LEGAL ISSUES ARISING FROM EMPLOYEE INVESTMENT DIRECTIONS UNDER INDIVIDUAL ACCOUNT PLANS

by

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I. OVERVIEW

The federal law that governs employee benefit plans provides for two types of pension benefit plans: defined benefit plans and defined contribution plans. A defined benefit plan is a plan that provides definitely determinable benefits upon a participant's retirement and is funded in advance in accordance with actuarial principles. For example, the benefit formula of a defined benefit plan may state the benefit as a percentage of a participant's final average compensation multiplied by years of service. Since participants in defined benefit plans are entitled to a fixed benefit at retirement, the plan sponsor bears the investment risk associated with assets funding the benefit. By contrast, a defined contribution plan (also known as an "individual account plan") provides individual accounts for each participant. Benefits under a defined contribution plan are based solely upon the balance of the participant's account at retirement or separation from service, and such account balance is solely a function of the amount contributed to the account plus or minus future gains, expenses, and losses.

In the not so distant past, the vast majority of employees covered by pension plans participated in defined benefit plans. Whether one points to the decline of labor unions, a stifling regulatory environment or employers' desires to share investment risk with employees one fact seems certain: the number of employees covered by defined benefit pension plans has decreased inexorably over the past two decades.

The dramatic decline in the number of active defined benefit plans has been accompanied by a marked increase in the number of active defined contribution plans. Employers sponsoring defined contribution plans have sought to limit their liability with respect to the investment of employees' plan accounts by allowing employees to make investment decisions for their accounts. If certain requirements are met, federal law relieves employers and other plan fiduciaries of responsibility for investment decisions made by employees. These requirements are the subject of regulations of the U.S. Department of Labor and are discussed in this outline.

II. OVERVIEW OF SECTION 404(C) REGULATIONS

A. *ERISA Fiduciary Duty and Liability*. One of the express purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), is to establish "standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans.…" and to provide "appropriate remedies" to plan participants and beneficiaries for the breach of such responsibilities. ERISA § 2(b). The term "fiduciary" is defined in ERISA as a person who has discretionary authority over the management or administration of a plan or over the management or administration of its assets. ERISA § 3(21)(A). If plan fiduciaries fail to invest plan assets prudently or in a diversified manner that minimizes the risk of large losses, they face personal liability under ERISA. ERISA §§ 404(a), 409.

B. *Effect of Section 404(c) of ERISA.* Section 404(c) of ERISA provides that where a participant or beneficiary of an individual account plan exercises control over the assets of his or her account, the plan's fiduciaries are relieved of any potential liability that results from the exercise of such control, and the participant or beneficiary will not be considered a fiduciary by reason of the exercise of such control. However, Section 404(c) does not protect plan fiduciaries from liability for selecting investment alternatives imprudently or failing to monitor such alternatives. In addition, the Preamble notes that Section 404(c) protection applies only where a participant has in fact exercised control over the assets of his or her account. Thus, if the plan provides that a participant's account will be invested in a given investment alternative in the absence of an effective participant instruction, no Section 404(c) relief would apply to such transaction unless such alternative is a qualified default investment alternative (a "QDIA") as discussed on page 7, below.

C. *History of Section 404(c) Regulations*. Although Section 404(c) was enacted in 1974 as part of ERISA, the United States Department of Labor (the "DOL") did not promulgate proposed regulations for Section 404(c) until September 3, 1987. Those proposed regulations received extensive public comment (and criticism) and were reproposed by DOL on March 13, 1991. In the October 13,1992 issue of the Federal Register, final regulations under Section 404(c) (29 C.F.R. § 2550.404c-1) (the "Regulation") and a preamble to the Regulation (the "Preamble") were published. On October 24, 2007, the DOL issued final regulations relating to the Section 404(c) relief available to a fiduciary for an investment in a QDIA made on behalf of a participant who fails to direct the investment of the participant's account. On April 28, 2009, the DOL issued Field Assistance Bulletin 2008-03, which contains question-and-answer guidance on the final QDIA regulations, and, on April 29, 2008, issued technical corrections to such final regulations. On July 23, 2008, proposed amendments to the Regulation were published in the Federal Register that conform the Regulation, specifically the information requirements of the Regulation, to proposed regulations under Section 404 of ERISA that were also published on the same day, both of which are intended to be effective for plan years beginning on or after January 1, 2009.

III. OPERATIONAL ASPECTS OF THE REGULATION

A. *Requirements Not a Safe Harbor*. The provisions of the Regulation are intended by the DOL to state the requirements a plan must meet to afford protection to fiduciaries under

Section 404(c) of ERISA. Thus, the Regulation is not a "safe harbor," and failure to comply with the requirements of the Regulation results in no Section 404(c) relief.

B. *No Negative Implication for Noncomplying Plans.* A plan's failure to comply with the requirements of the Regulation does not imply that the plan's fiduciaries have breached any of their duties under ERISA or that the plan itself is not in compliance with ERISA's requirements. As the DOL states in the Preamble, failure to comply with the requirements of the Regulation merely results in plan fiduciaries not being accorded the statutory relief described in Section 404(c) of ERISA. Although the Preamble to the DOL's proposed Section 404(c) regulations stated this proposition, the DOL included this provision in the Regulation itself in response to concerns raised by a number of commentators. Regulation § 2550.404c-1(a)(2).

C. *Transactional Nature of Section 404(c) Relief.* The Preamble observes that the relief provided by Section 404(c) of ERISA applies only to individual transactions that meet the requirements of that section. If a participant is granted investment control with respect to only a portion of his or her account, Section 404(c) relief applies to the participant-directed portion of the account if the requirements of the Regulation are met. Moreover, a plan's failure to comply with each aspect of the Regulation for certain investment transactions does not necessarily render Section 404(c) relief inapplicable to all participant-directed transactions made under the plan. Rather, each individual transaction must be scrutinized to determine if, with respect to that transaction, all of the requirements of Section 404(c) have been met.

D. *Burden of Proof.* The DOL notes in the Preamble that it considers Section 404(c) to be a statutory exception to ERISA's general fiduciary duty provisions. For this reason, the DOL asserts that the party seeking to rely upon Section 404(c) bears the burden of proving its applicability.

E. *Effective Date of the Regulation.* The Regulation is effective for transactions occurring on or after the first day of the second plan year beginning on or after October 13, 1992. Regulation § 2550.404c-1(g)(1). Plans maintained pursuant to one or more collective bargaining agreements ratified before October 13, 1992 are subject to the Regulation on the later of the effective date for noncollectively bargained plans or the date on which the last collective bargaining agreement terminates. Regulation § 2550.404c-l(g)(2). However, the Regulation also provides that transactions occurring prior to the Regulation's effective date are to be governed by Section 404(c) without regard to the Regulation. Regulation § 2550.404c-1(g)(3). This last provision is especially important because Section 404(c) refers explicitly to regulations promulgated by the DOL to determine whether relief is afforded to a particular transaction. Thus, absent Section 2550.404c-1(g)(3) of the Regulation, no relief would have been provided under Section 404(c) until the Regulation became effective. The effective date of the DOL's final regulation on QDIAs was December 24, 2007.

IV. REQUIREMENTS OF SECTION 404(C) UNDER THE REGULATION

A. *General Requirements for an ERISA Section 404(c) Plan.* Relief under the Regulation is provided to "ERISA section 404(c) plans." The Regulation provides generally that an "ERISA section 404(c) plan" is an individual account plan (described in Section 3(34) of ERISA) that (i) provides an opportunity for a participant to exercise control of the assets in his or her account; and (ii) provides a participant with the opportunity to choose to invest some or all of the assets in the account in a broad range of investment alternatives. Regulation § 2550.404c-l(b)(1).

B. *Opportunity to Exercise Control*. The following requirements must be met for a plan to be considered to provide a participant with the opportunity to exercise control over the assets in his or her account:

- The participant is provided with or has the opportunity to obtain sufficient information to make informed decisions on investments available under the plan; and

- The plan must provide the participant with a reasonable opportunity to give investment instructions to an identified plan fiduciary.

Regulation § 2550.404c-1(b)(l).

1. *Information Requirements of the Regulation*: The information requirements of the Regulation are perhaps its most significant focus. These requirements are also the primary focus of proposed amendments to the Regulation, which are part of a broader effort to establish a uniform disclosure framework for all participant-directed individual account plans. In order to achieve a uniform set of information requirements, the DOL has issued proposed regulations mandating that certain information be provided to participants in a participant-directed individual account plan, regardless of whether that plan is intended to be a Section 404(c) plan. Those requirements are now incorporated into the Regulation so that the information requirements for a Section 404(c) plan are largely the same as those for a non-Section 404(c) plan (with two additional Section 404(c) plan information requirements). Regulation § 2550.404c-l(b)(2)(B).

(i) *Required Information – Plan-related Information.* Information related to the plan that must be furnished to plan participants includes (i) on or before the date a participant is eligible for the plan (and within 30 days after any material change in such information) (a) an explanation of when the participant may give investment instructions, (b) an explanation of any specified limitations on such instructions, (c) a description of or reference to the plan provisions relating to the exercise of voting, tender and similar rights with respect to a designated investment alternative as well as any restrictions on such rights, (d) an identification of all designated investment alternatives, and (e) an identification of all investment managers; (ii) on or before the date a participant is eligible for the plan (and at least annually thereafter), an explanation of any fees and expenses for plan administrative services (*e.g.*, legal, accounting, recordkeeping) that may be charged to the plan and the basis on which such charges will be allocated (*e.g.*, pro rata, per capita) to a participant's account, (iii) at least quarterly, a statement including the dollar amount actually charged during the preceding quarter to a participant's account for administrative services and a description of the services provided for such amount, (iv) on or before the date a participant is eligible for the plan (and at least annually thereafter), an explanation of any fees and expenses that may be charged against a participant's account for services provided on an individual, rather than plan, basis (*e.g.*, fees for processing plan loans or qualified domestic relations orders, fees for investment advice or similar services charged on an individual basis); (v) at least quarterly, a statement including the dollar amount actually charged during the preceding quarter to a participant's account for individual services and a description of the services provided for such amount.

(ii) *Required Information – Investment-related Information.* Information related to the plan's investments that must be furnished to plan participants includes (i) on or before the date a participant is eligible for the plan (and at least annually thereafter), (a) the name of each designated investment alternative, (b) an Internet Web site address that is sufficiently specific to lead to supplemental information regarding the designated investment alternative including the name of the investment's issuer or provider, the investment's principal strategies and attendant risks, the assets comprising the investment's portfolio, portfolio turnover, performance, and related fees and expenses, (c) the type of category of the investment alternative (*e.g.*, money market fund, balanced fund), and (d) the type of management utilized by the investment alternative (*e.g.*, actively managed, passively managed); (ii) on or before the date a participant is eligible for the plan (and at least annually thereafter) for designated investment alternatives with a return that is not fixed (a) the average annual total return for 1-year, 5-year and 10-year periods, if available, (b) the name and returns of an appropriate broad-based securities market index over these same time periods, (c) a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future, (d) the amount and a description of each shareholder-type fee (*e.g.*, sales load, redemption fees, surrender charges), (e) the total annual operating expenses of the investment alternative expressed as a percentage (*e.g.*, expense ratio), and (f) a statement indicating that fees and expenses are only one of several factors that should be considered when making investment decisions; (iii) on or before the date a participant is eligible for the plan (and at least annually thereafter) for designated investment alternatives with a fixed return, (a) the fixed rate of return and the term of the investment, and (b) the amount and description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part; and (iv) subsequent to an investment in a designated investment alternative, any materials provided to the plan relating to the exercise of voting, tender and or similar rights with respect to such investment, to the extent that such rights are passed through to a participant.

(a) *Comparative Format.* This investment-related information must be provided in a chart or similar format that is designed to facilitate a comparison of such information for each designated investment alternative available under the plan and must also include (i) a statement indicating the name, address, and telephone number of the fiduciary to contact for information to be provided upon request (as further described below) and (ii) a statement that more current investment-related information may be available at the listed Internet Web site addresses.

(iii) *Required Information – Additional Section 404(c) Requirements*. Information that must be furnished to plan participants includes (i) an explanation that the plan is intended to be a Section 404(c) plan and that plan fiduciaries may be relieved of liability for losses that are the direct and necessary result of participant investment instructions and (ii) for investment alternatives that permit investment in employer securities, a description of the confidentiality procedures relating to the purchase, holding and sale of such securities and the exercise of voting, tender or other similar shareholder rights with respect to such securities, and the name, address and phone number of the plan fiduciary responsible for monitoring compliance with such procedures.

(iv) *Requested Information*: Information that need be provided only upon the request of a plan participant includes (i) copies of prospectuses for designated investment alternatives subject to either the Securities Act of 1933 or the Investment Company Act of 1940 (or similar document for an entity not registered under either of these Acts); (ii) copies of financial statements or reports relating to designated investment alternatives to the extent provided to the plan; (iii) a statement of the value of a share or unit of each designated investment alternative as well as the date of the valuation; and (iv) a list of the assets invested in each investment alternative that will constitute “plan assets” under applicable regulations promulgated by the DOL.

(v) *Consequences of Providing Information*: The Regulation provides explicitly that a fiduciary has no obligation to provide investment advice to plan participants, and the Preamble notes that the Regulation does not require plan sponsors “to bring participants and beneficiaries up to the level of financial expertise of the fiduciaries of the plan.” Regulation § 2550.404c-l(c)(4).

2. *Restrictions on Frequency of Investment Instructions*: Plans may impose reasonable restrictions on the frequency of participant investment instructions. A “reasonable” restriction permits participants to give instructions with a frequency that is appropriate considering the volatility of the investment alternative in question. Regulation § 2550.404c-1(b)(2)(ii)(C). In response to numerous comments on the March 1991 proposed regulations, the Regulation has made certain rules with respect to instruction frequency more liberal, especially where volatile investment alternatives are involved.

(i) *Diversified Investment Alternatives*: At least three of the diversified investment alternatives (described below at III.C.) must permit participants to give investment instructions to transfer funds among such alternatives at least once within any three-month period. Regulation § 2550.404c-1(b)(2)(ii)(C)(1).

(ii) *Volatile Investments*: The Regulation establishes special rules with respect to “volatile investment alternatives” (*i.e.*, those that permit transfers more frequently than every three months). The plan must permit participants to transfer volatile investments into one of the other diversified investment alternatives (for example, a money market account) at least as frequently as they may give instructions for the volatile alternative. Regulation § 2550.404c-1(b)(2)(ii)(C)(2)(ii). Alternatively, the plan may offer a low risk, liquid investment fund, sub-fund or account to accept transfers from volatile investment alternatives as frequently as they are permitted to give investment instructions with respect to each such volatile investment alternative and then permit transfer out of such fund, sub-fund or account to other investment alternatives as frequently as permitted under those alternatives. Regulation § 2550.404c-1(b)(2)(ii)(C)(3)(ii). It should be noted that if the most volatile investment alternative offered by a plan would, for example, require monthly investment instructions, permitting monthly movement of funds among all investment alternatives would satisfy this rule. Moreover, since this rule looks to the frequency with which participants may give investment instructions rather than to the underlying volatility of the investment alternative in question, a plan would create a greater transfer burden by allowing more frequent transfers than would be required solely on account of volatility. As a practical matter, the daily valuation and transaction processing of most plans has made compliance with the volatile investment rules automatic.

3. *Reasonable Charges for Implementing Instructions and Declining to Follow Instructions*: A plan will not fail to provide participants with a reasonable opportunity to give investment instructions if it imposes a reasonable fee for implementing such instructions. Regulation § 2550.404c-1(b)(2)(ii)(A). In addition, a fiduciary may decline to implement participant investment instructions where implementation would (i) result in the plan engaging in a prohibited transaction; (ii) generate income taxable to the plan; (iii) result in a transaction inconsistent with plan documents or ERISA; (iv) cause plan assets to be held outside of the United States; (v) jeopardize the plan's tax-qualified status; or (vi) result in a loss in excess of the participant's account balance. Regulation § 2550.404c-1W(b)(2)(ii)(B).

4. *Qualified Default Investment Alternatives.* A participant is treated as exercising control over the assets in his or her account, in the absence of an investment election by the participant, if such assets are invested by a fiduciary in a qualified default investment alternative (a "QDIA"). Accordingly, the fiduciary will be relieved of liability for any loss, or by reason of any breach, that occurs as a direct and necessary result of an investment in a QDIA. However, the fiduciary will not be relieved of the duty to prudently select and monitor any QDIA or from any liability resulting from failure to satisfy these duties, including liability for any resulting losses.

In order to qualify for such relief, the following six conditions must be satisfied:

- the assets invested on behalf of a participant must be invested in a QDIA;
- the participant must have had the opportunity to direct the investment of assets in his or her account but did not do so;
- the participant must receive an informational notice in advance of the first investment in the QDIA and annually thereafter;
- material, such as investment prospectuses, provided to the plan for the QDIA must be furnished to the participant;
- the participant must have the opportunity to direct investment out of the QDIA without penalty and as frequently as with other plan investments, but at least quarterly; and
- the plan must offer a "broad range of investment alternatives" as required in the Regulation (and as further described below).

Key to this relief is the requirement that the assets be invested in a QDIA, which is defined as an investment alternative that

- does not typically hold or permit the acquisition of employer securities;

- provides the opportunity to transfer out of the investment alternative without penalty and as frequently as from other plan investments, but at least quarterly;

- is (a) managed by an investment manager meeting the requirements of ERISA §3(38), a professional trustee or the plan sponsor (or a committee of the plan sponsor) that is a named fiduciary (b) a registered investment company under the Investment Company Act of 1940; and

- qualifies as one of three specified types of investment products consisting of a mix of equity and fixed income investments appropriate for the plan or the individual participant (either a balanced fund, a life-cycle or targeted-retirement-date fund or a managed account) or a specified type of principal preservation product or fund (which is available only for a maximum 120-day period in connection with eligible automatic contribution arrangements).

C. *Broad Range of Investment Alternatives*: To provide a "broad range of investment alternatives" a plan must allow participants to:

- affect materially the potential return on investments and the degree of risk to which such investments are subject;

- choose from at least three diversified investment alternatives, each of which has materially different risk and return characteristics and which, in the aggregate, allow for the creation of a portfolio with risk and return characteristics that fall within the range normally appropriate for the participant; and

- diversify investments so as to minimize the risk of large losses.

Regulation § 2550.404c-l(b)(3). An example in the Regulation suggests that if a plan offers an open-ended investment alternative, it is not necessary for the plan to provide three diversified investment alternatives. Regulation § 2550.404c-1(f), Example 1. In this example, a plan that offers investment alternatives of a diversified equity fund and "any other asset administratively feasible for the plan to hold" was found to meet the disclosure requirements of the Regulation; however, the investment alternatives used in the facts of the example suggest that the DOL regarded them as providing a broad range of investment alternatives.

1. *Look-Through Investment Alternatives*: If a plan offers "look-through" investment alternatives, the investments underlying the "look-through" alternative are considered in determining whether the above requirements are satisfied. Regulation § 2550.404c-1(b)(3)(ii).

The Regulation defines “look-through” investments to include mutual funds, common or collective trust funds and fixed rate investments offered by a bank or similar institution, pooled separate accounts or fixed rate investment contracts offered by insurance companies, and entities whose assets are plan assets. Regulation § 2550.404c-l(e)(1). In determining whether a plan provides a participant with a reasonable opportunity to diversify his or her investments, the nature of the alternatives offered by the plan and the size of a participant’s account must be considered. If the portion of a participant's account over which he or she exercises control is so small that diversification can be achieved only by providing “look-through” investment alternatives, a plan may satisfy the above diversification requirements only by offering such alternatives. Regulation § 2550.404c-1(b)(3)(i)(C).

D. *Special Rules for Employer Securities*: The Regulation provides Section 404(c) relief for investments in employer securities only if the employer security is a “qualifying employer security” publicly traded on a national exchange or other generally recognized market with sufficient frequency and in sufficient volume to assure that participant buy-sell orders could be acted upon promptly, and voting, tender and other shareholder rights are passed through to participants. Regulation § 2550.404c-l(d)(2)(ii)(E)(4). The Regulation requires that procedures be established to ensure confidentiality of information relating to participant directions concerning employer securities and the exercise of shareholder rights in connection with such securities. Regulation § 2550.404c-1(d)(2)(ii)(E)(4)(vii). In addition, a plan fiduciary must be appointed to ensure that such confidentiality procedures are adequate and to monitor compliance with them. Regulation § 2550.404c-1(d)(2)(ii)(E)(4)(viii). Finally, the Regulation requires that an independent fiduciary be appointed in circumstances where there is potential for undue employer influence upon plan participants. Regulation § 2550.404c-l(d)(2)(ii)(E)(4)(ix).

V. CONCLUSION

When the proposed Section 404(c) regulations were first issued in 1987, there was speculation that the investment alternatives mandated by the regulations would lead many employers sponsoring participant-directed account plans to forgo the protection afforded by Section 404(c). By contrast, the flexibility of the Regulation -- for example, defining required investment alternatives in terms of risk and return characteristics -- makes it likely that both institutional and in-house trustees of participant-directed account plans will require compliance with the Regulation as the only means for eliminating fiduciary liability for participant investment decisions.