOL rules, a plan fiduciary will not be liable for any investment losses that occur as a result of automatically investing a participant's assets in a default investment option that is a QDIA. QDIAs are investment options that comply with DOL regulations that are designed to protect participants' interests even where they do not make affirmative elections with respect to their retirement savings accounts. Examples of investment options that the DOL has deemed appropriate for use as a QDIA include target date funds, balanced funds, and managed accounts. Of course, QDIAs must be prudently selected and monitored just like other plan investment options.
  - **Special considerations for target date funds:** Target date funds that share the same target retirement date may have very different investment strategies and risks. While these funds generally move to a more conservative allocation as the target retirement date approaches, some target date funds may not reach their most conservative investment mix until 20 or 30 years *after* the target date, while others reach their most conservative investment mix at the target date or soon thereafter. Target date fund managers may also shift their approach in the future and change underlying investments. Plan fiduciaries should be aware of these and other differences when evaluating available options and consider these differences in relation to their priorities for addressing market risk, inflation risk, and longevity risk.

Case study: Evaluating target date funds can present a trap for the unwary

Consider this scenario:

A plan offers a suite of actively managed target date funds. The funds are criticized as underperforming the target date funds offered by another provider based on a rote comparison of reported returns. However, a "look under the hood" of the supposedly comparable alternative reveals that the funds are quite different in strategy and construction. The plan's target date options have a different glide path that dictates a different asset allocation, resulting in a higher allocation to bonds than the supposedly comparable alternatives. This different asset allocation results in different performance, given the different risk profile. In short, fiduciaries should utilize benchmarks against which the funds at issue can meaningfully be compared.

- **Special considerations for employer stock funds:** If a plan sponsor decides to make its company stock available as an investment option under the plan, proper monitoring of the employer stock fund will include ensuring that the investment fiduciaries and plan participants have information about the company's financial condition so that they can make informed investment decisions. In addition, participants must be given the opportunity to divest (sell) their investments in publicly traded employer securities and reinvest their money in other diversified investment options in the plan. Where *employee contributions* to the plan are invested in company stock, the participants must have the right to divest immediately. Where *employer contributions* are invested in company stock, participants must be allowed to divest if they have three years of service. Some plan sponsors will limit the amount of employer stock participants may hold in their accounts. Because of the potential for conflicts of interest where the company offers its own stock for investment by its employee benefit plans, some plan sponsors may elect to outsource the fiduciary oversight of their employer stock fund to an independent fiduciary in order to minimize risks. The independent fiduciary would be responsible for evaluating the company stock, monitoring its performance, and making recommendations and decisions as to existing and new investments in company stock or liquidations of plan holdings in company stock. In all events, it is important to remember that an employer stock fund should be monitored just as other plan investments.
- **Considerations for specialized funds:** ERISA requires fiduciaries to diversify the investments of the plan so as to minimize the risk of large losses, but ERISA does not prohibit the use of specialized funds even if the individual investment option is not diversified across multiple industries. Plan sponsors may consider offering such funds based on the circumstances of their plan and participants. For example, it may not be inappropriate to offer a gold fund if the plan fiduciaries have a reasoned basis for including it in the plan such as concerns regarding inflation. Similarly, some plan sponsors may consider offering real estate funds or real estate investment trust funds, depending on the needs of their plan. Keep in mind, as with any investment option, fiduciaries should monitor these investment options using appropriate benchmarks based on the specific strategy of the investment option. For example, one real estate fund may be actively managed and invest directly in properties, while another real estate option may instead be passively managed and invest in stock of real estate companies. These two investments may be too dissimilar in strategy for purposes of monitoring performance and fees.

Fiduciaries tasked with overseeing plan investments should remain apprised of regulatory developments impacting their responsibilities with respect to the selection and oversight of investments. For example, in November 2020, the Department of Labor issued a rule regarding Financial Factors in Selecting Plan Investments that was purportedly aimed at addressing when and how environmental, social, and governance (ESG) considerations could factor into fiduciary decision-making for plans. Prior to the rule, under DOL authority, fiduciaries who chose investments had to give "appropriate consideration" to relevant "facts and circumstances" to satisfy the duty of prudence, but did not have to engage in any particular set of procedures. The November 2020 rule required plan fiduciaries to select investments for their plans based solely on pecuniary factors, rather than on ESG considerations.

In March 2021, the DOL announced that it would not enforce the November 2020 rule, and in October 2021, the Department issued a new proposed rule that would remove barriers to plan fiduciaries' ability to consider ESG factors when they select plan investments. In December 2022, the DOL released its final rule titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," which amends the DOL's regulation on investment duties under Section 404(a) of ERISA. The amendments provide guidance on how ERISA's fiduciary duties of prudence and loyalty apply to selecting investments and investment courses of action and exercising shareholder rights such as proxy voting.

The final amendments largely mirror the principles-based (i.e., prudential and in best interests) approach to investing required under ERISA itself. But they also clarify that a fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG considerations on the particular investment or investment course of action.

The final rule is clear that whether any particular consideration is a risk/return fact will depend on the individual facts and circumstances and that the weight given to any factor by a fiduciary should appropriate reflect a reasonable assessment of its impact on risk and return. Accordingly, fiduciaries have leeway to determine whether and to what extent ESG factors are relevant to any given investment decision.

The DOL has also weighed in on making cryptocurrencies and alternative investments such as private equity available to 401(k) plan investors.

In March 2022, the DOL issued a Compliance Assistance Release addressing its views on the availability of cryptocurrencies on 401(k) investment platforms. While the release did not take a definitive position, it noted that a plan fiduciary's decision to make cryptocurrencies available to its participants will be subject to ERISA's duties of prudence and loyalty and expressed concern about 401(k) participants investing in cryptocurrencies due to price volatility, challenges to valuing cryptocurrencies, and other related concerns.

In December 2021, the DOL published a statement that clarified a 2020 Information Letter, which had concluded that plan fiduciaries could, consistent with ERISA's fiduciary rules, include private-equity investments as a component of a multi-asset class investment vehicle in a 401(k) plan, as long as the fiduciary evaluated the risks and benefits associated with the investment alternative. The DOL's 2021 statement clarified that the department was not endorsing or recommending private-equity investments in 401(k) plans and served as a reminder that a fiduciary considering such investments should engage in an objective, thorough, and analytical evaluation and that they or their professional advisers should have the necessary skill to conduct such evaluation.

Having chosen to offer your employees the valuable benefit of a retirement savings plan, we know you take your responsibilities with respect to plan investments seriously, and we hope this information is of assistance to you. Keep in mind that being a plan fiduciary does not require you to be a financial expert. What is important is making thoughtful decisions as part of a consistent and documented process and utilizing experts when needed.

T. Rowe Price would like to recognize Alison V. Douglass for her contributions to authoring this chapter.

ALISON V. DOUGLASS
Partner, Goodwin Procter LLP

Alison Douglass, a partner in Goodwin's Complex Business Litigation and Dispute Resolution, Financial Industry Litigation and ERISA Litigation practices, focuses her practice on a wide array of complex commercial litigation, primarily in the areas of ERISA, mutual fund and securities litigation. Alison has been selected for inclusion to Chambers USA: America's Leading Lawyers for Business in ERISA Litigation since 2014 and clients laud her abilities, saying: "She is an extremely talented litigator who excels as an advocate and on case strategy." She has also been recognized by The Legal 500 and named a "Rising Star" by Law & Politics and Boston magazine.

T. Rowe Price would like to recognize Christina L. Hennecken for her contributions to authoring this chapter.

CHRISTINA L. HENNECKEN
Partner, Goodwin Procter LLP

Christina Hennecken is a partner in the firm's Complex Litigation & Dispute Resolution, ERISA Litigation and Consumer Financial Services Litigation practices. Christina represents financial institutions in class actions, government enforcement proceedings and investigations, and complex civil litigation involving the Employee Retirement Income Security Act, the Consumer Financial Protection Act, and other federal and state consumer protection statutes. She joined Goodwin in 2014.

Selecting and overseeing plan service providers

3

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The Employment Retirement Income Security Act of 1974 (ERISA) requires you to administer your plan prudently and solely in the interest of the plan's participants and beneficiaries. Administering a 401(k) plan is a multifaceted job, and virtually all plans retain outside professionals to help with at least some administrative tasks. Selecting appropriate service providers—and ensuring that they remain a good fit for your plan over time—is one of your most important responsibilities as a fiduciary.

This chapter addresses considerations related to selection and oversight of plan service providers and will help you think through several issues that commonly arise when carrying out those duties.

Selecting plan service providers

As an ERISA fiduciary, you are required to select plan service providers using a "prudent" process. What a prudent process looks like depends on the facts and circumstances, and there is no single, one-size-fits-all checklist you must follow to act prudently when selecting service providers for your plan.

But in general terms, hallmarks of a prudent selection process include evaluating your plan's specific needs, gathering relevant information about potential providers, and analyzing the information you gather thoroughly to come to a reasoned choice.

The types of service providers you choose to retain will depend both on the specific needs of your plan and on the resources available within your organization to meet those needs.

Considering the types of outside service providers you may need

The first step for retaining an appropriate slate of plan service providers typically is to reflect on the aspects of plan administration where you and your plan could benefit from outside help. The market offers a wide range of services related to the operation and administration of retirement plans, and not all of those services are necessarily essential—or even beneficial—for every plan. The types of service providers you choose to retain will depend both on the specific needs of your plan and on the resources available within your organization to meet those needs.

Examples of professional service providers commonly retained by retirement plans include:

- **Plan recordkeepers:** A recordkeeper's primary function is to maintain records tracking participants in the plan, the investments they hold, and assets moving in and out of their accounts.
- **Trustees:** ERISA requires that all plan assets be held in trust by one or more trustees. A plan trustee has exclusive authority over plan assets, except to the extent that the trustee is subject to direction by another fiduciary (commonly known as a "directed trustee" arrangement) or that one or more investment managers have been delegated the authority to manage, acquire, or dispose of plan assets.

- **Custodians:** A custodian is responsible for securely holding the assets of the plan. A custodian generally does not have authority to make investment decisions on its own and instead acts under the direction of a trustee.
- **Investment managers:** An investment manager has discretionary authority to select, monitor, and replace plan investment options. Under ERISA, an investment manager must be a registered investment adviser, bank, or insurance company that has acknowledged in writing that it is a fiduciary to the plan.
- **Investment advisers:** Plan investment advisers provide information and advice that plan fiduciaries may use in making decisions about the plan's investment menu. Unlike an investment manager, investment advisers do not have authority to make decisions about plan investment options on their own.
- **Plan consultants:** Plan consultants may provide advice about aspects of plan administration other than investment options, such as plan service provider arrangements and fees.
- **Third-party administrators:** A third-party administrator may handle various day-to-day aspects of running a retirement plan, such as maintaining plan documents, performing nondiscrimination testing to ensure compliance with IRS requirements, and preparing annual reports.
- **Legal counsel:** Legal counsel may provide advice on a host of topics, including plan-design issues, compliance with ERISA fiduciary standards and prohibited transaction rules, and satisfaction of Internal Revenue Code tax-qualification requirements.
- **Accountants and auditors:** Accountants may be retained to perform independent financial statement audits as part of the annual Form 5500 filing process.

Some providers (or groups of affiliated providers) may offer multiple services—for example: trustee, investment management, and recordkeeping services—for a single fee through what is often called a "bundled" service arrangement.

Depending on their specific role and responsibilities, service providers may or may not act as plan fiduciaries. Service providers that perform "purely ministerial functions," such as preparing employee communications, calculating benefits, and processing claims, "within a framework of policies, interpretations, rules, practices, and procedures made by other persons," lack the type of discretionary authority that defines fiduciary status under ERISA. In addition, attorneys and accountants are not considered plan fiduciaries if they perform only their usual professional functions when dealing with a plan—that is, if they act purely as attorneys or accountants typically do. By contrast, some other types of plan service providers—such as trustees, investment managers, and investment advisers—ordinarily qualify as fiduciaries under ERISA.

Regardless of whether an outside service provider is a plan fiduciary, you have a duty to act prudently and loyally when hiring them and a continuing duty to monitor them once they have been retained.

Identifying service providers that match your plan's needs

The market for retirement plan services is generally highly competitive, with many potential providers available to choose from, each with its own mix of experience and capabilities. So how do you narrow the offerings down to identify a provider that is a good match for your plan? Performing your own research based on publicly available information, or asking trusted contacts for recommendations, can be a good place to start in compiling a list of potential candidates. Before making a final decision, you will want to identify multiple options, collect relevant information about each of them, and evaluate how they stack up against each other in light of your particular plan's needs and goals. To help ensure that you're considering appropriate providers and asking them the right kinds of questions, you might consider working with an independent consultant that has expertise in helping plans conduct service provider searches.

Whether or not you opt to engage a consultant, once you've compiled an initial group of potential candidates for a service provider role, one common and often valuable means of gathering additional information about them is to solicit formal bids through a request for proposal (RFP). An RFP affords you an opportunity to share pertinent information about your plan with potential bidders and elicit information about bidders' experience, services, and fees that can help you make a well-informed decision. Issuing an RFP provides structure to the information-gathering process. It can be easier to perform an apples-to-apples comparison when evaluating the candidates if you share the same information about your plan's requirements with each bidder and ask them to address a uniform set of topics. While the specifics of the RFP will vary depending on the role you are seeking to fill and your particular plan's needs, you should aim to solicit bids from a large group of potential providers to give you a good sense of the range of available options and how each bidder fits in among the field.

When evaluating potential service providers, plan fiduciaries often find it helpful to gather information on the following topics:

- **Information about the firm:** Information about the firm's financial condition and experience with retirement plans of similar size and complexity can be helpful in assessing whether the provider is well situated to meet your plan's needs.
- **Quality of the firm's services:** A key part of any service provider search is understanding what a prospective provider has to offer and how well you expect them to perform. Insights that can help you determine how well a service provider is likely to perform for your plan may include information about the firm's experience or performance record; the identity, experience, and qualifications of the specific professionals who would handle your plan's account; and any recent litigation or enforcement action taken against the firm. You might also consider asking prospective service providers for references to provide additional perspective on how the provider has performed in similar circumstances.
- **Description of business practices:** It is often valuable to inquire about the firm's approach to providing the services in question. For example, if you are hiring an investment manager, you might ask how the firm identifies, evaluates, and monitors investment options. You might also want to determine whether the firm has fiduciary liability insurance.
- **Fees:** Soliciting clear and complete fee proposals is an important aspect of virtually any service provider search. To help you fully evaluate each firm's proposal and make sound comparisons, ask each provider to specify which services are (and are not) covered by its fee estimates.
- **Required fidelity bonds:** If the service provider will be handling plan assets, you should confirm that the provider has an appropriate fidelity bond, which protects the plan against loss resulting from fraudulent or dishonest acts.
- **Licensing:** If a service provider must be licensed (as is the case for attorneys and accountants, for example), it is a best practice to check with relevant authorities to confirm that the necessary licenses are up to date. You may find it valuable to research whether there are any pending complaints against the provider.
- **Commitment to fiduciary standards:** If the service provider is being retained to act in a fiduciary capacity, consider confirming that the provider accepts its fiduciary responsibilities and has fiduciary compliance and training structures in place.

[3] 29 C.F.R. § 2550.408b-2(c).

While cost is an important factor, ERISA does not require plan fiduciaries to automatically select the lowest-cost provider without regard to other factors, such as the provider's experience and the quality and level of service to be provided.

- **Potential conflicts of interest:** You should gather information relevant to assessing whether a provider has any relationships that could present conflicts that might impair its ability to render services solely in the plan's best interests. A potential conflict is not disqualifying on its own; there are many acceptable ways of resolving or mitigating potential conflicts. As the hiring fiduciary, your job is to identify potential conflicts and consider whether measures are in place that will adequately protect the plan.

The information you collect from prospective providers will help you identify which providers' options, experience, services, and fees align best with your plan's needs. While cost is an important factor, ERISA does not require plan fiduciaries to automatically select the lowest-cost provider without regard to other factors, such as the provider's experience and the quality and level of service to be provided. As a general matter, you will not want to select a service provider based on any one factor alone, and how you weigh different factors may depend on circumstances specific to your plan.

Documenting your process and entering service provider contracts

When hiring a plan service provider, it is a best practice to develop a written record of your process for evaluating the candidates and the reasoning behind your ultimate choice. Such a record may prove useful if questions arise down the road about your selection process or decision.

It is also advisable to formalize your relationships with plan service providers through written agreements. Among other things, a formal contract can serve as a useful reference point for overseeing the service provider's performance. Before you sign a service provider contract, you should make sure you fully understand all of the terms, including what obligations you and the service provider will have and the details of how the service provider will be compensated for its work. You also should keep in mind that, to qualify as a "reasonable" service arrangement under ERISA § 408(b)(2), service provider contracts must "permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous."[3]

Hiring service providers with strong cybersecurity practices

In recent years, cybersecurity and data privacy have become an area of increased focus when it comes to retirement plan administration. The Department of Labor (DOL) issued guidance in 2021 ("Tips for Hiring a Service Provider with Strong Cybersecurity Practices") emphasizing the importance of cybersecurity practices when hiring plan service providers, with a focus on ensuring that any service providers responsible for keeping participant data confidential and plan accounts secure have sound cybersecurity practices in place.[4]

The DOL suggested taking steps such as:

- Asking about the service provider's security practices, protocols, and third-party audit results and comparing them to industry standards adopted by financial institutions.
- Asking how the provider validates its security practices and a contractual right to review third-party audit results demonstrating compliance with security standards.
- Evaluating the service provider's information security track record, including by reviewing public information about relevant security incidents, litigation, or other legal proceedings relating to the service provider's services.
- Asking whether the service provider has experienced past security breaches and, if so, what happened and how the service provider responded.
- Asking whether the service provider has insurance policies that cover losses caused by cybersecurity breaches and identity theft.

The 2021 DOL Guidance also suggests including terms addressing the topics below in service agreements between plan sponsors and their service providers:

- Information security reporting;
- Clear provisions on the use and sharing of information and confidentiality;
- Notification of cybersecurity breaches;
- Compliance with records retention, destruction, privacy and security laws; and
- Insurance.

Considerations related to service provider fees and compensation

Who pays?

An initial question you may confront when hiring a plan service provider is: Who will pay the associated costs—the plan sponsor or the plan? While a plan sponsor is generally free to cover any plan-related costs itself, not all plan-related expenses can be paid out of plan assets. Before allocating responsibility for plan-related expenses to the plan, it is important to understand the rules about the types of expenses for which such an arrangement is (and is not) allowed.

Broadly speaking, paying expenses out of plan assets is an option if:

- the plan document does not prohibit it;
- the services for which the fees are incurred relate to "fiduciary," rather than "settlor," functions; and
- the services are necessary to operate the plan and the compensation is "reasonable."

Expenses associated with fiduciary functions generally include costs of plan administration, such as trustee and recordkeeping fees. If the other conditions are met, fees for such services can be paid from plan assets, either by deducting the fees from participant accounts or by paying the fees from a plan forfeiture account or expense account.

Settlor costs, by contrast, are incurred by the plan settlor (typically, the sponsoring employer), generally in connection with plan-design-related issues. For example, costs associated with conducting studies before establishing or amending a plan are settlor expenses. Plan sponsors are required to pay such settlor expenses like any other business expense, and those expenses cannot be charged to the plan.

Is the provider's compensation "reasonable"?

Where service provider fees are paid out of plan assets, you have an obligation as a fiduciary to ensure that those fees are "reasonable." The reasonableness of service provider compensation is assessed in light of the services provided to the plan—and what is reasonable, therefore, may vary from plan to plan and service provider to service provider. As with any other fiduciary responsibility, it is important that you follow a prudent process when determining the reasonableness of a service provider's fees and that you document the steps you took to investigate the issue and the rationale behind the decisions you reached.

[4] See U.S. Department of Labor, Employee Benefits Security Administration, Tips for Hiring a Service Provider With Strong Cybersecurity Practices, available at https://www.dol.gov/sites/dolgov/files/ebsa/key-topics/retirement-benefits/cybersecurity/tips-for-hiring-a-service-provider-with-strong-security-practices.pdf.

To evaluate the reasonableness of a service provider's compensation meaningfully, you should understand both the amount and sources of that compensation. Service providers may be paid through:

- direct compensation (compensation paid directly by the plan to the service provider);
- indirect compensation (compensation received from other sources in connection with services provided to the plan, such as "administrative fee payments" or "revenue sharing" from plan investment options); or
- a combination of both.

DOL regulations require that certain plan service providers, including recordkeepers, disclose to plan sponsors information about the compensation they receive. As a fiduciary responsible for hiring and monitoring service providers, you should make sure that you receive all disclosures required by the DOL and that you diligently review the information provided to you. Reviewing fee disclosures can help confirm that you understand all of the compensation a provider is receiving in connection with its services to your plan and that you are up to date on any changes in the type or amount of compensation. If the disclosure is unclear or incomplete, or there are aspects you do not understand, it is advisable to follow up with the provider to resolve any open questions.

The reasonableness of service provider compensation is assessed in light of the services provided to the plan—and what is reasonable, therefore, may vary from plan to plan and service provider to service provider.

Monitoring plan service providers

Choosing service providers for your plan is not a "set it and forget it" exercise. After you select a service provider, you have a continuing obligation to monitor them.

While you have a fiduciary duty to monitor both fiduciary and nonfiduciary service providers, it is important to understand which service providers fit into which category. When you appoint a service provider to carry out fiduciary functions for your plan, you can be held liable for any breaches of fiduciary duty committed by that service provider if you do not review its performance at reasonable intervals "in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards and satisfies the needs of the plan." There is no single procedure for overseeing appointed fiduciaries that is appropriate in all cases; the approach adopted may vary based on the nature of the plan and other relevant facts and circumstances.

Steps that may be helpful for ensuring that your plan's service providers are performing as expected include:

- evaluating any notices related to possible changes in compensation or other information previously provided to the plan;
- reading any service provider reports;
- checking the actual fees charged;
- asking about policies and practices; and
- following up on any participant complaints.

In addition, because market trends evolve over time, a prudent monitoring process should also include periodic assessments of the reasonableness of service provider compensation. As noted above, regularly reviewing service provider fee disclosures is an important starting point for ensuring that service providers' compensation remains reasonable.

[5] See U.S. Department of Labor, Employee Benefits Security Administration, Guidance on Settlor v. Plan Expenses, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/guidance-on-settlor-v-plan-expenses.

[6] See 29 C.F.R. § 2550.408b-2(c).

A general benchmarking study is another tool commonly used by plan fiduciaries to evaluate whether a service provider's fees remain competitive. A benchmarking study collects industry data to provide an approximate range of fees for services available on the market, supplying helpful context for the information contained in fee disclosures. Some plan fiduciaries may engage a consultant to assist them with benchmarking exercises, and consultants can offer an independent perspective on how the plan's service arrangements line up against what else might be available. While benchmarking can help fiduciaries ascertain market rates based on general factors like the plan's total assets and number of participants, it ordinarily does not account for a particular plan's specific objectives and service requirements.

Processes such as RFPs and requests for information (RFIs) can provide more tailored information about competitive rates for a particular plan. Plan fiduciaries typically use RFIs to elicit basic fee and service information from other service providers as a means of evaluating how a current provider's compensation compares with prevailing rates for similar services. An RFP seeks more extensive, detailed information from a range of service providers (frequently including the incumbent) through the submission of competitive bids.

While RFIs and RFPs can provide a more in-depth understanding of how plan fees and services compare with what is available on the market, they usually involve more time and expense than some other tools for monitoring service provider compensation, such as simpler benchmarking exercises. A more intensive process is not necessarily a better choice, and before deciding what tools to use, you should consider the relative benefits and drawbacks of each in light of the particular circumstances of your plan.

> **[A] prudent monitoring process should also include periodic assessments of the reasonableness of service provider compensation.**

Case study

The decision in *Ramos v. Banner Health*® provides a helpful reference point for understanding where fiduciaries may come up short in fulfilling their duties with respect to service provider compensation. The court in Ramos found that plan fiduciaries did not do enough to monitor recordkeeping and administrative fees where, among other facts:

- The plan for many years paid recordkeeping and administrative fees through an uncapped, asset-based revenue-sharing arrangement with no sunset provision.
- The plan recordkeeper's compensation, calculated on a per-participant basis, fluctuated significantly over the relevant period with little discernable relationship to the services provided.
- In more than 20 years, the plan's fiduciaries never performed an RFP, RFI, or other market-based analysis to test the reasonableness of the plan's recordkeeping fees.
- The fiduciaries received limited reporting on recordkeeping fees from a plan consultant but did not inquire further to understand whether the plan's fees were reasonable in light of its size and requirements and evolving market rates.
- Plan fiduciaries did not attempt to renegotiate fees when some services previously performed by the plan administrator were shifted to a different provider.
- When the plan transitioned to a per-participant fee arrangement, the fiduciaries accepted the recordkeeper's fee proposal without negotiation.

[8] 461 F. Supp. 3d 1067 (D. Colo. 2020), aff'd, 1 F.4th 769 (10th Cir. 2021).

T. Rowe Price would like to recognize Deanna Rice for her contributions to authoring this chapter.

DEANNA M. RICE

Partner, O'Melveny & Myers LLP

Deanna Rice is an experienced litigator who focuses her practice on appeals and complex civil litigation. Deanna has argued before the U.S. Supreme Court and U.S. Court of Appeals for the Sixth Circuit and has authored appellate briefs on a wide range of subjects, including federal constitutional law, administrative law, securities law, intellectual property, ERISA, tax, and insurance law. She also has substantial experience at all stages of trial-court litigation, including briefing dispositive motions, coordinating discovery, and shaping trial strategy. Deanna maintains a robust pro bono practice focused primarily on issues of criminal law and procedure, and she serves as the Administrative Coordinator for the Amicus Committee of the National Association of Criminal Defense Lawyers.

Helping participants 4

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As discussed elsewhere in this guide, ERISA and the Internal Revenue Code (Code) make plan sponsors responsible for many different aspects of the design and operation of their retirement plans. Whether considering the fiduciary obligations imposed by ERISA or the nondiscrimination and vesting rules under the Code, many of these requirements are intended to ensure that all plans are organized in a way that provides a solid foundation from which participants can build toward a financially secure retirement.

In addition to these organizational responsibilities, plan sponsors also have important responsibilities regarding how they directly interact with individual plan participants. These responsibilities, at a minimum, require plan sponsors to provide participants with certain information about each plan's features and how they can exercise their rights under the plan. Accordingly, this chapter offers a primer on the various notices and disclosures that ERISA and the Code require plan sponsors to send to participants.

For many employers, the decision to offer a retirement plan not only reflects a decision to establish a plan in accordance with all regulatory requirements, but also to offer a plan that enables participants to maximize their benefits. Accordingly, this chapter also provides an overview of some of the optional plan features that are most commonly made available to help participants take full advantage of their plan. This includes an overview of how automatic enrollment features can help participants save more for their own retirement and how education and advice programs can offer support to participants who may be uncomfortable managing their own accounts.

It is important to remember that the decision to offer some of these optional features is a settlor decision, but in other cases, that decision is itself a fiduciary act. In all cases, however, any plan sponsor that chooses to make these optional features available must implement them in accordance with their fiduciary duties.

Participant notices and disclosures

ERISA and the Code require plans, through their fiduciaries and administrators, to provide various notices and disclosures to participants upon the occurrence of certain events and also periodically. Accordingly, in most instances, the ultimate responsibility for delivering these materials falls on the plan sponsor. While some very large plan sponsors may draft custom materials for their participants, in most cases, plan sponsors hire third-party service providers to draft and deliver all of these resources.

The Department of Labor (DOL) and Internal Revenue Service (IRS) have issued regulations and other guidance explaining how ERISA- and Code-required notices and disclosures should be delivered to participants. Not only does this guidance outline the necessary content and formatting, but it also describes various standards and safe harbors for delivering documents to participants electronically. This includes, for example, the DOL's long-standing "affirmative consent" and "wired at work" safe harbors, as well as its more recent "notice and access" safe harbor. Plan sponsors should be familiar with how their plan delivers notices and disclosures and work with their service providers to develop solutions that best meet the needs of their plans and participants.

The DOL and IRS also make available a number of resources to help plan sponsors identify and satisfy their notice and disclosure obligations.[1] Plan sponsors should review these resources, work with their service providers, and consult with counsel as necessary to ensure that they are satisfying all of these obligations.

[1] For example, DOL's Employee Benefits Security Administration publishes its *Reporting and Disclosure Guide for Employee Benefit Plans* and the IRS offers *Publication 5411: Retirement Plans Reporting and Disclosure Requirements*.

While the following summary offers a snapshot of some of the most common notices and disclosures that must be delivered to retirement plan participants, it is important to recognize that the disclosure obligations that apply to any particular plan will depend on the type of plan involved and its particular features. For example, some disclosures only apply to defined benefit plans, while others only apply to defined contribution plans that permit participants to direct their own investments.

Disclosures required for all plan participants

- **Pension Benefit Statements.** Defined contribution plans that permit participants to direct their own investments must furnish participants with quarterly benefit statements providing information about each participant's account balance and investments. By comparison, defined contribution plans that do not permit participant-directed investments must only send a benefit statement once each year. Defined benefit plans must send a benefit statement to participants disclosing their accrued benefit every three years.

  Starting in 2022, at least one statement sent to defined contribution plan participants each year must include a lifetime income illustration (LII) projecting the monthly payments that a participant could expect to receive if his or her current account balance was used to purchase a single life annuity or qualified joint and survivor annuity.

- **Summary Plan Description.** ERISA requires a plain language summary plan description (SPD) to be sent to every participant within 90 days of becoming covered by the plan and to beneficiaries within 90 days after first receiving benefits. The SPD must inform participants of their benefits, rights, and obligations under the plan. The SPD must also be furnished upon participant request and, in most cases, at least every five years.

- **Summary of Material Modification.** If there is a material change to a plan or the information included in the SPD, the plan must either provide an updated SPD or a summary of material modification (SMM) to each participant no later than 210 days after the end of the plan year in which the change is adopted. To the extent that a plan is required to furnish an SPD and it has not yet updated the SPD to reflect changes described in an SMM, the plan must furnish any applicable SMMs with the SPD.

- **Summary Annual Report.** Plan sponsors must annually provide participants with a narrative statement summarizing the plan's Form 5500. This disclosure is referred to as the summary annual report, or SAR.

Design- and event-based disclosures

- **Participant-Level Fee Disclosures (404a-5).** Defined contribution plans that allow participants to direct their own investments are required to furnish a series of disclosures intended to help participants understand how they can direct the investment of their accounts, the different investments that are available, the fees that may be charged to their account, and the past performance of each investment. Additionally, these disclosures must provide an explanation of plan-level fees that may be charged to participants as well as an explanation of fees for plan services that may be utilized by individual plan participants (e.g., loan and QDRO processing).

  These disclosures are often referred to as the "404a-5 disclosures" because they are described in section 404a-5 of the DOL's regulations interpreting ERISA. In practice, these disclosures do not appear on a single standalone document. Instead, they are made through various plan resources, including any website set up for participants and the quarterly benefit statements discussed above. A significant portion of these disclosures must be provided on or before the date on which a participant can first direct their investments and at least annually thereafter.

  One of the key components of the 404a-5 disclosures is the so-called comparative chart. This chart is intended to help participants compare plan investment options by providing in one place (1) a comparison of each investment's fees and (2) a comparison of each investment's past performance or expected return. For example, in the case of plan investments that have a variable rate of return (e.g., mutual funds), the comparative chart must display each investment option's performance for the trailing 1-, 5-, and 10-year periods, alongside the same performance measures of an appropriate broad-based benchmark.

- **404(c) disclosures.** While a plan's fiduciary is always responsible for selecting and monitoring investments that are offered through a participant-directed defined contribution plan, if certain conditions are satisfied, ERISA section 404(c) relieves these same fiduciaries of responsibility for losses that result from a participant's allocation of his or her account among the different options. To qualify for this relief, the plan's fiduciary generally must (1) disclose that the plan intends to rely on ERISA section 404(c), (2) disclose that fiduciaries may be relieved of liability for losses that result from a participant's investment instruction, (3) provide the required 404a-5 disclosures, and (4) provide certain additional disclosures in the event that a plan offers employer securities.

In addition to making these required disclosures, 404(c) relief is also generally conditioned upon (1) the plan providing participants with a reasonable opportunity to exercise control over assets in their accounts, (2) the plan providing participants an opportunity to choose from a broad range of investment alternatives, and (3) participants exercising independent control over investment instructions.

- **Mapping notices.** From time to time, a defined contribution plan that allows participants to direct their own investments may replace an existing investment option with a new option. When this happens, ERISA provides plan fiduciaries with a special type of relief intended to facilitate the transfer of assets from the plan's old option to its new option, without losing reliance on ERISA section 404(c). That is, in this circumstance, even though the plan fiduciary is directing the investment change, participants can still be treated as exercising control over their accounts—as is required under ERISA section 404(c)—if the plan timely furnishes a special notice to participants in advance of the change and the new investment's characteristics are reasonably similar to the investment being replaced.
- **Blackout notices.** At least 30 days, but not more than 60 days, before any "blackout period," plan administrators must notify participants about the upcoming blackout period. A blackout period is a period of more than three consecutive business days when there is a temporary suspension, limitation, or restriction under a defined contribution plan on directing or diversifying plan assets, obtaining loans, or obtaining distributions.
- **Automatic enrollment notices.** As discussed elsewhere in this chapter, plans that adopt automatic enrollment must send various notices and disclosures to participants.
- **Safe harbor notices.** Certain defined contribution plans that use a design-based safe harbor to satisfy the Code's nondiscrimination rules must send each participant an initial and annual safe harbor notice informing them of their ability to make contributions and how the employer will make contributions on their behalf.

> Automatic enrollment, reenrollment, and escalation are powerful tools because they can help overcome the inertia that can otherwise prevent participants from contributing, or increasing contributions, because they are unsure about how to get started, simply forget to save, or have other concerns about putting money aside for retirement.

- **402(f) Notices.** When a plan participant requests a distribution that is an "eligible rollover distribution"—i.e., a distribution that may be rolled over to another plan or IRA—the plan administrator must provide the participant with an explanation of the rollover rules and the consequences for not rolling over the distribution, including any possible taxes and penalties. This written explanation is generally referred to as the "Rollover Notice" or the "402(f) Notice" because the requirement is described in Code section 402(f). The 402(f) Notice is generally provided to a participant when requesting a distribution, and, subsequently, the participant must be given at least 30 days (which may be waived by the participant) to consider whether to receive the distribution or request a direct rollover.

Automatic enrollment and QDIAs

What are automatic enrollment, reenrollment, and escalation?

Automatic enrollment, reenrollment, and escalation are among the most important tools that plan sponsors have to help their employees save—and save more—for retirement. Additionally, many plan sponsors adopt these features, in part, to help them pass nondiscrimination testing.

Automatic enrollment, reenrollment, and escalation are powerful tools because they can help overcome the inertia that can otherwise prevent participants from contributing, or increasing contributions, because they are unsure about how to get started, simply forget to save, or have other concerns about putting money aside for retirement. The decision to adopt automatic enrollment, reenrollment, or escalation is a settlor decision, not a fiduciary decision. However, any plan sponsor that adopts such a feature must implement their decision in accordance with ERISA's fiduciary duties and any specific requirements under the Code.

- **Automatic enrollment.** In the case of automatic enrollment, new participants are defaulted into making a minimum level of contributions, unless they elect to contribute at a different level or to make no contributions at all.
- **Automatic reenrollment.** While automatic enrollment occurs when a participant is first enrolled in the plan, an offshoot of this concept called automatic "reenrollment" may also be used by some plans to periodically and automatically default all current plan participants (not just new participants) into making a minimum level of contributions.
- **Automatic escalation.** Automatic escalation is a feature that automatically increases the level of contributions that participants who are already enrolled in the plan will make, unless they elect not to have the increase apply.

What are qualified default investment alternatives?

Qualified default investment alternatives, or QDIAs, are investments that are selected by a plan fiduciary for participants who do not affirmatively choose how their contributions will be invested. QDIAs are particularly important for employees who are automatically enrolled in a plan because, by definition, those employees have not made an affirmative election to participate. Accordingly, QDIAs answer the question of where to invest contributions when a participant has not made any election.

From a legal standpoint, a QDIA can also be an important risk mitigation tool for plan sponsors. While plan sponsors are always responsible for selecting and monitoring the investments offered to participants through their plan's lineup, including any QDIA, a plan sponsor will not be responsible for losses resulting from the allocation of a participant's account into a QDIA that satisfies certain conditions described in ERISA and DOL regulations. In general, those rules require plan sponsors to provide certain notices to participants and designate one of the following types of investments as the plan's QDIA: (a) a target date or life cycle fund, (b) a balanced fund, or (c) a managed account using a target date or life cycle approach.

Automatic enrollment notices

Plans that offer automatic enrollment and QDIAs are subject to additional notice requirements. Although the specific notices required for any plan will depend on the type of plan involved and its particular features, any plan adopting automatic enrollment will generally be required to furnish an automatic enrollment notice to plan participants before contributions are automatically made on their behalf and before the start of each plan year. These notices inform participants that contributions will automatically be made on their behalf, that they have a right to opt out, and how automatic contributions will be invested in the absence of instructions.

Investment education and advice

Because each participant has different financial goals and a different tolerance for risk, some plan participants like the idea of directing the investments in their own accounts. For other participants, however, the idea of managing their own account may be daunting, especially if they have a limited understanding of financial and investing concepts.

From a legal standpoint, a QDIA can also be an important risk mitigation tool for plan sponsors.

To help this latter group of participants, plan sponsors commonly make available various forms of investment education and advice. This section of the chapter is intended to help plan sponsors understand some of the relevant considerations when deciding whether or not to make these features available. To start, it is important to recognize that the decision to offer an education or advice program is itself a fiduciary act. Accordingly, similar to other fiduciary decisions, plan sponsors should understand the services being offered, who will provide such services, the fees that will be charged, and any conflicts of interest that may be involved with such services.

Investment education

One important distinction that plan sponsors should consider is the difference between investment education and advice. Investment education focuses on general financial and investing concepts and does not trigger ERISA's fiduciary or prohibited transaction rules. Investment advice, by comparison, considers the individual needs of participants and is subject to ERISA's fiduciary and prohibited transaction rules. To help distinguish education from advice, DOL Interpretive Bulletin 96-1 outlines categories of participant communications and tools that are deemed to be education and not advice.

Many educational tools and communications have been developed over the years based on Interpretive Bulletin 96-1. For example, retirement plan service providers typically offer services to educate participants on the importance of making and increasing contributions and the power of compounding returns. They also have services to educate participants on how to diversify their accounts or set appropriate asset allocations based on their age. Educational programs may come in the form of static written materials or interactive calculators and models that allow participants to compare potential outcomes based on different inputs. In some cases, a plan may even seek to target education for those participants who may be most at risk, such as employees who are missing out on matching contributions by opting out of automatic enrollment and employees who may not have appropriately diversified their investments.

Investment advice

In contrast to education, advice programs provide participants with individualized fiduciary recommendations about how to invest and manage their accounts. These programs often help participants allocate investments within their account based on their individual goals, preferences, and risk tolerance.

Because ERISA's fiduciary and prohibited transaction rules generally prevent investment advice fiduciaries from making recommendations that increase their own compensation—e.g., by recommending their own products—plan sponsors must be careful to ensure that any advice program under their plan does not run afoul of ERISA's prohibited transaction rules. That is, if a program provides fiduciary-level investment advice, plan sponsors must ensure that the program is either designed to avoid prohibited transactions or qualifies for a prohibited transaction exemption (PTE), such as PTE 2020-02. At a very high level, PTE 2020-02 permits investment professionals and their firms to receive additional compensation as a result of their advice, subject to a series of regulatory conditions.

Shifting advice standards

Long-standing DOL regulations include a five-part test for determining whether a participant recommendation or communication constitutes fiduciary investment advice, and in many cases, the asset allocation programs offered through plans are fiduciary in nature. Plan sponsors should be aware, however, that the DOL has announced new interpretations of its five-part test that newly view certain recommendations and communications as fiduciary advice, even though those same activities would not have been viewed as fiduciary advice under the DOL's prior interpretations. These new interpretations, which are primarily focused on rollover advice, may impact how service providers design tools and services that are intended to help participants make rollover decisions. Additionally, it may impact how participants independently interact with financial professionals in contexts that fall outside of a plan fiduciary's responsibilities.

DOL's new interpretations represent a substantial shift in its thinking on investment advice and, as of this writing, the DOL's regulatory agenda indicates that it is currently working on another project to revise its regulatory definition of fiduciary investment advice. Plan sponsors should stay current on these developments and consider how these recent views, and any future changes, may impact service provider interactions with participants and, perhaps, even how plan sponsors may interact with participants.

Plan sponsors should also understand that other regulatory regimes outside of ERISA affect how advice may be offered to participants. For example, when a broker-dealer makes an investment recommendation to a plan participant, including a rollover recommendation, the recommendation will generally be subject to the Securities and Exchange Commission's (SEC's) Regulation Best Interest (Reg BI). Additionally, in recent years, a handful of securities and insurance regulators at the state level have sought to strengthen the advice standards that apply to investment professionals within their states. Plan sponsors should be aware of and consider how their education and advice programs may be impacted by these new requirements.

[2] Before providing its recent interpretations, in 2016, the DOL issued a rule that expanded its long-standing regulatory definition of fiduciary investment advice, along with a series of new and amended prohibited transaction exemptions. In 2018, the 5th Circuit Court of Appeals invalidated that rulemaking in its entirety. Accordingly, the DOL's 1975 5-part definition of fiduciary investment advice remains in place, although the DOL's interpretations of that rule have recently changed.

[3] The DOL's interpretations newly indicate that a recommendation to roll assets out of a retirement plan and into an IRA may be fiduciary investment advice. Additionally, according to this view, a rollover recommendation may be part of a fiduciary advice relationship even if it is the first interaction between a plan participant and the adviser.

Case study: Helping participants maximize their benefits

In order to help participants maximize their benefits, plan sponsors should consider, in addition to regularly monitoring their plan's investments and service providers, establishing a process for periodically reviewing existing plan features, how those features are being utilized, and how well those features are working to help employees adequately prepare for their retirement. Because this process may involve both settlor and fiduciary decisions, plan sponsors should be careful to ensure that any expenses related to oversight activities paid for by the plan are limited to fiduciary decision-making and implementation efforts. The following illustration demonstrates how such a review can help contribute to better participant outcomes:

> In 2019, for the first time, Employer X established a 401(k) plan for its employees. The plan adopted automatic enrollment and defaults automatically enrolled participants in the plan's QDIA, a suite of age-based target date funds. Employer X also hired the plan's recordkeeper to provide semiannual education sessions to Employer X's employees. The committee responsible for overseeing Employer X's 401(k) plan (Committee) is interested in helping its employees maximize their benefits and is concerned with how the plan only narrowly passes nondiscrimination testing each year.
>
> The Committee has a process for periodically reviewing the plan's investments and service providers to evaluate their performance and fees. Additionally, the Committee has a process for periodically reviewing participation rates, deferral rates, the diversification of investments within participant accounts, and the utilization of the plan's hardship and loan features. The Committee also recently directed a survey of participants to determine whether Employer X's 401(k) plan is meeting employee expectations.
>
> Through these efforts, the Committee determined that, because of recent economic disruption, many participants affirmatively opted not to make contributions in 2020 and have yet to opt back in. Furthermore, the Committee found that when younger employees move assets out of the QDIA, they are moving into the plan's investment option that seeks to preserve principal, and a number of participants reported that they were unsure about how to direct the investment of their accounts.
>
> Based on these findings, the Committee decided to launch an internal campaign to encourage employees to attend the educational sessions that are already being offered to them. Additionally, the Committee decided to further explore additional education and advice services and their associated costs. Finally, the Committee made a recommendation to the decision-makers at Employer X that the plan be amended to automatically reenroll all plan participants every three years, beginning in 2023.

T. Rowe Price would like to recognize Adam R. McMahon for his contributions to authoring this chapter.

ADAM R. McMAHON
Partner, Davis & Harman LLP

Adam McMahon is a partner in the law firm of Davis & Harman LLP. Adam works with retirement plan service providers and employers to help them develop real-world solutions for implementing the requirements imposed on them by ERISA, the Internal Revenue Code, and other federal laws impacting retirement savings. Adam also keeps clients up to date on the latest legislative and regulatory developments impacting retirement savings.

Plan qualification and administrator basics

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In this chapter, we'll discuss the significance of requirements—frequently referred to as qualification requirements—under the Internal Revenue Code and applicable to 401(k) and other retirement plans. We'll also discuss the importance of maintaining a plan document (including amendments) that complies with the qualification and other applicable legal requirements, correcting errors that may occur in either plan language or plan administration from time to time, and some basics regarding IRS examinations (audits). Although the Internal Revenue Code does not directly impose fiduciary requirements, these are important rules with significant consequences for employers and participants in the event of noncompliance. We'll also discuss the Annual Return/Report (Form 5500) and reporting required to be filed by the plan administrator annually regarding deferred vested participants.

Favorable tax treatment for retirement plans

Most retirement programs are designed to meet special rules set forth in the Internal Revenue Code that result in favorable tax treatment of contributions to the program, earnings within the program, and benefits paid from the program. Programs that meet these special rules are commonly referred to as having "qualified" for favorable tax treatment, which has resulted in these rules frequently being referred to as qualification requirements or rules and the plans that meet these rules being referred to as qualified plans. Big picture, the qualification rules are in place to encourage employers to establish qualified plans for the benefit of their employees. The favorable tax treatment available under qualified plans provides tax benefits to sponsors of those plans (typically employers) as well as the participants in the plans. Examples of qualified plans include:

- Defined contribution plans (participant benefit is based on account value)
  - 401(k) plans
  - Profit sharing plans
  - Employee stock ownership plans (ESOPs)
  - Money purchase pension plans
- Defined benefit plans (participant benefit is based on a formula)

There are other retirement plans that are similar to qualified plans in that they offer favorable tax treatment to employers and participants but only if they comply with specific rules from the Internal Revenue Code. Although these other plans are not subject to the qualification rules (at least not directly), they similarly provide tax benefits to employers as well as participants. Examples of these other retirement plans include:

- 403(b) plans (also known as tax-sheltered annuities)
- 457 plans

Whether a qualified plan or not, any retirement program that is intended to provide favorable tax treatment with respect to contributions, earnings, and/or benefits must meet the special tax rules that apply with respect to that particular type of program for that favorable tax treatment to be available.

In addition to fiduciary duties specified under ERISA, qualified retirement plans (and other retirement plans for which favorable tax treatment is available) are subject to Internal Revenue Code rules that set forth a wide range of requirements, including those related to what the written plan document must include, the group of employees eligible to participate in the plan, and the amount of benefits that can be made available under the plan.

General qualification requirements

The Internal Revenue Code's qualification requirements affect many important design choices and options under qualified plans. These requirements are generally designed to ensure:

- Employees who are otherwise eligible do not have to wait too long before they are permitted to participate
- A sufficient number of rank-and-file employees (referred to as non-highly compensated employees) are covered, generally meaning they are eligible to participate and share in plan benefits
- Benefits that have been earned cannot be taken away once a participant has completed a modest period of service
- Benefits are not unduly earned by, and do not unduly favor, longer service or highly compensated employees
- Contributions to plans by employees and employers are limited
- Employee contributions made on a pretax, Roth, and after-tax basis comply with rules applicable to the type of contribution
- Benefits are paid to participants in retirement or at other specified times
- Certain protections are provided to spouses of participants

The policy objectives described above underpin qualification requirements regarding eligibility, minimum participation, minimum coverage, vesting, nondiscrimination, benefit accrual, maximum compensation permitted to be considered, and maximum total employer and employee contributions (annual additions), among others. The qualification requirements also require that these and certain other requirements be included in a written plan document to the extent they apply to the particular type of plan. Even if not required to be included within a plan document, a qualified plan must be administered in compliance with all applicable qualification rules.

Nondiscrimination requirements

From the perspective of the qualification rules, prohibited discrimination under a qualified plan refers to treatment of non-highly compensated employees as compared with highly compensated employees. Generally, highly compensated employees under a qualified plan are those who earn above a specified annual compensation level in the preceding year. For 2023, that compensation level is $135,000 in preceding year compensation. That level is subject to adjustment in future years for inflation.

Put simply, qualified plans are prohibited from unduly favoring highly compensated employees. The rules that have been put into place to enforce this prohibition are broadly referred to as nondiscrimination rules, although they include Internal Revenue Code provisions that are not explicitly labeled by Congress as dealing with nondiscrimination. One thing these rules prevent is covering a group of employees that has an overconcentration of highly compensated employees, considering all employees of certain related entities (generally, referred to as the employer's controlled group) and certain leased employees. These rules also place constraints on an employer's ability to make larger contributions on behalf of, or to otherwise favor, highly compensated employees or to allow participants to earn benefits based on compensation over a specified amount. These rules include prescribed mathematical tests and limitations on the amount of compensation, service, and other factors on which benefits are based that is permitted to be considered.

For example, under a 401(k) plan, the rules prohibit highly compensated employees from making contributions from their own pay (elective deferrals) at a rate that is too much higher than the rate at which lower-paid employees contribute to the plan. The rate at which highly compensated employees may make pretax or Roth contributions from their pay to 401(k) plans is determined by what is referred to as the "actual deferral percentage" (ADP) test. In addition, there is a similar limitation on the rate at which highly compensated employees may make after-tax contributions and receive employer matching contributions under a 401(k) plan, which is determined by the "actual contribution percentage" (ACP) test.

Instead of performing the ADP test, some employers adopt one of the safe harbor plan designs that are permitted under the Internal Revenue Code. Under a safe harbor design, the employer would commit to making matching contributions at a minimum level or a minimum nonelective contribution for each covered employee as well as certain other design features such as, for example, vesting of employer contributions. A safe harbor plan design may also include automatic enrollment and even automatic escalation of elective deferrals, but an employer is not required to adopt a safe harbor plan design to include automatic contribution features in a 401(k) plan (in fact, many 401(k) plans with automatic features are not safe harbor by design).

Plan document requirements

Applicable tax qualification requirements, as well as certain other rules, generally must be reflected in the plan document for the qualified plan that is adopted by the employer. Although not the subject of this chapter, it is important to understand that ERISA also generally requires that your plan be in writing and, as noted in an earlier chapter, plan fiduciaries are required to follow the terms of that plan to the extent those terms are consistent with ERISA. The IRS runs programs intended to help employers adopt and maintain written plan documents that include applicable tax qualification requirements. The IRS also sometimes publishes sample plan document language that employers or preapproved plan providers (as described below) can use in drafting qualified plans.

Individually designed plans

To help employers ensure that the qualified plans they design and adopt include the required written provisions, the IRS has a program under which it will review these plans. A plan document that is designed by an employer is frequently referred to as an "individually designed plan." Under current guidance, the IRS will review a plan document when it is first adopted and when it is terminated. An employer may also be able to seek rulings regarding whether a plan has experienced a partial termination and with respect to certain plan mergers. The IRS has also announced that there may be certain other points in time or circumstances under which it may, from time to time, consider determination letter requests with respect to individually designed plans. For example, in the past, the IRS has opened the determination letter program on a temporary basis for individually designed statutory hybrid plans (cash balance and pension equity plans are two types of statutory hybrid plans).

Upon a finding that the plan includes all required provisions on review, the IRS will issue what is referred to as "favorable determination letter" to the employer with respect to the plan that it has reviewed. The IRS review reflected in a favorable determination letter is strictly limited to the written provisions of the individually designed plan it has reviewed.

Preapproved plans

Another IRS program that helps ensure that qualified plans include the required written provisions is the preapproved plan program. An alternative to adopting an individually designed plan and filing a determination letter request for the plan, an employer may adopt a preapproved plan document. Under the preapproved plan program, a financial services company, law firm, or other organization (the preapproved plan provider) asks the IRS to approve a form of a plan document (the preapproved plan). This preapproved document will allow the employer to make certain choices about the design of the plan from a preestablished list of options, with those choices typically made by the employer within an adoption agreement. The adoption agreement is coupled with what is referred as the basic plan document that describes all of the provisions of the plan in detail, including detail underlying the options from which an employer may select in the adoption agreement. From the perspective of the adopting employer, the adoption agreement it has executed and the basic plan document together constitute the employer's plan document, and it is important that both be read and maintained together to understand the terms of its plan.

Under the preapproved plan program, the preapproved plan provider will have submitted the basic plan document and any form adoption agreement for the IRS to review. Upon a finding that the documents submitted include all required tax qualification and other required provisions on review, the preapproved plan provider will receive an "opinion" letter from the IRS. Although technically different than a favorable determination letter issued to an employer that adopts an individually designed plan, an opinion letter generally serves the same purpose—it provides evidence that the IRS has examined and approved of the written terms of (the form of) the language of the preapproved plan document.

Assuming that the employer chooses only from among the options offered in the adoption agreement or by the preapproved plan provider (and does not make other changes to the plan document other than certain limited changes that are permitted), the opinion letter received by the preapproved plan provider should provide the employer with a measure of comfort that the IRS is satisfied that the plan document as adopted by the employer includes the required provisions. In the case of certain minor modifications to the preapproved plan, an employer may be able to obtain a determination letter from the IRS that those minor modifications do not result in the employer losing reliance on the opinion letter.

It is important that qualified plan terms be followed and kept up to date. Plan terms must be kept current both with legal requirements as well as with any changes in plan design the employer makes and certain changes in administration. This is done through plan amendments, the timing and form of which depend on whether the plan is individually designed or preapproved. It is also important that the plan's summary plan description (SPD) accurately summarizes the terms of the plan in accordance with Department of Labor rules and is timely distributed. For more detail regarding the SPD requirements, see chapter 4.

Plan amendments

Although there is some comfort in having a favorable determination letter for an individually designed plan or in adopting a preapproved plan with an opinion letter from the IRS, there is no guarantee that the IRS will not later challenge either the plan language or the way your plan has been operated. It is especially important that plan amendments be adopted in a timely way. In the case of a preapproved plan, amendments required to comply with legal changes generally are the responsibility of the preapproved plan provider. Care should be taken if you make any other amendment to a preapproved plan that you have adopted to ensure that the amendment does not cause you to lose the ability to rely on the opinion letter issued to the provider.

Timing of amendments

When changes to the qualification rules or sometimes even other changes are enacted into law, certain or all types of qualified plans may need to be amended to reflect the change. In that case, the law giving rise to the change may specify a deadline by which an amendment or amendments reflecting the change must be adopted. If Congress does not specify a deadline, the IRS will typically announce a deadline by which the required amendment will need to be adopted. For individually designed plans, this deadline will normally be the last day of the second calendar year that begins after the IRS lists the change on what the IRS refers to as the "Required Amendments List." The required timing is a bit different for amendments required to be adopted by preapproved plan providers.

Other times an amendment may be required because the employer changes the design of its plan. In other words, the change to the plan is not due to a change in law but instead due to an optional change that an employer wishes to make. In such a case, the employer generally is required to adopt the amendment by the end of the plan year in which the change is to become effective. Depending on the nature of the change, it may be necessary for the amendment to be adopted even earlier. For example, if an employer were adding a Roth feature to an existing 401(k) plan the amendment is required to be adopted before it becomes effective.

Restrictions on amendments

Certain amendments are not permitted, and others are only permitted to be made with respect to future benefits under (contributions to) the plan. For example, an amendment to increase the age as of which an employee may take an in-service distribution may be permissible with respect to future contributions but may not be permissible with respect to amounts previously contributed to a participant's account. As another example, an amendment to the vesting schedule for employer nonelective or matching contributions may not be permissible for existing participants even with respect to future contributions. Care must be taken to ensure that any plan amendment complies with all applicable legal requirements.

> The IRS offers a comprehensive and flexible program for correcting qualified plan errors, including mistakes in the plan document and failures to follow the terms of the plan document. Under certain circumstances, errors can be self-corrected without the employer paying any fee.

Correction of errors

Mistakes happen. In the world of qualified plans, mistakes are frequently referred to as qualification defects, errors, or failures. Fortunately, the IRS maintains a comprehensive and relatively flexible correction program, which has been endorsed and expanded by Congress, under which many errors related to qualified plans may be corrected. This program is referred to as the "Employee Plans Compliance Resolution System," or "EPCRS," under which qualification defects, including errors in the written terms of a qualified plan as well as errors in plan administration, may be corrected. On an ongoing basis, employers should have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable tax code requirements with respect to their qualified plans. In fact, without such practices and procedures, an employer may be ineligible to use many aspects of EPCRS and also may be in a materially worse position with respect to IRS sanctions in the case of errors discovered during an IRS examination.

EPCRS contains three basic components—two of which generally allow an employer to voluntarily correct errors (one of which requires a submission to the IRS, the other does not) and the third of which allows an employer to correct certain failures identified by the IRS on audit with payment of a sanction. The "Self-Correction Program" (SCP) portion of EPCRS, which Congress explicitly expanded in retirement legislation passed at the end of 2022, permits an employer to voluntarily correct certain errors without any submission to the IRS or payment of any fee if the eligibility requirements are satisfied. If SCP is either not available or determined to not be the most desirable route, an employer still may voluntarily correct many errors under the "Voluntary Correction Program" (VCP) portion of EPCRS, which is described immediately below. If an error has not been properly corrected on a voluntary basis by the employer but instead is discovered by the IRS on audit, the IRS may offer the employer the opportunity to correct the error through the third component of EPCRS known as the Audit Closing Agreement Program (Audit CAP). Audit CAP is described in more detail under the heading "IRS Examinations" in this chapter.

Voluntary Correction Program

For correction methods that are uncertain, novel, or otherwise unclear as applied to a particular error, it may be more desirable to receive written approval from the IRS of the proposed correction method instead of using SCP. In some cases, VCP may be the only voluntary option to correct an error because SCP is not available. To correct an error under VCP, an application including a detailed description of the error, proposed correction, and certain other information must be filed with the IRS together with payment of a user fee by the employer. The proposed correction should be consistent with the general correction principles and guidelines set forth in EPCRS. If the IRS agrees to the proposed correction, or an agreed modification of the proposed correction, it will issue written approval of the agreed correction in a document that is referred to as a "compliance statement."

> The user fee for a VCP application generally is much smaller than the sanction the employer would be required to pay if the IRS were to discover errors during an examination, making the program an attractive option in many cases.

Note that VCP may not be available in certain cases, such as if any of the employer's plans have received a notice of an IRS examination that has not been closed. ECPRS describes other situations in which VCP is not available. In addition, correcting an error through VCP (or otherwise under EPCRS) resolves only those specific errors under the Internal Revenue Code from the perspective of the IRS. For example, a compliance statement under VCP does not address or otherwise provide any comfort related to whether the plan that is subject of the statement otherwise complies with applicable qualification requirements or requirements under other applicable laws, such as ERISA. That said, certain ERISA requirements are identical to corresponding Internal Revenue Code requirements and are within the Department of the Treasury's and IRS' interpretive authority.

The IRS has stated that the most common errors submitted for correction under VCP are:

- late plan amendments required by tax law changes
- not accurately following the plan's definition of compensation in determining contributions
- not including employees in the plan who should have been included or including employees in the plan who should not have been included
- not accurately following the Internal Revenue Code's loan provisions
- allowing impermissible in-service distributions to participants who are still employed before the terms of the plan or Internal Revenue Code allow
- not properly making required minimum distributions when required under the tax code
- adopting a plan that an employer is not eligible to adopt (for example, governmental employers generally are not permitted to adopt a 401(k) plan)
- failure to satisfy the 401(k) ADP/ACP nondiscrimination tests or timely take corrective actions
- failure to follow the top-heavy plan rules that apply when certain owners and officers of the employer have at least 60% of the plan assets in their accounts
- not limiting total employee and employer contributions to the annual maximum permitted under the Internal Revenue Code

Receiving a compliance statement from the IRS through VCP does not assure that plan participants or the Department of Labor (DOL) will not raise a complaint under ERISA concerning the same or a related error. Certain ERISA compliance errors may be able to be corrected under a similar, but far more limited, program established by the DOL named the Voluntary Fiduciary Compliance Program (VFCP). More information about the DOL's VFCP program is available in chapter 6.

IRS examinations

The IRS conducts examinations (often referred to as audits) of a range of qualified plans every year. These audits are handled by specialists who have been trained to conduct examinations of plans' compliance with the complex qualification requirements. If the IRS finds errors during an audit that had not previously been properly corrected under EPCRS, there may be significant consequences for the plan, the employer, and the plan participants. The IRS may also challenge the methodology or completeness of a self-correction under SCP in certain cases during an audit.

The first contact regarding an IRS audit may be a phone call followed up by an initial appointment letter. From the IRS perspective, the phone call may be a follow-up to a letter that by that time had already been sent but not yet received. The initial letter will be accompanied by an information document request (IDR) (or more than one IDR) that includes document and information requests related to pre-selected examination issues and additional issues that have been identified while selecting the plan for audit. Some of the major areas audited related to 401(k) and other defined contribution plans include:

- Employee stock ownership plans
- Compliance with applicable code limitations, such as deductions under section 404 and maximum annual additions under section 415(c)
- Participant loans
- 401(k) cash or deferred arrangements including elective deferrals and matching contributions
- 403(b) and 457 plans
- Worker classification, in particular, misclassification of employees as independent contractors

Employers generally should establish a single point of contact, usually an attorney, to work with the IRS during the audit. As issues arise during the audit, there are options available including direct resolution of legal issues with the IRS agent and, if necessary, a conference with the agent's supervisor or even requesting informal or formal guidance on specific technical issues from IRS attorneys.

If the IRS finds errors during its examination, the IRS may offer the employer the opportunity to correct (and the employer may agree to correct) those errors under the third component of EPCRS described above, which is referred to as the Audit Closing Agreement Program. In addition to correcting the errors and paying the cost of all required corrections, the IRS will require the employer to pay a negotiated sanction. The sanction under Audit CAP is a negotiated amount that is determined based on the facts and circumstances including a range of factors described within EPCRS. The IRS has said that the required sanction amount will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures, considering those factors. Not surprisingly, the sanction generally would be expected to be larger than the VCP user fee that would have applied with respect to the plan had the employer voluntarily applied under EPCRS.

Annual return/report (Form 5500)

A variety of reporting and disclosure requirements apply in connection with retirement plans, many of which are described in other chapters in this guide. For qualified plans, such as 401(k) plans, the plan administrator must file with IRS and DOL (and if applicable, PBGC) an Annual Return/Report electronically each year with the IRS and DOL on Form 5500. The agencies require a range of information be included on the Form 5500, including information on the qualification of the plan, type of plan and features, plan's financial condition, plan's investments, and the operations of the plan. Small plans (generally, those with fewer than 100 participants at the beginning of the plan year) may be eligible to file the shorter Form 5500-SF instead of the regular Form 5500. The instructions for the Form 5500-SF describes which plans are eligible to file this shorter form.

[1] On June 3, 2022, the Employee Plans Division of the IRS launched a pre-examination compliance pilot program. Under the pilot program, a plan sponsor—whose retirement plan was selected for audit—is asked for a demonstration of how the plan satisfies a specific qualification requirement and also given 90 days to review other aspects of their plan to determine if they meet current tax law requirements. If the plan sponsor uncovers mistakes, the sponsor may be able to self-correct, even though the plan has been selected for possible audit. For mistakes that are not eligible for self-correction, the plan sponsor may enter into an agreement with the IRS using the VCP fee structure instead of the more costly Audit CAP. The IRS has stated that it considers the 2022 pilot program to have been a success and will likely make use of similar compliance programs in the future.

One of the most significant reporting and disclosure requirements applicable to qualified plans is the Annual Return/Report (Form 5500), which must be filed electronically each year through the ERISA Filing Acceptance System (EFAST2). The Annual Return/Report generally includes a number of attachments, such as for most plans an audit of the plan by an independent qualified public accountant.

Plan independent audit

As a general rule, any qualified plan or other plan that is subject to ERISA that has at least 100 participants and has plan assets must be audited each year by an independent qualified public accountant. The audit must be attached to the Form 5500 filed for the plan. There is an exception to the audit requirement for small plans, which generally applies to plans with fewer than 100 participants at the beginning of the plan year and that meet certain other requirements. In some circumstances, a plan audit may not be required of a small plan that has grown to have at least 100 participants, but that still has no more than 120 participants at the beginning of the year, that remains eligible to file a Form 5500-SF rather than a full Form 5500 for that year.

The DOL has expressed significant concern with the quality of plan audits. Among other things, the DOL has stated that, in its view, certified public accounting firms that handle relatively few employee benefit plan audits generally tend to make more mistakes in their audits. Based on these and other concerns, the DOL has said that individuals who engage an auditor for their plan should obtain references and discuss the auditor's work for other employee benefit clients. The DOL has also suggested that the proposed engagement letter with the auditor should be carefully reviewed before work begins, including to ensure that the letter adequately describes specific items such as the audit work to be performed, the timing of the audit, and fees.

Once an audit has been concluded, the DOL suggests making sure that the auditor has considered each of the following when preparing the audit report:

- whether the plan assets covered by the audit have been fairly valued
- whether plan obligations are properly stated and described
- whether contributions to the plan were received on time
- whether benefit payments were made in accordance with the plan's terms
- whether issues were identified that may impact the plan's tax-qualified status
- whether transactions prohibited under ERISA were properly identified

Form 5500 due date

The Form 5500 for a plan year is due by the last day of the seventh calendar month after the end of the plan year. So, for example, the Form 5500 for a calendar year 401(k) plan generally is due to be filed by the end of July in the next calendar year. A one-time extension of the deadline to file the Form 5500 (of up to two-and-one-half months) can be obtained by filing Form 5558 with the IRS on or before the regular due date for the Form 5500. If filed, a copy of the completed Form 5558 requesting the extension must be retained with plan records. Unlike the Form 5500, the Form 5558 is not filed electronically but instead must be mailed to the address specified in the instructions.

Annual registration statement identifying separated participants with deferred vested benefits

The plan administrator of a qualified plan is also required to file an Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits electronically each year with the IRS on Form 8955-SSA. Terminated employees who have a vested benefit in the plan are required to be included in the form. The form also allows the plan administrator to delete or remove separated participants who were previously reported on a Form 8955-SSA after their vested benefit has been fully distributed from the plan. The IRS provides the information on the Form 8955-SSA to the Social Security Administration (SSA), which later uses that information to notify individuals who file a claim for Social Security benefits that there are "potential" benefits to which they may be entitled under the qualified plan. If the Form 8955-SSA is not updated when a participant receives full distribution (or if there is confusion in the reporting or records between the IRS and SSA), the notice from the SSA to the former participant can be very confusing and lead a former participant who previously received a full distribution of their vested benefit to believe they remain entitled to benefits under the plan.

Like the Form 5500, the due date for the Form 8955-SSA is the last day of the seventh month after the plan year ends. Also, like Form 5500, a one-time extension of the deadline to file the Form 8955-SSA (of up to two-and-one half months) can be obtained by filing Form 5558 with the IRS on or before the regular due date for the Form 8955-SSA.

Case study: Preventing an overconcentration of highly compensated employees

In order to test that a plan does not cover too many highly compensated employees as compared with the portion of the non-highly compensated employee population that is covered, coverage testing must be performed. It's important that the plan administrator ensure that whoever is performing this test has correct and complete data so that the test results can be relied upon. One issue that frequently arises in performing coverage testing is the treatment of employees who are in the plan sponsor's controlled group but not eligible to participate in the plan. The following illustration demonstrates the importance of using correct and complete information in performing the coverage test and provides a simplified example of how one of the coverage tests, referred to as the ratio percentage test, works.

During 2023, Company A maintained a profit sharing plan for its employees. There are two other entities, Company B and Company C, that are 100% subsidiaries of Company A ; therefore Company A, Company B, and Company C are treated as a single employer for purposes of certain qualification requirements under the Internal Revenue Code, including coverage testing. One of the coverage tests, the ratio percentage test, is calculated by comparing the percentage of nonexcludable non-highly compensated employees (NHCEs) that benefit under the plan to the percentage of nonexcludable highly compensated employees (HCEs) that benefit under the plan. If the ratio of those percentages (the percentage of nonexcludable NHCEs benefiting under the plan over the percentage of nonexcludable HCEs benefiting under the plan) is at least 70%, then the plan passes the ratio percentage test. If that ratio is less than 70%, the plan must pass a different test (referred to as the average benefits test) or take remedial action to ensure coverage testing is passed.

Assume that to perform the ratio percentage test, Company A looks only at its own employee data. Further assume that Company A has 60 nonexcludable NHCEs and 72 nonexcludable HCEs and that all nonexcludable Company A employees benefit under the plan for purposes of the coverage test rules. If this were the correct data to consider, the percent of nonexcludable NHCEs benefiting under the plan would be 100% and the percent of nonexcludable HCEs benefiting under the plan would also be 100%. This would result in the ratio of those percentages being 100%, which is not less than 70%, and therefore the (incorrect) conclusion that the plan passes coverage testing. Unfortunately for Company A, it must consider all employees in the controlled group when conducting the ratio percentage test, meaning that Company B and Company C employees must be included in the test.

Looking to controlled group data, assume that Company B has 65 nonexcludable NHCEs and 7 nonexcludable HCEs and that Company C has 100 NHCEs (all of whom are excludable under the coverage testing rules) and 1 nonexcludable HCE. Considering this data, the percent of nonexcludable NHCEs benefiting under the plan would be 48%. This is determined by dividing the number of nonexcludable NHCEs who are benefiting under the plan (the 60 such employees from Company A) by the total of all nonexcludable NHCEs in the controlled group (60 from Company A and 65 from Company B). Using the same process, the percent of nonexcludable HCEs benefiting under the plan would be 90%. This is determined by dividing the number of nonexcludable HCEs who are benefiting under the plan (the 72 such employees from Company A) by the total of all nonexcludable HCEs in the controlled group (72 from Company A, 7 from Company B, and 1 from Company C). The ratio of those percentages, 48% (the NHCE benefiting percentage) divided by 90% (the HCE benefiting percentage), is 53%, which is less than 70%. Accordingly, using correct and complete data, the plan actually fails the ratio percentage test and therefore must continue testing using the average benefits test to determine whether it can pass that test or is otherwise required to take additional remedial actions to pass the Internal Revenue Code's coverage requirements. It's extremely important that plan administrators provide correct and complete information so that the coverage test can be completed correctly and the results can be relied upon.

T. Rowe Price would like to recognize Dominic DeMatties for his contributions to authoring this chapter.

DOMINIC DEMATTIES

Partner, Thompson Hine LLP

Dominic DeMatties is a partner in Thompson Hines' Employee Benefits & Executive Compensation practice group. He focuses his practice on design, implementation and administration of a wide range of employee benefit programs, with an emphasis on compliance of tax-qualified and nonqualified deferred compensation arrangements with ERISA, the Internal Revenue Code (such as the tax qualification rules, 409A, and excise tax provisions), and other applicable laws and rules.

Fiduciary liability, DOL audit, fiduciary insurance, and bonding

6

T. ROWE PRICE

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Fiduciary liability and threat of private litigation

Through a combination of shifting demographics, increased longevity, and other factors, the proportion of the United States population at or above age 65 is growing. By some estimates, the number of retirement-age Americans will nearly double by 2060 and will comprise a larger percentage of the general population than ever before.[1]

Not surprisingly, an aging population places increasing emphasis on the adequacy of retirement resources. Defined contribution plans sponsored by employers—for example, 401(k) and 403(b) plans—are now the most common species of private retirement account and, as such, are receiving increased scrutiny by regulators, participants, and the plaintiffs' bar.

This increased scrutiny has led to an increase in litigation challenges involving 401(k) and similar employer-sponsored retirement plans. The Employee Retirement Income Security Act of 1974 (ERISA) litigation can implicate a wide array of plan administrative activities, including selection of service providers, performance of plan investment options, plan governance, and more. Moreover, ERISA claims can present the prospect of personal liability being assessed, not just against service providers or employers, but also against individual plan fiduciaries. In some circumstances, that exposure can reach co-fiduciaries that were not directly involved in challenged activities as well as nonfiduciary "parties in interest."

Several factors make ERISA litigation even more attractive to would-be plaintiffs and their counsel. Given the amount of money held by private retirement plans—estimated at $11 trillion at the end of 2021 by one source[2]—some degree of interest from entrepreneurial lawyers was inevitable. Indeed, ERISA class-action litigation has become commonplace, given ERISA's fee-shifting provisions, and the possibility of common fund fee awards (i.e., attorney-fee awards set at a percentage of all funds recovered by settlement or judgment). In many cases, industrious plaintiffs' lawyers launch litigation against plans that are generally well run, in the hope of finding errors, omissions, or other actionable circumstances through discovery.

[1] See, e.g., Population Reference Bureau, Fact Sheet: Aging in the United States, accessed at https://www.prb.org/resources/fact-sheet-aging-in-the-united-states/ (last viewed April 3, 2023).

[2] See, e.g., Investment Company Institute, 2022 Investment Company Fact Book, Chapter 8 ("US Retirement and Education Savings"), accessed at https://www.icifactbook.org/pdf/2022_factbook_ch8.pdf (last viewed April 4, 2023).

Common types of litigation

Litigation involving 401(k) and similar plans typically focuses on a breach of a fiduciary's duty, a statutory prohibited transaction (e.g., a self-dealing transaction with a plan), or another statutory violation. In claims asserting fiduciary breach, evidence of a "prudent process" will usually be enough to defeat liability, since courts are generally supposed to defer to fiduciaries' discretionary judgments about plan administration. Thus, fiduciary defendants can often defeat claims by showing that challenged actions or decisions were the product of thorough, deliberate, and well-informed fiduciary processes.

ERISA litigation can take many forms, many of which can arise in the context of retirement plan administration. Some of the claims arising in litigation include:

Excessive fees for plan investments and/or plan administrative services:

Since over a decade ago, the ERISA plaintiffs' bar has brought dozens of class-action lawsuits claiming that plan investment costs are excessive, and it has more recently challenged service fees for recordkeeping or other plan administrative services. Many fiduciary defendants have defeated such claims by establishing that a decision to select or maintain a given investment, or to retain a given service provider, was the result of a prudent process. Evidence of such a prudent process often includes regular fiduciary review of investment performance and regular consideration of corresponding investment costs relative to costs of similar investment options. Additionally, periodic attention to service provider pricing—whether through regular monitoring of service costs or through implementation of bidding or other competitive processes to ensure market-driven pricing—can often help fiduciary defendants establish viable defenses to such claims. Notably, however, plan fiduciaries are not required to engage the lowest-cost provider they can find. A number of courts have noted that other considerations (e.g., the precise nature and quality of services provided) can lead a prudent fiduciary to engage a provider with somewhat higher costs.

> [F]iduciary defendants can often defeat claims by showing that challenged actions or decisions were the product of thorough, deliberate, and well-informed fiduciary processes.

Investment selection

Plan participants can also challenge specific investments as imprudent, although the underlying reasons may vary. In some cases, a plaintiff will assert that one or more plan investments are imprudent—examples include private equity, hedge fund, or similar investments—which plaintiffs sometimes criticize as being too risky for retirement investing. Similarly, plan participants sometimes challenge plan investment options because they have underperformed relative to fund benchmarks or other widely available investment alternatives.

Conflicts of interest/plan governance

Conflicts of interest that affect, or could affect, plan fiduciaries' decisions are another common species of a claim. For example, many lawsuits have challenged plan investments that include administrative fee payments, alleging that these payments benefit the employer/plan sponsor—for example, by reducing the company's direct costs of maintaining the plan. Other litigation has seized upon plan-governance arrangements that place nonfiduciaries in charge of plan administration or situations in which named fiduciaries improperly deferred fiduciary decisions to company personnel without proper authority or qualifications to handle those decisions. In some cases, participants have also challenged plan transactions that provide direct or indirect benefits to the fiduciary directing the transaction, or to another party in interest to the plan, which includes plan service providers, family members of fiduciaries, and corporate officers of the employer/sponsor.

Investments in employer stock or other employer securities

While ERISA requires fiduciaries to diversify plan investments to avoid the risk of large losses, certain employer-issued securities are not subject to the diversification requirement. In the context of 401(k) and similar plans, an employer stock fund often appears among the investment funds available to plan participants. Litigation involving employer stock investments is most common when the employer's stock declines significantly—leading to claims that the employer's stock was not a prudent investment—but can also arise in other ways. For example, when a corporate spinoff results in a new corporation, stock in the new company can sometimes remain in the plan, leading plaintiffs to assert that the new company's stock is not exempt from diversification rules, since that stock is not issued by the "employer" of the original company.

Practices that can mitigate litigation risk

Litigation rarely arises from fiduciary activity that achieves outstanding investment returns or other high-quality outcomes. In those cases, participants have little incentive to bring suit, and when they do, the challenged results often help to establish the prudence of the underlying decisions.

Not surprisingly, litigation is more common where investment options underperform, plan administration costs erode returns, or conflicts of interest drive decisions that adversely affect plan participants' interests. In such cases, fiduciary defendants' responses usually cannot rely on positive investment outcomes or other favorable results; rather, defense in those cases tends to focus on fiduciary process—i.e., making a case that a challenged act or decision resulted from thorough and well-informed deliberations by qualified fiduciaries who are pursuing participants' best interests.

For example, in cases challenging the selection and monitoring of a plan investment adviser, defendants should be prepared to demonstrate that the decision to engage that adviser was thorough and well informed and properly balanced the provider's qualifications and performance record, the nature and quality of services provided, and the costs associated with those services.

Even after the initial engagement of an investment adviser, fiduciaries should continue to review the advisor's performance on a regular basis, whether annually, quarterly, or another appropriate periodic basis. This includes periodic monitoring of investment performance and changes in the provider's own fee arrangements, as well as industry changes that could result in more competitive pricing for services the plan is receiving. Additionally, plan fiduciaries should periodically explore whether asking the plan's service providers to participate in a competitive bidding process would improve services, lower plan costs, eliminate undesirable investment options, or otherwise benefit participants.

Where plan fiduciaries have complex decisions, such as the comparative merits of similar investment options, it is often prudent to seek advice from a qualified third-party professional, such as an investment consultant, investment adviser, or the plan's outside counsel. In addition to helping fiduciaries identify and evaluate all relevant considerations and/or options—which benefits participants—engagement of a qualified professional helps establish that fiduciary decision-making is deliberate, thorough, and well informed.

> **Records establishing that plan fiduciaries timely and appropriately evaluated investment options, provider contracts, and other plan arrangements can defeat fiduciary claims, even where the decision itself did not produce the desired results.**

In all such situations, documentation of the fiduciary "process" can be critically important. Records establishing that plan fiduciaries timely and appropriately evaluated investment options, provider contracts, and other plan arrangements can defeat fiduciary claims, even where the decision itself did not produce the desired results. For example, when plan fiduciaries replace one investment fund with another, they should memorialize the reasons for the changes, including both the removal of one fund and the selection of the fund replacing it. Documentation like this could not only support a defense against removal of an option that later outperformed its benchmarks but it also claims that the replacement option performed poorly. In general terms, documentation should provide enough information that a reader can glean the reason(s) for a specific decision, as well as the fiduciaries' consideration of alternative courses of action.

Case study

While documentation is important, plan fiduciaries should avoid the temptation to retain large volumes of unnecessary material. In one case, a well-meaning plan fiduciary testified in deposition that they received regular fiduciary training, proudly adding that they had kept over 10 years' worth of the training materials as reference. This prompted the attorney taking the deposition to cross-examine the witness on the contents of those materials, which had been produced in discovery and included many detailed recommendations about fiduciary process. Eventually, the witness was forced to admit multiple situations where they—and the other plan fiduciaries—had failed to follow the recommendations included in those materials. Not surprisingly, these exhibits and the associated testimony helped plaintiffs defeat summary judgment.

Addressing a DOL audit or investigation

In addition to establishing the legal framework for plan administration, ERISA also charges the U.S. Department of Labor (DOL) with enforcement of ERISA's fiduciary rules and similar requirements. These enforcement efforts are primarily handled through the Employee Benefits Security Administration (EBSA), which maintains enforcement programs that cover approximately 750,000 retirement plans holding an estimated $12 trillion in assets at the end of the DOL's 2022 fiscal year. For 2023, the DOL boasts an agency budget of $14.6 billion and nearly 17,000 full-time employees.

Like most other federal agencies, the DOL has very broad subpoena power to compel production of documents and to require witnesses to submit to deposition. In most civil matters, the DOL can exercise that authority based on "nothing more than official curiosity." In practical terms, this means that the DOL can launch an investigation without "probable cause," or even a reasonable factual basis to believe its target has violated any law. Unlike most other federal agencies, the DOL also has a dedicated legal department in the Office of the Solicitor of Labor, which supports EBSA enforcement activities around the country. The DOL can thus take direct enforcement action without seeking approval or assistance from another agency, such as the Department of Justice. The DOL can, and does, use this capability to sue alleged offenders in federal court, seeking recovery of monetary losses to plans, disgorgement of profits received in violation of ERISA, injunctive relief, and, in many cases, civil penalties. In addition to its civil investigatory powers, EBSA also has responsibility for enforcing ERISA's criminal provisions.

Current enforcement priorities

The DOL publicly announces its ongoing enforcement priorities, as well as its current enforcement projects. While the DOL updates the list periodically, as of early 2023, its main enforcement priorities for 401(k) and similar plans include:

- **Late deferrals**—Investigating situations where sponsors fail to make prompt, accurate deposits of employee payroll deferrals into the 401(k) plan.
- **"Missing" participants**—Inquiring about sponsors' policies and procedures for tracking "missing" participants, including former employees who continue to hold vested account balances, and communicating with those participants.
- **Plan investment conflicts**—Evaluating potential conflicts of interest regarding plan investments—which can include inquiry into excessive service provider fees—but also underlying processes for selecting providers and/or plan investment options.

These enforcement priorities do not limit the DOL's regulatory reach, however. The DOL is authorized to pursue any other circumstances that violate, or may violate, the controlling statutory provisions and regulations.

The DOL cybersecurity guidance

Since retirement plan administration typically involves sensitive personal and financial data, cybersecurity is an area where the DOL is recently giving much closer scrutiny. In April 2021, the DOL issued detailed guidance ("Cybersecurity Program Best Practices") on cybersecurity procedures for retirement plans. At the time, the DOL also issued separate guidance on the cybersecurity considerations involved in selecting and monitoring plan service providers, which is addressed in Chapter 3.

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[3] See, e.g., EBSA Fact Sheet, "EBSA Restores Over $1.4 Billion to Employee Benefit Plans, Participants, and Beneficiaries," accessed at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/ebsa-monetary-results (last viewed April 11, 2023).

[4] See, e.g., *United States v. Morton Salt*, 338 U.S. 632, 652 (1950) ("Even if one were to regard the [agency's] request for information in this case as caused by nothing more than official curiosity, nevertheless law enforcing agencies have a legitimate right to satisfy themselves that corporate behavior is consistent with the law and the public interest."). This well-known observation regarding agency authority involved the Federal Trade Commission but also applies to the DOL with equal force.

Since issuing the guidance, the DOL has made cybersecurity a regular focus for audits and investigations of 401(k) and similar plans. Any DOL inquiry into cybersecurity processes is likely to include a review of the following:

- **A formal, documented cybersecurity program**—Although styled as "best practices" guidance, recent DOL inquiries suggest a regulatory expectation that retirement plans will have a well-documented cybersecurity program aimed at protecting the systems used in plan operations, participant assets held by the plan, and sensitive participant data used in plan administration. The DOL's guidance encourages plan fiduciaries to establish a program that addresses a variety of topics, including:
  - **Clearly defined roles and responsibilities for cybersecurity**—The DOL guidance explicitly recommends that the plan's cybersecurity program be managed "at the senior executive level." Appropriate experience and qualifications, along with regular training and periodic background checks, are another point of emphasis.
  - **Strong access control procedures**—Control over access to plan-related systems and facilities is another important consideration. In addition, the DOL guidance recommends that access privileges should be regularly monitored (at least every three months), with users and/or accounts deleted, where appropriate, and consistent with the overall cybersecurity program. Use of current data encryption technology, complex passwords, and multi-factor authentication; hardware and software updates; and similar security controls is also encouraged.
  - **Employee training**—Regular cybersecurity training for all employees (not just those directly involved in plan administration) is another point of emphasis, both to raise awareness of emerging threats and to assist in responding to threats or breaches as they arise.
  - **Planning for redundancy/resiliency in plan operations**—The guidance also speaks to a business resiliency program "which effectively addresses business continuity, disaster recovery, and incident response." The guidance indicates that plan sponsors should maintain response-and-recovery plans that not only address cybersecurity threats and breaches, but that also contemplate recovery from disasters and other disruptions that threaten plan systems, participant assets, or sensitive plan data.

> [The] DOL has made cybersecurity a regular focus for audits and investigations of 401(k) and similar plans.

- **Regular risk assessments**—Under the DOL guidance, plan fiduciaries should also schedule regular risk assessments to identify and prioritize potential cybersecurity threats. The guidance includes a specific recommendation for a reliable annual audit of security controls by an independent auditor to "provide a clear, unbiased report of existing risks, vulnerabilities, and weaknesses." Additionally, the DOL recommends that retirement plans incorporate cybersecurity planning into the ongoing development of plan-related systems such that cybersecurity considerations form an integral part of those systems.
- **Vendor and third-party service provider management**—Retirement plan vendors and service providers routinely access and handle confidential participant information. The 2021 DOL guidance ("Tips for Hiring a Service Provider with Strong Cybersecurity Practices") also recommends that plan fiduciaries take steps to ensure appropriate vendor and service provider engagement with cybersecurity needs, discussed in more detail in Chapter 3.

Addressing DOL audits and investigations

The DOL routinely investigates plans for compliance with ERISA, and the foregoing considerations address only a fraction of the issues and circumstances that might be implicated in a DOL inquiry. While DOL inquiries can arise spontaneously, as noted above, those inquiries are often traceable to external events such as participant complaints or defects in regulatory filings. While a regulatory inquiry does not necessarily mean that the DOL believes there are problems, plan sponsors and fiduciaries should approach a DOL audit or investigation with caution.

Tip: If you become aware of errors in plan administration, it is often advisable to implement a voluntary correction before the DOL makes any inquiry. The DOL's Voluntary Fiduciary Correction Program allows self-correction of such errors, usually avoiding enforcement action. The Internal Revenue Service (IRS) sponsors self-correction programs for tax-qualification errors, as well. However, plan sponsors under audit or investigation are not eligible for these programs. Additionally, in our experience, the DOL will sometimes investigate plan errors that were already self-corrected pursuant to the IRS correction program. Thus, when undertaking any correction, it is important to ensure that the correction will adequately address any errors, whether they fall under DOL or IRS jurisdiction.

Preparation is often a key component in resolving a DOL inquiry. It is wise to have a response plan in place, even before the DOL makes contact. Having a response plan can help avoid missteps early in the process that can become expensive obstacles to resolution. Any response plan should identify the specific person(s) designated to meet with DOL investigators and should include training of all personnel who might receive the DOL's initial contact to ensure that the inquiry is directed to the right representative. Additional components of a response plan can vary depending on the nature of your operations and the manner of the DOL inquiry (subpoena, site visit, audit, informal request for information, etc.).

Common elements of a response would include:

- Dialogue with the investigator in an attempt to glean information about the DOL's concerns and to limit unreasonably broad or burdensome demands for information.
- Assessment of the company's capability to prepare documents—especially where large volumes of material are involved—and to meet associated timelines.
- Where witness interviews are sought, a procedure for engaging with potential witnesses that avoids any appearance of witness manipulation or other improper conduct.
- Additionally, it's advisable to make a conscious effort to ensure that witnesses are prepared to answer the DOL's questions and to secure permission for a company representative to attend any interviews.
- When and how to put the company's insurance carrier(s) on notice, since many common types of commercial insurance provide coverage for legal fees and, in some cases, monetary exposures.

When faced with an investigation, it can also be critically important to involve legal counsel. In-house counsel can be well suited to handle a DOL inquiry, but it is sometimes more effective to engage outside counsel who will serve as a buffer between investigators and company personnel. Counsel with DOL experience can usually assist in narrowing the scope of inquiry, arranging for extensions to meet informational demands, and lodging objections to DOL inquiries, where appropriate. Additionally, outside counsel can often assist by quickly locating plan administrative errors, advising on and implementing corrections, then working to persuade the DOL that the curative effort was adequate and/or that no enforcement action is warranted.

Tip: Inexperienced clients frequently attempt a "do-it-yourself" approach to a DOL investigation, whether in an effort to save costs or in the often-mistaken belief that friendly cooperation could lead to lenient treatment of violations. Experience shows that this approach often backfires. For example, some clients have produced material beyond what the DOL requested, thereby prompting investigation into errors that might otherwise have gone undetected.

When the investigation concludes, the DOL typically issues a "closing letter." In many cases, the closing letter will merely state that no violations were found or that the violations were minimal or have been adequately addressed. Similarly, if the DOL believes corrective action is needed, a closing letter will specify the violations found and invite corrective proposals. Of course, where serious errors or violations are found, the DOL may elect to pursue litigation.

ERISA fiduciary insurance and fidelity bonding requirements

ERISA fidelity bonds

Subject to certain exemptions, ERISA imposes certain mandatory bonding requirements. Plan fiduciaries are responsible for ensuring that these bonding requirements are met both for themselves and for any (nonexempt) service provider who handles plan funds. Because the bond (often called a fidelity bond) is to protect the plan, the plan may pay for the costs of the bond.

ERISA requires that every fiduciary and every other person (including nonexempt service providers) who "handles" funds or other property of the plan be bonded. The fidelity bond protects the plan if the fiduciary or person handling the property or funds causes the plan to lose property through fraudulent or dishonest acts. The fidelity bond may name specific individuals or list specific positions or be a blanket bond that includes all of the insured's officers and employees.

Some of the specific rules applicable for the fidelity bonds are as follows:

- "Handling" is read broadly to mean whenever there is a risk that the person could cause loss of the plan's property through fraud or dishonesty, e.g., not just physical contact, but through the power to control the funds. This would include plan administrative or investment committees with final authority over plan funds.

- The bond must be from a surety or reinsurer approved by the U.S. Department of the Treasury (available at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm).
- The bond must be for at least 10% of the money handled by the insured person, with a minimum of $1,000 and a cap of $500,000 ($1,000,000 for plans that hold employer securities). The bond can be for more than these minimums.
- The plan must be a named insured or otherwise able to enforce its rights under the bond.
- Unless exempt (such as certain banks, insurers, or broker-dealers), every person who handles funds or other property of the plan must be bonded.

ERISA fiduciary insurance

Unlike fidelity bonding, fiduciary insurance is not required. It is often advisable to have this insurance, however. As discussed in this and other chapters, as a fiduciary, you have substantial responsibilities. Equally significant, ERISA can impose **personal liability** on fiduciaries for losses caused by fiduciary breaches, including, in certain circumstances, breaches of co-fiduciaries.

The Basic Rules

ERISA prohibits a plan from excusing or paying for a fiduciary's breach of duties. The plan can pay for fiduciary insurance, but the insurance must include the right to recover against any fiduciary that has been found to breach his fiduciary duty.

The company typically may indemnify (i.e., pay for) a fiduciary breach, and a company or the fiduciary can pay for fiduciary insurance that does not include the right to recover against a fiduciary.

Many forms of insurance (e.g., Director and Officers or Employment Practices Liability Insurance) typically *exclude* coverage for ERISA fiduciary claims. Accordingly, if you want to have coverage for ERISA fiduciary claims, it is important to review the insurance coverage to make sure you are covered by either a fiduciary rider or a separate policy. Common items covered and excluded in an ERISA fiduciary policy are:

- Included are breaches of fiduciary duties arising under ERISA and negligence in administration of a plan (e.g., inaccurate communications to a participant).
- Typically included are defense costs, settlements, and judgments. Fines and punitive damages are typically excluded.
- Excluded are claims of dishonesty, fraud, and criminal acts or where personal gain is realized.
- Also excluded are benefits due under the plan.

Many items can vary by policy and should be considered when acquiring a policy. Some key items include:

- Handling of claims for wrongful acts that occurred before inception of the policy or future claims resulting from current or past lawsuits.

Tip: Fiduciary insurance policies are typically "claims made" policies—the policy covers claims made during the policy period, even if the alleged wrongful conduct occurred before that period. It is generally a sound practice to give the fiduciary insurer notice when the insured becomes aware of facts or circumstances that may lead to a claim.

- The amount of the deductible and whether defense costs reduce the policy coverage.
- Whether DOL or other agency investigations are covered for defense costs and whether the 20% penalty applicable for court orders or settlement of fiduciary breach claims with the DOL is covered.

In conclusion, although ERISA prohibits a fiduciary from being excused for liability for a fiduciary breach, a properly designed ERISA fiduciary liability policy can provide you funds to defend yourself in any lawsuit or investigation and protect you from having to pay for any losses yourself.

Highlights:

- The increasingly important role for 401(k) plans has put pressure on plan performance and has led to increasing ERISA-based litigation challenging 401(k) plan fees and the selection of investment options.
- Engaging in a prudent fiduciary process is your best line of defense—instead of having to show, after the fact, that a prudent fiduciary would have come to the same decision.
- The DOL has made clear that although cost is a factor, a fiduciary is not required to accept the lowest-cost provider—you can and should consider quality and service (and any other factors relevant under the circumstances) in evaluating and retaining any service provider.
- A prudent process documenting that you as a plan fiduciary offered a diversified mix of investments can be a powerful rebuttal to hindsight-based claims that certain funds cost too much and performed relatively poorly.
- The DOL routinely investigates plans for compliance with ERISA, so plan sponsors and plan fiduciaries should have a plan in place for addressing such inquiries, should they arise.

T. Rowe Price would like to recognize Charles F. Seemann III for his contributions to authoring this chapter.

CHARLES F. SEEMANN III

Office Managing Principal, Jackson Lewis P.C.

Charles F. Seemann III is office managing principal of the New Orleans, Louisiana office of Jackson Lewis P.C. His practice emphasizes ERISA class action defense and employment law, but encompasses a wide variety of litigation and counseling matters as well.

Charles's primary practice focus includes the defense of ERISA plans and plan fiduciaries at both public and private companies, multi-employer plans and plan fiduciaries, and financial institutions providing services to ERISA plans. Routinely, he defends large ERISA class actions, COBRA class actions, and ESOP litigations. In addition to ERISA, Charles has extensive experience in a wide range of employment matters, including stock-option disputes and executive compensation litigation; wage and hour advice and litigation; and private litigation and regulatory investigations in discrimination, hostile-environment and similar matters. Charles is admitted to practice in both Louisiana and Texas, but has represented clients in complex and class action matters in numerous jurisdictions, including New York, California, Ohio, Illinois, Pennsylvania, Michigan, Massachusetts, Indiana, Florida, Oklahoma, Georgia, Tennessee, Virginia, Mississippi, and Washington D.C.

Doing what's right for your participants

Congratulations! You've completed Fiduciary Guide, an overview of ERISA fiduciary responsibilities and duties—which courts have described as "the highest known to law." We hope this guide helps you better understand who is a fiduciary, their basic responsibilities, and the importance of a well-documented process for fiduciary decision-making. We also hope it helps you recognize that while you're not required to be an expert, it's important to seek help from experts when needed.

ERISA contains specific obligations relating to interactions between your plan and participants, but we hope that you will think about going beyond the basics by considering plan features (such as auto-enrollment) and services (such as participant education) that are intended to improve participant outcomes. While outcomes are not part of your fiduciary responsibility, remember that you are responsible for properly implementing and operating plan features, programs, and services.

We encourage you to continue to stay current and learn more about topics that are of special significance to your responsibilities.

Thank you again for your interest in a serious but important responsibility—safeguarding retirement security for you and your co-workers.

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