Focus On . . . ERISA Section 404(c)

BY DAVID A. PRATT

Compliance with Section 404(c) of ERISA has been an important issue in many of the recent high-profile fiduciary breach cases, including Enron *and* WorldCom. *Some experts suggest that fewer than 10 percent of plans that rely on relief under Section 404(c) actually satisfy all of the requirements of the regulations.*

The US Departmenr of Labor (DOL) issued final regulations under Section 404(c) on October 13, 1992. [57 Fed. Reg. 46906, Oct. 13, 1992] In the preamble to the Regulations, DOL stated that:

> It is the Department's view that section 404(c) is similar to a statutory exception to the general fiduciary provisions of ERISA and, accordingly, the person asserting applicability of the exception will have the burden of proving that the conditions of section 404(c) and any regulation thereunder have been met.

This view has been accepted by courts. [*In re WorldCom, Inc. ERISA Litigation*, 263 F. Supp. 2d 745 (S.D.N.Y., 2003) at fn. 12. *See also In re Unisys Savings Plan Litigation*, 74 F.3d 420, 446 (3d Cir. 1996) and cases cited therein; *Allison v. Bank One-Denver*, 289 F.3d 1223, 1238 (10th Cir. 2002)]

The structure of the regulations suggests that Section 404(c) relief is available only if *all* of the applicable requirements of the regulations are satisfied. Some of the requirements are straightforward: for example, the plan must be an individual account plan. Some are not: for example, a participant or beneficiary will not have the required opportunity to exercise control over assets in his or her account unless he or she is provided a description of the available investments. When is a description adequate for this purpose? When, if ever, will a failure to comply be *de minimis*, so that 404(c) relief is available despite the failure?

As Fred Reish and Bruce Ashton point out:

> Although the regulations do not divide the information requirements into "fundamental" and "transactional" requirements, it is clear that certain requirements . . . go to the heart of whether the plan is a 404(c) plan, while other requirements relate to specific investment options or transactions and may, therefore, be viewed as transactional. That is, if the plan sponsor fails to provide information about a specific investment option or transaction, the fiduciaries may lose 404(c) relief as to that investment decision, but will not lose 404(c) relief altogether. [Fred Reish and Bruce Ashton, "Top 10 Countdown of 401(k) Fiduciary Problems," 2002 ASPA Annual Conference]

The Statute

The requirements of the statute are deceptively straightforward. Section 404(c) applies to a retirement plan if:

(1) The plan provides for individual accounts; and

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(2) The plan permits a patticipant or beneficiary to exercise control over assets in his or her account; and
(3) A participant or beneficiary actually exercises control over the assets in his or her account, *as determined under regulations of the Secretary of Labor.*

If these requirements are satisfied, then:

(A) The participant or beneficiary will not be deemed to be a fiduciary by reason of the exercise of control; and
(B) 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 exercise of control by the participant or beneficiary.

There are special rules for SIMPLE plans [ERISA § 404(c)(2)] and for automatic rollovers under Code Section 401(a)(31)(B) [ERISA § 404(c)(3)] which are not discussed further in this article.

DOL says that 404(c) protection does not extend to the selection of investment alternatives, as this is not a necessary or direct result of a participant direction: "The responsible plan fiduciaries are also subject to ERISA's general fiduciary standards in initially choosing or continuing to designate investment alternatives offered by a 404(c) plan." [DOL letter to Douglas O. Kant, 1997 WL 1824017, Nov. 26, 1997] Moreover, Section 404(c) does not relieve plan fiduciaries of the responsibility for determining whether it is appropriate to offer employer stock as an investment option under the Plan. [*Tittle v. Enron Corp.*, 284 F. Supp. 2d 511 (S.D. Tex. Sepr. 30, 2003)]

The Regulations

The final regulations [29 C.F.R. § 2550.404c-1] describe:

> The kinds of plans that are "ERISA section 404(c) plans,"
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> The circumstances in which a participant or beneficiary is considered to have exercised independent control over the assets in his or her account, and
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> The consequences of a participant's or beneficiary's exercise of control.

The standards set out in the regulations are applicable solely in determining whether (1) a plan is an ERISA Section 404(c) plan and (2) a particular transaction engaged in by a participant or beneficiary is afforded relief by Section 404(c). The standards are *not* intended to be applied in determining whether, or to what extent, a plan which does not meet the requirements satisfies the fiduciary responsibiliry or other provisions of Title I of ERISA. [29 C.F.R. § 2550.404c-1(a)(2)(a)]

What Is an "ERISA Section 404(c) Plan"?

In order to be an ERISA Section 404(c) plan, the plan must satisfy the following three basic requirements: [29 C.F.R. § 2550.404c-1(a)(2)(b)(1)]

1. It is an *individual account plan* described in Section 3(34) of ERISA. According to the preamble:

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

2. The plan provides an opportunity for a participant or beneficiary *to exercise control* over assets in his or her individual account (see below); and

3. The plan provides a participant or beneficiary 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 (see below).

In *Allison v. Bank One Denver,* [289 F.3d 1223 (10th Cir. 2002)] Bank One, a fiduciary of the plan, invested a portion of the plan assets in a limited partnership. The limited partnership became bankrupt. Bank One argued that, once the plan became "participant-directed," it no longer had a fiduciary duty to the plan, a position accepted by the district court. However, the Plan provided that:

> A Participant shall have the right to direct the Trustee with respect to the investment or re-investment of the assets comprising the Participant's individual account only if the Trustee consents in writing to permit such direction. If the Trustee does consent . . . the Trustee and each Participant *shall execute a letter agreement* as a part of this

> Plan containing such conditions, limitations, and other provisions as they deem appropriate before the Trustee shall follow any Participant direction. . . . The Trustee shall not be liable for any loss, or by reason of any breach, resulting from a Participant's direction of the investment of any part of his individual account. [emphasis added]

All parties agreed that no "letter agreements" were ever signed. So, the court held that investment discretion was never transferred to the participants, and the bank continued to be liable.

Opportunity to Exercise Control

A plan provides a participant or beneficiary an opportunity to exercise control over assets in his or her account only if the following requirements are satisfied. [29 C.F.R. § 2550.404c-2(b)(2)]

Opportunity to Give Investment Instructions

Under the terms of the plan, the participant or beneficiary has 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. [29 C.F.R. § 2550.404c-1(b)(2)(i)(A)] A fiduciary may decline to implement (i) instructions which are described in Regulations Section 2550.404c-1(b)(d)(2)(ii) (See "Effect of Independent Exercise of Control," below) or (ii) instructions specified in the plan, including instructions:

1. Which would result in a prohibited transaction described in ERISA Section 406 or Section 4975 of the Code; and

2. Which would generate income that would be taxable to the plan. [29 C.F.R. § 2550.404c-1(b)(2)(ii)(B)]

Information Is Provided

The participant or beneficiary is provided, or has the opportunity to obtain, *sufficient information to make informed decisions with regard to investment alternatives available under the plan.* For this purpose, a participant or beneficiary will not be considered to have sufficient investment information unless:

a. The information listed in Exhibit I is provided anromatically to the participant or beneficiary; and

b. The information listed in Exhibit II is provided automatically or on request to the participant or beneficiary.

> Note that the list is not a "safe harbor" but rather a nonexclusive list. That is, providing the listed information does not necessarily mean that the plan has provided or given the participant the opportunity to obtain "sufficient information to [enable the participant] to make informed decisions." Thus, in some circumstances, the plan may be required to make available more information than is listed in the Regulation in order to comply with the information requirement. [Reish and Ashton, *supra*]

The obligation of an ERISA Section 404(c) plan fiduciary to disclose information is not limited to information concerning those investment alternatives intended to satisfy the "broad range" requirement of the regulation, but rather extends to information concerning the plan itself and each investment alternative made available under the plan.

Under the regulations, a participant or beneficiary will not have the required opportunity to exercise conttol over assets in his or her account unless he or she is provided a description of the available investments. [*See* item (ii) of Exhibit I] Unlike the DOL's regulations governing summary plan descriptions, the regulations do not specifically require that communications be written in a manner calculated to be understood by the average plan participant. However, this is clearly the cortect standard: the basic concept underlying the detailed requirements of the regulations is that participants and beneficiaries must have sufficient information to make informed investment decisions, and they do not have "sufficient information" if they do not understand the information. At least one Circuit Court has applied this standard: "For Unisys to prevail under section 1104(c), however, it must establish that the Plans provided information sufficient for the average participant to understand and assess." [*In re Unisys Savings Plan Litigation*, 74 F.3d 420, 447 (3d Cir. 1996)]

Employer Stock

Under the regulations, the description of available investments must include a description of each investment alternative and a general description of its investment objectives and risk and return characteristics. [29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(ii)] The investment brochures distributed to participants often do not meet this requirement with respect to the employer stock fund:

> a. The investment information provided in the brochures is entirely generic, and does not describe the particular risk and return characteristics of an investment in that employer's stock.
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> b. Research makes it clear that (1) it is generally riskier for a plan participant to invest in stock of his or her employer than in another individual stock, (2) plan participants tend to severely underestimate the risks of investing in their employer's stock, and (3) both of these factors have been widely known for some time. "Several research studies have examined the investment behavior of 401(k) plan participants. The largest ongoing empirical study to date has been conducted by the non-partisan Employee Benefit Research Institute ("EBRI Study"). The EBRI Stndy, which began in 1996, covers 35,367 401(k) plans with 11.8 million active participants and $579.8 billion in plan assets. This study has consistently found that, when company stock is offered as an investment option, participants strongly tend to select company stock in lieu of a more diversified equity mutual fund." [Colleen E. Medill, *Enron and the Pension System,* in Rapoport and Dharan, eds., Enron Corporate Fiascos and Their Implications (Foundation Press, 2004) at page 481]
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> Accordingly, the investment brochures, in order to comply with the requirements of the regulations, should spell out the specific risk and return characteristics of an investment in employer stock by an employee, in relation to the risk and return characteristics of the other investments available under the Plan.

Often, the only indication that employer stock might be at all riskier than any mutual fund is a statement that "It generally carries more risk than do the mutual funds offered through the Plan." This is woefully inadequate to alert the average Plan participant to the risks of investing in employer stock.

Plan fiduciaries may not be relieved of liability under Section 404(c) for participants' decisions to invest in employer stock if the participants do not receive adequate information regarding employer stock. Moreover, ERISA Section 404(c) does not relieve plan fiduciaries of the responsibility for determining whether it is appropriate to offer employet stock as an investment option under the Plan. [*Tittle v. Enron Corp.*, 284 F. Supp. 2d 511 (S.D. Tex. Sept. 30, 2003)] In the *Enron* case, the court noted that Section 404(c) relief applies only to the extent that the participant "exercises independent control" over the investment of his or her account. Citing the DOL regulations, the court noted that a participant's exercise of control will not be considered "independent" if, among other things:

> The participant or beneficiary is subjected to improper influence by a plan fiduciary or plan sponsor with respect to the transaction; or
>
> A plan fiduciary has concealed material non-public facts regarding the investment from the participant or beneficiary, unless the disclosure of such information by the plan fiduciary to the participant or beneficiary would violate any provision of federal law or any provision of state law which is not preempted by ERISA. The court rejected the defendants' assertion that Federal law prohibited the fiduciaries from publicly disclosing the accounting fraud and Enron's true financial condition.

Commentators on the proposed regulations asked for clarification that a plan that fails to comply with the requirements of Regulations Section 2550.404c-1(d)(2)(ii)(E)(4) (special requirements for the acquisition or sale of employer securities) loses Section 404(c) protection only for transactions in employer securities. The preamble to the final regulations states that:

> A plan which otherwise qualifies as an ERISA section 404(c) plan would not cease to be an ERISA section 404(c) plan merely because a particular non-core investment alternative offered under the plan (e.g., an employer security investment alternative) fails to meet the requirements for section 404(c) relief. Accordingly, to the extent that an employer security investment altemative fails to comply with the requirements of paragraph (d)(2)(ii)(E)(4), the fiduciaries of a plan which otherwise meets the requirements of section 404(c) would lose section 404(c) protection and would be tesponsible 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.

The court also pointed out that, under the terms of the Enron plan, matching contributions were required to remain invested in Enron stock until the participant attained age 50. Accordingly, Section 404(c) protection was not available with respect to the investment of matching contributions prior to age 50.

In *In re Dynegy, Inc. ERISA Litigation* [309 F. Supp. 2d 861 (S.D. Tex. Mar. 5, 2004)] the court refused to dismiss the plaintiffs' claim that the fiduciary breached

its duties of loyalty and prudence by failing to eliminate the Dynegy Stock Fund as an investment option. The defendants argued that they were exempted from liability by Section 404(c). The plaintiffs argued that Section 404(c) was not applicable, because the defendants prevented Plan participants from exercising control with respect to Dynegy stock by concealing material, non-public facts.

Factors That Do Not Negate the Opportunity to Exercise Control

A plan does not fail to provide an opportunity for a participant or beneficiary to exercise control merely because: [29 C.F.R. § 2550.404c-1(b)(2)(ii)]

1. The plan charges participants' and beneficiaries' accounts for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform such participants and beneficiaries of actual expenses incurred with respect to their individual accounts.
2. The plan permits a fiduciary to decline to implement investment instructions.
3. The plan imposes reasonable restrictions on the frequency of investment instructions. No restriction is reasonable unless, with respect to each investment alternative, it permits participants and beneficiaries to give investment instructions with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject. In addition, the plan must satisfy the frequency requirements set out in Exhibit III.

What Is a Broad Range of Investment Alternatives?

A plan offers a broad range of investment alternatives only if the available investment alternatives provide the participant or beneficiary with a reasonable opportunity to:

(A) Materially affect (i) the potential return on amounts with respect to which he or she is permitted to exercise control and (ii) the degree of risk to which such amounts are subject;
(B) Choose from at least three investment alternatives:
(1) Each of which is diversified. As the preamble notes, "Inasmuch as employer securities would not themselves represent a diversified investment alternative, . . . employer securities or a fund of such securities could not be used as one of the investment alternatives intended to satisfy the broad range of investments requirements of the regulation."
(2) Each of which has materially different risk and return characteristics;
(3) Which in the aggregate enable the participant or beneficiary, by choosing among them, to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and
(4) Each of which, when combined with investments in the other alternatives, tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio;
(C) Diversify the investment of that portion of his or her account with respect to which he or she is permitted to exercise control so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' or beneficiaries' accounts. The nature of the investment alternatives offered, and the size of the portion of the individual's account over which he or she is permitted to exercise control, must be considered. Where that portion of the account of any participant or beneficiary is so limited in amount that the opportunity to invest in look-through investment vehicles (such as mutual funds) is the only prudent means to assure an opportunity to achieve appropriate diversification, a plan must offer look-through investment vehicles in order to satisfy this requirement.

If look-through investment vehicles are available, the underlying investments of those vehicles are considered in determining whether the plan satisfies the requirements of (B) and (C).

The SEC recently announced that it has begun an investigation into mutual fund investments in 401(k) plans. [*See* Nadel and Friedman, "SEC Turns Up Heat on 401(k) Fiduciaries," *www.bnatax.com/tm/insights_SEC401K.htm*]

In the preamble, the DOL noted 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 of such plan. Thus, for example, in the case of look-through investment vehicles, the plan fiduciary has a fiduciary obligation to prudently select such vehicles, as well as a residual fiduciary obligation to periodically evaluate the

performance of such vehicles to detetmine, based on that evaluation, whether the vehicles should continue to be available as participant investment options. Similat fiduciary obligations would exist in the case of an investment universe consisting of investment alternatives which are not look-through investment vehicles but which are specifically designated by plan fidnciaries. In those situations where the ERISA section 404(c) plan by its own provisions limits the investment universe by designaring specific investment alternatives which are not look-throtugh investment vehicles, the plan fiduciary must comply with the requirements of ERISA section 404(a)(1)(D).

DOL has issued opinions confirming the duty to provide only prudent investment options. [*See, e.g.*, Adv. Op. No. 98-04A]

Exercise of Control

Section 404(c) relief applies only with respect to a transaction where a participant or beneficiary has exercised *independent control in fact* with respect to the investment of assets in his or her individual account. [29 C.F.R. § 2550.404c-1(c)(1)(i)] In view of the transactional nature of the relief provided by Section 404(c), a determination whether a participant or beneficiary has in fact exercised control must be made on a case by case basis, taking into account the relevant facts and circumstances.

If the investment was the result of an exercise of control, then the participant or beneficiary will also be deemed to have exercised control with respect to the exercise of voting, tender, and similar appurtenant rights, provided that (1) he or she was provided a reasonable opportunity to give instructions with respect to such incidents of ownership, including the provision of the information described in Regulations Section 2550.404c-1(b)(2)(i)(B)(1)(ix), [*see* item (ix) of Exhibit I] and (2) the participant or beneficiary has not failed to exercise control by reason of the circumstances described in Regulations Section 2550.404c-1(c)(2) (improper influence, concealment of material non-public facts, or incompetence).

Whether a participant or beneficiary *has* exercised independent control in fact with respect to a transaction depends on the facts and circumstances. An exercise of control is *not* independent in fact if:

The participant or beneficiary is subjected to improper influence by a plan fiduciary or the plan sponsor with respect to the transaction. As the preamble notes, "the question of whether thete has been improper influence by a plan sponsor or fiduciary in a given situation is inherently factual in nature and can only be determined on a case by case basis, taking into account all surrounding facts and circumstances."; or

A fiduciary has concealed material non-public facts regarding the investment from the participant or beneficiary, unless the disclosure of such information by the plan fiduciary to the participant or beneficiary would violate any provision of federal law or any provision of state law which is not pteempted by ERISA. Section 404(c) relief is unavailable if any fiduciary (not necessarily the defendant) has concealed material; or

The participant or beneficiary is legally incompetent, and the fiduciary accepts his or her instructions, knowing him or her to be incompetent.

The following question and answer are from the DOL Q&A Session at the 2000 ASPA Annual Conference:

Does 404(c) apply to participants who are mapped into like funds during administrative changes, i.e., large cap to large cap? How about one S&P index to anothet S&P index?
DOL Response: In order for the protections afforded by Section 404(c) to be applicable, the participant must have exercised independent control in fact with respect to the investment of assets in his ot her account. The question presented raises an issue as to whethet the participant is making the choice of investment as is required by the Seetion 404(c) regulations. If the investment choices for mapping purposes are disclosed in advance and a participant affirmatively makes an election with respect to the mapping funds, then presumably Section 404(c) will apply if all other requitements are met.

The final regulations do not provide 404(c) protection for a default investment option.

The final regulation retains the approach of the 1991 ptoposal, pursuant to which plan fiduciaries will not be relieved of responsibility for investment decisions under an ERISA section 404(c) plan uuless those decisions have affirmatively been made by participants and beneficiaries who have exercised independent conttol. In this regard, it should be noted that, as in any other type of ERISA-covered plan, fiduciaries of ERISA section 404(c) plans have a dury to provide for the

investment of idle plan assets, and lack of participant direction will not absolve a fiduciary from such duties. The Department also notes that plan provisions providing for investments in the absence of an affirmative exercise of control may be followed only if the fiduciary determines that following such provisions would not violate his fiduciary duties, including his duties under sections 404 and 406 of ERISA.

Transactions Involving a Fiduciary

In the case of a sale, exchange, or leasing of property (other than a transaction described in Regulations Section 2550.404c-1(d)(2)(ii)(E)) between an ERISA Section 404(c) plan and a plan fiduciary or an affiliate of a fiduciary, or a loan to a plan fiduciary or affiliate, the participant or beneficiary will *not* be deemed to have exercised independent control unless the transaction is fair and reasonable to him or her. [29 C.F.R. § 2550.404c-1(c)(3)] For this purpose, a transaction will be deemed to be fair and reasonable if he or she pays no more than, or receives no less than, adequate consideration (as defined in Section 3(18) of ERISA) in connection with the transaction.

Investment Advice

A fiduciary has no obligation under the Act to provide investment advice to a participant or beneficiary under an ERISA Section 404(c) plan.

Effect of Independent Exercise of Control

If a participant or beneficiary of an ERISA Section 404(c) plan exercises independent control over assets in his individual account, then

he or she is not a fiduciary by reason of such exercise of control; and
no other fiduciary will be liable for any loss, or with respect to any breach of part 4 of Title I of the Act, that is the *direct and necessary result* of that exercise of control. [29 C.F.R. §§ 2550.404c-1(d)(1), 2550.404c-1(d)(2)(i)]

This does *not* apply [29 C.F.R. § 2550.404c-1(d)(2)(ii)] with respect to any instruction which, if implemented,

(A) Would not be in accordance with the plan documents, insofar as the documents are consistent with Title I of ERISA;

(B) Would cause a fiduciary to maintain the indicia of ownership of any plan asset outside the jurisdiction of the U.S. district courts, other than as permitted by section 404(b) of ERISA and 29 CFR 2550.404b-1;

(C) Would jeopardize the plan's qualified status under the Code;

(D) Could result in a loss in excess of a participant's or beneficiary's account balance; or

(E) Would result in a direct or indirect:

(1) Sale, exchange, or lease of property between a plan sponsor (or any affiliate of the sponsor) and the plan, except for (i) the acquisition or disposition of any interest in a fund or portfolio managed by a plan sponsor or affiliate, or (ii) the purchase or sale of auy qualifying employer security (as defined in section 407(d)(5)) which meets the conditions of section 408(e) of ERISA and Reg. section 2550.404c-1(d)(2)(ii)(E)(4);

(2) Loan to a plan sponsor or any affiliate;

(3) Acquisition or sale of any employer real property (as defined in section 407(d)(2)); or

(4) Acquisition or sale of any employer security, except to the extent that:

Such securities are qualifying employer securities (as defined in section 407(d)(5));

Such securities are stock or an equity interest in an existing publicly traded partnership, as defined in section 10211(c)(2)(A) of the Revenue Act of 1987;

Such securities are publicly traded on a national exchange or other generally recognized market;

Such securities are traded with sufficient frequency and in sufficient volume to assure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently;

Information provided to shareholdets of such securities is provided to participants and beneficiaries with accounts holding such securities;

Voting, tender and similar rights are passed through to participants and beneficiaries with accounts holding such securities;

Information relating to the purchase, holding, and sale of securities, and the exercise of voting, tender and similar rights by participants and beneficiaries, is maintained in accordance with procedures which are designed to safeguard the confidentiality of such information, except to the extent necessary to comply with Federal laws or state laws not preempted by the Act;

The plan designates a fiduciary who is responsible for ensuring that (i) these procedures are sufficient to safeguard the confidentiality of the information, (ii) such procedures are being followed, and (iii) the independent fiduciary required by 29 C.F.R. section 2550.404c-1(d)(2)(ii)(E)(4)(ix) is appointed; and

An independent fiduciary is appointed to carry out activities relating to any situations which the fiduciary designated by the plan determines involve a potential for undue employer influence upon participants and beneficiaries with tegard to the direct or inditect exercise of shareholder rights. For this purpose, a fiduciary is not independent if the fiduciary is affiliated with any sponsor of the plan.

The individual investment decisions of an investment manager, who is designated directly by a participant or beneficiary, or who manages a look-through investment vehicle in which a participant or beneficiary has invested, are not direct and necessary results of the designation of the investment managet or of investment in the look-through investment vehicle. However, this will not be construed to result in liability under Section 405 of ERISA with respect to a fiduciary (other than the investment manager) who would otherwise be relieved of liability by Section 404(c)(2).

Examples from the Regulations [29 C.F.R. § 2550.404c-1(f)]

(8) Pursuant to the terms of the plan, plan fiduciary F designates thtee reputable investment managers whom participants may appoint to manage assets in their individual accounts. Participant P selects M, one of the designated managers, to manage the assets in his account. M prudently manages P's account for 6 months after which he incurs losses in managing the account through his imprudence. M has engaged in a breach of fiduciary duty because M's imprudent management of P's account is not a direct or necessary result of P's exercise of control (the choice of M as managet). F has no fiduciary liability for M's imprudence because he has no affirmative duty to advise P (see paragraph (c)(4)) and because F is relieved of co-fiduciary liability by reason of section 404(c)(2) (see paragraph (d)(2)(iii)). F does have a duty ro monitor M's performance to determine the suitability of continuing M as an investment manager, however, and M's imprudence would be a factor which F must consider in periodically reevaluating its decision to designate M.

(9) Participant P instructs plan fiduciary F to appoint G as his investment manager putsuant to the tetms of the plan which provide P total discretion in choosing an investment manager. Through G's imprudence, G incurs losses in managing P's account. G has engaged in a breach of fiduciary duty because G's imprudent management of P's account is not a direct or necessary result of P's exercise of control (the choice of G as manager). Plan fiduciary F has no fiduciary liability for G's imprudence because F has no obligation to advise P (see paragraph (c)(4)) and because F is telieved of co-fiduciary liability for G's actions by reason of section 404(c)(2) (see paragraph (d)(2)(iii)). In addition, F also has no duty to determine the suitability of G as an investment manager because the plan does not designate G as an investment manager.

Brokerage Accounts

As in Example (9), above, some plans allow participants to set up a brokerage account, under which the investment of the assets in that participant's account is managed by any investment manager chosen by the participant. These arrangements raise numerous difficult issues:

Even though there is nothing in the 404(c) regulations that specifically makes 404(c) protection unavailable for broketage accounts, there is still some question of whether it is possible to comply with all of the 404(c) requirements tespecting such accounts. One of the requirements of the regulations is to provide participants with all information reasonably required to enable them to make informed investment decisions. The obvious question is, can that be done in the context of a brokerage account? [Reish and Ashton, *supra*]

Prohibited Transactions

Section 404(c) relief applies only to the provisions of part 4 of title I of ERISA. It does not relieve a disqualified person from the taxes imposed by Section

4975 of the Code with respect to the transactions prohibited by Section 4975(c)(1).

EXHIBIT I
Information to be Provided Automatically

The participant or beneficiary must be provided by an identified plan fiduciary (or a person or persons designated by that plan fiduciary):

(i) An explanation that the plan is intended to constitute a plan described in section 404(c) and the regulations, and that the fiduciaries may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by such participant or beneficiary. The SPD is now required to state whether the plan is intended to be a 404(c) plan; [29 CFR section 2520.102-3(d)]

(ii) A description of the investment alternatives available and, with respect to each investment alternative, a general description of the investment objectives and risk and return characteristics of such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designed investment alternative;

(iii) Identification of any designated investment managers;

(iv) An explanation of the circumstances under which participants and beneficiaries may give investment instructions and explanation of any limitations on such instructions, including (1) any restrictions on transfer to or from a designated investment alternative, and (2) any restrictions on the exercise of voting, tender and similar rights appurtenant to a participant's or beneficiary's investment in an investment alternative;

(v) A description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales (e.g., commissions, sales load, deferred sales charges, redemption or exchange fees);
(vi) The name, address, and phone number of the plan fiduciary (and, if applicable, the person or persons designated by the plan fiduciary) responsible for providing the information described in 29 C.F.R. section 2550.404c-1(b)(2)(i)(B)(2) upon request, and a description of the information which may be obtained on request (see Exhibit II);

(vii) In the case of plans which offer an investment alternative which is designed to permit a participant or beneficiary to directly or indirectly acquire or sell any employer security ("employer security alternative"), a description of the procedures established to provide for the confidentiality of (1) information relating to the purchase, holding and sale of employer securities, and (2) the exercise of voting, tender and similar rights, by participants and beneficiaries, 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;

(viii) In the case of an investment alternative which is subject to the Securities Act of 1933, immediately prior to or following the participant's or beneficiary'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 section 404(c) protection;

(ix) 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 and beneficiaries under the terms of the plan, and a description of or reference to plan provisions relating to such rights.

EXHIBIT II
Information to be Provided Automatically or Upon Request

The participant or beneficiary must be provided by the identified plan fiduciary (or a person or persons designated by the plan fiduciary), either directly or upon request, the following information, based on the latest information available to the plan:
(i) A description of the annual operating expenses of each designated investment alternative which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets;

(ii) Copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternative, to the extent such information is 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 section 404(c) protection;

(iii) A list of the assets comprising the portfolio of each investment alternative which constitute plan assets (see 29 C.F.R. section 2510.3-101), the value of each such asset (or the proportion of the investment alternative which it comprises), and, with respect to any asset which is a fixed rate investment contract issued by a bank, savings and loan association or insurance company, the name of the issuer, the term of the contract and the rate of return on the contract;

(iv) Information concerning the value of shares or units in available investment alternatives, and the past and current investment performance of such alternatives determined, net of expenses, on a reasonable and consistent basis; and

(v) Information concerning the value of shares or units in designated investment alternatives held in the account of the participant or beneficiary.

Exhibit III
Frequency of Investment Instructions

(1) At least three of the investment altetnatives made available pursuant to 29 C.F.R. section 2550.404c-1(b)(3)(i)(B), which constitute a broad range of investment alternatives, must permit participants and beneficiaries to give investment instructions at least once in any three month petiod. The preamble states:

Several commentators asked if the three-month minimum is applicable only to transfers among the core investment alternatives. The three-month minimum is applicable only to such transfers and does not apply to transfers between core investment alternatives and other alternatives. Such an investment alternative would, however, be subject to the general volatility rule contained in paragraph (b)(2)(ii)(C) (which requires that the ftequency of opportunity to give investment instructions be determined telative ro the anticipated market volatility of the investment) as a condition to affording section 404(c) relief for amounts invested in that alternative.

(2)(i) At least one of the investment alternatives meeting the requirements of 29 C.F.R. section 2550.404c-1(b)(2)(ii)(C)(1) must permit investment instructions with regard to transfers into the investment alternative as frequently as participants and beneficiaries are permitted to give investment instructions with respect to any investment alternative made available by the plan which permits participants and beneficiaries to give investment instructions more frequently than once within any three month petiod; or

(ii) With respect to each investment alternative which permits investment instructions more frequently than once within any three month period, participants and beneficiaties must be permitted to ditect their investments from such alternative into an income producing, low risk, liquid fund or accounr as frequently as they are permitted to give investment instructions with respect to each such alternative and, with respect to such fund or account, participants and beneficiaries must be permitted to direct investments from the fund or account to an investment alternative meeting the requitements of 29 C.F.R. section 2550.404c-1(b)(2)(ii)(C)(1) as frequently as they are permitted to give investment insttuctions with respect to that investment alternative; and

(3) With tespect to transfers from an employer security alternative, either:

(i) All of the investment alternatives meeting the requirements of 29 C.F.R. section 2550.404c-1(b)(2)(ii)(C)(1) must petmit participants and beneficiaries to give invesrment instructions with regard to transfers into each of the investment altetnatives as frequently as participants and beneficiaries are permitted to give investment insttuctions with respect to the employer security alternative; or

(ii) Participants and beneficiaries must be permitted to direct their investments from each employer security alternative into an income producing, low risk, liquid fund or account as frequently as they are permitted to give investment instructions with respect to such employer security alternative and, with respect to such fund or account, participants and beneficiaries are permitted to ditect investments from the fund or account to each investment alternative meeting the requirements of 29 C.F.R. section 2550.404c-(b)(2)(ii)(C)(1) as frequently as they are permitted to give investment instructions with respect to each such investment alternative.

EXHIBIT IV
Section 404(c) Checklist

All of the following questions should be answered Yes for the plan to be classified with confidence as an ERISA section 404(c) plan, with respect to a particular ttansaction. Isolated and minor failures to comply may not deptive the fidnciaries of 404(c) protection, but it is safer to comply fully.

1. Is the plan an individual account plan (see above)?
2. If the plan requires steps to be taken or documents to be executed as a precondition of participants or beneficiaries exercising control, have all requirements been satisfied?

3. Under the terms of the plan, do participants and beneficiaries 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?

4. Is the participant or beneficiary provided, or does he or she have the opportunity to obtain, sufficient information to make informed decisions with regard to investment alternatives available under the plan?

5. Does the plan provide to participants and beneficiaries (i) automatically, ALL of the information listed in Exhibit I above and (ii) either automatically or upon request, ALL of the infotmation listed in Exhibit II above?

6. Does the plan chatge to participants' and beneficiaries' accounts only the teasonable expenses of carrying out investment instructions?

7. Does the plan periodically inform participants and beneficiaries of actual expenses incurred with respect to theit individual accounts?

8. If the plan imposes restrictions on the frequency of investment instructions, are the restrictions (indiv-idual-ly and in comhination) reasonable? (Note: no testriction is reasonable unless, with respect to each investment alternative, it permits participants and beneficiaries to give investment instructions with a ftequency which is apttopriate in light of the market volatiliry to which the investment alternative may reasonably be expected to be subject. In addition, the plan must satisfy the frequency requirements set out in Exhibit III.)

9. Does the plan offers a broad range of investment alternatives that provide the participant or beneficiary with a reasonable opportunity to materially affect (i) the potential return on amounts with respect to which he or she is permitted to exercise control and (ii) the degree of risk to which such amounts are subject?
10. Does the plan offet at least three investment alternatives that satisfy the 4 requirements set out in paragraph (B) under "What Is a Broad Range of Investment Alternatives," above?

11. Do the available investment alternatives allow the participant to diversify the investmenr of his or her account in the manner described above?

12. With respect to the transacrion in question, has the participant or beneficiary exercised independenr control in fact with respect to the investment of assets in his or her individual account?

13. With respect to the exercise of voring, tender and similar rights, was the participant or beneficiary provided a reasonable opportunity to give instructions with respect to such rights, including the provision of the information described in section 2550.404c-1(b)(2)(i)(B)(1)(ix) of the regulations (see item (ix) of Exhibit I)?

14. The participant or beneficiary was not subjected to improper influence by a plan fiduciary or the plan sponsor with respect to the transaction in question.

15. No fiduciary has concealed material non-public facts regarding the investment from the participant or beneficiary (unless the disclosure of such information by the plan fiduciary to the participant or beneficiary would violate any provision of federal law or any provision of state law which is not preempted by ERISA).

16. The fiduciary did not accept the participant's ot beneficiary's instructions, knowing him ot her to be incompetent.

17. The particular investment is the result of an affitmative instruction from the participant or beneficiary and is not, *e.g.*, a default option or the result of mapping.

18. In the case of a transaction (other than a transaction desctibed in 29 C.F.R. section 2550.404c-1(d)(2)(ii)(E)) between an ERISA section 404(c) plan and a plan fiduciary or an affiliate, or a loan to a plan fiduciary or affiliate, the transaction is fair and reasonable to the participant or beneficiary.

19. The loss or fiduciary breach, for which 404(c) protection is claimed, is the direct and necessary result of that exercise of control by the participant or beneficiary.

20. The instruction from the participant or beneficiary, if implemented, would be in accordance with the plan

documents, insofar as the documents are consistent with Title I of ERISA.

21. The instruction from the participant or beneficiary, if implemented, would nor cause a fiduciary to maintain the indicia of ownership of any plan asset outside the jurisdiction of the U.S. district coutts, other than as permitted by section 404(b) of ERISA and 29 C.F.R. 2550.404b-1.

22. The instruction from the participant or beneficiary, if implemented, would not jeopardize the plan's qualified status under the Code.

23. The instruction from the participant or beneficiary, if implemented, could not result in a loss in excess of the participant's or beneficiary's account balance.

24. The instruction from the participant or beneficiary, if implemented, would not result in a direct or indirect sale, exchange, or lease of property between a plan sponsor (or any affiliate of the sponsor) and the plan, except for (i) the acquisition or disposition of any interest in a fund or portfolio managed by a plan sponsor or affiliare, or (ii) the purchase or sale of any qualifying employer security (as defined in section 407(d)(5)) which meets the conditions of section 408(e) of ERISA and 29 C.F.R. section 2550.404c-1(d)(2)(ii)(E)(4).

25. The instruction from the participanr or beneficiary, if implemented, would not result in a direct or indirect loan to a plan sponsor or any affiliate.

26. The instruction from the participant or beneficiary, if implemented, would not result in a direct ot indirect acquisition or sale of any employer real property (as defined in section 407(d)(2)).

27. The instruction from the participant or beneficiary, if implemented, would not result in a direct or indirect acquisition or sale of any employer security, except to the extent that the conditions listed in (E)(4) under "Effect of Independent Exercise of Control," above, are satisfied. ■