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DIGEST



## Changing 403(b) Plans for Changing Times

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**W**ith new regulations forthcoming, gains in the 401(k) and public sector 457 market-places are ripe to be applied to the schools and nonprofit 403(b) market. These new regulations will also introduce important due diligence and compliance expectations that will reshape the way public sector employers must manage these benefits for their plan participants. Those organizations that adhere to these regulatory changes will find that they have enormous opportunities to reduce fund fees, improve the performance of offered funds and introduce new, enhanced services that will directly benefit their employees.

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## Changing 403(b) Plans for Changing Times

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Significant changes are coming to 403 (b) plans for public schools and tax-exempt organizations. On November 16, 2004 the Internal Revenue Service (IRS) issued two sets of regulations. One provided immediate, temporary regulatory changes. Another established proposed regulatory changes for which IRS was seeking public input. Together, these temporary and proposed regulations are expected to be finalized in 2007 and become effective in 2008.

These regulatory changes will dramatically alter the way in which 403(b) plans must be managed. In the overview section of the proposed regulations, IRS clearly states, "A major effect of the legal changes in Section 403(b) has been to diminish the extent to which the rules governing Section 403(b) plans differ from the rules governing other arrangements that include salary reduction contributions, i.e., Section 401(k) plans and Section 457(b) plans for State and local government entities."

Many of the characteristics of defined contribution plans were overhauled by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The act aligned key 401(k), 457(b) and 403(b) provisions. EGTRRA

- Provided comparable annual contribution limits that are now set at \$15,000
- Changed the definition of includable compensation
- Introduced catch-up provisions that allowed participants aged 50 and over to contribute additional annual amounts (now \$5,000) above the maximum
- Permitted rollovers from one type of plan to another.

State and local government 457(b) plans still have the advantage over other defined contribution plans with no 10% penalty tax if funds are withdrawn from the plan prior to the recipient reaching age 59½, as well as a catch-up provision for eligible but previously unfunded compensation deferrals that doubles the maximum contribution (now \$30,000 per year) in the three years prior to retirement.

This alignment of defined contribution plans prompted both private and public

sector government employers to improve their management of plan investment options and services but had little impact on schools and nonprofits, even though EGTRRA applied to them as well.

While 403(b) plan employers may see these regulatory changes as a challenge or even a headache, the changes clearly provide employers with strategic opportunities to enhance and reposition this important retirement benefit and put their own plan in line with top-performing ones. The regulations admit that there have been few updates since the 1960s when these plans were first introduced. Many of the IRS codes are obsolete or were overruled by subsequent acts that may have

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modified this benefit but were not reflected in new guidelines.

In essence, the regulations acknowledge an absence of change during the past several decades, even though enormous changes have taken place in the defined contribution retirement field. One could say the same inertia has prevented schools and nonprofits from reaping the benefits of dramatic marketplace changes. While 401(k) and 457 (b) plans have experienced significant marketplace improvements that benefit plan participants, the essential characteristics of 403(b) plans have remained comparatively static.

- Multiple providers and individual contracts are still offered by 403(b) plans, while both 401(k) and 457(b) plans have reaped significant economies of scale by moving to single providers

and leveraging total plan assets to reduce participant fees and improve fund performance.

- The hands-off management approach that typified the 457(b) market in the '80s and '90s is still rampant today in 403(b) markets. More management involvement has consistently led public sector 457(b) plans to improve education, introduce robust investment advice capability and strengthen customer services.
- ERISA-like standards, which predominantly applied to only the 401(k) market, are extended, whether technically applicable or not, to the other types of plans. The result is more effective compliance oversight of plan benefits.

Frankly, employers that see 403(b) changes solely as a compliance responsibility requiring the minimum amount of change miss the chance to improve this benefit for their employees and make this benefit a more powerful recruitment and retention tool for the employer.

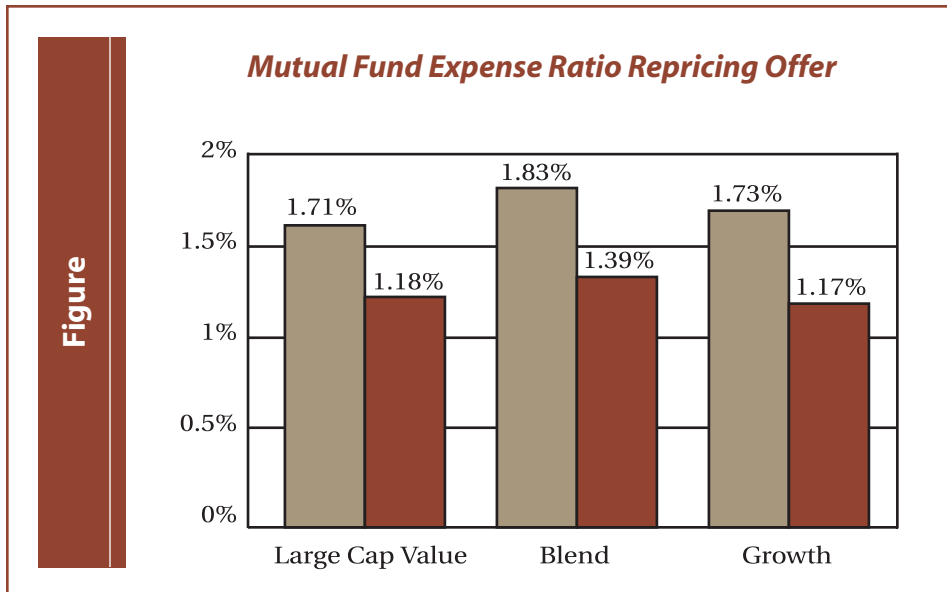
What follows are several suggested strategies 403(b) plan providers might consider to capitalize on marketplace changes and bring their plans in line with model employers.

### **Consolidation of Providers/Determination of Appropriate Fund Options**

Historically, employers have equated numerous providers with competition and optimal fund options and services. Model employers, however, recognize that consolidation of providers through competitive request for proposal (RFP) processes permits them to use their participants' aggregate plan assets to bring down fund fees and administrative expenses.

RFPs are generally required as a way to reduce the number of 403(b) providers. For those employers with a sole provider, renegotiation may be a viable route to maximize investment returns for participating employees. As an example of the competitive marketplace in 401(k) and 457 plans, the figure represents an actual negotiated fee reduction in the expense ratios of large cap mutual fund offerings in a small, rural county 457 plan. Plan

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providers will generally agree to fund fee reductions rather than subject their entire portfolio with an employer to the competitive environment and likely replacement with another provider. Changes of this magnitude fall directly to the bottom line of the participant accounts. Economies of scale clearly work.

Basically, employers are beginning to understand that more is not better.

Today, most 401(k) and 457(b) plan sponsors are introducing investment policies that describe their fund options; characteristics of those options; the basis for determining what funds will be offered; benchmarks against which funds will be evaluated; and the process by which underperforming funds will be reviewed, monitored and, where appropriate, replaced.

***A competitive RFP process and a well-developed investment policy represent the two most powerful tools employers can use to select and maintain optimally performing providers and investment fund options.***

Many employers are also recognizing that offering many funds may create more confusion, complexity and increased over-

sight responsibility than is advantageous for participant-directed investments. They are reducing the total funds offered while ensuring that the core funds of their plans provide appropriate asset-class diversity. Because good fiduciary behavior dictates regular evaluation of fund options, a reduced number of funds provides reduced administrative responsibility for those plans that are managed by employers.

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### **Closer Scrutiny of Provider Services**

Virtually all employers use professional services in their defined contribution plans. Employers rely on both company representatives and third-party consultants (attorneys, accountants, actuaries, brokers) to meet with employees, explain eligibility and plan provisions, summarize key strengths of investment strategies, offer investment guidance and advice, and respond to participants' service needs.

Fiduciary due diligence requires this type of benefit manager to act prudently and ensure that others act prudently in their actions. This requirement mandates closer scrutiny than many 403(b) plan providers historically exercised. Model employers are beginning to incorporate explicit performance standards and ex-

pectations of all providers through contractual guarantees of service and specific financial consequences for providers who fail to deliver promised services.

### **Reimbursement of Expenses**

Employers that are more active in their management of defined contribution responsibilities recognize that their increased role has a corresponding increased cost. It is often difficult, if not impossible, for schools and nonprofits to direct funds to this type of benefit. Model employers are increasingly obtaining reimbursement from plan providers to cover the costs of both compliance and improved oversight and regular investment review and incorporating these estimated increased costs in their competitive RFPs.

Expenses are readily identifiable. Legal and plan compliance services will be increasingly necessary, although plan providers often have internal counsel that can provide adequate plan-compliance assistance. Fund reviews can also be obtained by plan providers, although external, neutral third-party oversight assures an additional level of review. Education for plan participants should be a core component of plan provider services, but it is also important to recognize that those who have oversight responsibilities (trustees, administrative personnel) should also be educated regarding their duties.

### **Compliance**

The proposed regulations require that a Section 403(b) program be *maintained pursuant to a plan*. The plan, in both form and operation, must satisfy the regulatory requirements of Section 403(b) and contain all the material terms and conditions of benefits under the plan. There has been some question as to whether *the plan* must be a single document or if it can be a set of documents. As stated informally by IRS, the combination of documents that contain applicable Code requirements may be sufficient. Whether the final regulations specify a single written plan document or the use of aggregate documents, employers will certainly have greater responsibilities in assuring that their plan document(s) accurately reflects the oper-

### 403(b) Checklist for Meeting Due Diligence and Fiduciary Responsibilities

- ✓ Form a 403(b) advisory committee/board of five to seven members.
- ✓ Review existing 403(b) provider(s) for investment performance, investment options, fees, expenses, service, etc.
- ✓ Create an investment policy statement.
- ✓ Create a 403(b) plan document(s).
- ✓ Establish standards for ongoing monitoring of the plan.
- ✓ Establish fiduciary criteria.
- ✓ Create and issue an RFP.
- ✓ Determine the need for outside advisory expertise.

ation of the plan while complying with IRS requirements.

State and local government had similar responsibilities after the passage of 2003 regulatory changes and the Small Business Job Protection Act of 1996 (SBJPA). SBJPA required public sector employers to establish a trust, annuity or custodial document for the sole benefit of plan participants and their beneficiaries. Although it can be argued that plan sponsors always had fiduciary responsibilities, this act codified the requirement by establishing a trust agreement.

### Employer Action Required

In light of the forthcoming regulations, employers can consider several actions to help meet fiduciary responsibility and due diligence requirements and ease administration.

1. Review existing 403(b) provider contracts to determine current investment fund performance and expenses, along with sales and servicing requirements of the provider. This review will provide a benchmark to judge future

enhancements to the plan as well as serve as an indicator of periodic due diligence review of the plan.

2. Develop an investment policy statement that creates the guidelines by which investment options will be selected, fund performance evaluated and decisions made.
3. Consider conducting an RFP process that solicits responses from providers and compares investment services and fund performance if multiple providers contract with the employer or a single provider is selected. This information will help immensely with the financial and administrative decision of whether to transition to a sole provider. Remember, the litmus test of that decision should be whatever delivers the best net return to the participant.
4. If you now use a single provider or have a manageable number of providers, consider renegotiating the provider contract(s). As previously mentioned, existing providers will likely reduce fund expenses and improve service performance standards rather than subject existing participant accounts to the competitive marketplace. **B&C**

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