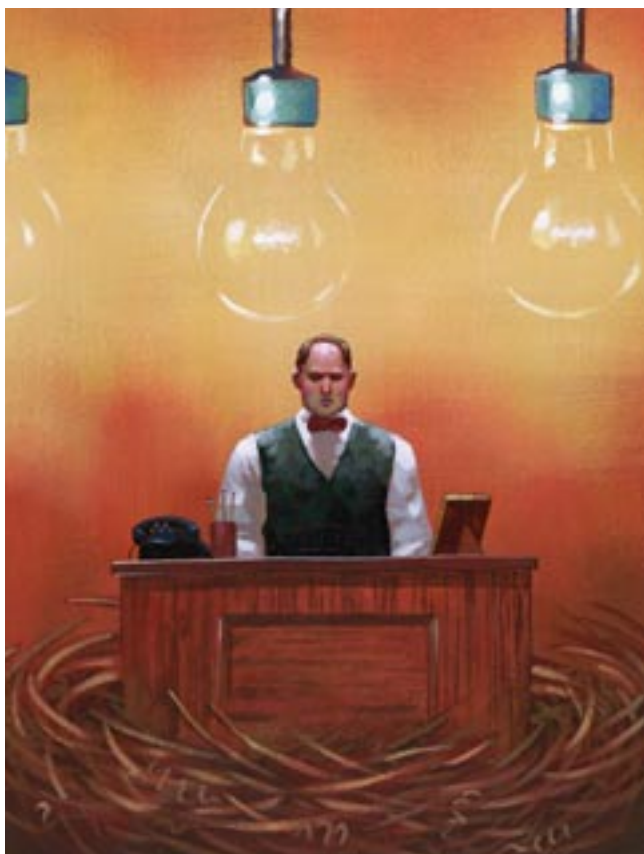


401(k) INVESTMENTS: Satisfying ERISA's Fiduciary Rules

“Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.” ERISA §409(a)



BY FRED REISH & FRANKLIN SANTAGATE

In the late 1990s, 401(k) investing seemed easy, for both employers and employees. A company selected brand-name mutual funds for its 401(k) plans, and the investments almost always went up. Similarly, participants selected from among the offered funds and, with few exceptions, the earnings in their accounts compounded at double-digit rates.

The early 2000s brought a different story. Regardless of the funds selected by the employers, the vast majority went down (at least the funds invested in stocks went down) and then went down some more. Employees' dreams of wealth and early retirement were crushed by the bear market.

As a result, fiduciary litigation by employees against employers became front-page news. The officers of Enron, Worldcom, Lucent, and others were named as defendants in lawsuits filed by class-action attorneys on behalf of the employees. And, because ERISA imposes personal liability on the company officials who select the investments for 401(k) plans (the fiduciaries), some corporate officers (including CFOs, controllers, and financial

This article was written by Fred Reish. The Snip It/Clip It was developed by Franklin Santagate.



managers) are looking at losing much or all of their personal net worth – including their savings, homes, and financial security.

However, the premise of the late 1990s was wrong – it is not easy to pick quality investments for 401(k) plans. Similarly, the current premise is also wrong. Litigation is not the natural consequence of sponsoring a 401(k) plan – if the plan is properly managed.

What, then, is the truth? From the perspective of the Employee Retirement Income Security Act of 1974 (ERISA), the truth lies in §404(a) and §404(c). Those are the two primary sections in ERISA that govern fiduciary responsibilities and that offer protection from poor investment decisions by employees.

Section 404(a): Fiduciary Duties

Section 404(a) is known as the “prudent expert” rule. It requires that fiduciaries act at the level of a knowledgeable investor when selecting 401(k) plan investment alternatives. In other words, it is not enough for fiduciaries to “do their best” – unless they are knowledgeable about the selection of investments for retirement purposes.

More specifically, fiduciaries need to know how to pick the right kind of investment options to permit other people (that is, the employees) to build reasonable portfolios based on their risk tolerances and time horizons. As several courts have said, “a pure heart and an empty head” are no defense to claims of a fiduciary breach. That is, good intentions are not enough; they must be combined with knowledge about selecting investments for retirement.

THE QUESTIONS TO ANSWER

If you are acting as a fiduciary for your company’s 401(k) plan, do you understand the investment concepts of modern portfolio theory, the efficient frontier, correlation among asset classes, and so on?

If not, then the law requires that you acquire the expertise to make skillful and prudent decisions about the investments to offer to the participants. There are many questions to answer in tackling this job:

- What kinds of investments should be offered?
- How many funds should be offered?

- Should the funds be actively managed or should they be passive index funds (like the S&P 500 index)?
- Should international funds, real estate investment trusts, momentum funds, sector funds, and the like be offered?
- What are the criteria for selecting the funds?

To better understand the fiduciary duties imposed by ERISA, each part of the “prudent expert” rule should be examined:

1. THE “PRUDENT EXPERT” REQUIREMENTS

A fiduciary must act with “care, skill, prudence, and diligence.” Here is what that statement means.

Care

The “care” standard requires that a fiduciary be careful and thorough in investigating and understanding the investment alternatives available to the plan, as well as the standards to be applied for selecting the investment package, the individual investments, and the related services (like investment education or lifestyle funds).

Evidence of this care would include documentation of the search for appropriate 401(k) investments; materials regarding the investment alternatives, their performance, and expenses; the process used to select the specific investments to be offered to the participants; and so on. These materials should be maintained as part of a due diligence file to show that proper care was exercised.

Skill

It is not enough to simply gather information about the investments. That information needs to be reviewed by a person who has the skills necessary to properly understand the importance of the data and its significance in the context of selecting investments for participants to direct. In evaluating funds, the following questions should be asked:

- What are the benchmarks?
- Is it preferable to evaluate fund performance to an index or to a peer group – or should both be used?
- Which is the appropriate peer group?

If a fiduciary lacks the knowledge and skill necessary to answer these questions (and others) regarding the evaluation and selection of investments, the fiduciary is required by ERISA to obtain the necessary expertise.

Under ERISA, a **FIDUCIARY** is not **evaluated** based on whether the investments went *up or down* . . . Instead, the **FIDUCIARY** is **evaluated** on whether a **CAREFUL, SKILLFUL, PRUDENT, AND DILIGENT PROCESS** was followed.

Prudence

The investment decisions of the fiduciaries must be prudent; that is, those decisions must be both reasoned and based on an understanding of the information that should have been reviewed and evaluated.

Diligence

A diligent fiduciary ensures that all of the steps necessary to reach a reasoned decision have been taken. If information is missing, or if questions are raised, the diligent fiduciary gathers the additional information or gets answers to those questions.

A “Prudent Process”

These requirements are sometimes referred to as “procedural prudence” or “a prudent process.”

To satisfy the requirement of engaging in a “prudent process,” the fiduciary must gather the right information, review it in the right way, and make the right decision (that is, a reasoned decision).

Under ERISA, a fiduciary is not evaluated based on whether the investments went up or down after they were selected. Instead, the fiduciary is evaluated on whether a careful, skillful, prudent, and diligent process was followed.

2. A FIDUCIARY MUST ACT BASED ON THE CIRCUMSTANCES THEN PREVAILING.

When 401(k) plans first came into common use in the late 1980s and early 1990s, the alternatives were limited. For the most part, companies were forced to select the offerings of a bank or of one mutual fund family. In many cases, investment changes could only be made on a quarterly basis.

There was little in the way of investment education for participants and, for small and mid-sized plans, there was virtually no investment advice available for either employers or employees. Those were the circumstances prevailing at that time.

Today’s Reality

The 401(k) world has changed dramatically from that

time. Today it is possible to choose among a variety of well-known and highly regarded mutual fund families within a single offering. It is also possible to receive fiduciary services, including investment advice or management on the selection of the funds to be offered in the plan. And, today, it is possible to provide more comprehensive investment education and enrollment services for participants.

A plan sponsor has a fiduciary responsibility to understand what is currently available in the marketplace and, through a “prudent process,” to decide on the appropriate investments and services for its participants.

3. A FIDUCIARY MUST ACT AS A “PRUDENT EXPERT” ACTING IN A LIKE CAPACITY AND FAMILIAR WITH SUCH MATTERS.

The “prudent expert” rule requires that the plan sponsor (and its key officers) understand their responsibilities as investment fiduciaries; that is, they must understand the responsibilities of a person “familiar with such matters” acting in a “like capacity.”

The task is not simply to select a group of mutual funds or even a group of funds that have performed well in the past. Instead, the responsibility is to pick the right kinds of funds which, individually and in the aggregate, provide employees with the types of investments necessary to build prudent portfolios in their accounts.

4. A FIDUCIARY’S CONDUCT MUST BE CONSISTENT WITH AN ENTERPRISE OF A LIKE CHARACTER AND WITH LIKE AIMS.

A 401(k) plan is, in essence, a retirement plan where the fiduciaries choose the investments, but the participants use those options to put together investment portfolios in their accounts. The “aim” of a 401(k) plan is to provide secure and meaningful retirement benefits to the participants.

Therefore, the responsible corporate officers have a fiduciary duty to select investments (and services) that are consistent with that goal. For example, fiduciaries need to consider whether the investment options they have chosen are appropriate for the participants, given their knowledge of investing.



Fiduciary Activities

As explained above, the “prudent expert” standard measures the performance of a fiduciary as the duties are fulfilled under ERISA. The primary investment duties for 401(k) fiduciaries are:

- The development of an investment policy for the plan.
- The selection of the investment alternatives to be offered to the participants.
- The selection of investment services for participants who lack investment knowledge or experience.
- The selection of a “default” investment.
- The selection of advisors, such as an investment advisor or a manager.
- The monitoring and, if necessary, the removal of investment options.

Each of these activities is a fiduciary act. As such, they must be undertaken according to the “prudent expert” standard; that is, the key officers must engage in a “prudent process” to consider and decide each issue. They must review the right information in the right way and reach a reasoned decision. Or, alternatively, they must seek outside help.

FULFILLING THE DUTIES

In developing the plan’s investment policy, the fiduciary must do the following:

- Decide on the types of investments to be offered (the “investment categories”);
- Determine the criteria for the selection of the investments to fill those categories;
- Decide on the additional programs and services to be offered to the participants, such as investment education, enrollment meetings, lifestyle and asset allocation funds, and so on; and
- Determine the additional services needed to properly invest the plan, such as the use of investment advice or management services.

In selecting the funds, the fiduciaries would apply the criteria established in the investment policy to a universe of funds. The funds offered to the participants must be prudently selected, based both on the criteria in the investment policy and on the fiduciary requirements of ERISA.

INVESTMENT REQUIREMENTS

In addition, the investment choices must, as a group, offer *different asset classes* (stocks, bonds, and cash) and *investment styles* (large company stocks, small company stocks, growth stocks, and value stocks) so that employees can reasonably manage both the risk of their investments and their potential return.

In ERISA, this is often referred to as the “broad range” rule – participants must be offered a broad range of investments so they can properly balance the investments in their accounts for their own needs. A broad range of investments includes a combination of both the types and the number of funds.

INVESTMENT POLICY AND THE IPS

ERISA requires that the plan fiduciaries make the necessary investment policy decisions. (See, for example, DOL Interpretive Bulletin 94-2.) Those decisions, in combination, are the plan’s investment policy. When the decisions are formalized in writing, they become the investment policy statement (IPS). These decisions include:

- the categories of investments to be offered;
- the criteria for the selection of the investment options; and
- the criteria for the monitoring of the investments.

Examples of criteria which might be used in the selection of investments are:

- the performance of the investments over 1-, 3-, 5- and 10-year periods as compared to the appropriate index and/or to the peer group;
- the expense ratio of a mutual fund, as compared to the expense ratio of the average fund in its peer group;
- the size of the mutual fund; and
- the tenure of the manager and the stability of the staff at the investment management firm.

GETTING THE KNOWLEDGE

Fiduciaries can acquire the necessary knowledge to fulfill their fiduciary responsibilities in two ways:

- 1) Become an expert through study and investigation.
- 2) Hire the expertise, by either hiring an individual investment advisor or by working with a provider who combines the investments with a fiduciary-compliance service.

For example, the provider of investments for your company's plan might engage a registered investment advisor (RIA) to assist in the selection of those investments. (There is one obvious advantage to working with a 401(k) provider that uses an RIA to select the employee investment options: The cost of professional advice can be spread over a large number of plans, resulting in a small cost per plan for sophisticated investment services.)

Either way, however, the fiduciary is responsible for picking the right 401(k) investments for the plan – and will be held to the fiduciary standard of being a knowledgeable investor.

ONGOING DUTIES

After the investments have been selected for the plan, there is an ongoing fiduciary duty to monitor the investments and, where needed, to remove and replace them. The failure to prudently monitor, remove, and replace funds is a breach of fiduciary responsibility under ERISA, and could lead to personal liability.

So, you see, the fiduciary will be *held to the same standard* for both selecting and then monitoring the plan's investments – the knowledgeable investor standard.

Section 404(c): Protections

Section 404(c) is, in effect, an ERISA “insurance policy.” It says that, by prudently selecting and monitoring the investment options in the plan and complying with the §404(c) requirements, the fiduciary will not be liable for the investment decisions made by the participants.

Stated slightly differently, if the fiduciary does not comply with §404(c), then the fiduciary could be liable for losses due to poor participant investment decisions. The DOL recently emphasized this point in its brief concerning the Enron litigation, where it said:

“The only circumstances in which ERISA relieves the fiduciary responsibility for a participant-directed investment is when the plan qualifies as a §404(c) plan.”

Obviously, those who understand the benefits offered by §404(c) – specifically, that legal liability for imprudent

investment decisions is transferred to the participants – will make every effort to comply with this section. So, let's review what steps are necessary for compliance.

COMPLYING WITH 404(c)

Here, again, there are choices, including:

- Working with the company's attorney or a consultant to ensure that the company and the providers are satisfying all of the §404(a) and §404(c) rules; or
- Working with a provider that has, as part of its business model, an emphasis on §404(a) and §404(c) compliance, and that provides the necessary checklists and notices for employees.



ONE CRITICAL CAVEAT

There are over 20 required steps to §404(c) compliance, and all must be met. Unfortunately, some providers represent that their 401(k) packages satisfy §404(c); however, in reality, they fall short. To be safe, work with a provider that emphasizes both §404(c) compliance and provides comprehensive materials for satisfying §404(c).

Conclusion

By complying with ERISA §404(a) and §404(c), fiduciaries will help limit their potential liability. More importantly, such compliance will produce a 401(k) plan that is understood and appreciated by participants because it yields higher quality plan benefits. **BP**

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Fred holds a BS in Accounting from Arizona State University and a JD from the University of Arizona. He has written more than 100 pension-related articles and four books, including the *Plan Correction Answer Book* and the *Participant Directed Investment Answer Book*. He writes regular columns on 401(k) investment and fiduciary responsibility issues for *Plan Sponsor* magazine and the *Journal of Pension Benefits*.



Active professionally in the Los Angeles area, Fred has taught the Pension and Profit Sharing class at the Masters of Business Tax Program at USC. Nationally, he chaired the Government Affairs Committee of the American Society of Pension Actuaries (ASPA) and is now co-chairing the ASPA Government Affairs Task Force on 401(k) Fiduciary Responsibility and its 401(k) Marketing Conference.

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***Don't miss our 401(k) Snip It/Clip Its
on the next two pages***

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Managing Personal Asset Loss Liability as a 401(k) Fiduciary

One recent 401(k) newswire ended with the statement: “It looks like suing plan fiduciaries may now be a more promising avenue for trial lawyers than suing doctors.”

Who is doing the suing? Many are “almost-boomer retirees” who have lost substantial amounts in their 401(k) plans due to the market downturn, and who now can’t retire. They are very angry and want restitution.

Until recently, fiduciary liability was a theoretical issue. Now there are lawsuits against companies of all sizes, making the fiduciary risk very real.

WHO IS AT RISK?

The company, its Board of Directors, officers, trustees, and investment managers and advisors can all be designated as fiduciaries – and, therefore, all may have personal liability. In addition, *fiduciaries may be personally liable if they know, or even should have known, of a breach by another fiduciary.* Not knowing or not being kept in the loop will not constitute an effective legal position.

And, the risk for the fiduciary goes beyond the plan participants. The liability exposes the fiduciary to legal action and remedy not only by plan participants, but also by the participants’ legal estates and the DOL.

WHY YOU COULD BE AT RISK

Unfortunately, most small- to mid-sized employers have neither the time nor the internal resources necessary to comply with all of ERISA’s requirements.

And, many providers of 401(k) and profit-sharing plans (stock brokers, mutual fund and insurance companies, banks, trust departments, etc.) neither adequately educate employers on their fiduciary requirements nor design their retirement packages to include fiduciary compliance.

WHAT’S THE SOLUTION?

According to ERISA law as interpreted by the DOL, you must ensure that your company’s plan is in compliance (not just *intending* to be in compliance) with §404(a) and §404(c) provisions. The DOL position is clear, as stated in their amicus brief filed in the Enron case:

- Plan sponsors (fiduciaries) are responsible for their selection of investment alternatives.
- Only plans that fully comply with ERISA §404(c) will have protection against liability for the results of participant investment allocation decisions.

WHAT’S NEEDED?

In order to meet the §404(c) provisions, the §404(a) provisions must first be met, which require that investment fiduciaries prudently manage the investments of retirement plans. More specifically, ERISA requires that a fiduciary:

- Act solely in the interest of the participants (that is, be loyal to the participating employees);
- Act for the exclusive purpose of providing retirement benefits to participants;
- Pay the reasonable expenses of the plan; and
- Manage the plan and its investments in accordance with the “prudent expert” rule.

WHAT CAN YOU DO RIGHT NOW?

There are more than 20 mandatory requirements for complying with §404(c). Very few providers include documents, information, and procedures to satisfy them all.

Review the §404(a) and §404(c) checklists on page 35 to determine if your company’s 401(k) plan is in compliance. If such a checklist is not followed, the fiduciaries of the plan are at high risk for personal asset loss in the event of a participant suit for losses.

KEY POINTS TO REMEMBER

- 1) The key officers of a company are the investment fiduciaries for retirement plans. As such, they must conduct themselves according to ERISA’s fiduciary standards, including the “prudent expert” rule.
- 2) Failure to adhere to ERISA’s standards can result in personal liability for the failure to adhere to those standards.
- 3) To remove the burden of that responsibility, companies should look for investment packages that include a high level of fiduciary compliance and assistance, including §404(c) protection.
- 4) If the key officers lack the skill or knowledge to select investments, obtain that knowledge by hiring investment experts or by selecting an investment package with built-in fiduciary compliance.

Compliance with §404(c) is important. Failure to do so can expose company officers (and that could mean you!) to fiduciary risk of personal liability. Take the proper steps now to protect yourself and your company from this very real – and potentially costly – risk.



ERISA §404(a) & §404(c) Checklists

ERISA §404(a) COMPLIANCE CHECKLIST:

**If you cannot check every box,
the plan is not in compliance.**

- 1. Do you accept co-fiduciary responsibility for preparation of the investment policy statement (IPS), asset class selection, manager selection, and monitoring?**
Y___ N___

- 2. Based on IPS criteria, do you provide documented:**

- Investment class selection and monitoring for:
 - Trustee-directed accounts
 - Participant investment direction
- Investment manager selection
- Investment manager monitoring
- Asset allocation criteria and monitoring for trustee-directed accounts
- Asset allocation criteria and monitoring for default allocation (for participants who do not provide timely investment directions)
- Action decisions on monitored results of asset classes, managers, and asset allocations

ERISA §404(c) COMPLIANCE CHECKLIST:

**If you cannot check every box,
the plan is not in compliance.**

Note: §404(c) regulations require that items designated by + be provided to participants, as opposed to just making them available.

- 1. Do you provide the following so that participants can exercise control over assets in their accounts:**

Investment instructions/criteria for fulfillment:

- +Name, address, and telephone number of the fiduciary responsible for carrying out participant investment instructions
- +Notification to participants of any limitations on giving investment instructions
- +Notice to participants about transactions the fiduciary will not process in order to avoid disqualifying the plan
- +An explanation of any restrictions or limitations on instructions and transfers
- +Procedures for directing investments

Voting and tender rights:

- +Notification of any restrictions on the exercise of voting, tender, and similar rights. If voting and tender rights are passed through to participants, are there written procedures for their administration? Y___ N___

Sufficient information to make informed investment decisions:

- +Name, address, and telephone number of the fiduciary responsible for providing investment information

For each investment alternative, specific information re:

- +A general description of investment objectives
- +Risk and return characteristics
- +Type and diversification of assets in the portfolio
- +Identification of any designated investment managers
- Annual operating expenses
- Financial statements and reports
- Net asset value of shares
- Past and current investment performance, net of expenses

A description of any transaction fees and expenses in connection with purchases and sales, including:

- +Commissions +Sales loads
- +Deferred sales charges +Wrap fees
- +Redemption or exchange fees

- +A written notice stating that the plan intends to comply with §404(c), and the plan fiduciaries may be relieved of liability for losses due to participant investment direction

- +Detailed §404(c) procedures

- +A copy of the most recent prospectus provided immediately prior to or immediately following first investing in a fund

- +Written confirmation of investment instructions

- 2. Can participants choose from a broad range of investment alternatives? Y___ N___**

- Criteria included in the IPS for selecting and monitoring asset class selection to meet §404(c) requirements
- Documentation of asset class selection, monitoring, and changes when appropriate

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