Fiduciary Responsibilities in a Defined Contribution Plan

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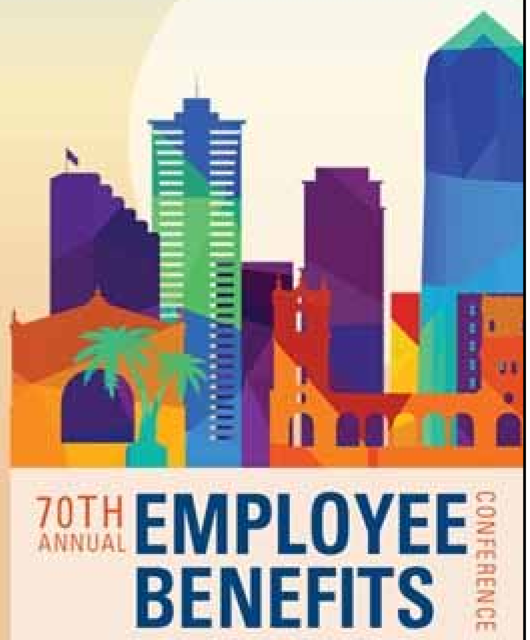

Topics to Be Covered

- Timely transfer of worker contributions (employee wage deferrals) and employer contributions to record keeper
- Choosing and monitoring investment options
- Understanding various share classes and fees
- Participant loans and hardships

What Is a Defined Contribution Plan?

- Individual account established for each participant
  - Account is sum of contributions plus or minus investment gains or losses adjusted for administrative expenses
  - In contrast to defined benefit plan, no guaranteed benefit at retirement
- Types of defined contribution plans
  - Profit Sharing
    - Employer contribution component (hourly, monthly contribution in CBA)
    - 401(k) elective wage deferral
    - Matching employer contribution
  - Money Purchase Plan
    - Similar to profit sharing plan but with pension plan features (annuity options)

Timely Transfer of Employee Contributions (Deferrals) and Employer Contributions

- DOL has Employee Contribution Initiative
- Beginning in 2010, EBSA announced series of enforcement actions in cases where contributions withheld from paychecks but never deposited in plans
  - Contributory Plans Criminal Project targeting fraud and abuse—Criminal prosecutions and jail time
  - EBSA working closely with other federal, state and local agencies to criminally prosecute individuals

Timely Transfer of Employee Contributions (Deferrals) and Employer Contributions

- DOL requires deferrals to be deposited as soon as they can be regularly segregated, but no later than 15th business day of month immediately following month deferral was withheld or received by employee
  - This is maximum time period but not safe harbor
  - DOL provides 7-business day safe harbor for employee contributions to plans with fewer than 100 participants
- Employee deferrals that are withheld from compensation become plan assets
- Failure to timely remit employee contributions also can be considered prohibited transaction

Timely Transfer of Employee Contributions (Deferrals) and Employer Contributions

In May 2003, DOL issued Field Assistance Bulletin No. 2003-02

- **Issue: In multiemployer defined contribution pension plan context, can collective bargaining, employer participation and similar agreements affect when participant contributions can reasonably be segregated from general assets?**
  - "To the extent that a [CBA]...describes such a process...[it] should be considered"
  - DOL noted that reasonable process for receiving participant contributions should take into account how quickly participating employers can reasonably segregate and forward contributions—and how costly to plan quicker process would be.
  - However, no matter how reasonable process, "Participants contributions become plan assets no later than the 15th business day of the month following the month in which... the amounts would otherwise have been payable to the participant"
  - **"[N]either a collective bargaining agreement, nor any other agreement between the plan and an employer, can justify a failure to comply with the maximum periods in the regulation"**

Timely Transfer of Employee Contributions (Deferrals) and Employer Contributions

- Other issues to consider
  - Voluntary Fiduciary Correction Program
  - Form 5500 Schedule H Compliance Questions—Reporting failure to collect deferrals
  - Compliance with delinquency collection policy
  - Consider Plan document provisions on what constitutes plan assets—Notice to employers that they are holding plan assets
  - Importance of collecting interest to allocate to accounts
  - Actions by Trustees for lengthy delinquencies for employer contributions

Monitoring Investment Options and Understanding Share Classes and Fees

- Fiduciary is someone who:
  - Exercises discretionary authority or control over plan assets or discretionary authority or responsibility for plan administration
  - Provides investment advice for fee
  - Acts as designated named fiduciary in plan document

Monitoring Investment Options and Understanding Share Classes and Fees

- Responsibilities as Fiduciary
  - Duty of prudence: Act with care, skill and prudence that prudent person would under similar circumstances
  - Duty of loyalty: Act for exclusive purpose of providing benefits to participants and defraying reasonable administrative expenses
  - Diversify investments to minimize risk of large losses
  - Comply with terms of plan documents
  - Avoid prohibited transactions where no permitted exemption
    - Party-in-interest
    - Self-dealing, conflicts of interest

Monitoring Investment Options and Understanding Share Classes and Fees

- Identifying players
  - Board of Trustees—Named fiduciary
  - Investment consultant—Fiduciary and sometimes designated named fiduciary
  - Investment Manager—Most of the time fiduciary
  - Recordkeeper
  - Third-party administrator
  - Custodian bank

Monitoring Investment Options and Understanding Share Classes and Fees

- Investment of accounts
- Directed by participants
  - Board of Trustees decides on menu of investment options and participants select from those investment options
  - Must offer broad range of investments, including at least three options, each of which is diversified and has materially different risk and return characteristics
  - Disclosure of certain minimum information about investment options
  - When no investment decision made by participant, investments made to default fund that meets requirements of Qualified Default Investment Alternative (e.g., target date funds, balanced funds)
- Trustee directed
  - Accounts are invested in vehicles selected by Trustees

Monitoring Investment Options and Understanding Share Classes and Fees

- Types of investments and fees
  - Mutual funds and collective investment funds
    - Fees are percentage of assets under management
  - Mutual funds typically have multiple share classes with different fee schedules
    - Retail (higher fees) vs. institutional
  - Recordkeepers paid per-capita fee or fee from expense ratio (retail share class)
  - Choice between actively and passively managed investments with passive investments charging lower fees

Monitoring Investment Options and Understanding Share Classes and Fees

- Class action landscape
  - Proliferation of class action cases related to excessive fees charged by investment vehicles
  - Supreme Court in *Hughes v. Northwestern University*, 595 U.S. 177 (2022) unanimously ruled that available other lower cost alternatives in investment lineup not defense to claims that individual options had unreasonable fees
  - Each investment option has to be subject to prudent review
  - Post-*Hughes* has resulted in cottage industry of class action cases

Monitoring Investment Options and Understanding Share Classes and Fees

- Claims asserted on fees
  - Retail mutual fund share class offered when lower cost institutional share classes available
  - Different less expensive investment vehicles, such as passive funds
  - Excessive recordkeeping fees
  - Failure to monitor fund lineup
  - Failure to conduct RFP for services
  - Prohibited transaction because contractual arrangements unreasonable

Monitoring Investment Options and Understanding Share Classes and Fees

- Motions to dismiss
  - Hundreds of class actions filed since Hughes and settlements reached in many cases totaling hundreds of millions of dollars
  - Goal of Plaintiffs' firms is to survive motion to dismiss
  - Does complaint state plausible claim that Trustees have acted imprudently?
  - Courts have allowed plaintiffs' claims to proceed to discovery. See, *Hughes v. Northwestern University* (7th Cir. 2023); *Kong v. Trader Joe's Co.* (9th Cir. 2022); *Perkins v. United Surgical* (5th Cir. 2024); *Davis v. Wash. Univ.* (8th Cir.)
  - Courts have also granted motions to dismiss for plans. See, *Albert v. Oshkosh* (7th Cir. 2022); *Smith v. CommonSpirit Health* (6th Cir. 2022); *Matney v. Barrick Gold of North America* (10th Cir. 2023)

Monitoring Investment Options and Understanding Share Classes and Fees

- Motions to dismiss
  - Cases where motions to dismiss granted largely involved claims where plan benchmarks were used to prove imprudent conduct
  - Cases allowed to proceed have more factual allegations such as offering different share classes with same risk and return profile except for expenses, or that recordkeeping costs were excessive
  - Question—How to react to avalanche of 401(k) fee lawsuits?

Monitoring Investment Options and Understanding Share Classes and Fees

- Establish process for evaluating investments and fees
  - Prudent conduct is all about process
  - Retain investment consultant to:
    - Evaluate and establish investment lineup—How many is too much?
    - Determine appropriate share classes
    - Confirm reasonableness of fees
    - Provide periodic reports on performance net of fees
  - If revenue sharing generated, determine if it is reasonably applied
  - Document reasonableness of recordkeeping fees periodically

Monitoring Investment Options and Understanding Share Classes and Fees

- Establishing process for evaluating investments and fees
  - Work with consultant to compare fees to industry averages
  - Review at periodic trust fund meetings and document due diligence in meeting minutes
  - Avoid esoteric investment options—You can't please everyone
  - Make changes periodically based on consultant recommendations
  - Maintain fiduciary liability insurance

Plan Loans and Hardships

- Plans may offer loans but not required provision
- Maximum amount of loan 50% of vested account balance or $50,000, whichever less. If 50% of vested account balance less than $10,000 participant may borrow up to $10,000
- In case of qualified disaster recovery distributions (QDRD), limit can be doubled to lesser of $100,000 or 100% of participant's vested benefit and suspension of loan repayment for up to one year
- Generally, employee must repay loan within five years with payments quarterly. Exception to five-year rule if employee uses loan to purchase primary residence

Plan Loans and Hardships

- Plan loan must have interest component
- Requirement to repay applies even if termination of employment
- Default will result in amounts included in gross income and 10% excise tax on early distributions may apply
- Important for loan documents and note to be signed
- Requirement to take all available loans from plans before taking hardship distribution is eliminated—Now optional provision

Qualified Birth or Adoption Distribution

- Plans allowed to make qualified birth or adoption distribution
- Up to $5,000 made during one-year period beginning on date on which child of individual is born or legal adoption by individual is finalized
- Distributions can be repaid without counting against contribution limits
- Subject to income tax but not 10% early withdrawal penalty

Emergency Withdrawals

- Plans may allow individuals to make penalty-free annual withdrawals of $1,000 to cover emergency personal expenses
- Subject to ordinary income taxes but not 10% tax on early distributions
- Can repay it over three years but no other emergency distributions can be taken unless amounts have been repaid

Participant Loans and Hardships

- Hardship Withdrawals—Withdrawal from participant's elective deferral account made because of immediate and heavy financial need
- Safe harbor for certain hardships
  - Medical expenses
  - Purchase of principal residence
  - Expenses to prevent eviction from, or foreclosure on principal residence
  - Tuition and fees for post-secondary education
  - Burial or funeral expenses
  - FEMA declared disaster

Participant Loans and Hardships

- Hardships can now apply to employer contributions that are qualified non-elective contributions (QNECs), qualified matching contributions (QMACs) and earnings on deferrals
- Requirement to exhaust all nontaxable available plan loans eliminated
- Elimination of six-month suspension of elective deferrals following hardship withdrawal
- Self-certification process (in writing or by recorded electronic medium and plan can rely on representation unless plan administrator has actual knowledge to contrary)

Participant Loans and Hardships

- Expanded distribution options and favorable tax treatment for up to $22,000 for disaster relief
- Ability to repay first-time homebuyer distribution used to purchase or construct principal residence in qualified disaster area but was not so used because of qualified disaster
- Individual may repay all or part of qualified disaster recovery distribution within three-year period beginning day after distribution
- Taxation over 3-year period and 10% additional tax on early distributions does not apply to qualified disaster recovery distribution

Participant Loans and Hardships

- Participants who are victims of domestic abuse may request distribution for lesser of $10,000 (included for inflation) or 50% of participant's account
- Participants may self-certify status as victim of domestic violence
- Distribution not subject to 10% tax on early distributions
- Participant can repay withdrawn money over three years

Participant Loans and Hardships

- Distributions allowed for participants with physician-certified terminal illnesses reasonably expected to result in death within seven years
- Physician certification of terminal illness
- Participants not subject to 10% tax on early distributions
- Recontribution of distributions allowed within 3-year period
- Even if not permitted by Plan, employee allowed to treat otherwise permissible in-service distribution as terminally ill individual distribution

Key Takeaways

- Establish vigorous process for collecting deferrals and employer contributions and collect interest wherever possible on outstanding amounts
- Establish regular procedures for review of portfolio line-up, including examination of number of funds offered and expense ratios
- Thoroughly analyze use of retail share classes and use of fees to pay for recordkeeping
- Periodically review reasonableness of recordkeeping fees and services offered
- Refresh Plan loan and hardship withdrawal provisions to reflect changes in law
- Determine whether all withdrawal scenarios consistent with goals of plan to provide secure retirement

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