

Participant-Directed Investments

**By
Nell Hennessy
Senior Vice President
Aon Consulting
Washington, D.C.**

Under section 404(c) of ERISA, if a participant's or beneficiary's exercise of control of plan assets in an individual account plan (as determined under DOL regulations), then:

- The participant or beneficiary is not deemed to be fiduciary, and
- Plan fiduciaries will be liable for any loss or ERISA violation that results from the participant's or beneficiary's exercise of control.¹

Thus, for example, if a participant nearing retirement chooses to invest all of his 401(k) assets in equities, no fiduciary will be liable if the plan satisfies the 404(c) requirements. Absent the protection of section 404(c), other fiduciaries could have co-fiduciary liability if such an investment failed to satisfy the prudence and diversification requirements of ERISA. Thus, complying with the DOL regulations, can be an important protection for plan fiduciaries when participants control the investment of their own accounts.

Requirements for section 404(c) plans

The DOL regulations require that a 404(c) plan:

- Provide an opportunity for the participant or beneficiary to exercise control over assets in the account ("control test"); and

- Provide at least three diversified investment alternatives, each of which has materially different risk and return characteristics from which the participant or beneficiary may choose to invest ("diversified investment test").²

Control Test. A plan meets the control test if:

- participants and beneficiaries have the opportunity to give investment instruction with a frequency which is appropriate in light of the market volatility of the investment alternatives, but not less frequently than once within any three-month period;
- the participant or beneficiary is given sufficient information to make informed investment decisions with respect to investment alternatives available under the plan.³

To meet the control test, the regulations require that relevant information go directly to all participants or be made available to them, including:

- an explanation that the plan is intended to comply with section 404(c) and that, as a result, plan fiduciaries may be relieved of any responsibility for losses resulting from the participants' investment instructions;
- a description of all investment alternatives under the plan, including a general description of investment objectives, risk and return characteristics, and the type and diversification of their portfolio assets;
- identification of any designated investment managers;

- an explanation of how to give investment instructions, any limits on giving instructions and any restrictions on the exercise of voting, tender or similar rights;
- a description of any transaction fees or expenses charged to the participants' accounts;
- a description of additional information available on request and the identity of the plan fiduciary or persons responsible for supplying that information;
- for any investment alternative subject to the Securities Act of 1933, a copy of the most recent prospectus immediately before or after the participant's initial investment;
- to the extent voting , tender or similar rights are passed through to participants, any materials provided to the plan concerning the exercise of such rights, as well as information describing the plan provisions relating to the exercise of such pass-through rights;
- a description of the annual operating expenses, fees and transaction costs imposed on each investment alternative and a computation of those expenses expressed as a percentage of average net assets;
- copies of any prospectuses, financial statements or reports that the plan receives relating to an investment alternative;
- for any investment alternative which holds "plan assets" (*e.g.*, common and collective trusts, private limited partnerships, etc), the value of such assets, and, for fixed-rate investment contracts issued by a bank, savings and loan, or insurance company, the name of the issuer of the

contract, the term of the contract and the rate of return on the contract;

- information concerning the value of shares or units in the investment alternatives, as well as information concerning their past and current investment performance; and
- information concerning the value of shares or units in the investment alternatives held in the account of the participant.⁴

Fiduciaries need not, however, respond to all such account balance inquiries. The DOL has noted: "{T}here is nothing in the regulation which would preclude a plan from establishing procedures which would serve to limit the frequency of requests for account balance information or from requiring that such requests be made only at particular times as long as such limitations did not result in participants or beneficiaries being prevented from obtaining sufficient investment information to make informed investment decisions . . ."⁵ Responses based on the latest valuation information available to the plan are sufficient under the regulation.⁶

Plans may also impose reasonable restrictions on the frequency with which participants may give investment instructions, appropriate for the investment's anticipated market volatility.⁷ At a minimum, the three required investment alternatives must allow transfers no less frequently than once within any three-month period. At least one of the three must allow transfers into it as frequently as the investment alternative permitting the most transfers . Alternatively, the plan may provide a low-risk, liquid fund or subfund to accommodate temporary transfers.

Diversified Investment Test. Under the DOL regulations, section 404(c) plan must provide at least three diversified investment alternatives, each of which has materially different risk and return characteristics. The minimum investment alternatives must allow for sufficient diversification, within the range normally appropriate for the participant, to minimize the overall risk of the participant's plan portfolio. The plan may offer other investment alternatives that are in addition to the three investment options used to satisfy the diversified investment test. For example, section 404(c) plans frequently offer employer securities, which do not represent a diversified investment alternative under the regulations.⁸

The DOL has indicated that fiduciaries bear responsibility for the investment options they select for the plan. The DOL noted in the preamble to the section 404(c) regulation that "the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction. . . ." ⁹ The normal prudence rules apply to those decisions.

Concern is occasionally raised about whether offering open "brokerage windows" that give the participants the right to make any investment is "prudent" given the relative unsophistication of some participants. Fiduciaries are concerned that they will be held liable for the investment decisions of those participants. However, if the plan does not limit investment choices, there should be no fiduciary responsibility under section 404(c), since all investment choices will have been made by the participant.

Unisys case

The regulations generally apply to transactions occurring on or after the first day of the second plan year beginning on or after October 12, 1992 (with a later effective date for collectively bargained plans).¹⁰ Thus the earliest effective date for calendar year plans was January 1, 1994.

Subsequent to the issuance of the regulations, the Third Circuit reviewed the applicability of section 404(c) as a defense in a fiduciary liability case arising from transactions that occurred prior to the effective date. In *re Unisys Savings Plan Litigation; Meinhardt v. Unisys Corp.*,¹¹ which dealt with the inclusion of Executive Life guaranteed investment contracts (GICs) in a 401(k) plan, the court held that section 404(c) allows a fiduciary who was shown to have committed a breach of duty in making an investment decision to argue that, despite the breach, it may not be held liable because the alleged loss resulted from the participant's exercise of control pursuant to section 404(c). Given the statute's unqualified instruction that a fiduciary is excused from liability for any loss that results from a participant's or a beneficiary's exercise of control, the court further held that a fiduciary may call upon section 404(c)'s protection where a nexus between a participant's exercise of control and the claimed loss is demonstrated. The holding conflicts with the DOL's position in the regulations that a fiduciary, notwithstanding section 404(c), is liable for the selection and monitoring of the different funds or investment vehicles that it makes available to participants.

Following remand from the Third Circuit, the district court ruled in favor of Unisys.¹² The Unisys plan, which was intended to comply with section 404(c), offered six different investment options. Participants could switch investments, but three of the investment funds required a minimum one-year commitment, a common provision to prevent interest rate arbitrage among fixed rate investment. The court found that this limitation did not result in loss of section 404(c) protection for the fiduciaries. The court

determined that Unisys disclosed adequate information to participants regarding the available plan investments. This disclosure included plan documents, SPDs, prospectuses and other materials provided by an in-house computer system, including several letters specifically addressing the Executive Life situation as its financial condition deteriorated. Focusing on the process that Unisys used in selecting and monitoring plan investments, the court found that Unisys had not breached its fiduciary duties in making the GICs available as plan investments. The court concluded that plan fiduciaries could not be liable for a breach where the participant's control over the investment was the cause of the loss.

Negative Elections and Fiduciary Overrides

The relief provided under section 404(c) is available if the participant or beneficiary actually exercised independent control in fact with respect to the investment of assets in his or her individual account under a section 404(c) plan. The DOL has taken the position that affirmative investment instructions are required.¹³ These instructions, however, need only happen once as long as future opportunities to switch investments remain available.¹⁴ The regulations provide, however, that independent control does not exist when the plan sponsor or fiduciary improperly influences the participant's decision or conceals material nonpublic facts from the participant.¹⁵

This presents a dilemma in plans that provide for enrollment through negative election (i.e., the employee is automatically enrolled in the plan unless he or she elects not to enroll). Negative enrollments have proven to increase participation, particularly among lower paid employees. However, some employers have been reluctant to use negative elections because of concern about potential liability for investment decisions if there is no investment instruction.

Affirmative directions are not required for pass-through rights, so long as the participant is given a timely opportunity with sufficient information to exercise those rights and fails to do so.¹⁶ This extends even to employer securities,¹⁷ even though DOL has taken the opposite position with respect to pass-through voting for ESOPs.

Whether a participant has exercised independent control depends on the facts and circumstances of the particular case.¹⁸ For example, fiduciaries of the plan may override the last investment direction of a missing participant or beneficiary, where the fiduciaries have determined that continuing to follow the direction would not be prudent. However, the section 404(c) protections would not be available with respect to investment decisions made by the plan fiduciaries (although they would be available on the other investment decisions that were not changed).

The plan fiduciary is not required to follow a participant's investment instruction that would result in a prohibited transaction or would generate taxable income to the plan.¹⁹ Also, a fiduciary need not follow participant instructions that would:

- contravene plan documents,
- cause the indicia of ownership of plan assets to be outside U.S. jurisdiction,
- jeopardize the plan's tax-qualified status,
- result in a loss exceeding the balance of the participant's account, or
- result in prohibited transactions between the plan and the plan sponsor.²⁰

Transactions with Employers and Employer Securities

In the case of a sale or exchange between a plan fiduciary and a participant directed individual account, the DOL takes the position that the participant has not exercised the requisite independent control unless the transaction involves an exchange for adequate consideration.²¹ The regulations provide that plan fiduciaries retain responsibility for participant-directed transactions with the plan sponsor, including acquisitions of employer real property or acquisitions of employer securities that are not publicly traded.²²

Investments in publicly-traded employer securities have their own special rules.²³ Such securities must be publicly traded on a national exchange or other generally recognized market and traded with sufficient frequency and in sufficient volume to assure that directions to buy and sell may be acted on promptly.²⁴ Also, participants must receive the same information other shareholders receive and voting, tender, and similar rights must pass through to the participants.²⁵ Participant decisions to buy, sell or vote employer securities must remain confidential.²⁶ If the fiduciary responsible for monitoring confidentiality detects a circumstance in which an employer might exercise undue influence over participant exercise of shareholder rights, then he or she must appoint an independent fiduciary to vote.²⁷ If a plan fails to meet these requirements for employer securities, "the fiduciaries of a plan which otherwise meets the requirements of section 404(c) would lose section 404(c) protection and would be responsible as fiduciaries only with respect to transactions involving the employer security investment alternative. Relief under section 404(c) for other investment alternatives would not be affected."²⁸

Investment Advice

A person can become an ERISA fiduciary status by rendering investment advice for a fee notwithstanding that another fiduciary (or the participant) possesses the authority to make the ultimate

decision to make an investment.²⁹ The DOL regulations provide that a person who provides advice concerning the value of securities or other property or makes recommendations about buying or selling them will be rendering "investment advice" if that person "renders such advice on a regular basis to the plan pursuant to a mutual agreement that such services will serve as a primary basis for investment decisions with respect to plan assets."³⁰ It is often very difficult to tell when information provided by a broker or other investment professional is "investment advice" sufficient to make that person a fiduciary. The DOL has recognized, for example, that registered securities broker-dealers, certain reporting dealers and banks are not deemed fiduciaries by reason of executing securities transactions on behalf of plans if such execution occurs on the specific instructions of a nonaffiliated fiduciary.³¹

In Interpretive Bulletin 96-1, the DOL identified additional circumstances under which the provision of investment-related information to participants and beneficiaries in participant-directed individual account pension plans would not constitute the rendering of "investment advice." The DOL identified the four categories of investment-related information and material which, if provided to plan participants and beneficiaries, will not result in the rendering of investment advice:

- (1) plan information;
- (2) general financial and investment information;
- (3) asset allocation models; and
- (4) interactive investment materials.

The DOL indicated that these categories are not all-inclusive but merely represent examples of the type of information and material that may be furnished to participants and beneficiaries without constituting investment advice.

Plan information includes information and materials that inform a participant or beneficiary about: (a) the benefits of plan participation, the benefits of increasing plan contributions, the impact of preretirement withdrawals on retirement income, the terms of the plan, or the operation of the plan; or (b) information that is described in the regulations under Section 404(c) of ERISA on investment alternatives under the plan, for example, descriptions of investment objectives, risk and return characteristics, historical return information and related prospectuses. For such information to fall into the safe harbor, it must be provided without reference to the appropriateness of any individual investment option for a particular participant or beneficiary under the plan.

General financial and investment information includes:

- general financial and investment concepts such as risk and return, diversification, dollar cost averaging, compounded return, and tax-deferred investment;
- historic differences in rates of return between different asset classes based on standard market indices;
- effects of inflation;
- estimations of future retirement income needs;
- determining investment time horizons; and
- assessing risk tolerance.

Asset allocation models include information and materials that provide a participant or beneficiary with models of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles. These models must be based on generally accepted investment theories that take into account historic returns of different asset classes over defined periods of time. All material facts and assumptions on which the models are based must accompany the models. To the extent that the model identifies any specific investment alternative available under the plan, the model must include a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where

information on those investment alternatives may be obtained. However, the plan need not offer more than one investment alternative in any particular asset class. The models must also be accompanied by a statement indicating that, in applying any particular asset allocation models to their individual situations, participants and beneficiaries should consider their other assets, income, and investments in addition to their interests in the plan.

Interactive investment materials include questionnaires, worksheets, software, and similar materials which provide a participant or beneficiary the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income. To come within the safe harbor, five conditions must be met:

- (1) the materials must be based on generally accepted investment theories and take into account historic returns of different asset classes over defined periods of time;
- (2) there must be an "objective correlation" between the asset allocations generated by the materials and the information and data supplied by the participant or beneficiary;
- (3) all material facts and assumptions—such as retirement ages, income levels, financial resources, replacement income ratios, inflation rates, and rates of return—must accompany the materials or be specified by the participant or beneficiary;
- (4) to the extent that an asset allocation generated by the materials identifies any specific investment alternative available under the plan, the asset allocation must be accompanied by a statement indicating that other investment alternatives with similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained;
- (5) the materials must either take into account other assets, income, and investments in addition to the plan or be accompanied by a statement indicating that, in applying any particular asset allocations to their individual situations, participants and beneficiaries should consider their other assets and income sources.

Interpretive Bulletin 96-1 indicates that the designation of a person to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect plan management. However, with respect to a section 404(c) plan, neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants and beneficiaries would itself give rise to fiduciary liability for loss. Moreover, a plan sponsor or fiduciary has no responsibility or liability with respect to the actions of a third party selected by a participant or beneficiary to provide education or investment advice so long as the plan sponsor or fiduciary has not selected, endorsed or otherwise made arrangements with the educator or adviser to provide the services.

¹ ERISA § 404(c); 29 USC § 1104(c).

² 29 CFR § 2550.404c-1(b)(1).

³ 29 CFR § 2550.404c-1(b)(2)

⁴ 29 CFR § 2550.404c-1(b)(2)(i)(B)(2).

⁵ 57 Fed. Reg. 46906, 46913 (Oct. 13, 1992).

⁶ Id..

⁷ 29 CFR § 2550.404c-1(b)(2)(ii)(C).

⁸ See 57 Fed. Reg. at 46919.

⁹ See 57 Fed. Reg. at 46919, note 27.

¹⁰ See 29 CFR § 2550.404c-1(g).

¹¹ 74 F.3d 420, 19 EBC 2393 (3d Cir. 1996), cert. denied, 117 S. Ct. 56, 20 EBC 1872 (1996).

¹² 21 EBC 2514 (E.D. Pa. 1997).

¹³ 29 CFR § 2550.404c-1(c).

¹⁴ 57 Fed. Reg. at 46906.

¹⁵ 29 CFR § 2550.404c-1(c)(2).

¹⁶ DOL Regs. Section 2550.404c-1(c)(1)(ii).

¹⁷ 57 Fed. Reg. 46906, 46927 (10/13/92).

¹⁸ See DOL Advisory Opinion 96-02A (Feb. 9, 1996).

¹⁹ 29 CFR § 2550.404c-1(b)(2)(ii)(B).

²⁰ 29 CFR § 2550.404c-1(b)(2)(ii)(B) and -1(d)(2)(ii)

²¹ 29 CFR § 2550.404c-1(c)(3)

²² 29 CFR § 2550.404c-1(d)(2)(ii)(E).

²³ 29 CFR § 2550.404c-1(d)(2)(ii)(E)(iV).

²⁴ 29 CFR § 2550.404c-1(d)(2)(ii)(E)(4) (iii) and (iv).

²⁵ 29 CFR § 2550.404c-1(d)(2)(ii)(E)(4) (v) and (vi).

²⁶ 29 CFR § 2550.404c-1(d)(2)(ii)(E)(4) (vii).

²⁷ 29 CFR § 2550.404c-1(d)(2)(ii)(E)(4) (ix).

²⁸ 57 Fed. Reg. at 46928.

²⁹ See, e.g., *Reich v. McManus*, 883 F. Supp. 1144, 19 EBC 1417 (commissions alone are sufficient to make an entity may be an ERISA fiduciary, even though commissions are not paid directly from the plan).

³⁰ 29 CFR § 2510.3-21(c)(1).

³¹ 29 CFR § 2510.3-21(d)(1). See also DOL Information Letter 84-063 (Dec. 13, 1984). The instructions must specify the security, the price range, the time span during which the transaction is to be completed (which cannot exceed five days) and the minimum and maximum number of securities which are to be purchased or sold. DOL Regs. Section 2510.3-21(d)(1)(ii).

³¹ Interpretive Bulletin 96-1, 29 CFR § 2509.96-1 (June 11, 1996).