PARTICIPANT-DIRECTED INDIVIDUAL ACCOUNT PLANS

AN OVERVIEW OF THE DEPARTMENT OF LABOR REGULATIONS AND THEIR APPLICATION TO CERTAIN PUBLIC RETIREMENT PLANS IN CALIFORNIA

California public employers sponsoring participant-directed retirement plans such 457(b) plans can reduce the potential for fiduciary liability by complying Federal Department Of Labor Code section 404(c) rules of the Employee Retirement Income Security Act (ERISA). Although ERISA is the federal law that sets minimum standards for pension plans in private industry, California Government Code section 53213.5(b) provides that:

> *Notwithstanding any other provision of law, participants choosing individually directed investments shall relieve the trustee and the local agency of responsibility under the terms of the plan and trust. That relief shall be conditioned upon the local agency compliance with communication and education requirements similar to those prescribed in subdivision (c) of Section 1104 of Title 29 of the United States Code for private sector employers.*

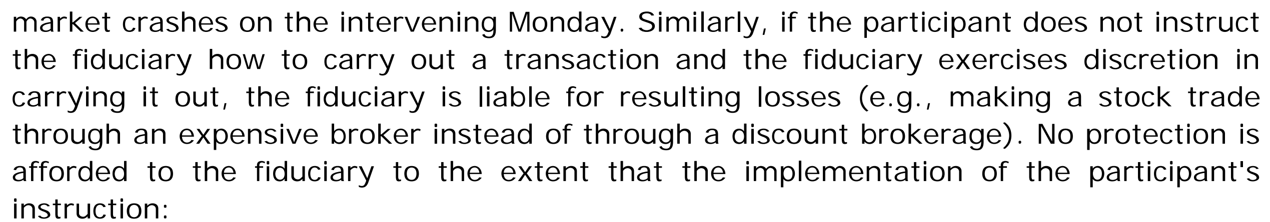
Although the California Code specifically mentions compliance with the communications and education requirements of ERISA section 404(c), we believe that the ability of a participant to "choose individually directed investments" necessarily involves the ability to "exercise control" over the investments in one's account. As a result, we recommend that California public employers familiarize themselves with the full scope of the regulations.

This article provides an overview.

SIGNIFICANCE OF ERISA SECTION 404(C)

ERISA section 404(c) has been compared with an insurance policy for plan fiduciaries in that compliance with the provision protects them from liability by shifting the risk of loss to the participants. However, fiduciaries do not completely escape the possibility of liability even under such a plan. The protection extends only on a transaction-by-transaction basis and only to the extent that the loss is the direct and necessary result of that participant's exercise of control.

For example, if a participant instructs the trustee to sell ABC Corp. stock on Friday and the trustee does not sell until Tuesday, the trustee may be liable for the loss when the



market crashes on the intervening Monday. Similarly, if the participant does not instruct the fiduciary how to carry out a transaction and the fiduciary exercises discretion in carrying it out, the fiduciary is liable for resulting losses (e.g., making a stock trade through an expensive broker instead of through a discount brokerage). No protection is afforded to the fiduciary to the extent that the implementation of the participant's instruction:

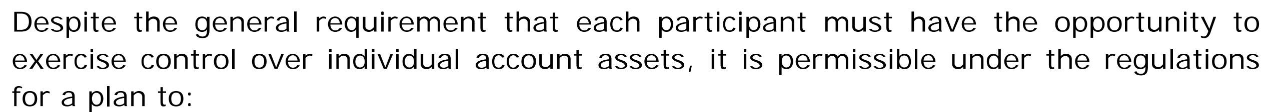
1. Would not be in compliance with the plan documents to the extent they are consistent with ERISA;
2. Would cause a fiduciary to maintain the indicia of ownership of any plan asset outside the jurisdiction of the U. S. district courts;
3. Would jeopardize the plan's tax qualified status;
4. Could result in a loss in excess of the participant's account balance; or
5. Would result in any of the following transactions between the plan and the employer or any affiliate of the employer (a person controlled by the employer, any officer, director, employee, partner, or relative of the employer, and any entity in which the employer is an officer, director or partner):
    a. A sale, exchange, or lease of property;
    b. A loan (note that this provision encompasses participant loans);
    c. The acquisition of any employer real property; or
    d. The acquisition of any employer security, except as provided for in the regulations.

The regulations make no provision for a "default investment." A default investment is the investment that the fiduciaries will make for any participant who fails to make an affirmative investment election under the plan. The regulations treat a default investment as being outside of the protection of ERISA section 404(c). As a result, the DOL subjects the default investment to the normal fiduciary liability standards without regard to ERISA section 404(c).

OPPORTUNITY TO EXERCISE CONTROL

Each participant must have the opportunity to exercise control over the assets in his or her account. The participants must:

1. Have a reasonable opportunity to give investment instructions to an identified plan fiduciary who is obligated to comply with such instructions. The regulations' requirements with respect to investment instructions and the identified plan fiduciary are discussed below.
2. Be provided with, or have the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives available under the plan. The regulations' requirements regarding the disclosure of investment information are discussed below.



Despite the general requirement that each participant must have the opportunity to exercise control over individual account assets, it is permissible under the regulations for a plan to:

1. Charge a participant's account for the reasonable expenses of carrying out investment instructions, provided that the plan establishes procedures to inform participants of actual expenses incurred with respect to their respective individual accounts;
2. Permit a fiduciary to decline to implement individual participant investment directions, including instructions which:
   a. Would result in a transaction listed in item 5 on page 2 above;
   b. Would result in a prohibited transaction; or
   c. Would generate unrelated business taxable income (UBTI) that would be taxable to the plan; or
3. Impose reasonable restrictions on the frequency with which participants may give investment instructions. The regulations' restrictions on the frequency of investment instructions are discussed below.

INVESTMENT INSTRUCTIONS AND IDENTIFIED PLAN FIDUCIARY

Under the regulations, the participants' investment instructions may be given orally or electronically and need not be in writing, provided that participants have the opportunity to obtain written confirmation of their instructions. These instructions must be given to an identified plan fiduciary who is obligated to comply with the instructions (except for certain limited exceptions mentioned above). The specific means by which participants are to communicate investment instructions do not necessarily have to be in the plan document so long as the plan has written procedures for such communication and information concerning these procedures is furnished to participants. The preamble to the regulations states that the "identified plan fiduciary" to whom investment instructions are to be given does not have to be individually named. It is sufficient that the identification of a fiduciary be by position or function (e.g., the plan administrator or the investment committee). It is the DOL's view that the statute does not preclude the use of electronic or telephonic communications of investment instructions (presumably on a direct basis to the mutual fund or other investment alternative providers). If this type of direct investment instruction is contemplated by a plan, the identified plan fiduciary will nonetheless be responsible for making sure that such investment instructions are properly confirmed in writing and are properly and timely executed.

REQUIREMENTS REGARDING DISCLOSURE OF INVESTMENT INFORMATION

The regulations establish a comprehensive set of disclosure requirements with regard to investment information. First, the plan fiduciary (or person designated by the plan fiduciary) is required to provide the following to each participant:

1. An explanation that the plan is intended to be an ERISA section 404(c) plan and that the fiduciaries of the plan may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by the participant;

2. A description of the investment alternatives available under the plan, and, with respect to each designated investment alternative (i.e., a specific investment identified as an available investment alternative under the plan – the term does not appear to include investments referred to by the plan as "any investment which is administratively feasible for the plan to hold"), a general description of the investment objectives and risk and return characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of that alternative;

3. Identification of any designated investment managers;

4. An explanation of the circumstances under which participants may give investment instructions and an explanation of any specified limitations on such instructions under the terms of the plan, including any restrictions on transfers to or from a designated investment alternative, and any restrictions on the exercise of voting, tender and similar rights relating to an investment alternative;

5. A description of any transaction fees and expenses which affect the participant's account balance in connection with the purchases or sales of interests in investment alternatives (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees);

6. The name, address, and phone number of the plan fiduciary (and, if applicable, the person or persons designated by the plan fiduciary to act on the participant's behalf) responsible for providing certain required information (described below) upon the request of a participant as well as a description of that information which may be obtained on request;

7. In the case of plans that permit the investment of participant's account in any employer security, certain information describing required procedures relating to such investments as required by the regulations;

8. In the case of an investment alternative which is subject to the Securities Act of 1933, and in which a participant has no assets invested, the participant must be provided with a copy of the most recent prospectus provided to the plan immediately following the participant's initial investment (in the alternative, a participant may be given a copy of the most recent prospectus immediately prior to the participant's initial investment); and

9. 9. Subsequent to an investment in any investment alternative, the plan must provide the participant any materials provided to the plan relating to the exercise of voting, tender or similar rights which are incidental to the participant's investment to the extent that such rights are passed through to participants under the terms of the plan.

In addition, the identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on the fiduciary's behalf) must provide the following information to

participants, either directly or upon request, which shall be based on the latest information available to the plan:

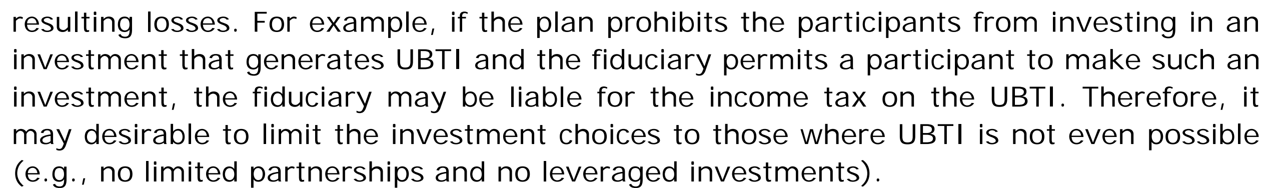
1. A description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, and transaction costs) which reduce the rate of return to participants, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative;
2. Copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternatives available under the plan, to the extent such information is provided to the plan;
3. A list of the assets comprising the portfolio of each designated investment alternative to the extent such assets constitute plan assets, the value of such assets, and, with respect to each such asset which is a fixed rate investment contract (issued by a bank, savings and loan association or insurance company) the name of the issuer of the contract, the term of the contract, and the rate of return on the contract;
4. Information concerning the value of shares or units in designated investment alternatives available to participants under the plan, as well as the past and current investment performance and such alternatives, determined, net of expenses, on a reasonable and consistent basis; and
5. Information concerning the value of shares or units in designated investment alternatives held in the account of the participants.

RESTRICTIONS ON THE EXERCISE OF CONTROL

As mentioned above, the plan may place reasonable restrictions on the exercise of control by the participants and still be in compliance with ERISA section 404(c) and the regulations. For example, the following restrictions are permissible:

1. A reasonable charge may be imposed on the participant or the participant's account for carrying out the participant's instructions, but only if the plan has established procedures designed to periodically inform participants of actual expenses occurred with respect to their respective individual accounts.
2. The fiduciary may decline to comply with a participant's instructions if implementation would not protect the fiduciary from liability as described above.
3. The fiduciary may decline to comply with a participant's instructions if implementation would result in a prohibited transaction (see discussion below).
4. The fiduciary may decline to comply with a participant's instructions if implementation could result in a loss in excess of the participant's account balance.
5. The fiduciary may decline to comply with a participant's instructions if implementation would generate income that would be taxable to the plan (UBTI).

Note that if the plan contains such restrictions and the fiduciary implements a participant's instructions contrary to the limitations, the fiduciary may be liable for the



resulting losses. For example, if the plan prohibits the participants from investing in an investment that generates UBTI and the fiduciary permits a participant to make such an investment, the fiduciary may be liable for the income tax on the UBTI. Therefore, it may desirable to limit the investment choices to those where UBTI is not even possible (e.g., no limited partnerships and no leveraged investments).

The regulations clarify that a plan may impose other "reasonable" limitations on the ability of a participant to direct the investments within the participant's accounts provided that the totality of such restrictions does not so restrict a participant's opportunity to exercise control so as to cause the plan in effect to fail the general requirements of ERISA section 404(c). Furthermore, the regulations do not contain a "uniformity" requirement that restrictions on participant investment directions apply on a uniform basis to all participants. In other words, a plan may restrict or limit certain participants' rights to exercise control under the plan without automatically violating ERISA section 404(c).

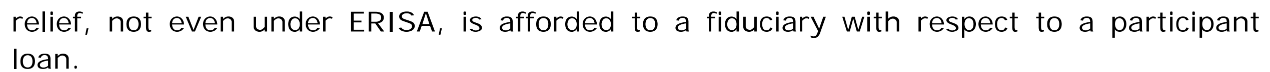
For example, some practitioners have suggested that a participant's investment direction should be limited to the participant's vested account balance or that a participant must have a minimum account balance before having the ability to direct investments. Even though such arrangements may be determined to be within the scope of ERISA section 404(c), they may be in violation of section 401(a)(4) of the Internal Revenue Code (Code) that prohibits discrimination in favor of highly compensated employees.

FREQUENCY OF INVESTMENT INSTRUCTIONS

The frequency with which each participant may give investment instructions as to any investment must be appropriate in light of the market volatility to which the investment may reasonably be expected to be subject. Regarding the three (minimum) diversified categories of investments mentioned below (discussed below under the heading "Broad Range Of Investments") which serve as the plan's "core" investment alternatives, at least three of them must permit the participant to make changes at least once every three-month period. Of the core investment alternatives, at least one category (but not necessarily the least volatile) must permit the participant to make changes no less frequently than the participant is permitted to give such instructions with respect to the most volatile investment alternative made available by the plan. Unlike the proposed regulations, the final regulations offer an alternative method of compliance which allows permits the use of a "cash-equivalency" type fund for the receipt and holding of proceeds from investments pending the next opportunity for participants to direct investments into one of the core investment alternatives.

PROHIBITED TRANSACTIONS

Although the regulations generally provide relief from the prohibited transaction provisions contained in ERISA in some circumstances, they do not provide relief under the prohibited transaction excise tax provisions contained in the Code. In some instances, it may become necessary for the plan fiduciary to apply to the IRS for exemptive relief from the Code's prohibited transaction rules. Note particularly that no



relief, not even under ERISA, is afforded to a fiduciary with respect to a participant loan.

BROAD RANGE OF INVESTMENTS

A plan must make available to its participants a broad range of investment alternatives that provide the participants with the opportunity to materially affect the risk and return of their accounts. The available alternatives must be sufficient to permit the participants to pursue a variety of investment objectives. The participants must be able to choose from at least three diversified categories of investments (core investments):

1. Each of which has materially different risk and return characteristics;
2. Which in the aggregate enable the participants to achieve a portfolio with aggregate risk and return characteristics within the participant's range; and
3. Each of which, when combined with investments in either of the other categories, tends to minimize the risk of a participant's portfolio at any given level of expected return.

When selecting a plan's core investments, plan fiduciaries should pay particular attention to any transfer restrictions which would have the effect of causing that alternative to fail to meet the three-month investment instruction requirement discussed above. Of course, such restrictions may be associated with non-core investment alternatives.

The plan must also provide the participants with the opportunity to diversify investments so as to minimize the risk of large losses. Where the account of any participant is so small that the investment in "look-through" investments (e.g., a pooled separate account of an insurance company) is the only prudent means to assure appropriate diversification, then the plan must offer look-through investments. The plan may allow the participants to use an investment manager.

We have developed a number of checklists, and other diagnostic tools, to help our clients to understand their ERISA section 404(c) obligations. If you would like help analyzing your 404(c) compliance, or you would like to discuss other ways to limit your fiduciary liability, please contact us.

Editor's Note: We did the best we could to make sure the information and advice in this article were current as of the date of posting to the web site. Because the laws and the government's rules are changing all the time, you should check with us if you are unsure whether this material is still current. Of course, none of our articles are meant to serve as specific legal advice to you. If you would like that, please call us at (916) 357-5660 or email us at contactus@seethebenefits.com.