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The purpose of this memorandum is to comment on potential issues related to vendor selection under the proposed 403(b) regulations issued by the IRS in 2004. While there are many points to consider on this issue, I believe the following three (3) elements are the most important for public education employers to consider:

1. *Nothing in the proposed regulations requires a public education employer to change the 403(b) providers currently available under its plan. However, if the regulations become finalized, as proposed, employers must review their entire 403(b) program, including the vendor selection process, to ensure that new compliance responsibilities are being satisfied.*

In general, the proposed 403(b) regulations impose additional administrative and compliance responsibilities on plan sponsors.<sup>1</sup> While the IRS has stated that many of the responsibilities imposed on employers under the proposed regulations are not new, it is the impression of most public school employers that they will have significantly more responsibility and therefore potential liability for maintaining and administering the 403(b) program.<sup>2</sup>

Once the regulations are finalized, employers will need to assess how well their current practices and procedures conform to their responsibilities as plan sponsors. If employers are not prepared to take on all of the responsibilities included under the regulations, they will need to find help to provide necessary services. There are basically three options available to employers for handling the compliance and administrative responsibilities imposed under the regulations. Employers can elect to perform all services themselves; they can hire outside service providers to perform the compliance tasks; or they can perform some tasks themselves and delegate certain tasks to an outside provider. Each employer will need to evaluate which approach will work best for it.

Employers should consider potential liabilities that may result when determining how to best maintain and administer 403(b) programs. Employers are responsible for the actions and services provided by another party on their behalf.<sup>3</sup> The IRS has no relationship with consultants, product or service providers, vendors or administrators used by the employer to administer and maintain the 403(b) plan. The IRS, in the event of an audit, will hold the employer responsible for compliance, even where the employer delegates those responsibilities to an independent service provider. Therefore, it is extremely important that employers carefully choose their “compliance partners” and obtain some kind of indemnification from each partner to ensure that the partner will bear the costs associated with any expenses, fines or penalties attributable to its mistakes or negligence.

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<sup>1</sup> For example, administering loans, making determinations for hardship withdrawal requests, terminating the plan and following termination protocols, and maintaining a plan document and adhering to its terms are responsibilities assigned to the plan sponsor under the proposed regulations.

<sup>2</sup> This is because the vendors or product providers currently perform the administrative and compliance tasks associated with distributions, loans, hardship withdrawals, QDROs, etc. Employers generally are not involved in the administration of such features.

<sup>3</sup> 403(b) plans that are properly maintained provide tax benefits to participants. If a plan is not properly maintained, the tax benefits are lost and the employer should be reporting contributions differently. This responsibility for proper tax reporting cannot be delegated. Liability always remains with the employer.

While finding quality partners for its 403(b) compliance initiative, the employer should also remember that the 403(b) program is a benefit highly valued by employees and beneficial to the employer. Efforts to find quality partners should not discourage employees from participating in the 403(b) program.

2. *While many public education employers will use the proposed regulations to reduce the number of 403(b) product providers under their program, it will probably not be in the best interest of the employer or the participants to use a single provider for the 403(b) plan.*

Most public education employers permit many 403(b) product providers under their program. However, for many reasons, reducing the number of providers is usually more difficult than adding new providers.<sup>4</sup> Therefore, it is anticipated that many employers will use the 403(b) regulations to “cull” their product providers to a more manageable number.

Some product providers and some advisors/consultants are suggesting that employers use a single 403(b) product provider to facilitate compliance because oversight of compliance issues will be simplified if one provider were responsible for the entire program. In other words, it would be easier for the employer to monitor the 403(b) plan. However, ease of operation is not the primary issue employers should consider when evaluating responsibilities to the plan and the participants.

Since the proposed regulations repeal Rev. Rul. 90-24, which permits participants to move their 403(b) accounts into 403(b) investments that are not included in the employer’s plan,<sup>5</sup> the selection of investments available under the 403(b) plan will become a more important issue for participants and employers. This repeal will effectively “lock” participants into only those investment options selected by the employer. Accordingly, if an employer selects a single product provider as the sole source of investment options to participants, the participants’ retirement planning opportunities will be significantly restricted. In addition, it is very possible that employers may face potential litigation, based on fiduciary responsibilities, if the employer’s selection of the provider was based on ease of operation rather than the participants’ best interests.

3. *It is possible that provider selection and the resulting menu of available investments may result in litigation by participants if the investment choices do not represent a diverse group of products and services based on the best interests of the participants.*

One of the unfortunate consequences of the repeal of Rev. Rul 90-24<sup>6</sup> is the possible increase in litigation by participants or beneficiaries against “plan fiduciaries.” Employers are generally

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<sup>4</sup> Several states, such as Texas, California, Washington and Iowa, have “any willing provider” statutes that effectively require public education employers to permit any 403(b) vendor that meets the state’s requirements into the 403(b) program.

<sup>5</sup> Although the repeal of Rev. Rul. 90-24 has not yet been finalized, the IRS appears to be adamant that this feature of the proposed regulations will remain in the final version of the regulations. Statements made by IRS representatives in public meetings describing the 403(b) regulations strongly suggest that the repeal of Rev. Rul. 90-24 remains a top priority.

<sup>6</sup> The fiduciary status of employers as plan sponsors would be no different under the regulations, if finalized as proposed. However, participants currently have the right to control their own investment strategies since Rev. Rul 90-24 permits them to move their 403(b) accounts to any vendor that satisfies the requirements in that ruling. If this right is restricted, employees will no longer have the control. Employers will. Therefore, it is possible that a participant may “test” the fiduciary responsibilities of his or her employer based on the employer’s selection of the investment option(s).

considered to be plan fiduciaries because of the discretion they have in establishing and maintaining a retirement program. Even though public education employers are not subject to the fiduciary requirements of ERISA,<sup>7</sup> there are several state laws and common law principles that may impose fiduciary duties on sponsors of retirement plans, including 403(b) plans. However, since these requirements are based on state law, each public education employer should ascertain whether or not the law or principle is in effect in the state in which the employer is located. Public education employers should consider the following when creating criteria to select investment options under their 403(b) plans:

1. State laws typically impose fiduciary standards on state and local governmental entities. Originally the application of fiduciary standards to plan sponsors began in common law. However, most states codified these standards under legislation similar to the Model Prudent Man Rule Statute of 1942.
2. Many states have enabling legislation that permits local governmental entities to establish retirement programs. Fiduciary standards are usually included in the enabling legislation and frequently include either very specific standards or general guidelines.
3. A survey by the National Council on Teacher Retirement<sup>8</sup> demonstrated a trend by states to apply the more stringent “prudent expert” fiduciary standard for governmental plan sponsors over the “prudent person” fiduciary standard. Therefore, there may be state laws that establish more stringent standards for plan fiduciaries than the general standard of what a prudent person would do in similar circumstances.<sup>9</sup>
4. Under common law principles, fiduciaries are required to administer the plan *solely in the interest of the beneficiary* and to deal fairly and communicate all material facts to beneficiaries.
5. Two similar “model” acts were developed in the 1990s that probably create a fiduciary duty on public employer plan sponsors. The Uniform Management of Public Employee Retirement Systems Act and the Uniform Prudent Investor Act were created in 1997 and 1994 respectively. If adopted by the state, these acts contain standards for state and local retirement plans and fiduciary standards for selecting investments available under the plan.
6. Finally, almost every state has a code of ethics applicable to state officials and employees.

While there are some cases relating to the fiduciary duties of governmental employers, there are not very many and they are generally not helpful in projecting how potential fiduciary claims may be resolved based on investment selection in 403(b) plans. Courts have generally not rewarded dissatisfied claimants because the plan fiduciary did not select investment products with the best returns. However, courts generally require fiduciaries to understand their responsibilities, to establish procedures designed to meet those responsibilities and then follow those procedures.

Accordingly, public education employers should not be liable if the selected investment options do not generate the highest return. However, it would be “prudent” to establish a procedure that

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<sup>7</sup> Employee Retirement Income Security Act of 1974, a federal law that imposes requirements on employee benefit plans that are sponsored by employers other than governmental and church organizations.

<sup>8</sup> NCTR, *Protecting Retirees’ Money; Fiduciary Duties and Other Laws Applicable to State Retirement Systems*, [4<sup>th</sup> ed 2000]

<sup>9</sup> Only 9 states used the prudent person rule and 36 states used the prudent expert rule. 5 states use a hybrid standard.

evaluated all relevant facts and circumstances, such as 403(b) compliance abilities, fees, ratings, willingness to indemnify the employer, flexibility in working with other providers, disclosures about relationships with consultants or other professional advisors, important product features, whether the investment would further participant ability to diversify investments, and other elements that support the fiduciary duties of the plan sponsor. Employers should also regularly review this procedure and keep records of the process.

As previously stated, there has been minimal litigation in the past because employers could generally rebuff potential claims by pointing out that employees had an expansive universe of investment options by using Rev. Rul 90-24 to manage their 403(b) plan investments. However, if Rev. Rul 90-24 is repealed, as anticipated by most experts in the 403(b) industry, there is certainly the possibility that participants will investigate potential claims against employers for failure to offer proper investment options under the plan.

This memorandum was written for the member firms of the National Tax Sheltered Accounts Association to disseminate to public school districts regarding the changes being brought about by the new §403(b) regulations. Legend has had no involvement in the preparation of this memorandum and does not intend to provide any legal or tax advice.