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Self-Directed Retirement Plans: Fiduciary Liability under ERISA §404(c)

by Jeffrey DuFour, Stewart Frank, & Judson Sagers, Tillit Group LLC

In recent years, the trend in employee retirement plans has been to deemphasize defined benefit pension plans, and instead turn to defined contribution plans, which are often employee-directed. There are many reasons for this: increased turnover (and hence mobility) of employees, lower costs, and a greater desire on the part of employees to manage their own retirement. Employers were also anxious to make the move to defined contribution plans for reasons of their own: retirement plan cost controls and the perceived reduction in liability that would come from shifting responsibility to participants.

According to ERISA §404(c), the fiduciary of a retirement plan can indeed shift responsibility for investment decisions to employees, and if the rules are followed, the fiduciary can avoid liability for poor results. However, the rules are extremely complex and technical; *a small mistake can have severe consequences*. Some fiduciaries have discovered, too late, that they did not follow all the rules and are denied protection under §404(c), resulting in fiduciary liability for employees' poor investment decisions.

This paper will provide a brief overview of the 20 or so rules that fiduciaries need to follow to gain this limited protection. [Important disclaimer: Do not rely solely on this paper for advice in this matter. For specific advice, please consult with a competent ERISA attorney.] Following the overview will be a list of the rules themselves.

Most of these requirements revolve around three concepts: communication, control and diversification. First, all information that employees may reasonably need must be communicated to them in writing. This is a crucial prerequisite for an employee to be considered to have control. *There can be no control without information*. There can also be no control if the employee is under improper influence. This is why many fiduciaries refrain from providing investment advice to employees. There is no obligation under ERISA §404(c) to advise participants, and most plan sponsors draw the line at general investment education.

Even if the employees have enough information to make a free and rational decision, and are given the opportunity to exercise control, *they must still exercise control in fact, providing affirmative instructions to the plan administrator on how to invest the money.* Many fiduciaries assume that, if the employee does not provide instructions, the money

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can be put in a low-risk default account, thus relieving fiduciaries of any further responsibility. *This is not true.* If an employee has not made an affirmative election, there is no §404(c) protection, and the fiduciary retains responsibility to manage the assets prudently.

Certain responsibilities cannot be delegated to employees. First, the fiduciaries must select the investment options that will be offered in the plan. Because employees' choices are limited to the available funds in the plan, the selection of funds is a fiduciary act and requires due diligence. This means that plan sponsors must exercise prudence and skill in selecting investment options, remembering that they must be chosen solely in the interests of the participants. Choosing an investment manager or service provider on the basis of administrative convenience for the sponsor would be viewed as questionable at best. Also, making this choice to secure a more favorable line of credit for the sponsor would be a prohibited transaction. Furthermore, investments must be chosen to provide a broad range of investment alternatives, each with its own "materially different risk and return characteristics." In doing so, the participant, through diversification, can minimize the risk to the overall portfolio. Each investment, in turn, must be diversified in and of itself, so that participants are given the opportunity to minimize the risk of large losses. This is why employer securities cannot be offered in a §404(c) plan as one of the core investment alternatives intended to satisfy the regulations' broad-range requirement.

In addition, plan sponsors have an ongoing role under ERISA to monitor the performance of investment managers, comparing results against relevant benchmarks and peer groups. This is also a fiduciary function that cannot be ignored; §404(c) protection may disappear if a plan sponsor fails to monitor investment performance and other factors prudently, and when necessary, replace the investment manager with a more appropriate alternative. *Prudence is not a mind-set that can be set aside once investments are chosen; ongoing due diligence is critical in making sure each investment alternative remains a prudent option.*

The following pages are a summarized checklist of the rules under ERISA §404(c), which fiduciaries should review at least annually. For a complete description and exact language, please see the relevant section of the Code of Federal Regulations, and consult your ERISA attorney as necessary to ensure compliance.

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Annual ERISA §404(c) Checklist

§404(c) Requirements	Person Responsible	Completion Date	How Satisfied
Opportunity to Exercise Control 1. Participant has reasonable opportunity to give investment instructions to an identified plan fiduciary, who must comply with these instructions; 2. Participant is allowed to give investment instructions with a frequency which is appropriate in light of the market volatility of the investment alternative; for core alternatives which constitute a broad range (see below), no less frequently than once in any three-month period. ***Sufficient Information to Exercise Control*** Fiduciary must provide the following information to participants: 3. An explanation that the plan is intended to be a §404(c) plan, and that fiduciaries may be relieved of liability for investment decisions made by participants; 4. A description of the investment alternatives, their risk & return characteristics, and enough information to make an informed investment decision; 5. Identification of any designated investment managers; 6. An explanation of how to give investment instructions, and limitations on giving such instructions; 7. A description of any transaction fees or sales commissions/charges; 8. Name, address, and phone number of the plan fiduciary responsible for providing plan information; 9. For plans with a company stock investment option, a description of the procedures used to protect employee confidentiality;			

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§404(c) Requirements	Person Responsible	Completion Date	How Satisfied
10. For investment alternatives subject to the Securities Act of 1933, a copy of the most recent prospectus provided to the plan; 11. Materials provided to the plan relative to the exercise of voting, tender, or similar rights, to the extent such rights are passed through to participants. The fiduciary must provide the following information to participants, either directly or upon request. 12. A description of the annual operating expenses of each fund; 13. Copies of prospectuses and financial statements for each fund; 14. A list of the assets comprising the portfolio of each fund, and their value; 15. Current valuation of shares of each fund, and past and current investment performance, net of expenses; 16. Current valuation of shares of the funds held in the account of the participant. ***Broad Range of Investment Alternatives*** A plan must offer a broad range of investment alternatives sufficient to provide the participant with a reasonable opportunity to: 17. Materially affect the potential return on amounts in his/her individual account; 18. Choose from at least 3 investment alternatives, each of which is diversified, has materially different risk and return characteristics, enables the participant by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within a range appropriate for the participant;			

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§404(c) Requirements	Person Responsible	Completion Date	How Satisfied
19. Diversify his/her investment to minimize the risk of large losses when combined with investments in the other alternatives. ***Actual Exercise of Control*** 20. Whether the participant has exercised independent control is determined by the facts and circumstances. However, a participant's control is not independent if: a. The participant is subjected to improper influence by a plan fiduciary; b. A plan fiduciary has concealed material non-public facts regarding the investment from the participant (unless the disclosure would be a violation of law); or c. The Participant is legally incompetent and the fiduciary accepts investment instructions knowing him or her to be incompetent.			

<u>Fiduciary Responsibilities Still Retained by the Fiduciary</u>

Remember, even if fiduciaries set up a 401(k) plan for the employees, and are vigilant about complying with the requirements of ERISA §404(c), they still retain certain additional responsibilities that cannot be delegated, pursuant to §404(a). Thus, even with a 404(c) plan, the fiduciaries must:

1. Select investment options for the plan (whether mutual funds or otherwise) using appropriate quantitative and qualitative criteria by following a prudent due diligence process; and
2. Monitor the activities of the investment managers using appropriate quantitative and qualitative criteria to ensure that the investment remains a prudent option for the plan.

In fact, the Preamble to the final ERISA §404(c) regulations states, "the act of designating investment alternatives… is a fiduciary function." Hence, ERISA fiduciary standards apply "to both the initial designation of investment alternatives and investment managers and the ongoing determination that such alternatives and managers remain suitable and prudent investment alternatives for the plan. Therefore, the particular plan fiduciaries responsible for performing these functions must do so in accordance with ERISA."

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