

So You Don't Think Retirement Plan Fiduciaries Need Section 404(c) Protection!

If your company's defined contribution (e.g., 401(k)) plan allows participants to control how their accounts are invested, but the plan does not qualify for special protection under ERISA Section 404(c), plan fiduciaries could be held liable for imprudent participant investment decisions.

Allison v. BankOne-Denver, 289 F.3d 1223 (10th Cir. 2002), illustrates the consequences of not qualifying for Section 404(c) protection. It held fiduciaries liable for participants' decisions to invest 100% of their defined contribution plan accounts in a hedge fund that failed.

ERISA Section 404(c) protects fiduciaries from liability for losses proximately resulting from participant investment decisions.

Therefore, we strongly recommend securing Section 404(c) protection whenever possible. Failing that, plan fiduciaries need to reconsider participant direction features to make sure they appropriately limit their risk, such as by doing away with participant direction entirely or by such milder steps as requiring participants to invest in a diversified way.

The Department of Labor has conditioned Section 404(c) protection on satisfaction of many highly technical requirements. The attached checklist will help you determine whether your company's defined contribution plans meet those requirements.

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A Section 404(c) Compliance Test*

ERISA imposes fiduciary responsibility for the investment management of a plan's assets on the plan's trustee, subject to three exceptions. The first two exceptions relieve a trustee of this responsibility when it is following instructions given by an "investment manager" or proper instructions of a fiduciary "named" in the plan. The third exception – Section 404(c) – relieves the trustee and all other fiduciaries of responsibility for investment decisions made by plan participants.

Section 404(c) is an optional safe harbor. While it does provide the best possible protection, adequate protection with respect to participant directions should exist even when Section 404(c) does not apply, especially if the plan documents expressly provide that participants are "named fiduciaries" of the plan as to any investment rights they have to which Section 404(c) does not apply.

From the enactment of ERISA until recently, it was widely thought that the Section 404(c) safe harbor was available to any defined contribution plan that offered participants a reasonably broad range of investment alternatives. However, the Department of Labor ultimately concluded otherwise and issued regulations, which set forth very detailed requirements that must be satisfied for Section 404(c) to be available. Subject to a special rule for collectively bargained plans, these regulations are effective for plan years beginning on or after October 2, 1993.

This Compliance Test is designed to assist you in determining (1) the extent to which a plan satisfies the requirements of Section 404(c) as interpreted by the Department of Labor, and (2) the probable consequences of the failure to satisfy a given requirement. A glossary of defined terms (which are denoted by capitalization) is set forth on the last page of this test.

1. Is the plan a defined contribution plan subject to ERISA¹ which allows some or all Participants² to direct how they wish part or all of their accounts to be invested, *i.e.*, does it give them "Investment Powers"?³

Yes

No

If you answered "no," Section 404(c) is irrelevant to the plan.

2. Is the investment "direction" in question an actual instruction (as opposed to an election by default)?

Yes

No

If you answered "no," Section 404(c) does not apply to the "direction."

3. With respect to an investment (an "Investment Alternative") as to which Participants have Investment Powers, does the plan provide that Participants making investment instructions can obtain written confirmation of their instructions and are such confirmations actually available?⁴

Yes

No

If you answered "no," Section 404(c) does not apply to that Investment Alternative.

* Prepared by Ethan Lipsig.

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¹ See DOL Reg. § 2550.404c-1(b)(1), which uses the synonymous term, "individual account plan."

² In this Compliance Test, the term "Participant" also includes beneficiaries who are given Investment Powers.

³ See DOL Reg. § 2550.404c-1(b)(1)(i).

⁴ See DOL Reg. § 2550.404c-1(b)(2)(i)(A).

4. With respect to an Investment Alternative to which Section 404(c) is to apply, is an identified plan fiduciary normally obligated to comply with Participant investment directions made in accordance with plan procedures?⁵

- Yes
- No

If you answered “no,” Section 404(c) does not apply to that Investment Alternative.

5. Does the plan offer at least three Investment Alternatives (“Major Investment Alternatives”), each of which meet all of the following requirements?⁶

(a) At least quarterly movement of old and new money is permitted into and out of each Major Investment Alternative.⁷

- Yes
- No

(b) Each of the Major Investment Alternatives is of a sufficiently different nature so as to permit any prudent risk/return ratio to be achieved by allocating funds among the Major Investment Alternatives.⁸

- Yes
- No

(c) Each Major Investment Alternative is diversified.⁹

- Yes
- No

(d) Each Major Investment Alternative has materially different risk and return characteristics.¹⁰

- Yes
- No

(e) All otherwise applicable Section 404(c) requirements are met as to each Major Investment Alternative.

- Yes
- No

If you answered “no” to any subparagraph, Section 404(c) does not apply to the plan.

⁵ A plan will not fail to comply with Section 404(c) solely because a fiduciary declines to implement participant instructions which:

- (a) would violate provisions of the plan which are consistent with ERISA;
- (b) would cause indicia of ownership of plan assets to be improperly held outside United States jurisdiction;
- (c) might jeopardize the plan’s tax-qualified status;
- (d) would involve certain transactions with the plan sponsor, the acquisition of employer real property or, unless specific conditions are met, the acquisition of employer securities (*see* DOL Reg. § 2550.404c-1(d)(2)(ii)(E) and paragraph 18 of this Test);
- (e) would result in a prohibited transaction;
- (f) might result in a loss in excess of the participant’s account balance; or
- (g) might generate taxable income to the plan. *See* DOL Reg. §§ 2550.404c-1(b)(3)(i)(B) and (d)(2)(i). Needless to say, such instructions normally should be rejected.

⁶ *See* DOL Reg. §§ 2550.404c-1(b)(3)(i)(B). “Major Investment Alternatives” is our term.

⁷ *See* DOL Reg. § 2550.404c-1(b)(2)(ii)(C)(I).

⁸ *See* DOL Reg. § 2550.404c-1(b)(3)(i)(B)(3).

⁹ *See* DOL Reg. § 2550.404c-1(b)(3)(i)(B)(I). To achieve this, each Major Investment Alternative will normally have to be a “look through” investment, *i.e.*, a mutual fund, bank common fund, insurance company pooled separate account, group trust, BIC, GIC or self-constructed portfolio. *See* DOL Reg. §§ 2550.404c-1(b)(3)(i)(C), (b)(3)(ii) and (e)(1).

¹⁰ *See* DOL Reg. § 2550.404c-1(b)(3)(i)(B)(2).

6. With respect to an Investment Alternative to which Section 404(c) is to apply, does the Participant have, or have access to, the information he or she needs to make informed investment decisions?¹¹

- Yes
- No

If you answered “no,” Section 404(c) does not apply to that Investment Alternative.

7. At a minimum, has an identified plan fiduciary (or the fiduciary’s delegate) given the Participant the following information:¹²

(a) Notice that the plan is a Section 404(c) plan and of Section 404(c)’s legal significance?¹³

- Yes
- No

(b) Information on the plan’s Investment Alternatives and, with respect to each “Designated Investment Alternative,”¹⁴ its investment objectives, risk/return characteristics, the type of assets comprising its portfolio and the extent of its diversification?¹⁵

- Yes
- No

(c) The identity of any designated investment managers?¹⁶

- Yes
- No

(d) The plan’s investment direction procedures and limitations, including limitations on the Participant’s exercise of voting, tender offer or similar rights with respect to Investment Alternatives?¹⁷

- Yes
- No

(e) Any transaction charges that the Participant might incur, such as commissions, loads, etc., as a result of exercising Investment Powers?¹⁸

- Yes
- No

(f) The further information that is available upon request (see paragraph 8 below) and the name, address and phone number of the plan fiduciary (or the plan fiduciary’s delegate) who is responsible for providing such information?¹⁹

- Yes
- No

¹¹ See DOL Reg. § 2550.404c-1(b)(2)(i)(B). This requirement cannot be met unless the requirements in paragraph 7 are met as well, but the paragraph 7 requirements are probably not a safe harbor.

¹² *Id.*

¹³ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(i).

¹⁴ This term is defined in DOL Reg. § 2550.404c-1(e)(4) as “a specific investment identified by a plan fiduciary as an available investment alternative under the plan.” This would presumably exclude a reasonably broad Investment Alternative category, such as “any mutual fund.”

¹⁵ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(ii).

¹⁶ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(iii).

¹⁷ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(iv).

¹⁸ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(v).

¹⁹ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(vi).

(g) The confidentiality protections that exist with respect to the exercise of Investment Powers relating to employer securities?²⁰

Yes

No

(h) A copy of the prospectus with respect to an Investment Alternative which is subject to the Securities Act of 1933, to be provided immediately before or after the Participant's initial investment in that Alternative?²¹

Yes

No

(i) Information on voting or the exercise of tender offer or similar rights with respect to assets actually held in the Participant's account to the extent those rights are passed through to the Participant?²²

Yes

No

If you answered "no" to any of these items, Section 404(c) does not apply to a Participant's exercise of Investment Powers with respect to which the requirements were not satisfied.

8. With respect to an Investment Alternative to which Section 404(c) is to apply, does the plan identify a plan fiduciary who will provide (and who in fact does provide) the following information either directly or upon request?²³

(a) Information on annual operating expenses as to each Designated Investment Alternative?²⁴

Yes

No

(b) Copies of any prospectuses, financial statements, reports or other materials provided to the plan relating to the Investment Alternative?²⁵

Yes

No

(c) As to each Designated Investment Alternative, the plan assets in its portfolio and their values or percentage composition of the portfolio?²⁶

Yes

No

(d) If the Investment Alternative is a fixed rate investment contract issued by a bank or insurance company, the contract's issuer, its term and its rate of return?²⁷

Yes

No

²⁰ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(vii). See paragraph 18 for more details about these confidentiality requirements.

²¹ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(viii).

²² See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(1)(ix).

²³ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2).

²⁴ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2)(i).

²⁵ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2)(ii).

²⁶ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2)(iii).

²⁷ *Id.*

(e) If the Alternative is a Designated Investment Alternative, information on its share or unit value and past and current performance?²⁸

Yes

No

(f) As to a Designated Investment Alternative, the value of shares or units of that investment credited to the Participant's account?²⁹

Yes

No

If you answered "no" to any of these items, Section 404(c) does not apply to a Participant's exercise of Investment Powers with respect to which the requirements were not satisfied.

9. If transaction expenses are charged to the account of a Participant who exercises Investment Powers, is the Participant periodically notified of the actual charges made against his or her account?³⁰

Yes

No

If you answered "no," Section 404(c) does not apply to investment directions of the Participant with respect to which such charges are levied.

10. With respect to an Investment Alternative to which Section 404(c) is to apply, do Participants have the opportunity to give buy and sell instructions as frequently as is reasonable, depending upon the anticipated market volatility of the Investment Alternative?³¹

Yes

No

If you answered "no," Section 404(c) does not apply to that Investment Alternative.

11. If restrictions are imposed on the frequency of investment instructions, does at least one of the Major Investment Alternatives allow Participants to give investment instructions at least as frequently as is allowed with respect to any other Investment Alternative?³²

Yes

No

If you answered "no," Section 404(c) does not apply to the plan.

²⁸ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2)(iv). Investment performance must be stated in a consistent, reasonable fashion, and net of expenses. *Id.*

²⁹ See DOL Reg. § 2550.404c-1(b)(2)(i)(B)(2)(v).

³⁰ See DOL Reg. § 2550.404c-1(b)(2)(ii)(A).

³¹ See DOL Reg. § 2550.404c-1(b)(2)(ii)(C).

³² See DOL Reg. § 2550.404c-1(b)(2)(ii)(C)(2)(i).

12. With respect to an Investment Alternative into which or from which money can be moved more frequently than quarterly, whenever money can be moved into or out of that Alternative, can the money be transferred between that Alternative and a low risk, income producing, liquid Investment Alternative (such as a money market fund)?³³

Yes

No

If you answered "no," Section 404(c) does not apply to the plan.

13. With respect to Investment Powers involving the exercise of voting, tender offer or similar rights, have the following special requirements been met (in addition to all other applicable Section 404(c) requirements):³⁴

(a) Was the investment to which the rights relate acquired pursuant to directions of the Participant to which Section 404(c) applied?

Yes

No

(b) Was the Participant given a reasonable opportunity to make instructions and was he or she given the information described in paragraph 7(i)?

Yes

No

If you answered "no" to either, Section 404(c) does not apply to the Participant's voting, etc. instructions.

14. Is a Participant's exercise of Investment Powers free from improper plan sponsor or plan fiduciary influence?³⁵

Yes

No

If you answered "no," Section 404(c) does not apply to any instruction tainted by such improper influence.

15. Do plan fiduciaries disclose material non-public facts with respect to an Investment Alternative, assuming such disclosure would not violate securities or banking laws?³⁶

Yes

No

If you answered "no," Section 404(c) does not apply to any transaction affected by such non-disclosure.

16. Is a Participant's exercise of Investment Powers honored only if he or she is legally competent?³⁷

Yes

No

If you answered "no," Section 404(c) does not apply with respect to instructions from known incompetents.

³³ See DOL Reg. § 2550.404c-1(b)(2)(ii)(C)(2)(ii).

³⁴ See DOL Reg. § 2550.404c-1(c)(1)(ii).

³⁵ See DOL Reg. § 2550.404c-1(c)(2)(i).

³⁶ See DOL Reg. § 2550.404c-1(c)(2)(ii).

³⁷ See DOL Reg. § 2550.404c-1(c)(2)(iii).

17. In the case of a transaction with plan fiduciaries, does a Participant pay no more than, or receive no less than, adequate consideration in connection with the transaction?³⁸

- Yes
- No

If you answered “no,” Section 404(c) does not apply to the transaction.

18. If employer securities are an Investment Alternative to which Section 404(c) is to apply, are all the following conditions met with respect to that Alternative:³⁹

(a) The securities are qualifying employer securities.⁴⁰

- Yes
- No

(b) The securities are publicly traded on a national exchange or other generally recognized market.⁴¹

- Yes
- No

(c) The securities are traded with sufficient frequency and in sufficient volume so that Participant directions to buy or sell may be acted upon promptly and efficiently.⁴²

- Yes
- No

(d) Information provided to holders of the securities is provided to Participants with accounts holding such securities.⁴³

- Yes
- No

(e) Voting, tender offer and similar rights with respect to the securities are passed through to Participants.⁴⁴

- Yes
- No

(f) Information relating to the purchase, holding, sale and exercise of voting, tender and similar rights with respect to such securities are effected by confidential procedures, to the extent lawful.⁴⁵

- Yes
- No

³⁸ See DOL Reg. § 2550.404c-1(c)(3).

³⁹ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4).

⁴⁰ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(i). The securities must be “stock” and, if the plan is a money purchase pension plan, the securities must meet several other requirements. The term “stock” also includes equity interests in certain publicly traded partnerships.

⁴¹ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(iii).

⁴² See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(iv).

⁴³ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(v).

⁴⁴ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(vi).

⁴⁵ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(vii). If a particular situation (*e.g.*, a proxy battle) involves “potential for undue employer influence upon participants,” an independent fiduciary must be appointed to handle the procedures in question. DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(ix).

(g) A fiduciary has been designated by the plan to insure that the requirements described in subparagraph (f) are satisfied.⁴⁶

Yes

No

(h) The Participant can move money into or out of any non-employer securities Investment Alternatives available to the Participant under the plan whenever he or she can move money into or out of employer securities investments.⁴⁷

Yes

No

(i) Whenever money can be moved into or out of employer securities, the Participant can transfer it to or from a low risk, income producing, liquid Investment Alternative (such as a money market fund) and can thereafter move money transferred to that low risk investment to any of the plan's Major Investment Alternatives whenever money can otherwise be transferred into or out of such Alternatives.⁴⁸

Yes

No

If you answered "no" to any of subparagraphs (a) through (g), Section 404(c) does not apply to Participant directions with respect to the employer securities in question. If you answered "no" to subparagraphs (h) or (i), Section 404(c) does not apply to the plan.

Glossary

Designated Investment Alternatives – Investment Alternatives in specific assets or funds, such as the plan's bond fund, the Growth Fund of America or the plan sponsor's stock, as opposed to the essentially unlimited right to invest in a broad asset category (e.g., any stock). Most large Section 404(c) plans offer only Designated Investment Alternatives.

Investment Alternatives – the investments with respect to which participants have Investment Powers, including both specific allowable investments (e.g., a plan's bond fund) and the right to invest in broad asset categories (e.g., any mutual fund). Although it will be uncommon, a plan may offer Investment Alternatives that are not intended to satisfy Section 404(c) as well as other Alternatives that are intended to satisfy that Section.

Investment Powers – a Participant's right to direct how all or a portion of his or her account is to be invested in the Investment Alternatives the plan makes available.

Major Investment Alternatives – Investment Alternatives that meet the Section 404(c) requirements set forth in paragraph 5 of the Test.

Participant – a participant or beneficiary of the plan who has Investment Powers.

⁴⁶ See DOL Reg. § 2550.404c-1(d)(2)(ii)(E)(4)(viii).

⁴⁷ See DOL Reg. § 2550.404c-1(b)(2)(ii)(C)(3)(i).

⁴⁸ See DOL Reg. § 2550.404c-1(b)(2)(ii)(C)(3)(ii).