TRISTAR PENSION CONSULTING

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Participant-Directed Account Liability

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A major trend in qualified plans, particularly 401(k) plans, is participant-directed accounts, which enable a retirement plan to give participants control over investment of their own plan accounts. Often times, plans are structured as participant-directed accounts to reduce company fiduciary investment responsibility under ERISA section 404(c) provisions.

Many employers are under the misconception that if their plans permit participants to direct the investment of their own accounts and are designed to comply with the 404(c) safe harbor requirements, they have no fiduciary liability. However, this is not the case, since the plan fiduciaries are still liable for selecting and monitoring the investment alternatives offered to the participants as well as numerous disclosure requirements.

This misconception cost First Union $26 million when suits were filed against it, not only because First Union limited investments to its own proprietary funds, but also because the available funds charged higher fees and had lower returns than comparable investments.

FIDUCIARY RESPONSIBILITY

The Employee Retirement Income Security Act of 1974 (ERISA) imposed the requirement that plan fiduciaries invest the assets of a qualified retirement plan in a prudent manner with proper diversification. A plan fiduciary is, for example, the employer sponsoring the plan, the plan committee responsible for administering the plan or the plan's trustee responsible for investing and managing plan assets.

For qualified defined contribution plans, ERISA section 404(c) allows fiduciaries to transfer investment responsibility to participants who direct the investment of their accounts. Generally, fiduciaries are not liable for losses resulting from the participant's exercise of investment control if all of the ERISA 404(c) rules are satisfied.

ERISA SECTION 404(C)

Under ERISA section 404(c), plan fiduciaries may be relieved of fiduciary liability for investment choices made by the participants if the plan satisfies certain requirements. Choosing to have a plan comply with section 404(c) regulations is voluntary. In order to be afforded 404(c) protection, over 20 requirements must be satisfied that fall into the following three categories:

- Offering a broad range of investment alternatives;
- Permitting participants the ability to exercise control of their investments; and
- Providing participants with specific information disclosures to help them make informed investment decisions.

The limited liability protection provided by 404(c) only applies to that portion of a participant's account on which he exercises control. If, for example, a 401(k) plan permits the participant to invest only that portion of his account attributable to his own deferrals, the plan's fiduciaries are only granted protection for the deferrals portion of the participant's account. They are still liable for that portion of the participant's account which is attributable to employer-contributed funds, if any, i.e., matching contributions.

TYPES OF INVESTMENT ALTERNATIVES

Regulations require the plan to offer a broad range of investments, consisting of at least three diversified investment alternatives ("core investment alternatives"), each of which has materially different risk and return characteristics. The core investment alternatives must allow a participant, by choosing among them, to achieve a portfolio with appropriate risk and return characteristics and diversification.

The regulations do not specify what the core investment alternatives should be. However, the regulations make it clear that the selection and monitoring of the core investment alternatives which are offered to participants and beneficiaries is a fiduciary responsibility.

Not only must there be diversification within investment categories, there must also exist diversification in the fund itself. In general, in order to achieve the required diversification, each core investment alternative will have to be a pooled investment fund such as mutual funds; common or collective trust funds and deposits in fixed rate investment contracts of banks or similar institutions; and pooled separate accounts or fixed rate investment contracts of insurance companies.

PARTICIPANT CONTROL OVER ACCOUNTS

The 404(c) regulations require that participants have the right to direct investment changes at least once in any three-month period. For more volatile funds, the regulations require that transfers be permitted more frequently than once every three months.

The participant's direction of investments must be independent, not influenced by the plan sponsor. The plan may impose charges on the participant's account for reasonable expenses if the participant is informed of the expenses.

ERISA BLACKOUT PERIODS

An ERISA blackout period is a period of time that exceeds three consecutive business days during which the participants or beneficiaries in a qualified plan are limited or restricted from their normal right to direct or diversify assets in their accounts or obtain plan loans or distributions. This situation usually occurs when a plan is changing recordkeepers or investment options.

An ERISA blackout period is required to be preceded by an advance notice to participants. If a restriction or limitation is regularly scheduled and was previously disclosed in writing, then it does not meet the definition of an ERISA blackout period. In general, the plan administrator must provide a notice to affected participants and beneficiaries at least 30 days before the last day on which participants may exercise their rights to process a transaction.

It is unclear whether fiduciaries have 404(c) protection during the blackout period since the participants technically are no longer exercising control over their accounts. Therefore, the length of a blackout period should be as short as possible to reduce exposure to fiduciary liability.

DISCLOSURE REQUIREMENTS

Many of the disclosure requirements imposed by the regulations are detailed and burdensome. The summary plan description delivered to the participant must explain that the plan is intended to constitute a plan described in section 404(c) of ERISA, and that the fiduciaries of the plan may be relieved of liability for any losses resulting from participant or beneficiary investment decisions.

In addition, the participant or beneficiary must be provided with, or have the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives available under the plan as described below.

REQUIRED DISCLOSURES

Participants are required to receive the following disclosures:

- A description of investment alternatives available under the plan, a general description of the investment objectives and risk and return characteristics of each of these alternatives as well as the identity of any investment managers;
- An explanation of the rules governing investment instructions, transaction fees and expenses affecting the participant's account balance;
- Immediately following an initial investment in a registered security, a copy of the most recent prospectus provided to the plan, unless the participant has already been provided with a copy of the most recent prospectus immediately prior to his investment (DOL Advisory Opinion 2003-11A permits a mutual fund summary prospectus, referred to as a "Profile," to be provided if it is the most recent prospectus in the plan's possession);
- To the extent that voting rights of an investment are passed through to participants, an explanation of the plan provisions relating to those rights and the materials provided to the plan to exercise those rights; and
- A description of information which may be obtained by participants upon request (see below) and the name of the plan fiduciary responsible for providing the information.

DISCLOSURES UPON REQUEST

The following information must be provided to participants either directly or upon request:

- A description of the annual operating expenses of each core investment alternative and the total amount of these expenses;
- Copies of prospectuses (or "Profiles" as described above) and any other materials relating to the plan's core investment alternatives;
- A list of the assets making up the portfolio of each core investment alternative (for example, the assets of a fund managed for the plan); and
- Information concerning the value of a share or unit and of the participant's interest in each core investment alternative as well as the past and current investment performance of each alternative.

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SPECIAL EMPLOYER SECURITY RULES

If plans permit participants to direct investments in employer securities, that investment alternative must be a separate fund, not one of the three core investment alternatives. A number of restrictions and special requirements apply, and the 404(c) protection of the regulations only applies if the securities are publicly traded.

COMMON FAILURES

Fiduciaries are not liable for losses resulting from the participant's exercise of investment control unless all of the ERISA 404(c) rules are satisfied. Some of the most common failures include:

- Failure to notify the participants that the plan is intended to constitute an ERISA section 404(c) plan and that fiduciaries may not be responsible for investment losses;
- Failure to identify the plan fiduciary responsible for providing disclosure information;
- Failure to act prudently in selecting the investment alternatives offered under the plan and/or not monitoring the performance and costs of the investment alternatives to ensure they remain prudent;
- Failure to provide a prospectus (or Profile) immediately preceding or following an initial investment; and
- Failure to identify the plan as intending to meet 404(c) requirements on Form 5500.

CONCLUSION

In today's litigious society, it's not only giants like Enron and First Union that have the potential for litigation for failure to meet fiduciary responsibilities. Small companies can be affected as well if fiduciaries seeking ERISA section 404(c) protection do not monitor their plans for compliance with the long list of requirements. Fiduciaries can even be held personally liable for investment losses.

Many plan sponsors do not fully understand the ways to comply with section 404(c). Qualified professionals have the knowledge to assist plan fiduciaries in complying with these many rules. To ensure that your plan fiduciaries are protected, perhaps it's time for your plan to have an in-depth ERISA section 404(c) compliance audit.

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