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White paper

ERISA Section 404(c)

What you don't know could hurt you

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Introduction

There is a lot of talk about "404(c) plans" in today's defined contribution retirement plan world. The purpose of this white paper is to discuss in detail the structure of today's modern retirement plan (i.e., defined contribution with investments directed by the plan participants and their beneficiaries) and explain how, by following detailed rules set forth in Department of Labor ("DOL") regulations, plan fiduciaries may be able to transfer the liability for investment decisions made by participants and beneficiaries from the plan fiduciaries to the parties actually making the decisions.

Throughout the course of this white paper, the following terms have these meanings:

- "404(c) plan" is a retirement plan covered by ERISA (Employee Retirement Income Security Act of 1974) that meets the requirements of ERISA section 404(c), as interpreted by the 404c-1 regulations
- "404c-1 regulations" refer to 29 CFR § 2550.404c-1, et seq.
- "404a-5 regulations" refer to 29 CFR §2550.404a-5, et seq.

What is ERISA Section 404(c)?

ERISA section 404(c) applies to retirement plans and provides that, in the case of individual account plans which allow participants and beneficiaries (hereinafter collectively referred to as "participants") to direct the investment of the assets assigned to their accounts: (i) a participant is not deemed a fiduciary by reason of his or her exercise of control over the account; and (ii) no person who is otherwise a fiduciary will be liable under the ERISA fiduciary responsibility rules for any loss, or by reason of any breach, which results from the participant's exercise of control over his or her account.

The Department of Labor ("DOL") issued the 404c-1 regulations in 1992 implementing the ERISA section 404(c) requirements. As a result, today's typical defined contribution plan allows participants to direct the investment of the assets in their accounts and such plan usually attempts to comply with the 404c-1 regulations. It should be noted that, although ERISA does not require plans to comply with section 404(c), compliance with the regulations will help fiduciaries of individual account plans (such as 401(k) plans, profit sharing plans, and money purchase pension plans) to avoid liability for losses resulting from participants' exercise of control over their plan accounts.

Basic requirements of a 404(c) Plan

In order to be a plan that is afforded the protections of ERISA section 404(c) (i.e., a "404(c) plan"), the 404c-1 regulations provide that the plan must satisfy the following three basic requirements:

(1) it must be an individual account plan described in section 3(34) of ERISA. According to the preamble of the regulations, relief would

be available under ERISA section 404(c) for the individual account portion of a "hybrid" plan where the decisions of a participant can only affect the account of the directing participant, provided that the other conditions of the regulation are met. However, to the extent that a participant's investment decisions can affect the benefits which may be paid to others under the particular "hybrid" arrangement, ERISA section 404(c) relief would not be available;

(2) the plan provides an opportunity for a participant to exercise control over assets in his or her individual account; and

(3) the plan provides a participant an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his or her account are invested.

A detailed look at ERISA Section 404(c) compliance requirements

The DOL regulations' requirements for compliance with ERISA section 404(c) can be broadly grouped into three categories: (i) participants' exercise of meaningful control over their respective accounts; (ii) participants' ability to choose from among a group of broad-based investment options; and (iii) plan fiduciaries' furnishing specific disclosure and investment information to participants.

Participants' exercise of meaningful control

Participants must have a reasonable opportunity to provide investment instructions for their accounts. They must also, in fact, provide such instructions. Liability for investment decisions made by participants only transfers to the participants from the plan fiduciaries if the participants are considered as being able to exercise meaningful control over their accounts.

To be considered as having an opportunity to exercise control of his or her account: (i) the participant must have a reasonable opportunity to give investment instructions (in writing or otherwise, with opportunity to obtain written confirmation of such instructions) to an identified plan fiduciary who is generally obligated to comply with such instructions; and (ii) the participant must be provided, or have the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives available under the plan.[1]

A fiduciary may decline to implement instructions from participants without obviating a participant's exercise of control if implementation: (i) would result in a prohibited transaction described in ERISA section 406 or Internal Revenue Code ("Code") section 4975; and/or (ii) would generate income that would be taxable to the plan. A fiduciary may also decline to implement instructions which, if implemented: (i) would not be in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Title I of ERISA; (ii) would cause a fiduciary to maintain the indicia of ownership of any assets of the plan outside the jurisdiction of the district courts of the United States other than as permitted by section 404(b) of ERISA and 29 CFR §2550.404b-1; (iii) would jeopardize the plan's tax qualified status under the Code; and/or (iv) could result in a loss in excess of a participant's account balance.[2]

Group of broad-based investment options

The general rule regarding investment options is that participants must be able to choose from a variety of investment options, and to make changes to their investments frequently. They must be able to choose from a range of investment alternatives that is: (i) broad enough to allow their investment choices to materially affect their potential return; and (ii) adequately diversified, with materially different risk and return characteristics, to allow them to achieve a balanced portfolio. The regulations define a "designated investment alternative" as a specific investment identified by a plan fiduciary as an available investment alternative under the plan.

Here is what the regulations say about what constitutes a "broad range" of investment alternatives[3]:

(1) there must be at least three designated investment alternatives from which participants may select;

(2) each of the designated investment alternatives must be diversified;

(3) taking into account all of the funds that constitute designated investment alternatives, the participant, by choosing among them, must be able to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the affected participant;

(4) each of the designated investment alternatives, when combined with other investments available to participants, tends to minimize through diversification the overall risk of a participant's portfolio;

(5) in determining whether a plan provides a participant with a reasonable opportunity to diversify his or her investments, the nature of the investment alternatives offered by the plan and the size of the portion of the individual's account

over which investment discretion is exercised must be considered; and

(6) if the investment lineup is restricted such that the participants cannot adequately diversify, the plan fiduciary in charge of constructing the designated investment alternatives must add look-through investments (i.e., mutual funds) in order to achieve adequate diversification.

Specific disclosure and investment information

Plan fiduciaries must provide specific disclosures and sufficient investment information to participants to allow them to make informed investment decisions. Certain information must be provided automatically and other information must either be provided automatically or upon request.

A plan fiduciary must automatically provide the following information to participants[4]:

(1) a statement that the plan is intended to constitute an ERISA 404(c) plan, and an explanation of what that means;

(2) the information required by 29 CFR §2550.404a-5, which includes a description of the investment alternatives available under the plan, including the risk and return characteristics of each alternative, and the type of assets and diversification of assets comprising each alternative;

(3) a description of the annual operating expenses of each designated investment alternative (for example, investment management fees, administrative fees, transaction costs) that reduce the rate of return to the participants, and the aggregate amount of such expenses, expressed as a percentage of average net assets of the designated investment alternative;

(4) identification of any designated investment managers;

(5) information regarding submission of investment instructions and the exercise of voting or tender rights, or any similar rights, applicable to the investments selected by the participant;

(6) a description of any transaction fees or expenses that affect the participant's account balance in connection with the purchases or sales of investment alternatives (for example, commissions, sales loads, deferred sales charges, redemption or exchange fees);

(7) a description of the additional information that is available to the participant upon request and the name, address, and phone number of the plan fiduciary responsible for providing that information;

(8) if the plan offers an investment alternative which is designed to permit a participant to directly or indirectly acquire or sell any employer security, a description of the procedures established to provide for the confidentiality of (i) information relating to the purchase, holding and sale of employer securities, and (ii) the exercise of voting, tender and similar rights, by participants, and the name, address and phone number of the plan fiduciary responsible for monitoring compliance with the procedures. The final regulation eliminated the requirement that an independent fiduciary must be responsible for activities relating to employer securities, except in situations which involve a potential for undue employer influence;

(9) information as to the past and current performance of investment alternatives available to participants; and

(10) subsequent to an investment in an investment alternative, any materials provided to the plan relating to the exercise of voting, tender or similar rights, to the extent that such rights are passed through to participants under the terms of the plan, and a description of or reference to plan provisions relating to such rights.

Plan fiduciaries must provide the following information to participants automatically or upon request[5]:

(1) copies of any prospectuses, financial statements and reports, and other information provided to the plan, relating to an investment alternative;

(2) portfolio composition information for plan assets;

(3) information about the value of shares or units available to participants and held in a participant's account; and

(4) in the case of an investment alternative which is subject to the Securities Act of 1933, immediately prior to or following the participant's initial investment, a copy of the most recent prospectus provided to the plan. In Adv. Op. No. 2003-11A, DOL ruled that a plan may provide participants with a special summary of a mutual fund's prospectus (called a "profile") instead of the prospectus in certain circumstances and still be eligible for ERISA section 404(c) protection.

Qualified Default Investment Alternatives (“QDIAs”)

In the case of a plan that allows participants to direct the investment of assets allocated to their accounts, how does the plan fiduciary deal with the situation where one or more participants fail(s) to provide investment direction? The plan fiduciary can, in the absence of appropriate investment direction from the participants, automatically invest the affected participants’ assets in qualified default investment alternatives (“QDIAs”) and effectively transfer the liability for such investment decision to the affected participants, provided the requirements of 29 CFR 2550.404c-5 are satisfied.

In general — Fiduciary relief

A participant in an individual account plan will be treated as exercising control over the assets in his or her account for purposes of ERISA section 404(c)(1) with respect to the amount of contributions and earnings that, in the absence of an investment election by the participant, are invested by the plan in accordance with the regulations on QDIAs. The regulations provide that a fiduciary of an individual account plan that permits participants to direct the investment of assets in their accounts and that meets the conditions of the regulations shall not be liable for any loss, or by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of: (i) investing all or part of a participant’s account in any QDIA; or (ii) investment decisions made by an ERISA section 3(38) investment manager in connection with the management of a QDIA.[6]

No relief from normal fiduciary duties

Nothing in the QDIA regulations relieves a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any QDIA under the plan or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. Likewise, there is no relief under the QDIA regulations for any ERISA section 3(38) investment manager from its fiduciary duties under part 4 of title I of ERISA or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. Finally, nothing in the QDIA regulations provides relief from the prohibited transaction provisions of section 406 of ERISA, or from any liability that results from a violation of those provisions, including liability for any resulting losses.[7]

Conditions of fiduciary relief applicable to QDIAs

In order for a plan fiduciary to obtain relief from liability for investing a participant’s assets in a QDIA when a participant fails to provide investment direction, eight general conditions must be met[8]:

(1) the affected assets must be invested in a QDIA, within the meaning of the regulations;

(2) the participant on whose behalf the investment is made had the opportunity to direct the investment of the assets in his or her account but did not provide investment direction for the assets;

(3) the participant on whose behalf an investment in a QDIA may be made is furnished a notice that meets the requirements of the regulations and in accordance with the following timelines: (i) (A) at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the date of any first investment in a QDIA on behalf of a participant, or (B) on or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal under the rules pertaining to the withdrawals from automatic contribution arrangements; and (ii) within a reasonable period of time that is at least 30 days in advance of each subsequent plan year;

(4) the plan fiduciary provides to the affected participants an explanation that the plan constitutes a 404(c) plan and that the plan fiduciaries may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by the participant, which, in the case of a participant who fails to give investment instructions, will be the default into the QDIA;

(5) any participant on whose behalf assets are invested in a QDIA may transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant who elected to invest in the QDIA, but not less frequently than once within any three-month period;

(6) a participant’s transfer out of the QDIA within the first 90 days after the investment is made must be without any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment); however, the foregoing shall not apply to fees and expenses that are charged on an ongoing basis for the operation of the investment itself (such as investment management fees, distribution and/or service fees, "12b-1" fees, or legal, accounting, transfer agent and similar administrative expenses), and are not imposed, or do not vary, based on a participant’s decision to withdraw, sell or

transfer assets out of the qualified default investment alternative;

(7) following the end of the 90-day period described in paragraph (6), any transfer or permissible withdrawal may not be subject to any restrictions, fees or expenses not otherwise applicable to a participant who elected to invest in that QDIA; and

(8) the plan offers a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).

QDIA notice to participants

The regulations require that the QDIA notice shall be written in a manner calculated to be understood by the average plan participant and contain the following elements[9]:

(1) a description of the circumstances under which assets in the individual account of a participant may be invested on behalf of the participant in a QDIA; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);

(2) an explanation of the right of participants to direct the investment of assets in their individual accounts;

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

(4) a description of the right of the participants on whose behalf assets are invested in a QDIA to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and

(5) an explanation of where the participants can obtain investment information concerning the other investment alternatives available under the plan.

Qualified Default Investment Alternative ("QDIA") defined

To be a QDIA, an investment alternative must satisfy many detailed requirements, summarized as follows.[10]

1. Generally — no employer securities. The alternative does not hold or permit the acquisition of employer securities, except for: (i) employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof; or (ii) employer securities acquired as a matching contribution from the employer/plan sponsor, or employer securities acquired prior to management by the investment management service, to the extent the investment management service has discretionary authority over the disposition of such employer securities, provided the QDIA is a managed account.

2. Ability of a participant to transfer. The alternative satisfies the requirements of the regulations regarding the ability of a participant to transfer, in whole or in part, his or her investment from the QDIA to any other investment alternative available under the plan.

3. The investment alternative is, alternatively: (i) managed by — (A) an investment manager, within the meaning of ERISA section 3(38); (B) a trustee of the plan that meets the requirements of ERISA section 3(38)(A), (B) and (C) [i.e., one who has the power to acquire or dispose of any asset, is a registered investment advisor, and has acknowledged its fiduciary status in writing]; or (C) the plan sponsor, or a committee comprised primarily of employees of the plan sponsor, which is a named fiduciary within the meaning of ERISA section 402(a)(2); (ii) an investment company registered under the Investment Company Act of 1940; or (iii) an investment product or fund designed to preserve principal in accordance with the regulations, which state that such a fund constitutes a QDIA for no more than 120 days after the date of a participant's first elective contribution or to which all investments therein were made prior to December 24, 2007.

4. The investment alternative constitutes one of the following.

a. "Life-cycle" or "targeted-retirement-date" fund or account. This alternative is an investment fund product or model portfolio that

applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that 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 products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. The regulations specify that asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant.

b. A balanced fund. This alternative consists of an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that 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. The regulations state that asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant.

c. A managed account. Another alternative is an investment management service with respect to which a fiduciary, applying generally accepted investment theories, allocates the assets of a participant's individual 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 (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. The regulations provide that asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant.

d. Preservation of principal: 120-day fund. This alternative is an investment product or fund designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. Such investment product shall seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product and be offered by a State or federally regulated financial institution. Such an investment product will constitute a QDIA for not more than 120 days after the date of the participant's first elective contribution. In other words, this is a temporary holding account.

e. Preservation of principal: pre-December 24, 2007 fund. This particular preservation of principal option applies solely for purposes of assets invested in such product or fund before December 24, 2007. This option is an investment product or fund designed to preserve principal; provide a rate of return generally consistent with that earned on intermediate investment grade bonds; and provide liquidity for withdrawals by participants, including transfers to other investment alternatives. Such investment product or fund must provide that there are no fees or surrender charges imposed in connection with withdrawals initiated by a participant and that such investment product or fund invests primarily in investment products that are backed by State or federally regulated financial institutions.

f. Variable annuity contracts, collective trust funds, and pooled accounts. An investment fund product or model portfolio that otherwise meets the regulatory requirements will not fail to constitute a life-cycle, targeted retirement date, or balanced fund solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio.

Blackout periods

<u>In general</u>

The ERISA section 3(16) administrator of an individual account plan must provide notice of any blackout period to all participants whose rights under the plan will be temporarily suspended, limited, or restricted by the blackout period and to issuers of employer securities subject to such blackout period. Thus, the administrator of a plan that allows participants to direct the investment of the assets in their accounts must be aware of the rules pertaining to blackout periods when changing the investment lineup available to participants.[11]

<u>“Blackout period” defined</u>

The term "blackout period" means, in connection with an individual account plan, any period for which any ability of participants under the plan, which is otherwise available under the terms of such plan, to direct or diversify assets credited to their accounts, to obtain loans from the plan, or to obtain

distributions from the plan is temporarily suspended, limited, or restricted, if such suspension, limitation, or restriction is for any period of more than three consecutive business days[12].

The term "blackout period" does not include a suspension, limitation, or restriction which occurs by reason of:

(1) the application of the securities laws;

(2) a regularly scheduled suspension, limitation, or restriction under the plan (or change thereto), provided that such suspension, limitation or restriction (or change) has been disclosed to affected plan participants through the summary plan description, a summary of material modifications, materials describing specific investment alternatives under the plan and limits thereon or any changes thereto, participation or enrollment forms, or any other documents and instruments pursuant to which the plan is established or operated that have been furnished to such participants and beneficiaries;

(3) a qualified domestic relations order or by reason of a pending determination (by the plan administrator, by a court of competent jurisdiction or otherwise) whether a domestic relations order filed (or reasonably anticipated to be filed) with the plan is a qualified order within the meaning of ERISA section 206(d)(3)(B)(i); or

(4) an act or a failure to act on the part of an individual participant or by reason of an action or claim by a party unrelated to the plan involving the account of an individual participant.

Notice to participants of the blackout period

The regulations provide a model notice that administrators may use to notify participants of any blackout periods.[13] Following is a listing of the regulatory content of the required notice, for those administrators who choose not to avail themselves of the model notice.

1. Content. The notice of the blackout period required by the regulations must be written in a manner calculated to be understood by the average plan participant and must include the following information[14]:

a. the reasons for the blackout period;

b. a description of the rights otherwise available to participants under the plan that will be temporarily suspended, limited or restricted by the blackout period (e.g., right to direct or diversify assets in individual accounts, right to obtain loans from the plan, right to obtain distributions from the plan), including identification of any investments subject to the blackout period;

c. the length of the blackout period by reference to: (i) the expected beginning date and ending date of the blackout period; or (ii) the calendar week during which the blackout period is expected to begin and end, provided that during such week's information as to whether the blackout period has begun or ended is readily available, without charge, to affected participants and beneficiaries, such as via a toll-free number or access to a specific web site, and the notice describes how to access the information;

d. in the case of investments affected, a statement that the participants should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets in their accounts during the blackout period;

e. in any case in which the required notice is not furnished at least 30 days in advance of the last date on which affected participants could exercise affected rights immediately before the commencement of the blackout period (except for a notice involving a blackout period that applies only to one or more participants solely in connection with their becoming, or ceasing to be, participants of the plan as a result of a merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor), the participants shall be provided: (i) a statement that Federal law generally requires that notice be furnished to affected participants at least 30 days in advance of the last date on which participants could exercise the affected rights immediately before the commencement of a blackout period, and (ii) an explanation of the reasons why at least 30 days advance notice could not be furnished; and

f. the name, address and telephone number of the plan administrator or other contact responsible for answering questions about the blackout period.

2. Timing. The delivery of the notice is subject to the following requirements[15]:

a. the notice of the blackout period must be furnished to all affected participants at least 30 days, but not more than 60 days, in advance of the last date on which such participants could exercise the affected rights immediately before the commencement of any blackout period;

b. the requirement to give at least 30 days advance notice does not apply in the following cases: (i) a deferral of the blackout period in order to comply with the advance notice requirements would result in a violation of the

requirements of ERISA section 404(a)(1)(A) or (B), and a fiduciary of the plan reasonably so determines in writing; (ii) the inability to provide the advance notice of a blackout period is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator, and a fiduciary of the plan reasonably so determines in writing; or (iii) the blackout period applies only to one or more participants solely in connection with their becoming, or ceasing to be, participants of the plan as a result of a merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor;

c. in any case in which the 30-day advance notice requirement does not apply, the administrator has to furnish the notice of the blackout period to all affected participants as soon as reasonably possible under the circumstances, unless such notice in advance of the termination of the blackout period is impracticable.

3. Form and manner of furnishing notice. The notice of the blackout period must be in writing and furnished to affected participants in any manner consistent with the requirements of 29 CFR §2520.104b-1, including the portion thereof relating to the use of electronic media.[16]

4. Changes in length of blackout period. If, following the furnishing of a notice of a blackout period, there is a change in the length of such period, the administrator must furnish all affected participants an updated notice explaining the reasons for the change and identifying all material changes in the information contained in the prior notice. Such notice of any change in the length of the blackout period must be furnished to all affected participants as soon as reasonably possible, unless such notice in advance of the termination of the blackout period is impracticable.[17]

Notice to an issuer of employer securities

If the plan holds employer securities, the administrator must furnish a special notice of a blackout period to the issuer of such securities and include such information as is specified in the regulations. Because this is a specialized situation, details of such notice requirements are not included herein; please refer to 29 CFR §2520.101-3(c) for the information to be provided.[18]

Fund mapping — Qualified change in investment options

Suppose the affected plan fiduciary wants to change out certain funds in the core fund lineup; i.e., make changes to the designated investment alternatives available to the participants for their investment direction. Usually, this is done by a fund mapping process that is triggered by a change in the performance of the affected fund or because of some other factor inherent in the plan's investment policy statement. For whatever reason, the plan fiduciary determines that Fund A needs to be replaced with Fund B, which is the same category, class, and type of fund as Fund A. In the course of the mapping process, the plan fiduciary will provide the appropriate blackout notices and then begin the process of moving (sometimes referred to as "mapping") all the participant accounts that are invested in Fund A to Fund B.

Some questions arise when this process is contemplated. First of all, what rights do the participants have? Are they forced to accept the migration dictated by the plan fiduciary out of Fund A (which they may like) and into Fund B? Secondly, is the right to a particular form of investment a protected benefit within the meaning of Code section 411(d)(6) and 26 CFR §1.411(d)-4? If it is a protected benefit, then participants may not be forced to migrate from Fund A to Fund B. Finally, how does the migration from Fund A to Fund B affect the protections for the fiduciaries under the 404c-1 regulations?

To answer those questions, we first need to examine ERISA section 404(c)(4) which describes a "qualified change in investment options." In typical ERISA double-speak, section 404(c)(4)(A) says: "In any case in which a qualified change in investment options occurs in connection with an individual account plan, a participant or beneficiary shall not be treated for purposes of paragraph (1) as not exercising control over the assets in his account in connection with such change if the requirements of subparagraph (C) are met in connection with such change." Translated, it means that if the fund mapping process constitutes a "qualified change in investment options," then the 404c-1 fiduciary protections remain intact. If the fund mapping process does not constitute a "qualified change in investment options," then the 404c-1 fiduciary protections are lost for the mapped funds.

The statute defines the term "qualified change in investment options" as a change in the investment options offered to the participant under the terms of the plan, under which: (i) the account of the participant is reallocated among one or more remaining or new investment options which are offered in lieu of one or more investment options offered immediately prior to the effective date of the change; and (ii) the stated characteristics of the remaining or new investment options provided under clause (i), including characteristics relating to risk and rate of return, are, as of immediately after the change, reasonably similar to those of the existing investment options as of immediately before the change.

There are certain administrative requirements that must be met in order for a change in investment options to constitute a “qualified change in investment options,” as follows[19]:

(1) at least 30 days and no more than 60 days prior to the effective date of the change, the plan administrator must furnish written notice of the change to the participants, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant or beneficiary to the contrary, the account of the participant will be invested, in the manner described above as a qualified change in investment options;

(2) after receiving the notice, the participant cannot have provided to the plan administrator, in advance of the effective date of the change, affirmative investment instructions contrary to the change; and

(3) lastly, the investments under the plan of the participant as in effect immediately prior to the effective date of the change were the product of the exercise by such participant of control over the assets of the account.

Here is what we know, then, about the impact of a “qualified change in investment options” on participants and plan fiduciaries:

(1) a participant does not have a right to maintain his or her investment in the fund that the plan fiduciary is replacing. However, a participant does have the right to direct that his or her investment in the fund that is being replaced be transferred to another fund that is a designated investment alternative (and not the fund or funds into which participants' investments are being mapped);

(2) IRS regulations [26 CFR §1.411(d)-4] provide that benefits that are not protected under Code section 411(d)(6) from reduction or elimination include the right to direct investments and the right to a particular form of investment, to include employer stock or securities, or investment in certain types of securities, commercial paper, or other investment media; and

(3) if the fund mapping constitutes a “qualified change in investment options,” then the participants shall not be treated as not exercising control over the assets in their accounts in connection with the change. Because the participants will be treated as continuing to exercise control over their accounts, the plan fiduciaries retain the 404c-1 fiduciary protection notwithstanding the fact that one or more funds constituting designated investment alternatives were swapped.

Fiduciary aspects of Section 404(c) compliance

Impact of the section 404a-5 regulations

The DOL issued the 404a-5 regulations on October 20, 2010, that impose an affirmative fiduciary duty on administrators of individual account plans that allow participants to direct the investment of assets allocated to their respective accounts. These regulations generally apply as of the later of August 30, 2012 or 60 days after the first day of the first plan year beginning on or after November 1, 2011. A full discussion of the content of these 404a-5 regulations is beyond the scope of this white paper, but it is important to point out the impact that these regulations have on the fiduciary aspects of 404(c) plan compliance.

First of all, compliance with the 404a-5 regulations is not voluntary, as is the case with the 404c-1 regulations. The 404a-5 regulations require the ERISA Section 3(16) plan administrator to furnish certain plan-related and investment-related information to participants in plans that allow participants to direct the investment of assets in their account, to include information on fees and expenses, as well as investment performance information. The 404c-1 regulations specifically require that, in order for a fiduciary to avail himself or herself of the benefits of the relief found in the 404c-1 regulations, such fiduciary must automatically provide to the participants all the information required under the 404a-5 regulations. Receipt of such information by participants is a precondition of the participants' exercise of control over their accounts.

Designated investment alternatives (“DIAs”)

The act of designating investment alternatives for participants to select is a fiduciary act. The 404c-1 regulations define a “designated investment alternative” as a specific investment identified by a plan fiduciary as an available investment alternative under the plan. The 404a-5 regulations define a “designated investment alternative” as any investment alternative designated by the plan into which participants may direct the investment of assets held in, or contributed to, their individual accounts. The 404a-5 regulations go on to say that the term "designated investment alternative" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants to select investments beyond those designated by the plan. The 404c-1 regulations specify that there must be a minimum of three broadly-diversified investment alternatives available to participants for them to be considered as having exercised control. Prudence would suggest that the trustee or named fiduciary tasked

with selecting the designated investment alternatives consider more than three investment alternatives, so as to make available to participants a meaningful lineup from which they can select investments.

Brokerage windows or fund windows

Today's typical defined contribution plan design includes a group of investments that are "designated investment alternatives" as well as additional investment opportunities that are accessed by means of a fund window (additional mutual funds) or a brokerage window (additional mutual funds and stocks, bonds, ETFs, etc.). Sometimes funds that are "designated investment alternatives" are referred to as the "core fund lineup." The requirements of ERISA section 404(c) must be able to be satisfied by looking only at the designated investment alternatives (i.e., the "core fund lineup"). In other words, plan fiduciaries cannot successfully transfer liability for investment decisions to the participants if the participants must go to the fund window or the brokerage window in order to find a broad range of investment alternatives.

The DOL has released Field Assistance Bulletin ("FAB") 2012-02R, in which it addresses the issue of brokerage windows and whether they are considered to be designated investment alternatives. This FAB is a revision of FAB 2012-02, in which FAQ 30 was replaced by FAQ 39. FAQ 39 now simply asks whether a platform, brokerage window or similar arrangement is a DIA for purposes of the regulation. In answering "No," the FAB states that whether an investment is a "designated investment alternative" will depend on whether it is specifically identified as available under the plan. The DOL indicates that the FAB does not prohibit the use of a platform, brokerage window or self-directed brokerage account, nor does the regulation mandate that a plan have a particular number of DIAs. There is, however, a fiduciary obligation to designate investment alternatives so that the plan participants can choose from a broad range of investment alternatives without having to go to the fund window or brokerage window.

The DOL states in its FAQ 39: "[A] plan fiduciary's failure to designate investment alternatives, for example, to avoid investment disclosures under the regulation, raises questions under ERISA section 404(a)'s general statutory fiduciary duties of prudence and loyalty."

FAB 2012-02R, FAQ 39 also indicates that there may still be questions about a plan fiduciary's responsibilities with regard to brokerage windows and similar arrangements. According to FAQ 39: "The Department intends to engage in discussions with interested parties to help determine how best to assure compliance with these duties in a practical and cost-effective manner, including, if appropriate, through amendments of relevant regulatory provision and that it plans to engage in discussions with interested parties to decide how to proceed."

Bottom line — a brokerage window or fund window can be a useful addition to a plan's investment menu, but they cannot satisfy the fiduciary duties that attach to designating a plan's investment lineup in such a way that participants will be deemed to have exercised control over their accounts under the 404c-1 regulations.

Observations — Responsibility for investment of plan assets

For today's defined contribution plan universe, there are four basic structures in terms of investing the plan's assets. Each fiduciary charged with the responsibility of investing or supervising the investment of the plan's assets will need to consider which structure is best for the affected plan and its participants. Following are some observations that may help the reader in analyzing an appropriate investment structure.

Trustee-directed plans

Prior to the release of the 404c-1 regulations in 1992, it was much more common to find defined contribution plans that had pooled accounts with the investments therein directed by the plan's trustee(s). Oftentimes, trustee(s) would engage a fiduciary investment advisor [ERISA Section 3(21)(A)(ii)] to assist the trustee with the selection of the investments in the pooled account. Even today, some defined contribution plans continue to use this approach to the investment of the plan's assets because, for some fiduciaries, it is deemed to be easier to comply with the various fiduciary rules associated with investment of plan assets than it is to allow participants to direct their own investments in a manner that will successfully transfer liability to the participant. A trusteed-directed approach is also indicated when the employees of a particular employer lack the financial sophistication necessary to make prudent investment selections, even with all the information that is required to be distributed to them about their investment choices.

ERISA Section 3(38) investment manager

When a named fiduciary or trustee does not want to assume the full fiduciary responsibility for investment of the plan's assets, such fiduciary can hire an ERISA section 3(38) investment manager to handle the investment of the plan's assets. Whichever fiduciary (i.e., named fiduciary or trustee) hires the investment manager, such fiduciary will be responsible for prudently selecting and monitoring the investment manager, but will not be liable for the investment decisions actually made by the investment manager. Plan fiduciaries will usually hire

investment managers if they want to transfer liability for the actual investment decisions from themselves to the investment manager and if they seek professional asset management to possibly improve the investment outcomes of plan participants.

Participant investment direction with Section 404(c) compliance

The preceding sections of this white paper have laid out in great detail the requirements necessary to achieve full compliance with the 404c-1 regulations and thereby transfer the liability for the investment decisions made by participants with respect to the assets in their accounts from the plan fiduciaries to the affected participants. When plan fiduciaries consider whether to allow participants to direct the investment of assets allocated to their accounts in accordance with the 404c-1 regulations, they should keep in mind the preamble to the 404c-1 regulations wherein it states that the requirements of 29 CFR 2550.404c-1 are not a safe harbor, but are the exclusive means of complying with ERISA section 404(c). This means that a fiduciary seeking the protections of ERISA section 404(c) must comply with all of the regulatory requirements in order to assure that protection. If there is a failure, in any given case, to comply with all of the requirements of the 404c-1 regulations, the affected fiduciaries open themselves up to personal liability for losses sustained by participants as a consequence of their own directed investments. That being said, fiduciaries are not subject to any penalty in addition to applicable fiduciary liability for the failure to have complied with all the requirements found in the 404c-1 regulations.

Participant investment direction without Section 404(c) compliance

What if the plan fiduciaries want to allow participants to direct their own investments and either intentionally or inadvertently fail to comply with the 404c-1 regulations? At least one case at the federal appeals court level has considered that question. In *Jenkins v. Yager*, CA-7 (2006), 444 F.3d 916, one of the issues that the Seventh Circuit Court of Appeals considered was whether plan fiduciaries committed a breach of fiduciary duty by allowing participants to direct the investment of assets in their accounts outside of the protections of the 404c-1 regulations. Following are relevant sections of the court's opinion.

> "Although section 404(c) and its accompanying regulation, 29 C.F.R. § 2550.404c-1, create a safe harbor for a trustee, we see no evidence that these provisions necessarily are the only possible means by which a trustee can escape liability for participant-directed plans. As 29 C.F.R. § 2550.404c-1(a)(2) states: 'The standards set forth in this section are applicable solely for the purpose of determining whether a plan is an ERISA 404(c) plan and whether a particular transaction engaged in by a participant or beneficiary of such plan is afforded relief by section 404(c). Such standards, therefore, are not intended to be applied in determining whether, or to what extent, a plan which does not meet the requirements for an ERISA 404(c) plan or a fiduciary with respect to such a plan satisfies the fiduciary responsibility or other provisions of Title I of the Act.' The Department of Labor also has stated that, for plans that do not meet the regulatory definition of a section 404(c) participant-directed plan, "noncomplying plans do not necessarily violate ERISA; noncompliance merely results in the plan not being accorded the statutory relief described in section 404(c). Final Regulation Regarding Participant Directed Individual Account Plans (ERISA section 404(c) Plans), 57 Fed. Reg. 46,906, 46,907 (Oct. 13, 1992)."
>
> "Therefore, we agree with the district court and believe that the statute, when read as a whole along with the accompanying regulations, permits a plan trustee to delegate decisions regarding the investment of funds to plan participants even if the plan does not meet the requirements for the section 404(c) safe harbor. Therefore, there is an "implied exception" to sections 403 and 405 for participant-directed plans, allowing plan participants to direct the investment of their own plan funds. If a participant-directed plan does not meet the conditions set forth in 29 C.F.R. § 2550.404c-1(b), the plan trustee and fiduciaries simply do not receive the benefits of section 404(c), and they are not shielded from liability for losses or breaches of duty which result from the plan participant's exercise of control. It does not necessarily mean that such a plan violates ERISA; instead, the actions of the plan trustee, when delegating decision-making authority to plan participants, must be evaluated to see if they violate the trustee's fiduciary duty."

Bottom Line — a plan fiduciary may allow participants to direct the investment of assets in their respective accounts without complying with the 404c-1 regulations and, in so doing, will not necessarily commit a fiduciary breach. However, such plan fiduciary will not enjoy the relief from liability for investment decisions made by participants that comes with compliance with the 404c-1 regulations.

Checklist for ERISA Section 404(c) compliance

Following is a checklist the author devised based on the 404c-1 regulations and the impact of the 404a-5 regulations thereon. One can glean three basic compliance points and 41 detailed requirements from this checklist. So as to facilitate ease of use, the detailed requirements have been numbered consecutively.

Summary of general requirements for a 404(c) plan

In general, a plan claiming to be a 404(c) plan must meet these basic requirements: (i) the plan is an individual account plan described in Section 3(34) of ERISA; (ii) each participant has the opportunity to exercise control over assets in his or her individual account; and (iii) each participant has an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his or her account are invested.

Detailed requirements for a 404(c) plan

Does the participant have a reasonable opportunity to give investment instructions?

1. Each participant has been provided with information as to how to give those instructions.
2. Each participant has the opportunity to give the investment instructions in writing or otherwise, with opportunity to obtain written confirmation of such instructions.
3. Each participant has been given the name and contact information of an identified plan fiduciary who is generally obligated to comply with the participant's investment instructions.
4. Has the participant been provided, or has had the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives available under the plan?
5. Has a fiduciary reviewed investment instructions received from each participant and determined whether they could be legally implemented? If not, has the fiduciary declined to implement them if certain conditions are met?
6. Has the fiduciary arranged for at least three broadly-diversified designated investment alternatives from which participants may select?
7. Has the fiduciary reviewed each of the designated investment alternatives to determine whether they are adequately diversified?
8. Has the fiduciary evaluated all of the funds that constitute designated investment alternatives to determine whether the participant, by choosing among them, would be able to achieve a portfolio with aggregate risk and return characteristics at any point with the range normally appropriate for the affected participant?
9. Has the fiduciary made a determination that each of the designated investment alternatives, when combined with other investments available to participants, tends to minimize through diversification the overall risk of a participant's portfolio?
10. In determining whether a plan provides a participant with a reasonable opportunity to diversify his or her investments, has the fiduciary considered the nature of the investment alternatives offered by the plan and the size of the portion of each participant's account over which investment discretion is exercised?
11. Does the investment lineup contain look-through investments (i.e., mutual funds) in order to achieve adequate diversification or has the fiduciary made a determination that adequate diversification exists in the designated investment alternatives without having to utilize look-through investments?

Has a plan fiduciary automatically provided the following information to participants?

12. A statement that the plan is intended to constitute an ERISA 404(c) plan, and an explanation of what that means.
13. The information required by 29 CFR 2550.404a-5, which includes a description of the investment alternatives available under the plan, including the risk and return characteristics of each alternative, and the type of assets and diversification of assets comprising each alternative.
14. Identification of any designated investment managers.
15. Information regarding submission of investment instructions and the exercise of voting or tender rights, or any similar rights, applicable to the investments selected by the participant.
16. A description of any transaction fees or expenses that affect the participant's account balance in connection with the purchases or sales of investment alternatives (for example, commissions, sales loads, deferred sales charges, redemption or exchange fees).
17. A description of the additional information that is available to the participant upon request and the name, address, and phone number of the plan fiduciary responsible for providing that information.
18. If the plan offers an investment alternative which is designed to permit a participant to directly or indirectly acquire or sell any employer security, the special information that must be disclosed to participants who

have the opportunity to purchase employer securities.

19. Information on the past and current performance of investment alternatives available to participants.
20. Subsequent to an investment in an investment alternative, any materials provided to the plan relating to the exercise of voting, tender or similar rights, to the extent that such rights are passed through to participants under the terms of the plan, and a description of or reference to plan provisions relating to such rights.
21. A description of the annual operating expenses of each designated investment alternative (for example, investment management fees, administrative fees, transaction costs) that reduce the rate of return to the participants, and the aggregate amount of such expenses, expressed as a percentage of average net assets of the designated investment alternative.

Has a plan fiduciary provided the following information to participants either automatically or upon request?

22. A description of the annual operating expenses of each designated investment alternative (for example, investment management fees, administrative fees, transaction costs) that reduce the rate of return to the participants, and the aggregate amount of such expenses, expressed as a percentage of average net assets of the designated investment alternative.
23. Copies of any prospectuses, financial statements and reports, and other information provided to the plan, relating to an investment alternative.
24. Portfolio composition information for plan assets.
25. Information about the value of shares or units available to participants and held in a participant's account.

Has a plan fiduciary reviewed that the qualified default investment alternatives (“QDIAs”) meet the following requirements?

26. The affected assets must be invested in a QDIA, within the meaning of the regulations.
27. The participant on whose behalf the investment is made had the opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets.
28. The participant on whose behalf an investment in a QDIA may be made is furnished a notice that is timely within the meaning of the regulations and that meets the requirements of the regulations for such notices.
29. The plan fiduciary provides to the affected participants an explanation that the plan constitutes a 404(c) plan and that the plan fiduciaries may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by the participant, which in the case of a participant who fails to give investment instructions will be the default into the QDIA.
30. Any participant on whose behalf assets are invested in a QDIA may transfer out of the QDIA with an appropriate frequency.
31. A participant’s transfer out of the QDIA within the first 90 days after the investment is made must be without any restrictions, fees or expenses.
32. Following the end of the 90-day period described above, any transfer or permissible withdrawal may not be subject to any restrictions, fees or expenses not otherwise applicable to a participant who elected to invest in that QDIA.
33. The plan offers a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).

In connection with the administration of any blackout period, has the plan fiduciary reviewed the following?

34. Content of the notice of the blackout period to make sure that it incorporates all of the regulatory elements pertaining to such notices.
35. Timing of the notice to verify that it was provided within the timelines set forth in the regulations.
36. Form and manner of furnishing the notice.
37. Notification of changes in length of blackout period (if any).

In the case where any fund in the plan’s core fund lineup is changed, has the plan fiduciary made the change in such a manner that it constitutes a “qualified change in investment options” by determining the following?

38. The new fund(s) has stated characteristics similar to those of the fund(s) being replaced.
39. At least 30 days and no more than 60 days prior to the effective date of the change, the plan administrator furnished notice of the change to participants.
40. The plan administrator has honored instructions received from participants who elected a fund other than the one into which the mapping was occurring.
41. Has the plan fiduciary selected the plan’s designated investment alternatives by a process of procedural prudence?
42. If the plan fiduciary has elected to use brokerage or fund windows in addition to

43. the designated investment alternatives, has the fiduciary reviewed Field Assistance Bulletin 2012-02 to determine the extent of its fiduciary obligations with respect to the investment selections that participants may make through the window(s)?

Conclusion

The major points to be gleaned from this white paper are that: (i) compliance with the 404c-1 regulations is difficult to achieve in actual practice; and (ii) plan fiduciaries should not smugly assume that they are protected from the investment decisions made by their plan's participants without first taking the time to review their plan documents and operations to determine whether or not their plans truly are 404(c) plans.

This material is not a recommendation to buy, sell, hold or roll over any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

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[1] 29 CFR 2550.404c-1(b)(2)(i)
[2] 29 CFR 2550.404c-1(b)(2)(ii)(B)
[3] 29 CFR 2550.404c-1(b)(3)
[4] 29 CFR 2550.404c-1(b)(2)(i), (ii)
[5] 29 CFR 2550.404a-5(d)(4)
[6] 29 CFR 2550.404c-5(a)
[7] 29 CFR 2550.404c-5(b)
[8] 29 CFR 2550.404c-5(c)
[9] 29 CFR 2550.404c-5(d)
[10] 29 CFR 2550.404c-5(e)
[11] 29 CFR 2520.101-3(a)
[12] 29 CFR 2520.101-3(d)(1)
[13] 29 CFR 2520.101-3(e)
[14] 29 CFR 2520.101-3(b)(1)
[15] 29 CFR 2520.101-3(b)(2)
[16] 29 CFR 2520.101-3(b)(3)
[17] 29 CFR 2520.101-3(b)(4)
[18] 29 CFR 2520.101-3(c)
[19] ERISA sec. 404(c)(4)(c)