K-12 403(b) Plans: Fiduciary Obligations, Fiduciary Responsibilities

March 16, 2010 (PLANSPONSOR (b)lines) – Following the adoption of the final 403(b) regulations that clarify the status of the employer as a "plan sponsor" with responsibilities for how the plan operates, the old "hands off" approach used by many school districts can lead to problems for district officials who do not recognize that they have a responsibility to make sure the 403(b) plan works effectively for the benefit of the district's employees.

Under the law in some states, school districts, as plan sponsors, have well-defined fiduciary duties related to the proper administration and oversight over the investments of their 403(b) plans. The failure to carry out these duties can have serious legal, financial and political implications. Even in states where the officials have sovereign or official immunity, the failure to carry out these fiduciary duties can lead to loss of public confidence and adverse publicity (as well as devastating effects on the employees).

In states where there is no specific law imposing fiduciary duties, district employees have access to the 403(b) because the district has made it available and because the district facilitates participation through payroll withholding. The employees may perceive that the district, as the plan sponsor, is endorsing the investments and service providers to the plan. Further, district officials are in a position of making decisions that will impact the accumulation of retirement savings by employees. Thus, even in these states, there is likely an expectation by the employees that the district and its officials – who are acting as the plan sponsor and in a very real sense as agents of the employees – will act in a manner that is consistent with good fiduciary practices. (In some states – such as California and Texas – with an open provider requirement under state law, these concepts may not apply.)

What are good fiduciary practices?

Stated simply, they are:
to operate the plan for the exclusive purpose of providing retirement benefits;
to act at all times in the best interest of the participants with regard to the plan and their retirement savings;
to ensure that the costs of the plan, including the investment related costs, are reasonable;
to avoid conflicts of interest; and
to act prudently in carrying out duties (referred to as the "prudent person" requirement).

The prudent person requirement is often viewed as the cornerstone of fiduciary good practice. It requires that the responsible party – in this case, district officials – act with the care, skill, diligence, and prudence that a hypothetical knowledgeable person would use in operating a retirement plan on behalf of others, taking into account the circumstances that exist at the time a decision is made or action is taken. Whether officials of a plan sponsor fulfill the prudent person requirement is judged by the steps they take or process they use in making decisions.

Thus, to fulfill the prudent person requirement, the plan sponsor needs to investigate the relevant facts, analyze the information gathered, and make an informed and reasoned decision. This is referred to as the "prudent process." To prove that these steps have been taken, detailed records of the information analyzed and the reasons for the decision should be kept.

Finally, fiduciary good practices dictate that the plan sponsor re-evaluate decisions on a periodic basis, often referred to as the duty to monitor, using the prudent process.

403(b) Best Practices

Applying these fiduciary rules, let's look at the issues a prudent 403(b) fiduciary should assess. The first relates to selecting investments.

The fact that the 403(b) is a retirement plan funded by employee salary deferrals and the employee makes his own investment decisions should add heightened concern on the part of the plan sponsor because employees are deferring a portion of their salaries that they would otherwise use to pay living expenses into the plan. Thus, how the funds are invested is critical – too conservative and the employee won't accumulate enough savings, too aggressive or too expensive and the employee may lose a large portion of his or her funds.

This reality makes it critical for the plan sponsor to select options that will enable participants to balance potential investment return against investment risk in a way that is suitable for the employee. Alternatively – or perhaps in addition – the district should consider providing lifestyle funds, in which the investments are managed to match a certain risk profile, target-date funds, in which the assets become more conservative as a particular retirement date is reached, or managed accounts, where a professional has discretion to manage an employee's money.

A second critical element is the costs related to the plan and the investments. There are numerous costs that may not be apparent on the face of things: 12b-1 fees built into mutual funds, asset based charges used to pay commissions, custodial fees, expense deductions, investment management fees, mortality and expense charges in annuities, transfer fees, wrap account fees, and withdrawal charges (also referred to as surrender charges). The latter can make it quite costly for a participant to move his funds from one investment to another, especially if the investments are with different providers.

Total costs are important because a reduction of 1% will make an enormous difference in a participant's retirement savings over a 20 or 30 year period.

There are two principal elements of cost: the cost of managing the investments, which includes the fees charged by the insurance company or mutual fund adviser, plus related expenses; and the commission paid to the adviser who assists in the sale to the participant. In the private sector 401(k) market, which uses a single vendor model, these costs are often no more than 1%-1.5%, whereas in the 403(b) market, where there are often multiple vendors, the costs can be double or triple that amount.

A prudent plan sponsor will know and evaluate these costs, weighing them against the value of what the employee receives in return. It is not necessary for the plan sponsor to select the lowest cost, but all other things being equal, the lower the cost, the better for participants.

Most school officials are not trained professional money managers, nor in most cases do they have access to the type of information necessary to make an assessment of the appropriateness of an investment for retirement, such as, the performance and risk (or volatility) associated with the investment and the cost of the investment. In those cases, the district may wish to engage advisers to assist them in the information gathering and evaluation process.

And where the district can engage a single provider that has already performed the analysis and has devised a 403(b)-compliant product that mixes high-quality investments with high service levels and low cost, the school district will have gone a long way to fulfilling good fiduciary practices.

The selection of investments is not the only decision that a 403(b) plan sponsor needs to make, though it may be the most critical. The selection of advisers to assist the participants – and understanding the compensation they will receive, especially compensation that is taken out of the investments – is also critical. An important part of this process is to understand the services the adviser will provide compared with the compensation he will receive. The assessment should be undertaken with the same care, skill, diligence and prudence, using the same process, as the selection of the investments.

Selecting Vendors

A typical pattern in many districts has been to permit a large number of investment providers to solicit deferral dollars from district employees. The often- expressed theory for this approach was that competition among providers (and among the brokers who brought the investments to the participants) would lead to reduced costs for participants. Unfortunately, this has not always proven to be the case, and in recent years, 403(b) sponsors are shifting to a single provider model. Such a model can have a number of significant advantages.

First, consider some of the disadvantages of the multiple vendor model. Moving funds from one provider to another may be more difficult for the participant because in many cases vendors charge surrender fees. The use of multiple vendors can also lead to duplication of investment options, but with different fees. How, for example, does a district justify offering multiple S&P 500 index funds with different management fees?

The single vendor model may eliminate a number of these issues. While not all single vendor solutions are created equal, through a prudent process, the 403(b) fiduciaries may find a vendor that provides an open architecture platform with well-respected fund managers (so that participants can adequately diversify their investments), investment solutions that are designed especially for the 403(b) participant (such as risk-based and target-date allocation models using low cost funds), reduced administrative, investment management and broker fees that are the same regardless of district size, elimination of surrender charges and wrap fees, plus robust participant services, such as investment education.

After engaging in a prudent process to analyze these investments, cost and service issues, if the fiduciaries select this type of single vendor approach, the district will be well on the path to fulfilling fiduciary good practice.

Conclusion

School officials who are responsible for their district's 403(b) plan have either a legal or ethical responsibility to act in the best interest of their fellow employees. In so doing, they need to understand their fiduciary responsibilities – the exclusive purpose requirement, the duty to avoid conflicts of interest, and the duty to act in the best interest of participants – and need to understand the process they should use in making decisions that will affect the retirement savings of the employees.

Among the most important issues they need to consider are the performance and costs associated with the investments offered for selection by the participants in the plan. Finding the right products – or a single vendor that provides the right products and services at a favorable cost – can significantly help school officials in fulfilling their responsibilities, which will in turn help the district's employees enjoy a more secure retirement.

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