Benefits Practice Center ISSN 1544-0575

ERISA §404(c) Compliance Considerations

Kathleen Sheil Scheidt

Katten Muchin Rosenman LLP
Chicago, IL

[Note: The author acknowledges and thanks David L. Wolfe of Drinker Biddle & Reath LLP, Chicago, who co-authored an earlier version of this report.]

Introduction

The continued focus on mutual fund fees and trading practices and the increasing number of lawsuits involving employer stock investments raise particular concerns for retirement plan sponsors that maintain defined contribution individual account plans that allow participants to direct the investment of their accounts. Market timing issues and revelations about undisclosed mutual fund expenses that may be passed through to investors lately have complicated the already challenging task of complying with §404(c) of the Employee Retirement Income Security Act.[1] However, these challenges should not deter plan fiduciaries from implementing or continuing to follow the steps necessary to satisfy the §404(c) requirements. A plan sponsor that fully complies with §404(c) should have a strong defense to participant claims stemming from poor investment performance.

This report provides a broad overview of the §404(c) requirements and analyzes considerations and challenges many plan sponsors face as they strive to comply with those requirements. The article outlines the disclosure obligations imposed by ERISA, highlighting regulatory guidance applicable to mutual fund prospectuses and mutual fund fees. The report analyzes some of the implications of offering certain investment alternatives (such as employer stock, brokerage accounts, mutual fund windows, lifestyle funds, and default investments) under a plan that allows participant-directed investments and discusses the qualified default investment alternative (QDIA) guidance issued to date. It also addresses operational issues and §404(c) considerations related to market-timing prevention and blackout periods. Finally, the report briefly discusses guidance related to participant investment education and advice. Each section presents considerations and suggestions for plan fiduciaries that want to strengthen their compliance with §404(c).

Overview of ERISA §404(c) Requirements

The Department of Labor regulations include approximately 25 specific requirements for §404(c) compliance. This report does not discuss each of the requirements in detail, but the basic steps that are necessary for compliance include:

- the plan must allow participants to direct the investment of their accounts within a broad range of investment alternatives;

- the plan must allow the participants to change their investment allocations as frequently as appropriate based on the volatility of the investment alternatives; and

• plan fiduciaries must provide specific disclosures and sufficient investment information to participants. A plan sponsor that fails to comply with §404(c) as to any of the required elements risks liability to participants and beneficiaries for investment losses, even if the plan is otherwise designed and administered as a §404(c) plan.

Even if a plan fully complies with §404(c), the plan fiduciaries retain responsibility for selecting the investment alternatives to be offered under the plan and monitoring the performance and costs of those alternatives to ensure that they remain prudent investment alternatives. This includes periodic analysis of the prudence of retaining employer stock as an investment alternative if it is available under the plan. Plan fiduciaries are not required to ensure favorable investment results, but they are obligated to take appropriate steps to investigate issues and alternatives and make decisions that are prudent under the circumstances when made.

Plans that are administered by a dedicated committee with clearly defined responsibilities often are in a better position to defend against participant claims than plans without a committee because they have a more focused approach to complying with §404(c). Plan sponsors that have not delegated administrative responsibility to a committee should consider doing so. Once a committee is established, the plan sponsor should inform participants how to contact the committee and ensure that the committee adequately documents all of its actions and activities. If the fiduciaries fulfill their duties of care, skill, prudence, and diligence and act in the best interests of plan participants in choosing and monitoring investment options and otherwise comply with §404(c), they will have defenses under ERISA against claims related to investment losses brought by participants who make unfortunate investment decisions.

Disclosure Obligations

ERISA §404(c) protection for plan fiduciaries depends in large part on the provision of sufficient investment information to participants to allow them to make informed decisions about investment alternatives available through an employer-sponsored plan. ERISA requires plan sponsors automatically to provide the following information to all participants:

• an explanation that the plan is intended to constitute a §404(c) plan and that the plan fiduciaries may be relieved of liability for any losses that are the direct and necessary result of investment instructions given by a participant or beneficiary;

• a description of the investment alternatives available under the plan;

• identification of any designated investment managers;

• rules about submission of investment instructions and the exercise of voting, tender or similar rights;

• a description of any transaction fees or expenses that are charged to participant accounts.

• copies of prospectuses applicable to the selected investments; and

• a description of the information that is available on request and the name, address, and phone number of the plan fiduciary responsible for providing that information.

Based on DOL Advisory Opinion 2003-11A, a plan may, consistent with the §404(c) regulations, distribute a special summary of a mutual fund prospectus, called a "profile," prepared under §10(b) of the Securities Act, instead of a prospectus in certain circumstances.[2] Specifically, the Advisory Opinion provides that if the most recent "prospectus" in the plan's possession is a profile, then delivering the profile to a plan participant or beneficiary immediately before or immediately after such individual's initial investment in a mutual fund would satisfy the prospectus delivery obligation under Labor Regulation §2550.404c-1(b)(2)(i)(B)(1)(viii). If the most recent prospectus in the plan's possession is a full prospectus prepared under §10(a) of the Securities Act rather than a profile prepared under §10(b), then the plan must deliver the §10(a) prospectus to satisfy the §404(c) requirement.

ERISA § 404(c) requires plans to provide a prospectus to participants upon request. The Advisory Opinion states that a plan may provide a profile instead, if that is the fund's most recent prospectus; however, if a participant specifically requests a Securities Act §10(a) prospectus, the plan must provide the most recent §10(a) prospectus to satisfy this requirement. ERISA also requires certain other information to be provided upon request, including:

- a description of the annual operating expenses of each investment alternative;
- copies of any financial statements and reports and other information provided to the plan relating to an investment alternative;
- specific information about assets included in the portfolio of an investment alternative that holds plan assets;
- information about the value of shares or units and the performance of investment alternatives available to participants; and
- information about the value of shares or units in investment alternatives held in a participant's account.

The most common cause of breakdown in §404(c) protection is failure to provide required information. One disclosure requirement that plan sponsors frequently overlook, which was highlighted in the DOL amicus brief in the *Tittle v. Enron Corp.* case,[3] is the explanation to plan participants that a plan is intended to constitute an ERISA §404(c) plan and that plan fiduciaries may not be responsible for investment losses resulting from participant-directed investments. Compared to the implementation steps involved with some of the other §404(c) requirements, plan sponsors should find it simple to provide this explanation to participants.

Many of the §404(c) disclosure requirements are burdensome and ongoing and often require coordination among various plan service providers. Participants and beneficiaries easily can claim that they did not have enough information to make informed investment decisions under a plan. However, plan sponsors may be able to protect themselves from such claims by making small changes in plan administration, coordinating the efforts of service providers, and monitoring investment disclosures and participant communications distributed by their plan vendors.

Mutual Fund Fees

A key component of the §404(c) disclosure obligations involves the provision of information about the fees and expenses related to investment in the alternatives available under a plan. In addition to ensuring that such fees and expenses are adequately disclosed, plan fiduciaries must investigate and monitor the fees and expenses charged by mutual funds and other investment alternatives to confirm that they are and remain reasonable. The 401(k) Plan Fee Disclosure Form posted on the DOL Web site lists the fees that most plan sponsors will encounter,[4] and the Securities and Exchange Commission's Web site contains a mutual fund cost calculator.[5]

Securities laws require mutual fund prospectuses to disclose certain fee information, but the prospectuses often do not clearly explain the fee amounts or other mutual fund expenses (such as trading commissions, directed brokerage arrangements, and soft-dollar arrangements between brokerage firms and mutual funds).[6] As a result, the total fees and expenses sometimes are substantially greater than the expense ratios identified in the prospectuses, which typically include only management fees and overhead. A primary issue for plan fiduciaries is whether the total fees and expenses make a particular mutual fund an imprudent investment choice for an employer-sponsored defined contribution plan. However, historically plan fiduciaries generally have not been aware of the hidden costs of mutual funds or have not pressed fund providers to fully disclose all of the mutual fund fees and expenses.[7]

The focus on the mutual fund industry has invited scrutiny of the fees charged by mutual funds. The SEC has adopted rules that improve disclosure of fund management fees by requiring mutual funds to report:

• the cost in dollars associated with an investment of $1,000 based on the fund's actual expenses for the period, which is intended to assist investors in estimating the actual costs, in dollars, that they bore over the reporting period; and

• the cost in dollars associated with an investment of $1,000 based on the fund's actual expense ratio for the period and an assumed return of five percent per year, which is intended to provide investors with a basis for comparing the level of current period expenses of different funds. The expense disclosure also must include the fund's expense ratio and the account value as of the end of the period for an initial investment of $1,000.[8] Furthermore, in recent months numerous mutual fund sponsors have reduced the expenses applicable to hundreds of mutual funds[9] and some industry participants are advocating increased transparency regarding practices such as trading commissions, directed brokerage agreements and soft-dollar arrangements.[10]

The SEC also has implemented rules that require more prominent information about brokerage commissions in mutual fund literature. In 2004, the SEC amended Rule 12b-1 under the Investment Company Act of 1940 to prohibit mutual funds from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares and requested comments on the need for additional changes to Rule 12b-1.[11] Rule 12b-1(h) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker-dealer. The prohibition applies to both the directing of transactions to selling brokers and the indirect compensation of selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission. The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the fund's portfolio transactions effected through any broker or dealer.[12]

Various other recent regulatory amendments and actions by the SEC target non-fee aspects of the mutual fund industry in an effort to curb abuses uncovered in recent years. The SEC also conducted an investigation covering defined contribution retirement plans by asking two dozen mutual fund companies to provide details about the arrangements they maintain to ensure that their funds are included in employer-sponsored plans.[13] The SEC inquiry focused on payments made by mutual funds and how they were disclosed to fund directors and defined contribution plan participants. For example, one of the SEC questions asked whether higher direct or indirect payments have resulted in an initial selection for or a different placement in a plan sponsor's retirement plan.[14] According to an SEC spokesperson, any payments that are made by fund companies to obtain access to employer-sponsored defined contribution plans must be disclosed in precise detail.[15]

Such rules and increased regulation of the mutual fund industry should make it easier for plan fiduciaries to evaluate and monitor the fees and expenses charged by particular mutual funds. Working with an independent investment consultant to analyze the reasonableness of the fees charged by the investment funds available under a plan is an advisable means of conducting such due diligence within the framework of the §404(c) requirements. Furthermore, forthcoming DOL guidance and pending legislation involving fee disclosure requirements should increase the transparency requirements for certain investment alternatives and make fee information more readily available to plan fiduciaries.

Investment Alternatives

The analysis of mutual fund fees is just one component of the investigation of investment alternatives. The prudent selection of the types of investment alternatives available to participants who direct the investment of their plan accounts is a fundamental step toward protecting plan fiduciaries from liability. Fiduciaries also must monitor the selected alternatives to ensure that they remain prudent investment choices. The following paragraphs discuss some of the issues related to the use of self-directed brokerage accounts, mutual fund windows, lifestyle funds, employer stock and default investment funds as plan investment alternatives.

Self-Directed Brokerage Accounts / Mutual Fund Windows

The availability of brokerage accounts and mutual fund windows through employer-sponsored retirement plans with participant-directed investments continues to be a topic of debate among practitioners in the context of ERISA §404(c) compliance. A self-directed brokerage account investment alternative gives plan participants access to nearly any available investment. Mutual fund windows are similar, but provide access to a wide range of mutual funds rather than individual stocks and bonds. Neither §404(c) nor the underlying regulations specifically address self-directed brokerage accounts or mutual fund windows, and the DOL has not issued specific guidance about how §404(c) would apply to such investment alternatives. An example in the §404(c) regulations and statements in the preamble indicate that a plan sponsor that makes brokerage accounts or, perhaps, mutual fund windows, available under a benefit plan should be eligible for §404(c) protection even if the plan sponsor does not restrict participant use of the brokerage account or mutual fund window alternative. However, to fulfill the fiduciary duties of prudence and acting in the best interests of plan participants, a plan sponsor may determine that certain limitations on brokerage accounts and/or mutual fund windows (*e.g.*, percentage of account, dollar limits, maximum percentage for any one security, etc.) are warranted to protect participant accounts.

A plan with a self-directed brokerage account or mutual fund window feature should be able to satisfy most of the §404(c) information requirements by including appropriate language in the summary plan description. The prospectus requirement applicable to most investments presents one of the most common challenges for §404(c) compliance for plans that offer brokerage accounts or mutual fund windows because plan fiduciaries must ensure that participants receive required information about available investment alternatives. The §404(c) regulations permit a plan fiduciary to delegate information disclosure obligations to others, such as investment brokers, but the fiduciary still must ensure that the disclosure requirements are satisfied. Therefore, the plan sponsor should carefully select the broker(s) through whom participants may use the brokerage account and/or mutual fund window and clearly delineate each broker's disclosure obligations.

Furthermore, in light of the increased scrutiny of investment fees, plan sponsors should confirm that the brokerage arrangements available through their defined contribution plans are comparable to other such arrangements available in the retirement plan marketplace in terms of the available investments, the commission schedule and Securities Investor Protection Corporation insurance, for example.

Lifestyle Funds

Lifestyle funds allow investors to match their time horizon and risk preference with a single fund, such as a conservative, moderate or aggressive fund. Mutual fund sponsors introduced lifestyle funds to provide a simple investment approach that allows less sophisticated or busy investors to create tailored investment portfolios, and plan fiduciaries select them as retirement plan investment alternatives for similar reasons. However, many plan participants use lifestyle funds in conjunction with other plan investment alternatives, which may defeat the purpose of the lifestyle funds and often adversely affects a participant's portfolio balance.

As long as plan fiduciaries prudently investigate and select the lifestyle funds offered under a plan and otherwise comply with §404(c), they should be entitled to §404(c) protection with respect to those funds. However, the special characteristics of lifestyle funds may require plan sponsors and other fiduciaries to exercise additional diligence with respect to participant communications. Plan fiduciaries should review all lifestyle fund explanatory materials to ensure that they are sufficient for participants to understand the purpose and use of lifestyle funds. The plan sponsor should consider hosting information sessions with a fund sponsor representative who will educate participants about the lifestyle funds and other investment alternatives and demonstrate examples of prudent investment allocations using the available funds. One approach some companies have adopted is to require participants who choose a lifestyle fund to invest a significant percentage – even 100 percent – of their account assets in that lifestyle fund. Regardless of the approach a plan sponsor adopts, it should ensure that the plan fiduciaries carefully research and select the lifestyle funds for a plan and that participants understand the function and optimal use of lifestyle funds.

Employer Stock

Unlike the ten percent limit on employer stock that applies to defined benefit plans, ERISA generally does not limit the amount of employer securities that may be held in an eligible individual account plan, subject to the prohibited transaction rules. Therefore, a defined contribution plan that permits unlimited investment in qualifying employer securities does not automatically fail to comply with §404(c). However, as lawsuits have revealed, unanticipated and often unfortunate consequences of investment in employer stock could uncover fiduciary breaches that stretch beyond the selection of employer securities as an investment alternative.

The first step in designating employer stock as an investment alternative should involve a determination of whether offering employer stock under a particular plan is prudent under the circumstances. This determination could include retention of an outside investment advisor to evaluate the employer stock as an investment alternative. Plan fiduciaries responsible for choosing plan investment alternatives should at least apply the standards they use to evaluate other potential plan investments, such as mutual funds and brokerage accounts, when they analyze employer stock as an investment choice.

After plan fiduciaries determine that the use of employer stock as an investment alternative is prudent under a plan, they should ensure that the plan complies in all respects with §404(c). ERISA §404(c) applies to a plan only if a participant or beneficiary has in fact exercised "independent control" with respect to the investment of account assets. Independent control may not exist if a participant has been subjected to improper influence by the plan sponsor or a plan fiduciary regarding a transaction or investment or if a plan fiduciary has concealed from the participant material non-public facts about an investment, particularly employer stock (unless required by law). Therefore, plan fiduciaries are not entitled to §404(c) protection if they mislead participants or fail to warn them of significant changes in the employer's financial status or other circumstances that could affect participant decisions to invest plan assets in employer stock.

Following the sharp decline in the value of Enron stock and other employer securities, legislators and commentators raced to present bills and suggestions for shielding participants from decreases in the value of employer stock held by retirement plans. Some proposals involved implementation of a cap on the percentage of plan assets that may be invested in employer securities. Other proposals focused on requiring plans to allow participants to transfer their account assets out of employer stock and into other investment alternatives. Still other proposals required employers to notify employees of stock sales by executives. The Pension Protection Act of 2006 amended the Internal Revenue Code by adding new §401(a)(35) and ERISA by adding new §204(j) to require qualified defined contribution retirement plans (other than certain employee stock ownership plans) to enable qualified plan participants and beneficiaries to divest employer securities held in their plan accounts and reinvest the resulting proceeds in certain diversified investments.[16] Plan administrators must provide qualified participants notice of their diversification rights at least 30 days before the first date on which the individuals are eligible to exercise their rights. The notice must set describe the diversification rights provided under I.R.C. §401(a)(35) and ERISA §204(j) and describe the importance of diversifying the investment of retirement account assets.[17]

Sponsors of §404(c) plans that permit investment in employer securities should review their plan provisions regarding employer stock investments. If a plan prohibits the sale of company stock for a particular period or until the occurrence of a specified event, the plan sponsor should consider whether the prohibition is reasonable, and whether or not it complies with the diversification requirements under I.R.C. §401(a)(35) and ERISA §204(j). In addition, as the DOL asserts in its amicus brief in the *Tittle v. Enron Corp.* case, plan fiduciaries should periodically analyze the prudence of retaining employer securities as an investment alternative.

Fiduciaries should monitor employer stock in the same manner that they periodically review other investment options to ensure that they continue to be appropriate plan investments. Such analysis should follow the fiduciaries' standard procedure and should be clearly documented. If the fiduciaries do not follow a standard procedure, they should create and maintain one. Alternatively, the plan sponsor could appoint an independent fiduciary on the plan's behalf to monitor the employer stock investment alternative. The plan sponsor might consider adopting a limit on the percentage of account assets that participants may invest in employer securities. Again, any such decision should be clearly documented. Whether or not a plan offers employer stock as an investment alternative, the plan fiduciaries should emphasize to participants the importance of investment diversification.

Default Funds and QDIAs

Defined contribution plans with participant-directed investments, especially plans that provide for automatic enrollment (i.e., automatic participation unless an employee opts out), often have participants who do not submit any investment instructions. Until quite recently plan sponsors generally addressed this situation by stating in their plan documents and employee communications that the accounts of participants who do not provide investment instructions will be invested in the lowest-risk investment alternative available under the plan (e.g., a money market fund). Default investment in a plan's designated money market fund may be the "safest" investment, but it also may yield the lowest return, which could raise prudence issues and prompt a lawsuit by affected participants (*i.e.*, in rising securities markets). In addition, before the enactment of the Pension Protection Act of 2006, this approach presented problems with §404(c) compliance because the §404(c) regulations state that plan fiduciaries are not relieved of liability for investing a participant's account unless the participant actually exercises control over the investment of the account.[18] ERISA §404(c)(5), effective for plan years beginning on or after January 1, 2007, now provides fiduciary relief for plans and fiduciaries that comply with the QDIA requirements by treating a participant as exercising control with respect to his or her plan account assets—even if the participant does not make an affirmative investment election.[19]

Given that most fiduciaries of plans with participant-directed investments prefer not to be involved in individual account investment decisions for participants who do not submit investment instructions, plan fiduciaries should consider selecting a default investment that complies with the QDIA requirements.[20] Fiduciaries retain responsibility for the actual selection of the default fund(s) and should monitor the selected default fund(s) to ensure that the default remains a prudent investment choice (whether or not the default is a QDIA), but may avoid liability related to the investment of participant account assets in the default fund(s) by following the DOL rules for default investments and providing the required information to participants.[21] Notably, a plan is not required to satisfy all of the §404(c) rules (other than the requirement that the plan offer a "broad range of investment alternatives" within the meaning of Labor Regulation § 2550.404c-1(b)(3)) for a plan fiduciary to obtain the relief provided by the QDIA provisions under §404(c)(5).[22]

The DOL regulations provide relief for fiduciaries under a QDIA arrangement if the arrangement satisfies the following requirements:[23]

- the fiduciary invests the assets in a QDIA (described below);
- the participant or beneficiary on whose behalf an investment is made had the opportunity to direct the investment of the assets in his or her account but did not;
- the participant or beneficiary is provided advance notice and annual notice (described below);
- information the plan receives with respect to a participant's or beneficiary's investment in a QDIA (such as fund prospectuses, account statements, and proxy materials) is provided to the participant or beneficiary under the disclosure requirements that apply to §404(c) plans;
- any participant or beneficiary on whose behalf assets are invested in a QDIA has an opportunity to transfer some or all of those assets to another investment alternative under the plan at least once every three months (or more frequently if the plan provides), and during the first 90 days of the QDIA investment those assets may not be subject to restrictions, fees or expenses (other than investment management and other similar fees and expenses), including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the QDIA (unless such fees are paid by the plan sponsor[24]); after the 90-day period, those assets may be subject only to the restrictions, fees or expenses that otherwise apply to participants and beneficiaries who direct the investment of their account assets in the QDIA; and
- the plan offers participants and beneficiaries the opportunity to invest in a broad range of investment alternatives.

To be a QDIA, an investment option must:[25]

- not hold or permit the acquisition of employer securities unless otherwise provided in Labor Regulation §2550.404c-5(e)(1)(ii) (securities held by a registered investment company or a similar pooled investment vehicle or securities contributed as an employer matching contribution or acquired at the direction of a participant or beneficiary prior to management by an investment management service that has discretionary authority over the disposition of the securities);
- satisfy the transferability requirements described above;
- be managed by: (i) an investment manager (as defined in ERISA §3(38)), a plan trustee that satisfies the requirements of ERISA §3(38)(A), (B) and (C), or the plan sponsor[26]—or a committee comprised primarily of employees of the plan sponsor—that is a named fiduciary as defined in ERISA §402(a)(2); (ii) an investment company registered under the Investment Company Act of 1940; or (iii) an investment product or fund that generally is designed to preserve principal;
- be an investment fund product or model portfolio that applies generally accepted investment theories, is diversified to minimize the risk of large losses and is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy (such as a “life-cycle” or “targeted-retirement-date” fund or account);

• be an investment fund product or model portfolio that applies generally accepted investment theories, is diversified to minimize the risk of large losses and is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole (such as a “balanced” fund);

• be an investment management service with respect to which a fiduciary (as defined in Labor Regulation §2550.404c-5(e)(3)(i)), applying generally accepted investment theories, allocates the assets of a participant's account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures offered through investment alternatives available under the plan, based on the participant's age, target retirement date or life expectancy (such as a “managed account”).[27]

If a plan is an “eligible automatic contribution arrangement” (EACA) under I.R.C. §414(w), the plan may use a short-term capital preservation QDIA,[28] which permits investment in a capital preservation product for a 120-day period following a participant's first elective contribution to an EACA. The short-term QDIA is intended to provide administrative flexibility for plans that satisfy the EACA requirements and allow employees to make permissible withdrawals within 90 days after the first investment in the QDIA in accordance with I.R.C. §414(w)(1).[29] In addition, the QDIA regulations incorporate a “grandfathered” QDIA concept, which provides fiduciary relief with respect to assets invested before December 24, 2007 in a product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, while providing liquidity for withdrawals and satisfying other requirements specified in the regulations.[30]

To satisfy the notice requirements applicable to a QDIA arrangement,[31] a plan must provide to or arrange for participants to receive:

• a description of the circumstances under which assets in the account of a participant or beneficiary may be invested in a QDIA on behalf of the participant or beneficiary (including, if the plan is an automatic enrollment arrangement, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the participant's right to elect not to have such contributions made on his or her behalf or to elect a different contribution percentage);

• an explanation of the right of participants and beneficiaries to direct the investment of assets in their accounts;

• a description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable), and applicable fees and expenses;

• a description of the right of the participants and beneficiaries on whose behalf assets are invested in a QDIA to direct the investment of those assets to any other investment alternative available under the plan, including a description of any applicable restrictions, fees, or expenses applicable to asset transfers; and

• an explanation of the location where or means by which participants and beneficiaries can obtain information about the other investment alternatives available under the plan.

The regulations require the notice to be written in a manner calculated to be understood by the average plan participant[32] and to be distributed within particular timeframes.[33] The notice timeframe depends on the circumstances under which the notice requirement applies. For a participant who does not submit instructions for the investment of his or her account assets, the notice must be provided at least 30 days before the participant's plan eligibility date, or at least 30 days before the date of any first investment in a QDIA on the participant's behalf.[34] A participant who is automatically enrolled in a plan must receive the notice on or before the date he or she becomes eligible to participate in the plan, provided that he or she may make a permissible withdrawal (within the meaning of Code §414(w)).[35] For each subsequent plan year, the notice must be provided within a reasonable period of time at least 30 days before the beginning of the plan year.[36] The notice must be a separate document and may not be included in a summary plan description or a summary of material modifications, but it may be distributed with other documents.[37]

Participant Investment Education and Advice/Active Investment Management Alternatives

Participants in traditional §404(c) plans are solely responsible for their account investments, regardless of their sophistication or inexperience with investing. They often must choose from a dizzying array of investment alternatives that frequently include employer securities, a variety of mutual funds, and even self-directed brokerage accounts and/or mutual fund windows. Many participants fail to diversify their investments because they are unable to comprehend or absorb all of the information necessary to enable them to make informed investment choices.

Despite the "informed decision" requirement of §404(c), ERISA does not currently require that plan sponsors offer investment education, regardless of participant demographics or the extensiveness of the investment alternatives offered under a plan. However, the plight of plan participants affected by company scandals and the weak market in recent years has underscored the importance of compliance with the §404(c) disclosure requirements, both by preventing employers from misleading participants about their company's financial health as well as facilitating informed participant investment decisions. Congress may at some point mandate that plan sponsors provide investment education to participants in plans that offer participant-directed investments. Meanwhile, some plan sponsors are voluntarily providing participant access to investment education and, in some cases, investment advice, and a growing number of plan sponsors and service providers are even going a step further to provide active investment management alternatives for plan participants.

For years practitioners have debated the risks of employer-provided investment education and advice. Many plan sponsors shied away from providing any guidance to participants based on the concern that they would negate their §404(c) protection by "advising" participants about investment decisions. DOL Interpretive Bulletin 96-1 explains the distinctions between investment education and investment advice with respect to plans offering participant-directed investments.[38] The DOL guidance has resulted to some degree in the increased availability of general financial and investment information, asset allocation models, and interactive investment materials and web sites designed to help participants make investment decisions, but many participants need more than general information to realize the full potential of their retirement plan accounts.

An advisory opinion that the DOL issued on behalf of Sun America Inc. supports the use of independent financial advisors to provide investment advice for individual participants.[39] Therefore, even in the absence of a Congressional or regulatory mandate for participant investment education, plan sponsors that want to increase their protection from fiduciary liability might consider offering participants more investment education or even independent financial advice regarding their plan investments or an investment management option. Some defined contribution plans already offer professional investment management as an investment alternative for which participants pay. Plan fiduciaries that decide to engage independent advisors or investment managers would be most prudent to treat these alternatives offered under an employer-sponsored individual account plan as additional investment options. Although such options are not the same as investment alternatives like mutual funds, they should be subjected to similar scrutiny and monitoring.

The prospect of employer-sponsored investment advice has provoked substantial debate in Congress and other forums and may expose plan fiduciaries to increased risk of investment-related liability. Some fiduciaries may seek to share the liability risk with independent financial advisors and investment managers by contracting with them to provide services to plan participants as co-fiduciaries. Recent legislation may simplify this process or provide more alternatives for fiduciaries—Section 601 of the Pension Protection Act of 2006 amended ERISA §408 and I.R.C. §4975 to add a statutory exemption that applies to the provision of investment advice under an "eligible investment advice arrangement," as defined in ERISA §408(g)(2), to participants and beneficiaries of a defined contribution plan that permits them to direct the investment of their plan accounts. If the arrangement satisfies the requirements under ERISA §408(g), ERISA §408(b)(14) and I.R.C. §4975(d)(17) exempt from the prohibited transaction rules the provision of investment advice, the investment transaction entered into pursuant to the advice, and the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate in connection with the provision of advice or the transaction consummated pursuant to the advice. The more educated participants are and the greater access they have to investment services and advice, the better their investment decisions and returns are likely to be. More favorable long-term investment success by participants should serve ultimately to reduce plan fiduciary exposure to lawsuits.

Plan Design and Operational Issues and Implications for §404(c) Compliance

Market Timing and Late Trading

The DOL has issued guidance for fiduciaries of 401(k) and other retirement plans that involve participant-directed investments and recommended review of the investment alternatives offered under the plans in light of the investigation of certain mutual funds.[40] The mutual fund investigation focused on late trading (transactions after the share price is set for the day – typically 4:00 p.m. Eastern Time), market timing (frequent trading to obtain short-term gains) and "perk" trading (special trading arrangements for senior managers that generally are not available to other fund investors), prompting the SEC to issue proposed amendments to the rules governing the pricing of mutual fund shares.[41]

The DOL advised that if a plan's investment alternatives include mutual funds that are formally under investigation, the plan fiduciaries should contact the fund provider and obtain specific information about the allegations. The fiduciaries should consider:

- the nature of the allegations;
- the potential impact on plan investments;
- steps available to the plan to limit future abuses; and
- actions to remedy any adverse effect on participant investments.

The plan fiduciaries also may need to consider whether to participate in related litigation or settlements. If a plan does not include mutual funds that are known to be under investigation, the plan fiduciaries still should obtain sufficient information about the funds and the fund provider's general response, if any, to the investigations to ensure that the funds maintain procedures and safeguards to limit their exposure to the practices under investigation.

The DOL recommended that plan fiduciaries adhere to their normal investment selection and monitoring procedures as appropriate and prepare a thorough record of all actions taken and potential remedies, including the reasons for the actions and decisions. Plan fiduciaries also should consider whether they should be communicating with participants regarding the mutual fund investigation if they have not already done so and providing periodic updates about investigation developments.

The mutual fund investigations raised questions regarding whether a plan's offering of mutual fund or similar investments that impose reasonable redemption fees on sales of their shares would affect the availability of relief under §404(c). Similarly, issues have been raised as to whether reasonable plan or investment fund limits on the number of times a participant may move account assets in and out of a particular investment within a particular period would affect the availability of §404(c) protection. The DOL guidance stated that these two approaches to curb market timing do not, in and of themselves, conflict with the trading opportunities based on volatility and other requirements set forth in the §404(c) regulations, provided that any such restrictions are allowed under plan terms and are clearly disclosed to plan participants and beneficiaries.[42]

In addition to implementing the DOL recommendations resulting from the mutual fund investigation, plan fiduciaries should review their plan provisions regarding redemption fees and/or trading restrictions, if any, and the practices of plan participants to determine whether there is any evidence of market timing or excessive or late trading. If the plan fiduciaries determine that participants are engaging in market timing or excessive or late trading, it may be advisable to implement appropriate trading limitations or redemption fees to protect the participants. Based on the DOL guidance, if the restrictions are reasonable and prudent and are properly documented in the plan and communicated to participants, the trading restrictions and/or redemption fees should not jeopardize the §404(c) protection for plan fiduciaries. If there is no evidence of market timing or excessive trading, no action may be necessary, but the fiduciaries should monitor the funds and periodically revisit the trading issue.

To address the trading issues at the mutual fund level, the SEC adopted Rule 22c-2 under the Investment Company Act of 1940 to authorize mutual funds (excluding money market funds and exchange-traded or other actively traded funds) to impose a redemption fee of up to two percent of the amount redeemed when they determine that a fee is in their best interest.[43] The mutual fund would retain the fees to help recoup the cost of market timing and excessive trading and reduce the impact of such practices on longer-term investors.

The SEC imposes disclosure requirements for mutual funds regarding their policies and procedures on market timing.[44] The rules require a fund to:

• describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;

• state in its prospectus whether or not the fund's board of directors has adopted policies and procedures regarding frequent purchases and redemptions of fund shares and, if not, to provide the board's rationale for the lack of such policies and procedures;

• describe in its prospectus any policies and procedures for deterring frequent purchases and redemptions of fund shares; and

• describe any arrangements to permit frequent purchases and redemptions of fund shares in its Statement of Additional Information.[45]

The rules require similar disclosures for insurance company separate accounts offering variable insurance contracts.[46]

Plan fiduciaries should expect to see additional details in mutual fund prospectuses and profiles as a result of these requirements and should take them into account as part of their investment alternative selection and monitoring procedures. In addition, to ensure compliance with the participant communication requirement mentioned in the DOL guidance, plan sponsors should consider referencing the mutual fund trading policies and procedures – and, if or when applicable, redemption fees – in summary plan descriptions or other plan communications to bring them to the attention of participants.

Blackout Periods – Trading Restrictions and Recordkeeper/Investment Alternative Changes

Trading restrictions intended to deter market timing and late trading may raise collateral concerns related to the imposition of blackout periods. The DOL guidance on the mutual fund investigation indicates that, if a plan were to impose trading restrictions that are not contemplated under the plan terms, such an approach would raise issues as to whether such restrictions constitute the imposition of a "blackout period" that requires advance notice to affected participants and beneficiaries.[47] A blackout period generally is a time during which participants are prohibited from engaging in certain transactions with their retirement plan accounts. Traditionally, most blackout periods arose as a result of investment alternative or recordkeeper changes and, in the case of public companies that offer employer stock funds through their defined contribution plans, the operation of securities rules that restrict trading on company stock. In addition to the traditional circumstances, plan fiduciaries now must also consider whether the application of trading restrictions, either plan-imposed or mutual fund-imposed, raises blackout issues for their plans.

The Sarbanes-Oxley Act requires sponsors of defined contribution plans to give participants at least 30 days (except in specified circumstances) written or electronic notice of an upcoming blackout period.[48] The notice must contain specific information, and plan sponsors are subject to a penalty of up to $100 per day for failure to comply. Plan fiduciaries risk liability for investment losses during blackout periods in which plan participants and beneficiaries are unable to direct the investment of assets in their plan accounts, unless the fiduciaries satisfy the ERISA requirements for imposing a blackout period.[49] The Sarbanes-Oxley Act also provides that, if a plan holds publicly traded employer securities, officers and directors may not trade employer securities during the blackout period if they obtained the securities in connection with employment as an officer or service as a director. If an officer or director violates the trading prohibition, he or she must return any related profits to the plan sponsor.

The DOL has issued rules to implement the blackout period notice requirement and the civil penalties under the Sarbanes-Oxley Act for failure to provide such notice.[50] In addition to informing plan participants about a blackout period, the employer should notify or remind its officers and directors of the trading restrictions during that period and monitor any employer security transactions to enforce the trading prohibition. The plan sponsor might consider posting frequent reminders to participants, officers, and directors and keeping records of those communications.

Depending on the design or administration of trading restrictions applicable to a particular plan, the plan sponsor may find that the blackout rules do not apply. The definition of "blackout period" does not include suspensions of participant rights imposed as a result of participant misconduct or regularly scheduled suspensions.[51] The examples of participant misconduct listed in the regulations do not include excessive or late trading, but it is arguable that participant trading that violates a plan's or mutual fund's trading policies – particularly if such policies have been communicated to participants – could be covered by the participant misconduct exception. Similarly, if the circumstances under which trading suspensions, limitations or restrictions relating to market timing or excessive trading may apply are disclosed to participants, the preamble to the DOL regulations implies that a resulting trading suspension, limitation or restriction may fall within the regularly scheduled suspension exception.[52]

Participant communications are particularly important in the context of blackout periods related to investment alternative or recordkeeper changes. For example, when a plan sponsor decides to replace the recordkeeper for a plan, a blackout or "lockdown" period usually is inevitable. The blackout period is necessary for the account transition from the prior recordkeeper to the replacement recordkeeper. During a blackout period, plan participants may not shift investments in the plan or otherwise access their account balances. The plan sponsor should consider the length of the blackout period and available performance guarantees when it evaluates new recordkeepers. To make the recordkeeper change as rapid and as smooth as possible, the plan sponsor should establish a transition plan with the old and new recordkeepers before the blackout period begins. The plan sponsor also should keep the participants, officers, and directors informed of the progress and notify them when the blackout period ends. In extreme situations, the plan sponsor may need to delay the blackout period entirely.

In addition to concerns related to blackout periods, a recordkeeper change could raise issues about §404(c) protection with respect to participant investment elections, depending on the transition approach. If a plan will be offering different investment alternatives with the new recordkeeper, the plan probably will “map” the old investment funds to the new investment funds, largely because of the time pressures involved in accomplishing the transition. ERISA §404(c) does not protect plan fiduciaries in the “mapping” context because participants technically are not exercising control over their account assets. Therefore, the plan sponsor should take care to match the risk and return characteristics of the prior funds with such characteristics of the new funds that will be available under the plan and permit participants to submit new investment elections as soon as possible after the recordkeeper change.

A plan sponsor that is facing a recordkeeper change involving new investment alternatives might consider permitting participants to elect *not* to have their investments mapped and to have their accounts invested in a default fund with the new recordkeeper. Following the blackout period, the participants could immediately submit new investment elections. Alternatively, the plan sponsor could permit participants to elect their new investment alternatives from among all of the new available alternatives before their accounts are transferred and the accounts could be transferred directly into the selected new investments.

Conclusions

ERISA §404(c) protection depends to a large extent on the policies and procedures followed by a retirement plan and its administrators, such as prudently selecting and monitoring plan investment alternatives, providing specified information to participants, implementing participant instructions, and complying with administrative procedures. The majority of plans that fail to comply with §404(c) fail because they do not:

- inform participants that the plan is intended to be a §404(c) plan;
- identify the fiduciary responsible for §404(c) compliance and participant disclosures; or
- provide participants with fund prospectuses and other required securities information and notify them of their right to request certain additional information.

Compliance with §404(c) provides an additional layer of protection for plan fiduciaries. Therefore, plan sponsors generally should do all they can to implement the §404(c) requirements, and they may find that they do not need to change their administrative structure much to satisfy the requirements. Failure to comply with §404(c) does not constitute a fiduciary breach, and even a good faith attempt to comply may help a plan fiduciary by providing evidence of the fiduciary’s overall prudence.

(Last updated May 2008)

Footnotes

1 29 U.S.C. § 1104(c).

2 DOL Adv. Op. 2003-11A (Sept. 8, 2003), available at http://www.dol.gov/ebsa/regs/aos/ao2003-11a.html. The DOL does not take a position on whether distributing a mutual fund profile instead of a prospectus is consistent with applicable securities laws.

3 Tittle v. Enron Corp., Civil Action No. H-01-3913 (S.D. Tex. 2002). The brief is available in the "Laws, Regs and Agency Documents" section of this Library.

4 *See* http://www.dol.gov/ebsa/pdf/401kfefm.pdf. The DOL also has published guidance for employers about 401(k) plan fees at http://www.dol.gov/ebsa/publications/401k_employer.html.

5 *See* http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm.

6 *See, e.g.,* Hechinger, John, "Deciphering Funds' Hidden Costs: Mutual-Fund Study Reveals How Much Investors Actually Pay in Undisclosed Charges," *Wall Street Journal*, March 22, 2004.

7 *See, e.g.,* Brandolph, David, "Challenges to Hidden Plan Fees May Be Next Wave of Mutual Fund Scandal," *BNA Pension & Benefits Daily*, June 21, 2004.

8 *See* 17 C.F.R. Parts 239 and 274 (Release Nos. 33-8408 and IC-26418). A summary of the rules is available at http://www.sec.gov/news/press/2004-16.htm. The rule became effective May 28, 2004.

9 Dodds, Colin, "Scandal Sets Off Fund-Fee Free Fall," *Ignites*, June 15, 2004.

10 *See, e.g.,* Hechinger, John and Davis, Ann, "Fidelity Fights Soft Dollar Deals," smartmoney.com, June 28, 2004, available at http://www.smartmoney.com/bn/ON/index.cfm?story=ON-20040628-000090-0259.

11 *See* 17 C.F.R. Part 270 (Release No. IC-26356). A copy of the proposed rule is available at http://www.sec.gov/rules/proposed/ic-26356.htm.

12 *See* 17 C.F.R. Part 270 (Release No. IC-26591).

13 Morgenson, Gretchen, "S.E.C. Inquiry to Encompass 401(k) Plans," *The New York Times*, July 7, 2004, available at http://www.nytimes.com/2004/07/07/business/07place.html.

14 *Id*.

15 *Id*.

16 *See* Pension Protection Act of 2006 (P.L. 109-280) §901, effective for plan years beginning after December 31, 2006.

17 *See* ERISA §101(m) (29 U.S.C. § 1021(m)), added by Pension Protection Act of 2006 (P.L. 109-280) §507(a).

18 29 C.F.R. § 2550.404c-1(a)(1). *See also* DOL Adv. Op. 2005-23A (Dec. 7, 2005) and DOL Adv. Op. 96-02A (Feb. 9, 1996).

19 Relief is not available for fiduciary decisions made prior to the effective date of the QDIA regulations, such as a decision by a fiduciary to invest assets in a default investment. However, if the notice and other QDIA requirements are satisfied, a fiduciary may (except to the extent limited

by the regulations) be relieved of liability with respect to all assets invested in the QDIA even if some of the assets were contributed prior to the effective date of the regulations. DOL FAB 2008-03, Q&A-2 and -3.

[20] *See* ERISA §404(c)(5) (29 U.S.C. § 1104(c)(5)), enacted as part of the Pension Protection Act of 2006 (P.L. 109-280, §624), and 29 C.F.R. § 2550.404c-5. The fiduciary relief provided under §404(c)(5) and the QDIA regulations is available to §403(b) plans that provide for participant-directed investments and are "pension plans" as defined in ERISA §3(2) and covered by Title I of ERISA. DOL FAB 2008-03, Q&A-5.

[21] 29 C.F.R. § 2550.404c-5(b).

[22] 29 C.F.R. § 2550.404c-1(a)(1).

[23] 29 C.F.R. § 2550.404c-5(c).

[24] *See* DOL FAB 2008-03, Q&A-11.

[25] 29 C.F.R. § 2550.404c-5(e).

[26] DOL Field Assistance Bulletin 2008-03, Q&A-1, confirms that the plan sponsor is not relieved of liability for management of the QDIA (*see* 29 C.F.R. § 2550.404c-5(b)(1)(ii)).

[27] *See* DOL Field Assistance Bulletin 2008-03, Q&A-11 and -16, for additional guidance on QDIA management and asset allocation.

[28] 29 C.F.R. § 2550.404c-5(e)(4)(iv).

[29] *See also* DOL Field Assistance Bulletin 2008-03, Q&A-18, -19 and -20.

[30] 29 C.F.R. § 2550.404c-5(e)(4)(v). *See also* DOL Field Assistance Bulletin 2008-03, Q&A-21 and -22.

[31] *See* 29 C.F.R. § 2550.404c-5(d).

[32] 29 C.F.R. § 2550.404c-5(d).

[33] 29 C.F.R. § 2550.404c-5(c)(3).

[34] 29 C.F.R. § 2550.404c-5(c)(3)(i)(A).

[35] 29 C.F.R. § 2550.404c-5(c)(3)(i)(B).

[36] 29 C.F.R. § 2550.404c-5(c)(3)(ii).

[37] 29 C.F.R. § 2550.404c-5(c)(3).

[38] 29 C.F.R. § 2509.96-1, Interpretive Bulletin Relating to Participant Investment Education, also available at http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.96-1.htm.

[39] DOL Adv. Op. 2001-09A (Dec. 14, 2001), available at http://www.dol.gov/ebsa/regs/AOs/ao2001-09a.html.

[40] Statement of Assistant Secretary Ann L. Combs on the Duties of Fiduciaries in Light of Recent Mutual Fund Investigations (Feb. 17, 2004), available at http://www.dol.gov/ebsa/newsroom/sp021704.html.

[41] *See* 17 C.F.R. Part 270 (Release No. IC-26288). A copy of the proposed rules is available at http://www.sec.gov/rules/proposed/ic-26288.htm.

42 *Id*.

43 *See* 17 C.F.R. Part 270 (Release No. IC-26782).

44 *See* 17 C.F.R. Parts 239 and 274 (Release Nos. 33-8408 and IC-26418). A copy of the final rule is available at http://www.sec.gov/rules/final/33-8408.htm. The rule became effective May 28, 2004.

45 *Id*.

46 *Id*.

47 Statement of Assistant Secretary Ann L. Combs on the Duties of Fiduciaries in Light of Recent Mutual Fund Investigations (Feb. 17, 2004), available at http://www.dol.gov/ebsa/newsroom/sp021704.html.

48 *See* 29 U.S.C. § 1021(i).

49 *See* 29 U.S.C. § 1104(c)(1), as amended by the Pension Protection Act of 2006 (P.L. 109-280) §621(a)(1), effective for plan years beginning after December 31, 2007. Section 624(b)(2) of the Pension Protection Act of 2006 requires the Secretary of Labor to issue (by August 17, 2007) interim final regulations providing guidance to assist plan fiduciaries in fulfilling their fiduciary responsibilities during a blackout period.

50 *See* 29 C.F.R. § 2520.101-3. For a sample client letter explaining notice of blackout periods, see the Practice Aids section.

51 *See* 29 C.F.R. § 2520.101-3(d)(1)(ii).

52 *See* Final Rule Relating to Notice of Blackout Periods to Participants and Beneficiaries, 68 Fed. Reg. 3716 (Jan. 24, 2003).

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE   CHICAGO   IRVING   LONDON   LOS ANGELES   NEW YORK   PALO ALTO   WASHINGTON, DC