THE ERISA COMPLIANCE GUIDE

Marcia S. Wagner
Stephen J. Migausky
Daniel L. Blynn

The Wagner Law Group

MARCIA S. WAGNER is a specialist in pension and employee benefits law, and is the principal of The Wagner Law Group, which she founded over 15 years ago. A *summa cum laude* and Phi Beta Kappa graduate of Cornell University and a graduate of Harvard Law School, she has practiced law for over twenty-five years. Ms. Wagner is recognized as an expert in a variety of employee benefits issues and executive compensation matters, including qualified and non-qualified retirement plans, all forms of deferred compensation, and welfare benefit arrangements. Ms. Wagner was appointed to the IRS Tax Exempt & Government Entities Advisory Committee, ended her three-year term as the Chair of its Employee Plans subcommittee, and received the IRS' Commissioner's Award. Ms. Wagner has also been inducted as a Fellow of the American College of Employee Benefits Counsel. For the past four years, 401k Wire has listed Ms. Wagner as one of its 100 Most Influential Persons in the 401(k) industry, and she has received the Top Women of Law Award in Massachusetts and is listed among the Top 25 Attorneys in New England by Boston Business Journal. Ms. Wagner has written hundreds of articles and 11 books about retirement and benefit plans. Ms. Wagner is widely quoted in such publications as The Wall Street Journal, Financial Times, Pension & Investments, and more, as well as being a frequent guest on FOX Business, CNN, Bloomberg, NBC and other televised media outlets. She resides in Massachusetts with her husband, Craig, and their four wonderful children.

STEPHEN J. MIGAUSKY has been practicing in the area of ERISA and employee benefit law for over 30 years, has authored numerous articles and is expert in all matters concerning, tax qualified plans, nonqualified plans, and fiduciary matters. Mr. Migausky is a graduate of Boston College and Boston College Law School.

DANIEL L. BLYNN is a third year student at the Georgetown University Law Center and a *cum laude* graduate of Brandeis University. He currently serves as the Senior Executive Articles Editor for the Georgetown Journal of Legal Ethics. In ERISA, Mr. Blynn has helped edit the Tax Management Portfolio: ERISA—Litigation, Procedure, Preemption and Other Title I Issues. Prior to working with Ms. Wagner, Mr. Blynn was a research assistant for Professor Michael Cedrone and is also the author of *Cy Pres Distributions: Ethics and Reform.* While at Brandeis, Mr. Blynn was a successful debater, making it to Quarterfinals of the American Parliamentary Debate Association's National Championship.

TABLE OF CONTENTS

CHAPTER 1 – WHO AND WHAT ARE FIDUCIARIES? 1

WHAT IS ERISA? 1
THE ERISA FIDUCIARY 1
DIAGRAM 1: DETERMINING IF AN INDIVIDUAL IS A PLAN FIDUCIARY 4
The Significance of Being a Fiduciary 5
The Duties of a Fiduciary 5
Liability for Breach of Fiduciary Duty 9
CONCLUSION 10

CHAPTER 2 – DOL REGULATORY EFFORTS IN 2010 – SIGNIFICANT CHANGES IN MANAGEMENT OF RETIREMENT PLANS 11

IMPROVING TRANSPARENCY THROUGH 408(B)(2) FEE DISCLOSURES 11
GREATER ACCOUNTABILITY FOR PROVIDERS OF INVESTMENT ADVICE TO PLANS 12
HELPING PARTICIPANTS MAKE BETTER INVESTMENT DECISIONS 14
Participant Level Fee Disclosures 14
Participant Level Investment Advice 15
MAKING SAVINGS LAST THROUGH RETIREMENT—LIFETIME INCOME OPTIONS 15
IMPROVING DISCLOSURES FOR TARGET DATE FUNDS ("TDFS") 16

CHAPTER 3 – SERVICE PROVIDER DISCLOSURE 18

COVERED PLAN 18
COVERED SERVICE PROVIDER 18
DISCLOSURES REQUIRED 19
Services 19
Fiduciary Status 19
Compensation Disclosures 20
Format of Disclosures and Manner of Receipt 21
Timing of Disclosures 21
THE PLAN FIDUCIARY'S RESPONSIBILITIES 22

CHAPTER 4 – SERVICE PROVIDERS AS FIDUCIARIES 24

INVESTMENT ADVISERS 24
BROKER-DEALERS 25
RECORDKEEPERS 26
THIRD PARTY ADMINISTRATORS 26
ATTORNEYS, ACTUARIES, ACCOUNTANTS AND CONSULTANTS 26

CHAPTER 5 – PARTICIPANT LEVEL DISCLOSURES 27

INVESTMENT NOTICES & OTHER FEES 27
Investment Options and Fees 28
Administrative Fees 29
Information Available upon Request 30
QDIA DISCLOSURES 30
SUMMARY PLAN DESCRIPTION 31
NOTICES OF SIGNIFICANT REDUCTION IN BENEFIT ACCRUALS 32

CHAPTER 6 – MANAGING YOUR FIDUCIARY DUTIES 34

LIMITING PERSONAL LIABILITY 34
PARTICIPANT DIRECTED ACCOUNTS 34
DIAGRAM 2: DETERMINING IF A PLAN IS A §404(C) PLAN 35
OPPORTUNITY TO EXERCISE CONTROL 36
DIAGRAM 3: DETERMINING IF A PLAN PROVIDES AN OPPORTUNITY TO EXERCISE CONTROL OVER ASSETS 38
BROAD RANGE OF INVESTMENT ALTERNATIVES 39
DIAGRAM 4: DETERMINING IF A PLAN PROVIDES A BROAD RANGE 40
EXERCISE OF CONTROL 41
OTHER MEANS OF LIMITING LIABILITY 41
DELEGATING FIDUCIARY DUTIES 41
CO-FIDUCIARY LIABILITY 42
LIABILITY INSURANCE 42

CHAPTER 7 – CONSEQUENCES OF FAILING TO MEET YOUR FIDUCIARY DUTY 44

TYPES OF VIOLATIONS 44
Civil Violations 44
Criminal Violations 45
ERISA AND TAX CODE PENALTIES 46
Tax Code Penalties 46
WHO MAY BRING LAWSUITS FOR A BREACH? 46
CORRECTING BREACHES 47
Eligibility 47
Application Procedures 48
TYPES OF ACTIONS THAT MAY BE CORRECTED 48
Delinquent Participant Contributions 49
Loans 49
Transactions Involving Plan Assets 49
Improper Valuation of Benefits 49
Duplicate or Excessive Plan Expenses 49
DOL INVESTIGATIVE AUTHORITY 50

CHAPTER 8 – FIDUCIARY RESPONSIBILITY AND THE MANAGEMENT OF PLAN ASSETS 51

INVESTMENT PROCEDURES 51
Benefits and/or Investment Committee 51
Trustees as Fiduciaries 52
Investment Manager 52
STATEMENT OF INVESTMENT POLICY 53
Continuous Monitoring 54
Utilization of An Independent Third Party Investment Expert 54
Replace Funds That Do Not Meet Investment Criteria 54
CONFLICTS OF INTEREST 54
SELECTING AN ADVISER 56
Selecting and Monitoring Pension Consultants 56
Selecting and Monitoring Plan Service Providers 58
DOCUMENTING PLAN OPERATIONS 60

CHAPTER 9 – PROHIBITED TRANSACTIONS 61

WHAT IS A PROHIBITED TRANSACTION? 61
DETERMINING IF AN INDIVIDUAL IS A PARTY IN INTEREST 62
DIAGRAM 6: IDENTIFYING PROHIBITED TRANSACTIONS 64
TYPICAL EXEMPTIONS 65
408(B)(2) EXEMPTION AND REGULATION 65
OTHER TYPICAL EXEMPTIONS 66
EXEMPTION REQUESTS 67

CHAPTER 10 – INVESTMENT ADVICE VS. INVESTMENT EDUCATION 70
WHAT IS INVESTMENT ADVICE? 70
WHAT CONSTITUTES INVESTMENT EDUCATION? 70
PLAN INFORMATION 70
GENERAL FINANCIAL AND INVESTMENT INFORMATION 71
ASSET ALLOCATION MODELS 71
INTERACTIVE INVESTMENT MATERIALS 71
RELATED PROHIBITED TRANSACTION RULES 72

Chapter 1 – Who and What are Fiduciaries?

At the core of ERISA is the requirement that identifiable persons take responsibility for the administration of retirement and welfare benefit plans. These people are called fiduciaries and this title (whether given formally or assigned because of functions performed by a person) comes with significant responsibilities associated with managing an ERISA plan. This book seeks to clarify who has these fiduciary responsibilities, what those responsibilities are, the relevant recent changes in the law, and how to avoid liability as a plan fiduciary.

Any discussion of the fiduciary's burden must begin with a discussion of who is a fiduciary. Because of the significant variances between different state laws, this book will primarily focus on the ERISA rules for fiduciaries and not coordinate state rules with regard to trusts and non-qualified plans. Thus, to determine who is an ERISA fiduciary, the first question is "what is covered by ERISA?"

What is ERISA?

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") is a federal law that establishes rules and regulations for the administration of voluntarily created pension or health plans. ERISA covers all plans established or maintained by either an employer engaged in commerce or an industry affecting commerce or any employee organization representing employees engaged in commerce or in an industry affecting commerce.[1] The types of plans covered under ERISA can include: pension benefit plans, such as defined benefit pension, profit sharing and 401(k) plans and welfare benefit plans (consisting of, among others, health insurance, long term disability and dental insurance plans).

As its title suggests, ERISA is primarily designed to ensure the security of retirement income benefits for those who were promised such benefits. ERISA does this through a variety of mechanisms. The statute requires disclosure of key information about the plan, establishes minimum standards for the vesting and accrual of benefits, and mandates an internal grievance process for the plan, among other provisions.

ERISA requires persons with authority over such plans or their assets to properly manage them and ensure that numerous technical requirements are met. These people are ERISA fiduciaries. They are charged with maintaining the plan's legal status and ensuring that participants and beneficiaries have their benefits properly managed and receive accurate information about the goings on of the plan.

The ERISA Fiduciary

[1] ERISA § 4(a)(1)-(3). Certain types of plans that are provided by employers or employee organizations are exempted from ERISA. These include governmental plans, church plans, plans existing solely for the purpose of complying with worker's compensation laws, plans maintained outside of the United States and excess benefit plans. *See* ERISA § 4(b)(1)-(5).

Fiduciary status entails significant responsibilities, yet it is not always clear who is a fiduciary. A plan can have more than one fiduciary, although every plan is required to have at least one. Any person who meets the definition of a fiduciary has the responsibilities of a fiduciary.[2] Under ERISA, a person is a fiduciary if he:

(i) Exercises any discretionary authority or discretionary control with respect to the management of the plan, or exercises any authority or control with respect to the management or disposition of plan assets
(ii) Renders investment advice for a fee or other compensation, direct or indirect, with respect to any plan asset, or has any authority or responsibility to do so; or
(iii) Has discretionary authority or discretionary responsibility in the administration of the plan.[3]

Note that satisfaction of any one of these requirements results in fiduciary status; it is not necessary to satisfy all three. These three criteria are functional tests for determining who is and who is not a fiduciary. While there are fiduciaries named in the plan document, ERISA more clearly envisions, as demonstrated by the definition of a fiduciary, giving this status to those who act like fiduciaries. Determination of fiduciary status is a fact intensive inquiry that presents a mixed question of fact and law and is situational or functional. Here is a small sample of acts that have been held to create fiduciary status:

- Appointing other plan fiduciaries
- Selecting plan investment vehicles
- Rendering investment advice for a fee
- Selecting, monitoring, or negotiating compensation for a third party service provider
- Exercising discretion in approving or denying benefits

Each of these actions involves discretionary decisions that affect the management and administration of the plan or assets which is why they have been held to be acts of a fiduciary.

Acting like a fiduciary is not the only way to become a fiduciary. Under ERISA § 402(a)(1), the plan document is required to name at least one fiduciary for the administration of the plan. This person, whether or not he exercises discretion over the plan or its assets, is a fiduciary because he has the legal authority to exercise such discretion, and thus the duty to ensure compliant actions. Individuals listed as trustee or plan administrators can also be considered fiduciaries (though not always in the case of administrators). Others potentially can be fiduciaries as well. Service providers, such as CPAs, attorneys, investment advisors and brokers can all become fiduciaries based upon the extent of their involvement in plan decisions.[4] While a fiduciary may be responsible for a breach of duty by other fiduciaries, a proper

---

[2] Though, some fiduciaries may not have the full responsibilities of a fiduciary and may be limited to only the duties that they are responsible for. Fiduciaries may also be liable for the wrong-doings of other fiduciaries. For more information, see *infra* Ch. 7.
[3] ERISA § (3)(21)(A)(i)-(iii).
[4] *See infra.* Ch. 4 for more information on the duties of service providers.

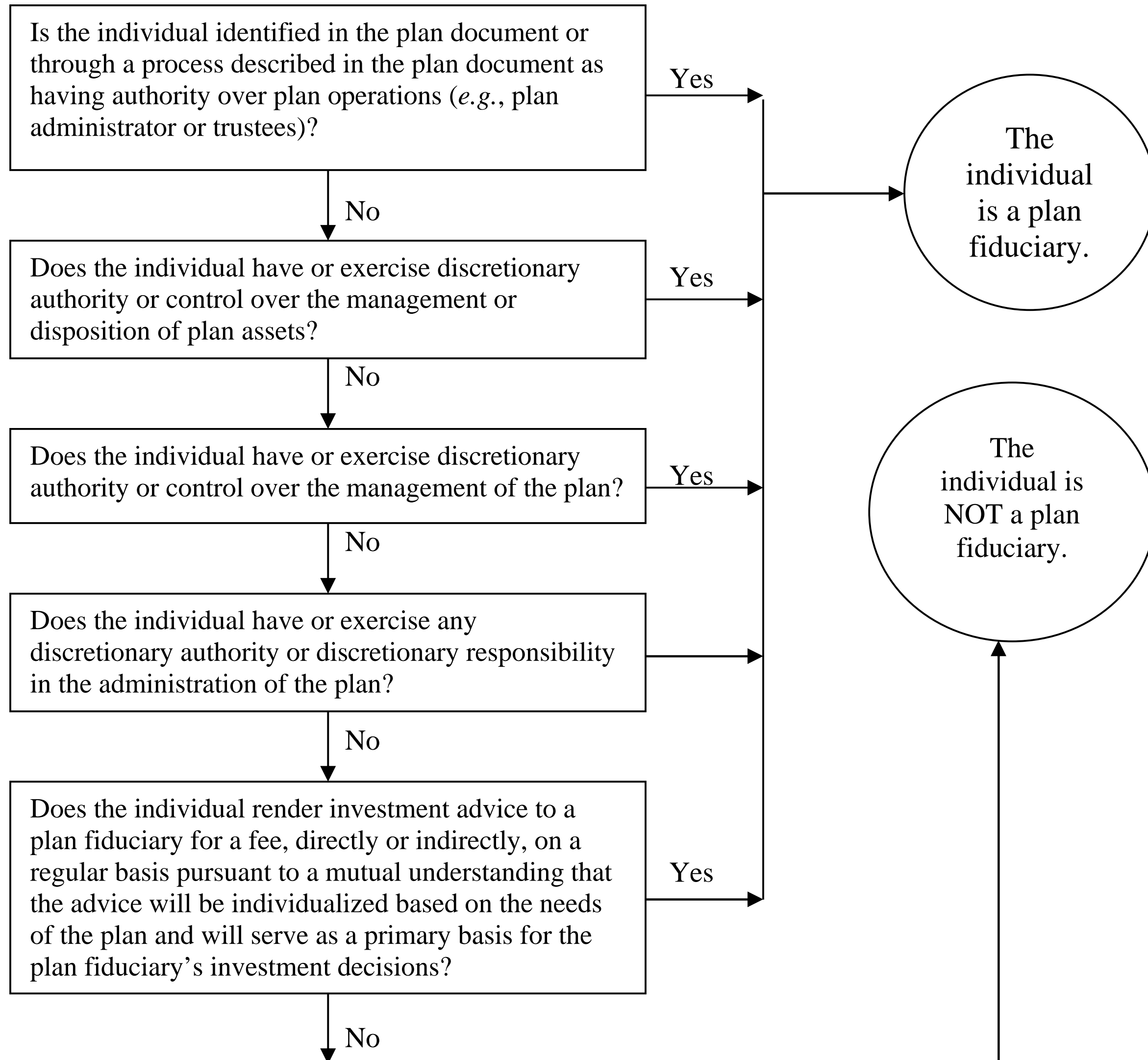
delegation of authority and monitoring the designee of fiduciary powers can avoid legal liability.[5]

The standards for becoming a fiduciary can be further clarified through a description of what does not qualify as fiduciary conduct; thus, purely ministerial acts do not endow a person with fiduciary status. Calculating benefits, maintaining records, and processing benefits claims are all actions that are ministerial and do not require discretion on the part of the employee. Conversely, using processed information to determine whether someone will receive benefits is more likely to be considered a fiduciary act because of the discretion involved.

[5] *See infra.* Ch. 6 for more information on limiting fiduciary duties

Diagram 1: Determining if an Individual is a Plan Fiduciary

INSTRUCTIONS: Use the flowchart below to determine if an individual is a plan fiduciary.



<u>Note</u>: Individuals who have committed certain crimes may not serve as fiduciaries.

<u>Note</u>: The test to determine fiduciary status is a functional one (*i.e.*, a person or entity that, in practice, has or exercises any discretionary authority or control with respect to the plan, is considered a fiduciary).

<u>Note</u>: Certain business decisions relating to the plan (*e.g.*, adopting or terminating a plan) are not fiduciary actions if conducted on behalf of the business, not the plan. An individual who implements business decisions, however, can be a fiduciary (*e.g.*, buying plan termination annuities would be a fiduciary act).

The Significance of Being a Fiduciary

Decision making authority over an ERISA plan entails certain obligations to the participants of that plan. Failure to meet these responsibilities can result in significant liabilities for the breaching fiduciary. Fiduciaries are personally liable for losses caused by their breaches; lost funds come from the fiduciary's pocket, not the plan's. Likewise, unjust enrichment or earnings must be disgorged. Thus, fiduciaries must be keenly aware of their obligations to the plan; otherwise they may be on the wrong end of a lawsuit from the DOL, IRS or from the plan's participants and beneficiaries.

The Duties of a Fiduciary

Fiduciaries have a general duty of loyalty to the plan they serve. Fiduciaries must discharge their duties solely in the interest of the participants and beneficiaries of the plan. This duty has been broken down into four distinct duties that encompass the primary responsibilities of a fiduciary. These duties, as listed in ERISA § 404(a)(1), are: the duty of prudence, the exclusive purpose rule, the duty to diversify, and the governing documents rule. In addition to these affirmative duties, there are specific prohibitions on fiduciary conduct, namely the prohibited transaction rules, that prevent the plan and fiduciaries from engaging in some conduct that is deemed inappropriate.

The Duty of Prudence

ERISA Fiduciaries are held to a high standard of decision-making expemplified by the duty of prudence. Section 404(a)(1)(B) of the statute articulates this duty by requiring fiduciaries to act:

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The duty of prudence imposes a very high standard on fiduciary conduct. Fiduciaries must act as a prudent person with subject matter expertise would act in a similar situation. Thus, fiduciaries must know what they are doing, or consult others who do, before making decisions that affect the plan.

The results of such decisions are often not as important as the process by which the decision was made. Fiduciaries are repsonsible for properly investigating investment menus and courses of action to ensure that they serve the goals of the plan. Markets can fluctuate and even the most experienced investor can make a decision that turns sour. It is important to ensure that due diligence was performed in making a decision, regardless of the result. The duty of prudence requires fiduciaries to investigate the merits of existing and proposed investments and in the process to collect and give appropriate consideration to all relevant information before making investment decisions.[6]

---

[6] *See, e.g.*, *Donovan v. Cunningham*, 716 F.2d. 1455 (5th Cir. 1983), *cert. denied*, 469 U.S. 1072 (1984).

Since the duty of prudence is largely procedural, fiduciaries are encouraged to create and maintain an investment policy statement ("IPS"), setting out the procedures by which the plan will determine which investment opportunities to pursue and/or offer to participants. An IPS likely will include a statement of the plan's investment objectives, guidelines for selecitng and changing investments, and a description of the roles of plan fiduciaries. The DOL encourages fiduciaries to establish an IPS to fulfil their duty of prudence.[7] Other plan procedure documents also serve this purpose and are recommended for any procedural decisions that fiduciaries may encounter.

In addition to the procedural requirements of the duty of prudence, there is a substantive element that fiduciaries must follow whereby the investigation and evaluation of an investment or investment course of action must be performed with the knowledge of an experienced investment fiduciary. This is a standard that many fiduciaries may be unable to meet, especially those without significant financial experience. The necessary financial analysis requires devising an appropriate IPS, regularly conducting reviews of the plan investments to ensure that they remain appropriate, defining the role of the various investments in the investment menu when applicable, collecting appropriate financial information on potential investment options, and executing fiduciary decisions in a timely and appropriate manner. Even if a plan sponsor or other plan fiduciaries are incapable of expertly gathering this information and making appropriate decisions, they are still held to the standard of an expert. When possible and certainly when the sponsor and fiduciaries are not financial experts, plans should seek the advice of experts to guide their decision-making process. Meeting with such experts regularly can also be of assistance in satisfying a fiduciary's duty to prudently monitor the current investment options.

Of course, investment decisions are only one example of acts that fall under the duty of prudence. Any decision a fiduciary makes regarding the plan must be made with all necessary prudence. Thus, fiduciaries should ensure that they gather all relevant information regarding other actions they plan to take (*e.g.*, decisions regarding benefit claims) and should idealy have procedural guidelines in place to make sure that all relevant issues have been considered.

The Exclusive Purpose Rule

Fiduciaries must act with the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of plan administration.[8] Known as the exclusive purpose rule, this provision requires that all other interests be subordinated to the interests of the plan's beneficiaries, including alternative interests of the plan sponsor or a fiduciary. Thus, fiduciary decisions will be judged solely on the basis of their potential costs and benefits to the plan. Acts that waste assets or do not further the goals of the plan cannot be taken. Additionally, any misappropriation or inappropriate dissipation of plan assets will also constitute a violation of the exlusive purpose rule.

---

[7] DOL Interpretive Bulletin 08-2, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines*, 29 CFR 2509.08-2.
[8] ERISA § 404(a)(1)(A).

Service Provider Fees

The exlusive purpose rule frequently comes into play regarding the issue of service provider fees. Services generating these fees, like other uses of plan assets, need to be prudently selected; otherwise the expenditure may waste plan assets. The DOL provides guidelines to ensure that fiduciaries are properly selecting fee arangements. Thus, compensation paid to service providers must be reasonable, the reasonableness of compensation can only be determined with sufficient information about fees, and sufficient information must be gathered through an objective process designed to determine the qualifications of the provider, quality of services, and reasonableness of fees in light of the services. Both the resulting fees and the procedure for ensuring their reasonableness are relevant factors in determining whether a fiduciary has been dutiful in his actions. Thus, as with choosing investments, the process for choosing service providers should be recorded. For fees relating to investment services, the IPS is an appropriate place to place these procedures; fees for administrative service providers can be located in a separate Fee Policy Statement.

The measures taken to evaluate both investment and administrative fees are similar. With both types of fees, fiduciaries should obtain information on the services or investments to be provided. This will include information about the qualifications of the people that will be providing services, total fees, how fees are determined, etc. This information should be compared to those of competitors. In some cases, a competitive bidding system would make this process more efficient and potentially drive down costs. Additionally, when comparing competitor fees, establishing rules that allow for simple, baseline comparisons of the competitors ("benchmarking") will streamline the process and ensure that the ideal outcome is ensured for the plan. Without such metrics for comparision, the plan is attempting to compare apples and oranges and fiduciaries may be responsible for later disagreements over how the plans should be measured against each other. Creating and following procedures established in advance will make it more likely that reasonable fees are paid.

Conflicts of Interest

Another problem which may arise under the exclusive purpose rule is potential conflicts of interest. If a fiduciary has conflicting obligations he or she is required to act in the best interest of the administration of the plan. The duty of loyalty to the plan trumps other duties that a fiduciary may have. Conflicts of interest are discussed in more detail in Chapter 9.

The Duty to Diversify

In addition to acting prudently and loyally serving the plan's interests, fiduciaries are obligated to ensure that plan assets are adequately diversified so as to avoid the risk of large losses.[9] The key aspect of this duty is to prevent plan assets from being exposed to risks of highly concentrated investments. There are no set rules on what is a sufficient amount of diversification for a plan. Fiduciaries should generally invest in a broad variety of asset classes

[9] ERISA §404(a)(1)(C).

and a variety of options within those classes to ensure that the plan's assets are properly diversified.

The duty to diversify and the duty of prudence, when combined, require that fiduciaries monitor plan investments. It is not enough to invest assets and then sit back and let the market work. Fiduciaries need to monitor assets to ensure that they are serving their intended purpose in the context of the plan's overall investment objectives. Thus, if an investment asset has recently become very risky, whereas it was originally thought of as a safe investment, the fiduciary needs to take measures to ensure that the preservation of value originally sought by the plan is maintained.

Diversification can also serve as a safeguard against fiduciary liability in certain circumstances. If plan participants decide their own investment allocations and the plan has a broad range of investment alternatives, then a fiduciary will not be held responsible for the investment decisions of the plan participant.[10] Conversely, if the plan does not have a broad range of investment alternatives, then fiduciaries are responsible for participant directed investments, even though participants may choose a particular course of action.

The Governing Documents Rule

ERISA explicitly requires that fiduciaries act "in accordance with the documents and instruments governing the plan," so long as such documents do not otherwise violate other ERISA provisions. This requirement is straightforward: follow the plan document unless it violates some other legal restriction. [11]

Considering that fiduciaries are responsible for following governing documents, new fiduciaries and advisers ought to do their due diligence by examining these documents to ensure their own compliance and the compliance of others. Documents that should be reviewed are: the plan document, trust agreement, any determination or opinion letters about the plan from the IRS, the Summary Plan Description ("SPD"), the IPS and any other policy statements, all summary investment information, safe harbor notices, Summary Annual Reports, Form 5500 filings and plan testing records. Fiduciaries should also consider checking in with the plan's ongoing record keeper. Finally, fiduciaries should ensure that all the various plan documents are consistent with each other.[12]

---

[10] See ERISA § 404(c) and the regulations promulgated thereunder for information about what constitutes a broad range of investment alternatives. These issues are also discussed in further Ch. 7.

[11] ERISA § 404(a)(1)(D).

[12] Recently, the Supreme Court found that fiduciaries are not liable under ERISA § 502(a)(1)(b) for inconsistencies between the plan document and the SPD. The court did indicate in dicta that equitable relief may be granted when an SPD improperly details benefits in excess of what the plan document actually indicates. *See CIGNA Corp. v. Amara*, 131 S.Ct. 1886 (2011). Additionally, potential liability still exists for misrepresenting information about the plan. *See, e.g.*, *Varity Corp. v. Howe*, 516 U.S. 489, 506 (1996) (holding that plan administrators violated their fiduciary duties when they lied to plan participants in order to get them to switch plans).

Prohibited Transactions

In addition to the affirmative duties imposed by ERISA on fiduciaries, there are also explicit prohibitions on engaging in certain conduct. These prohibitions prevent the plan from participating in certain types of transactions with certain specific parties related to the plan. Prohibited transactions are discussed in Chapter 9.

Settlor Functions

There are also certain acts that fall outside of ERISA fiduciary responsibilities, most notably, settlor functions. These are acts by an employer or plan sponsor that affect the plan, but are otherwise exempt from the traditional fiduciary duties. Settlor functions typically include basic business decisions about the establishment, termination, or design of a plan. As the 11th Circuit Court of Appeals has noted, "the ERISA scheme envisions that employers will act in a dual capacity as both fiduciary to the plan and as employer. ERISA does not prohibit an employer from acting in accordance with its interests as employer when not administering the plan or investing its assets".[13]

Employer actions, which are primarily business decisions, will not fall under ERISA's requirements. ERISA does not compel employers to refrain from actions that have an impact on plan finances or administration when these effects are collateral in nature.[14] The standard, as with the standard for being a fiduciary, is whether there is discretionary administration of the plan. Thus, decisions regarding the establishment of the plan, design modifications to the plan, or termination of the plan will not require the same loyalty to participants and beneficiaries as would other decisions affecting plan administration or investment.

The implications of settlor functions go further than not being bound by ERISA fiduciary duties. The distinction between settlor and non-settlor functions is relevant for determining fees that can be paid out of plan funds and those fees that must be paid by the sponsoring business. Costs incurred in making decisions about plan design cannot be paid by the plan (i.e. costs of settlor functions cannot be paid by the plan), whereas the cost of implementing plan design changes may be paid by the plan. Non-settlor costs may include new actuarial reports, determination letters from the IRS and communicating changes to participants and beneficiaries, as well as other compliance costs.[15]

Liability for Breach of Fiduciary Duty

A civil action for breach of fiduciary duty may be brought by the Secretary of Labor, any participant, a plan beneficiary, or another plan fiduciary.[16] Thus, many parties have standing to sue, increasing the probability that any fiduciary breach will be litigated.

---

[13] *Phillips v. Amoco Oil Co.*, 799 F.2d 1464, 1471 (11th Cir. 1986).
[14] *Id.* at 718
[15] *See* ERISA Advisory Opinion 2001-01A (U.S. Dep't. of Labor, 2001). The Advisory Opinion provides six useful hypotheticals that help distinguish between settlor functions and fiduciary functions, as applied to the payment of fees.
[16] ERISA § 502(a)(2).

The potential remedies available to successful plaintiffs are also considerable. Fiduciaries are personally liable for the consequences of the breaches they commit. This liability requires fiduciaries to make good any losses to the plan that occurred because of the breach.[17] Additionally, any personal profits that occur as a result of the breach must be disgorged to the plan.[18] In addition to these monetary penalties, equitable remedies may be available as the courts deem appropriate which may include removal of fiduciary status.

In addition to the equitable remedies and making good on plan losses, fiduciaries may also be assessed civil penalties by the IRS or DOL. The DOL is obligated to assess a 20% penalty on applicable recovery amounts for all breaches of fiduciary duty including prohibited transactions. Additionally, the IRS can impose further penalties for a fiduciary committing a prohibited transaction.

The total extent of monetary liability for a fiduciary breach can be significant. Injunctions and loss of fiduciary status are also consequences that may be incurred by breaching fiduciaries. Fiduciaries must take their responsibilities seriously if they are to avoid these consequences.

Conclusion

The identification of fiduciaries and understanding the role they perform are complicated questions which we have only begun to address. In its simplest form, the concept of a fiduciary is a person obligated to act exclusively for the benefit of an ERISA plan as a result of the possession or exercise of discretionary authority or control over plan administration and/or investments. While these are the basic principles underlying the definition of a fiduciary, the DOL has been expanding the concept to include more people who deal with benefit plans. ERISA's regulatory scheme is currently in flux, and fiduciaries – as well as third parties who might be treated as fiduciaries because of their role aiding in plan management – need to understand their obligations.

Readers should understand that the duties of fiduciaries are more extensive than those discussed thus far. In addition to the responsibilities referred to above, fiduciaries have a duty to make participant disclosures, to update the plan consistent with statutory and regulatory changes and, in the case of retirement plans, to ensure the plan's status as a qualified plan under IRS rules. Chapters 5, 6, 8 and 9 will explore specific requirements that a fiduciary must satisfy in a variety of situations.

[17] *Id.* at § 409(a).
[18] *Id.*

Chapter 2 – DOL Regulatory Efforts in 2010 – Significant Changes in Management of Retirement Plans

Calendar year 2010 was a year of tremendous regulatory activity for 401(k) plans. Federal agencies unleashed a torrent of new rules and proposals impacting both plan sponsors and plan participants. Even the most sophisticated practitioners are finding it challenging to stay abreast of all this regulatory activity. To fully understand and appreciate the looming changes, it is useful to identify the government policy objectives that gave birth to them. The key policy objectives can be categorized as follows:

- Improving the transparency of services and fees in the 401(k) market;
- Greater accountability for providers of investment-related services to plans;
- Helping plan participants make better investment decisions;
- Giving participants ways to make their retirement savings last a lifetime; and
- Improving disclosures for target date funds ("TDFs").

Improving Transparency through 408(b)(2) Fee Disclosures

The governmental policy objective to improve fee transparency in the 401(k) plan industry is based, in large part, on the groundwork laid by the U.S. Government Accountability Office ("GAO"). The GAO is also known as the investigative arm of Congress and over the last five years, it has issued a series of reports calling attention to the problem of hidden fees and potential conflicts of interests among service providers in the 401(k) market.[19]

These concerns have resulted in a major piece of rulemaking from the DOL, one that will require providers to deliver fee disclosures to plan sponsors for the first time.[20]

By April 1, 2012, service providers will need to deliver newly mandated notices under §408(b)(2) of ERISA ("408(b)(2) Fee Disclosures") to their existing plan sponsor clients. These 408(b)(2) Fee Disclosures must describe the services provided as well as the compensation directly or indirectly received by the provider.

After April 1, 2012, 408(b)(2) Fee Disclosures will need to be delivered whenever a provider agrees to renew or extend its services, or whenever it enters into a new service arrangement with a plan client.

There is a great deal of anticipation surrounding this new disclosure requirement, which is designed to plug a gaping "hole" in the regulatory oversight of ERISA plans. As succinctly explained by the DOL, under the current rules in effect, "plan fiduciaries have a duty to consider a service provider's compensation from all sources, but service providers are not obligated to disclose compensation from other resources."[21] The DOL's final rules under § 408(b)(2) would create the desired symmetry between the fee information that plan sponsors must review to

---

[19] *See e.g., US Gov't Accountability Office*, GAO-11-119, 401(k) Plans: Improved Regulation Could Better Protect Participants From Conflicts of Interest (2011).
[20] 29 C.F.R. § 2550.408b-2.
[21] Preamble to DOL's interim final regulations under § 408(b)(2) of ERISA (July 16, 2010), 75 Fed. Reg. 41600.

satisfy their fiduciary duties and the fee information that providers must proactively disclose to plan sponsors.

The current reality is that providers are not obligated to furnish fee information under ERISA, and plan sponsors may be unaware of the "indirect" compensation that providers may receive through the plan's investments. For example, a plan's recordkeeper may receive ongoing payments from the funds in his plan's menu for services as an administrative intermediary between plan participants and each fund. However, if the plan sponsor is unaware of the amount or even the existence of the flow of payments from its funds to a provider, the sponsor has no way of determining whether these "hidden" fees are reasonable. These costs are typically embedded in the expenses of the plan's investment funds, which can hurt participants by cutting into their investment earnings.

The use of plan assets to pay a service provider's fee is a prohibited transaction under §408(b)(2) of ERISA unless the services are provided under a reasonable arrangement for reasonable compensation (For more information on prohibited transactions, see Chapter 9). This statutory provision represents an important safeguard for participants under ERISA, forcing plan sponsors to protect them from excessive fees. The DOL's 408(b)(2) Fee Disclosure rules provide that a service arrangement will qualify as a reasonable arrangement only if the service provider delivers its 408(b)(2) Free Disclosures to the plan sponsor before initiating services. The disclosure requirement applies to fiduciary advisers, recordkeeping platforms and certain types of service providers that receive indirect compensation.

As a technical matter, compliance with the 408(b)(2) Fee Disclosures is only required if service fees are expected to equal or exceed $1,000. In addition to applying to fiduciary advisers and recordkeeping platforms, the new disclosure rules also apply to providers of the following services to the extent they receive an indirect compensation: accounting, actuarial, appraisal, banking, consulting, custodial, insurance, investment, legal, brokerage, and administrative services.[22]

Plan sponsors will need to review a provider's 408(b)(2) Fee Disclosures carefully. As fiduciaries, plan sponsors have a duty to establish that the provider's fees are reasonable before engaging the provider on behalf of the plan. The 408(b)(2) Fee Disclosure rules were issued by the DOL on July 16, 2010. The effective date was originally July 16, 2011, but the DOL pushed it back to April 1, 2012 to ensure it had sufficient time to "finalize" its interim final regulations and to give service providers and plan sponsors additional time needed for compliance.

Greater Accountability for Providers of Investment Advice to Plans

The DOL's now withdrawn proposal to change the definition of "investment advice fiduciary" was little more than four pages, double spaced.[23] But, if adopted, this undersized package of rules might have turned the retirement industry on its head, placing new limits on the ways in which pension consultants and advisors may advise plan sponsors and participants.

---

[22] For more information on service provider fee disclosures, see Chapter 8.
[23] The proposed regulation redefining the term "fiduciary" was issued October 22, 2010 (75 F.R. 65263, October 22, 2010); on September 19, 2011, the DOL announced that it would "repropose" the controversial proposal.

As discussed in Chapter 1, ERISA has a functional approach for determining whether a person is subject to its minimum fiduciary standards. For example, if an advisor actually provides any investment advice to a plan sponsor, it automatically becomes a fiduciary ("Investment Advice Fiduciary") to the plan under ERISA. Thus, an advisor can become a fiduciary, even if it is not formally appointed to serve as one.[24]

The DOL's current "investment advice fiduciary" regulations have not been updated since 1975. Under these existing rules, a person is deemed to provide investment advice resulting in fiduciary status only if it meets a five-factor test: (1) advice is given on the value of investments or on purchasing or selling investments, (2) this advice is rendered on a regular basis, (3) there is a mutual understanding or agreement, (4) that the advice will serve as the primary basis for plan investment decisions and, 5) the advice must is individualized based on the needs of the plan.

The proposed regulations would have substantially liberalized the test for "investment advice," broadly expanding the circumstances in which advisors will be viewed as investment advice fiduciaries. Under the DOL's proposal, a person would have been deemed to provide investment advice if there was any understanding that the advice could have been considered for purposes of plan investment decisions. To be considered investment advice, recommendations would have no longer needed to be provided on a regular basis, meaning that even one-time advice could have been viewed as fiduciary investment advice.

The current requirement that the advice be individualized under the existing 5-factor test would not have changed under the DOL's proposal, although as proposed, the advice could have been individualized based on the needs of either the plan or a participant in order to be viewed as fiduciary investment advice.

Under the proposed rules, an adviser would not have become an investment advice fiduciary if it could demonstrate that the plan client knew that the adviser was acting as a seller of securities, whose interests were adverse to the plan client and was not providing impartial advice. There was a separate safe harbor for advisers who merely provided investment education to participants, and another for recordkeeping platforms disclosing that they did not provide impartial advice.

Financial advisers are often associated with two types of firms: non-fiduciary broker-dealers that earn variable rates of compensation based on the investments selected by the plan or registered investment advisors ("RIAs") serving plans in a fiduciary capacity for a level fee. The DOL's proposal, if it has been adopted, would have cause many broker-dealers to become fiduciaries. This would have created significant problems, because ERISA prohibits fiduciary advisors from receiving variable compensation, due to the conflict that arises from the incentive to recommend investments which pay them the highest fees.

---

[24] Details on what constitutes a fiduciary can be found in Chapter 1.

As of October 2011, it is not known what elements of the proposed investment advice regulation will be incorporated into the next version of the rule. The DOL's announcement regarding the reproposal indicates that it will seek "the strongest possible protections to business owners and retirement savers." However, it also stated that the revised rule would clarify that fiduciary advice is limited to "individualized advice directed to specific parties" and that it would issue or amend exemptions applicable to certain fee practices of brokers and advisers that might have been affected by the original proposal but that have been identified as beneficial. The DOL also promised to clarify the continued applicability of long-standing exemptions that allow brokers to receive commissions in connection with mutual funds, stocks and insurance products.

Helping Participants Make Better Investment Decisions

Given the prominence of 40l(k)-style plans, the success of our current retirement system hinges on the average participant's aptitude for choosing investments. But according to the DOL, there is a growing concern that participants do not consider the information critical to making informed decisions. These concerns have resulted in two rules, one in final form on fee disclosures and another in proposed form on participant advice.

Participant Level Fee Disclosures

For plan years beginning on or after November 2, 2011, sponsors of plans with participant-directed investments will have a new fiduciary obligation to provide disclosures to participants. These disclosures must be provided on or before the time a new participant can first direct investments under the plan, and they must also be provided to all eligible employees and enrolled participants annually and, for certain information, quarterly. Under a special transition rule, calendar year plans will need to start delivering these disclosures to participants no later than May 31, 2012, and also deliver them annually in subsequent years.

The DOL has created a model disclosure form, which may have caused confusion among certain readers due to the fact that the model only covers the investment-related portion of the required disclosures. Along with these investment-related disclosures, plan sponsors must also provide plan-related disclosures concerning the plan's administrative service fees on an annual basis. Participants must also receive quarterly statements with the actual dollar amount charged to their accounts for such services. The first quarterly disclosures for fees and expenses actually deducted from a participant's account for the quarter ending on June 30, 2012 must be made no later than August 14, 2012.[25]

The new disclosure rules offer one significant administrative benefit for plans that are designed to comply with ERISA § 404(c). Under the existing 404(c) related rules, generally, a fund prospectus must be delivered to a participant before his or her initial investment in the fund. As a practical matter, this rule forces many plans to include a cumbersome number of fund prospectuses in the enrollment kits for new participants. However, the investment-disclosure

[25] *See* Preamble to Amendment to ERISA Regulation § 2550.404a-5(j)(3)(i) at 76 F.R. 42539 at 42541 (July 19, 2011).

requirements under ERISA § 404(c) will no longer require the automatic delivery of fund prospectuses to new participants, so long as the annual and quarterly disclosures are provided under the DOL's new disclosure rules.[26] More information on participant level disclosures can be found in Chapter 5.

Participant Level Investment Advice

The prohibited transaction rules under ERISA make it unlawful for fiduciary advisers to provide participant-level advice if it is conflicted. Advisers that earn variable rates of compensation (*e.g.*, broker-dealers earning 12b-1 fees from the plan's funds at different rates) that depend on the investment choices of participants are ordinarily prohibited from providing participant-level advice. To overcome this hurdle, the DOL issued proposed rules on March 2, 2010, which would allow various types of advisers to provide investment advice to participants.[27] These proposed regulations were issued by the DOL as directed under the Pension Protection Act of 2006.

Under the proposed regulations, participants may receive investment advice so long as the plan's individual financial adviser, and the advisory firm, both receive level compensation which does not vary with the investment decisions made by participants. Affiliates of the advisory firm are allowed to earn additional compensation under the DOL proposal, which is likely to benefit recordkeeping platforms affiliated with mutual funds. For example, if a plan also receives administrative services from a mutual fund complex, the advisory affiliate within the complex would be allowed to charge the plan a level fee for providing participant-level advice. And at the same time, the recordkeeping affiliate within the complex would be able to charge the plan an administrative service fee, and the fund managers within the complex would be allowed to receive management fees from the mutual funds included in the plan's menu.

Alternatively, the proposed regulations allow an adviser earning variable compensation to provide investment allocation advice to participants if such advice is based on an objective computer model that applies generally accepted investment theories. When the DOL issued its proposal, it also commented that the historical performance of individual funds (as opposed to the historical performance of an asset class) may be inappropriate criteria for a computer model's advice. In light of its perceived bias in favor of passively-managed index funds, the agency's comment drew heavy criticism from the public. Accordingly, the final version of the DOL's rules may incorporate modifications to address these concerns.

Making Savings Last Through Retirement—Lifetime Income Options

As millions of "baby boomers" reach retirement age, more and more Americans are beginning to draw down on their retirement savings. To enhance the retirement security of workers, the Obama Administration has made promoting the availability of guaranteed lifetime income products a policy objective to help participants reduce the risk that they will outlive their retirement assets.

---

[26] *See infra* Ch. 5.

[27] *See generally* 75 Fed. Reg. 9,360 (proposed Mar. 2, 2010).

The DOL, IRS and the U.S. Treasury Department jointly issued a Request for Information ("RFI") on February 2, 2010, requesting comments on how the existing rules might be modified to encourage the annuitization of defined contribution plan benefits. The RFI was a pre-rulemaking starting point for the agencies, which attracted nearly 800 comment letters from the public. This extraordinary response signaled that many people are interested in where the regulators are going in terms of proposed rulemaking.

After a hearing that narrowed the topics of interest, the following possibilities for future rulemaking emerged:

- DOL rules requiring enhanced disclosures for lifetime income options;
- IRS guidance on the interaction of tax-qualification rules and lifetime income products;
- DOL safe harbor for providing retirement income education;
- Required disclosures on what a participant's account balance would be worth if converted to an annuity; and
- DOL safe harbor for fiduciaries who select lifetime income investments for their plans.

Improving Disclosures for Target Date Funds ("TDFs")

The SEC has noted that the market losses incurred in 2008, coupled with the increasing significance of target date funds in 401(k) plans, have given rise to a number of concerns about target date funds. Due to the unexpected volatility exhibited by a number of TDFs in 2008, regulators have been paying close attention to how they are promoted by fund companies and utilized by plans.

The DOL and the SEC held a joint public hearing dedicated to exploring various public policy concerns surrounding TDFs in June 2009, leading to an Investor Bulletin published jointly by both agencies to better educate employers and participants on May 6, 2010. Shortly thereafter, on June 16, 2010, the SEC issued proposed regulations that would require certain disclosures to be included in marketing materials for TDFs with the aim of reducing the potential for investor confusion.

The DOL proposed its own set of regulations on November 30, 2010 which would require special disclosures for participants whenever TDFs are designated as the qualified default investment alternative ("QDIA") for a 401(k) plan.[28]

The QDIA rules provide guidance to plan sponsors on how they can add a default investment option to a plan in accordance with a fiduciary safe harbor making participants responsible for their "passive" decisions to invest in the QDIA. Under these rules, participants must receive annual QDIA notices. The DOL's current QDIA rules were issued in 2007, when the Department officially approved the use of TDFs as QDIA in 401(k)-style plans. The DOL proposal would amend the QDIA regulations by requiring additional information to be included in the annual QDIA notice to participants about the applicable TDF series used as the plan's

[28] *See* 75 Fed. Reg. 73,987 (Nov. 30, 2010).

default investment. As proposed, the QDIA notice would need to discuss the types of assets held by the TDF, its historical performance, the relevance of the stated target date and fees and expenses and would also need to contain a graphical representation of how its asset allocation changes over time (i.e., its glide path), as well as disclaimers about investment risk, and other related disclosures.

The DOL's proposal would also amend its participant level fee disclosure regulations to require enhanced disclosures for any TDF investment options to the plan menu. As modified by the DOL's proposal, the comparative investment chart that must be delivered annually to all participants would need to be expanded to include an appendix with the required information for TDFs. The appendix would have to disclosure much of the same information required by the proposed QDIA notice modification. The DOL expects both the appendix to the annual comparative chart as well as the additions to the annual QDIA notice to each be roughly two pages in length.

When it released its proposal, the DOL also confirmed that it would be publishing a series of tips intended to assist plan fiduciaries in obtaining and evaluating relevant information when selecting and monitoring TDFs as investment options for participant-directed retirement plan. The DOL's tips are intended to serve as guidelines for assessing the unique characteristics of TDFs when plan fiduciaries evaluate them in accordance with their duty of prudence under ERISA.

Chapter 3 – Service Provider Disclosure

ERISA and the Internal Revenue Code ("Code") prohibit transactions between retirement plans and those providing services to the plan.

Of course, the blanket prohibition on transactions between plan service providers and the plan itself doesn't tell the whole story since plans would otherwise be prevented from contracting for services with third parties. Both ERISA and the Code provide exemptions from the prohibited transaction rules that permit the plan and service provider to enter into a contract if the contract meets three qualifications: (1) the contract between the plan and service provider is reasonable; (2) the services are necessary for the operation of the plan; and (3) the compensation paid is reasonable. The DOL has issued regulations defining what constitutes a "reasonable contract or arrangement." Among other things, these rules provide that no contract or arrangement for services between a "covered plan" and a "covered service provider," nor any extension or renewal, is reasonable unless the provider makes specific disclosures to the plan fiduciary responsible for the administration and operation of the plan.[29]

Covered Plan

"Covered plan" is the first term requiring definition under the DOL's general rule presented above. A covered plan is any ERISA-covered defined benefit or defined contribution pension plan designed to provide retirement income that is established and maintained by an employer, and contains more than one covered participant. The most common forms of covered plans are 401(k) plans, profit sharing plans, defined benefit plans, cash balance plans, money purchase plans, employer stock option plans ("ESOPs") and ERISA-covered 403(b) plans. The DOL has specifically exempted SEP IRAs, SIMPLE IRAs, IRAs and Welfare Benefit Plans from having the disclosure regulation. The DOL has indicated that it will revisit required 408(b)(2) disclosures for Welfare Benefit Plans in the future.

Covered Service Provider

"Covered service providers" are service providers who enter into a contract or arrangement with a covered plan and reasonably expect to receive $1,000 or more from the plan in either direct or indirect compensation for the provision of "covered services." If the plan doesn't provide one of the covered services, the regulations will not apply to the service provider. The DOL has yet to define whether the $1,000 compensation threshold is for any specific period of service or for the entirety of a contract or arrangement with a covered plan. Since most service providers do provide services to a plan over a course of many years, it would be safer for service providers to assume that they will be "covered service providers" if they expect to receive more than $1,000 in compensation over the entirety of the provision of services to the covered plan.

Covered service providers are divided into three categories, the first of which consists of ERISA fiduciaries and registered investment advisers that provide services directly to the plan or that provide services to an investment contract, product or entity in which the plan holds a direct

[29] ERISA Regulation §2550.408b-2(c) as set forth in the interim final regulation at 75 F.R. 41600 et. Seq. (July 16, 2010).

equity investment. In the latter case, the investment contract, product or entity is itself deemed to hold plan assets and the service providers are ERISA fiduciaries because they provide services to the investment vehicle rather than directly to the plan. The latter group is treated separately because the regulations impose on them a separate obligation to disclose compensation information about the investment vehicle.

The second category of covered service provider includes firms rendering recordkeeping and brokerage services to individual account plans that permit participants and beneficiaries to direct the investment of their accounts. It includes recordkeepers and brokers that offer a platform of investment options as part of their contract or arrangement. These providers must disclose compensation information for each of the designated investment alternatives for which they are providing recordkeeping or brokerage services.

The third category of covered service provider includes those providing specified services that expect to receive indirect compensation from affiliates. Services specifically included under the third category are: accounting, auditing, actuarial, appraisal, banking, brokerage, consulting (including consulting services rendered with respect to the development or implementation of an investment policy statement or the selection or monitoring of plan investments or plan service providers), custodial services, insurance, investment advisory, legal, recordkeeping, third party administration and valuation services. As noted, unless there is an expectation of receiving indirect compensation, these providers will not have disclosure obligations.

Disclosures Required

Required service provider disclosures must be made in writing. It is to be noted, however, that the rule does not require that a formal contract or arrangement itself be in writing.

Services

The covered service provider must provide a description of the services it will provide to the plan under the contract. The DOL has not been specific as to the level of detail it requires as to the description of services provided. To further complicate matters, the DOL has stated that the level of detail to be included in the explanation may vary depending on the needs of the responsible plan fiduciary. Ultimately, the burden is on the plan sponsor or other plan fiduciary to request additional information if it believes a description of services lacks sufficient detail to determine whether the compensation to be received is reasonable.

Fiduciary Status

When applicable, covered service providers must provide an affirmative disclosure that they will or reasonably expect to provide fiduciary services under ERISA 3(21), the Investment Advisor Act of 1940, or relevant state laws and regulations. In practice, it would be preferable for those will not or do not reasonably expect to provide fiduciary services to make that disclosure as well.

Compensation Disclosures

There are four forms of compensation that covered service providers must disclose to the responsible plan fiduciary. A covered service provider must disclose whether they received: (i) direct compensation, (ii) indirect compensation, (iii) compensation paid among related parties and (iv) any compensation due in the event of termination of the agreement.

Direct compensation is compensation paid directly by a plan to a service provider for services performed for the plan.[30] This compensation can be money paid for annual plan administration, legal or accounting services, or any services paid for by the employer that are reimbursed by the plan. Whether the payment comes directly from participant accounts, forfeitures or any ERISA recapture account, does not factor into the determination as to whether compensation is deemed direct compensation or not. If the money will come directly from the plan, it is direct compensation. It is to be noted, however, that the disclosure requirement only applies to compensation that the service provider reasonably expects o receive. The failure to disclose unanticipated payments will not result in violation of the disclosure requirement.

Indirect compensation is more complicated. Indirect compensation is defined as compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, an affiliate, or a subcontractor (if the subcontractor receives such compensation in connection with services performed under the subcontractor's contract or arrangement).[31] The most common example of indirect compensation would be money paid to a covered service provider from fees deducted from the plan assets. It is important that the services for which the indirect compensation is received and the payer of the indirect compensation be identified in addition to reporting the amount of the indirect compensation.

Compensation paid among related parties is compensation that is paid on a transaction basis or charged directly to the plan's investments.[32] An example of transaction-based fees is a commission or finder's fee. 12b-1 fees are the most common example of compensation charged directly to the plan's investments.

Covered service providers must also disclose any amounts they will receive in connection with the termination of services, as well as calculations as to how those amounts will be calculated in the event of pre-payment of services.[33]

Required compensation disclosures can be made in a variety of ways, as long as the disclosures are made in such a way as to ensure that the responsible plan fiduciary has a reasonable basis upon which to evaluate the reasonableness of the compensation. This can be expressed as a monetary amount, formula, percentage of the covered plan's assets, or a per capita charge for each participant or beneficiary or, if the compensation cannot reasonably be expressed in such terms, by any other reasonable method.

---

[30] ERISA Regulation § 2550.408b-2(c)(1)(iv)(C)(1).
[31] ERISA Regulation § 2550.408b-2(c)(1)(iv)(C)(2).
[32] ERISA Regulation § 2550.408b-2(c)(1)(iv)(C)(3).
[33] ERISA Regulation § 2550.408b-2(c)(1)(iv)(C)(4).

If the covered service provider is providing recordkeeping services to the plan, a description of all direct and indirect compensation that the covered service provider expects to receive in connection with the recordkeeping services should be provided. If the covered service provider is offering recordkeeping services for "free" or expects the services to be provided without explicit compensation, the recordkeeper is required to provide the responsible plan fiduciary with a good faith estimate as to the cost of the recordkeeping services that will be provided to the plan.[34] The estimate for recordkeeping services must take into account the rates that the covered service provider would normally charge to a plan to perform the recordkeeping or the prevailing market rates charged for similar recordkeeping services for a similar plan with a similar number of covered participants and beneficiaries. Practically, this disclosure requirement will most affect bundled providers who sell their recordkeeping services as "free" to be made up with higher investment costs in other places.

Those providing services as a fiduciary to the plan, as an ERISA 3(21) fiduciary, or under the Investment Advisers Act, must disclose their status as a fiduciary in writing.[35] They must also disclose additional information with respect to each investment contract, product, or entity that holds plan assets in which the covered plan has a direct equity investment, and which fiduciary services will be provided pursuant to the contract or arrangement with the covered plan. The person acting as a fiduciary in this respect must disclose a description of the amount charged directly against assets in the plan in connection with acquisition, sale or transfer of assets within the plan. Sales loads, sales charges, redemption fees, account fees and surrender charges would all be examples of the compensation that needs to be described when acting as an investment fiduciary under the plan. In addition, the service provider must disclose the annual operating expenses or expense ratio as well as any ongoing additional expenses such as wrap fees.

Format of Disclosures and Manner of Receipt

The DOL does not proscribe a standardized format for making these disclosures other than stating that they should be in writing. The disclosures can be made across multiple documents and need not be contained in one all encompassing contract. Since there will be a variety of disclosure formats across a plethora of documents, many in the retirement plan community have questioned the efficacy of these disclosure requirements as it will be easy for most covered service providers to bury their disclosures in documents and language that may prove incomprehensible for plan fiduciaries.

Covered service providers must disclose the manner in which they will receive their compensation. This disclosure will have to inform the responsible plan fiduciary as to whether the covered plan will be billed or the compensation will be deducted directly from the covered plan's accounts or investments.

Timing of Disclosures

In general, covered service providers must make the disclosures required by 408(b)(2) regulations reasonably in advance of the date on which the plan services contract is entered into

[34] ERISA Regulation § 2550.408b-2(c)(1)(iv)(D).
[35] ERISA Regulation § 2550.408b-2(c)(1)(iv)(B).

or renewed. The DOL has not provided for a specific set of days or months before the contract is entered into that constitutes "reasonably in advance" but it is safe to assume that the materials should be provided to the responsible plan fiduciary with enough time to read the disclosures as well as seek any additional advice they feel they may require.

If there are changes to the compensation information relating to investment options, the appropriate service provider must disclose the change to the responsible plan fiduciary as soon as practically possible after the service provider is informed of the change. While required to be made "as soon as practicable", the timeframe for this disclosure cannot exceed 60 days.[36]

If the plan administrator or responsible plan fiduciary submits a request for disclosure information to the covered service provider, the covered service provider must disclose the requested information to the requesting party no later than 30 days after the receipt of the request.[37]

If errors are discovered in the disclosures, the service provider must correct the disclosure as soon as practicable but no later than 30 days after the provider becomes aware of the error or omission.[38]

The Plan Fiduciary's Responsibilities

In addition to requiring covered service providers to disclose their compensation and service arrangements, the plan fiduciary is responsible for collecting these disclosures from covered service providers. If the responsible plan fiduciary causes a plan to enter into a prohibited transaction with a service provider, both parties will have violated the prohibited transaction rules. However, the DOL takes the position that an otherwise diligent plan fiduciary should not be penalized as a result of a failure by a plan service provider to make the required disclosure. Accordingly, the regulations offer exemptive relief to the plan fiduciary if certain conditions are satisfied.

For a responsible plan fiduciary to qualify for this exemption, the plan fiduciary must not have known that the covered service provider failed to provide complete disclosure. If the fiduciary discovers that the covered service provider has not fully disclosed its compensation arrangements, the responsible plan fiduciary must request the service provider in writing to disclose the required information. If the service provider fails to cure its failure within 90 days of the plan fiduciary's request, the fiduciary is required to report the failure to the DOL within 30 days thereafter. If the service provider refuses to furnish the information, the DOL must be notified within 30 days of the refusal.

Upon discovery of a failure to disclose, the responsible plan fiduciary must evaluate the nature of the failure, the availability, qualifications, and cost of replacement service providers and the covered service provider's response to notification of the failure. After evaluating these

[36] ERISA Regulation § 2550.408b-2(c)(1)(v)(B).
[37] ERISA Regulation § 2550.408b-2(c)(1)(vi)(B).
[38] ERISA Regulation § 2550.408b-2(c)(1)(vii).

criteria, the responsible plan fiduciary must then determine whether or not to continue doing business with the covered service provider.

While these requirements are helpful by providing an exception for the responsible plan fiduciary for situations in which complete disclosures are not made, a question remains as to whether the responsible plan fiduciary could be deemed to know about inadequate disclosures. For example, at the end of every plan year the responsible plan fiduciary or plan administrator should receive an accounting detailing plan costs. If disclosures are made in the form of a formula and the costs of the services do not reflect the fees actually deducted from assets, is the responsible plan fiduciary considered to have knowledge of the inadequacy of disclosures? Moreover, for indirect compensation based on various formulas can be difficult for even service providers to easily explain requiring a plan fiduciary to accurately calculate costs as a check on the service provider may represent an additional trap for the fiduciary.

Chapter 4 – Service Providers as Fiduciaries

One of the extraordinary features of ERISA is that it can nullify the terms of an agreement for plan-related services by re-defining the rights and responsibilities of the respective parties and imposing penalties for failing to satisfy the revised terms of the agreement. Financial advisers who provide investment related services to plans should pay particular attention to this aspect of ERISA. Advisers should also note that plan sponsors may or may not be able to shift certain investment responsibilities that ERISA otherwise imposes on the plan sponsor to the financial adviser, depending on the role assume by the adviser.

ERISA § 3(21) sets forth three criteria to determine whether a person is a fiduciary. As discussed in Chapter 1, these criteria are (i) exercising discretionary authority over plan management or any authority over the management of plan assets, (ii) providing investment advice for a fee, and (iii) having discretionary authority over plan administration. If a service provider performs any of these functions, the provider is an ERISA fiduciary and must meet the obligations imposed by ERISA as a result of such status. Thus, while several types of service providers that are fiduciaries are discussed below, these are just examples illustrating how service providers may become a fiduciary.

Investment Advisers

Investment advisers are frequently classified as ERISA fiduciaries by virtue of rendering investment advice for a fee. This is for fairly obvious reasons: investment advisers, by definition, advise plans on how to invest plan assets for which they receive compensation from either the plan, the plan sponsor or a third party, such as a mutual fund. The regulation governing the definition of investment advice is more complicated, excusing some investment advisers from fiduciary status.

These regulations are subject to change. As discussed in Chapters 2, the DOL recently proposed, and subsequently withdrew, regulations that would have greatly expanded the definition of investment advice, resulting in more people being classified as investment advice fiduciaries. Plan fiduciaries and service providers alike should carefully watch developments with respect to these regulations, as they are likely to have a significant impact on ERISA plan management.

Certain activities will not cause an adviser to become a fiduciary. First, advice is not investment advice if it qualifies as investment education. Providing plan participants with general financial and investment information and materials that help them make informed investment decisions without pushing for any particular plan investment option will not result in fiduciary status for an adviser.[39] In addition, if the proposed regulations redefining the meaning of investment advice had been finalized, advisers might have qualified for a safe harbor carved out in the new rules. If the safe harbor is retained in the next iteration of the rule, advice will not result in fiduciary status if the service provider makes it clear that the advice is not being offered impartially and that the service provider does not have the best interests of the plan in mind.

[39] See Chapter 11 for more details on what comprises investment education.

On the other hand, the courts have held that if a plan sponsor is too dependent on a financial adviser's investment advice, the adviser is subject to the fiduciary requirements of ERISA even if the parties have agreed in writing that the adviser will not be providing fiduciary advice. These cases typically involve situations in which the plan sponsor routinely "rubber stamps" the adviser's recommendations, effectively creating an understanding between the parties that the recommendations are serving as a primary basis for the sponsor's investment decisions.[40] Thus, advisers who wish to avoid fiduciary status under the current regulations should ensure that plan fiduciaries are not using their advice as a primary basis for investment decision making.

Broker-Dealers

A person is an investment advice fiduciary under ERISA only if he or she makes investment recommendations that are tailored to the particular needs of a plan or participant. In addition, such advice must be rendered on a regular basis and it must be understood that such advice will be a primary basis for the recipient's investment decisions.

Under the securities laws, broker-dealers that execute transactions are allowed to give incidental investment advice in the course of their business. Most broker-dealers take the position that such incidental advice is only general information and does not take the particular needs of the plan or participant into account. Under such circumstances, a broker's incidental advice would not constitute fiduciary advice for purposes of ERISA.

Nevertheless, the relationship of some broker-dealers with their clients is such that the broker crosses the line and becomes a fiduciary. This is more likely to occur where the advice is rendered over an extended period of time and there is evident reliance on such advice by decision-makers for the plan. In such cases, a broker-dealer may become a fiduciary under ERISA and thereby subject to ERISA's high fiduciary standards. This outcome would eliminate the ability to make conflicted recommendations designed to encourage investments that generate higher fees for the broker. For practical purposes, this means that the broker would be unable to accept commission-based compensation. Brokers that are ERISA fiduciaries are limited to compensation that will not enable them to generate additional fees based on their advice. Such brokers would be limited to level compensation, such as fees based on a percentage of plan assets.

As required under the Dodd-Frank Act, in January 2011, the SEC's staff published a study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff's report recommended that the SEC consider rulemakings consistent with the authority already granted to the SEC under the Dodd-Frank Act, to create a uniform fiduciary standard that would apply to both brokers and registered investment advisers when they provide personalized investment advice to retail customers. The report did not provide guidance on the extent to which plan clients would be viewed as retail customers.

---

[40] See *e.g., Stanton v. Shearson Lehman/American Express, Inc.*, 631 F. Supp. 100 (N.D. Ga. 1986). See also *F.W. Webb Co. v. State Street Bank and Trust Co.*, No. 09 Civ. 1241(S.D.N.Y. Aug 12, 2010); *Ellis v. Rycenga Homes, Inc.*, 484 F. Supp. 2d 694 (W.D. Mich. 2007).

Depending on how the SEC decides to exercise its rulemaking authority under Dodd-Frank, brokers who advise plan clients and participants may be significantly affected and may be subject to new conflicts-related disclosure requirements under the securities laws. These changes would be in addition to any future regulatory changes imposed by the DOL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.

Recordkeepers

The activities of plan recordkeepers are generally confined to a narrow range of ministerial functions that do not give rise to fiduciary status. As the DOL has noted, when a recordkeeper acts "within a framework of policies, interpretations, rules, practices and procedures made by other persons," he is not acting in a fiduciary capacity.[41] Accordingly, functions, such as the maintenance of participants' service and employment records, preparation of reports and the calculation of benefits generally do not involve the exercise of authority over the plan or plan assets such as will cause the providers of such services to be a fiduciary.[42]

If recordkeeping is bundled with other services, a different result may ensue. A service provider that gives investment advice and also keeps records for the plan will be a fiduciary even if some work is ministerial.

Third Party Administrators

The role of third party administrator (also referred to as a "TPA") varies with the terms specified in each TPA's service agreement. In general, however, the TPA assists the named fiduciary or plan administrator in such matters as determining eligibility for and payment of benefits, plan funding and reporting and legal compliance. While the TPA may give advice on these matters, the ultimate responsibility for such issues falls on the employer and the plan administrator. Generally, the TPA does not make discretionary decisions about the plan's operations and does not have authority over the plan or plan assets. Because of this, the TPA, in most cases, is not a plan fiduciary.

Attorneys, Actuaries, Accountants and Consultants

Generally, attorneys, accountants, actuaries and consultants performing their usual professional functions are not treated as plan fiduciaries solely because they perform such services. However, such an individual could be considered a fiduciary if, based on the facts and circumstances, the individual exercised discretionary authority or control over the management or administration of a plan or any authority or control with respect to the management or disposition of plan assets. Fiduciary status could also result if such persons rendered investment advice for a fee or possessed discretionary authority or responsibility in the administration of a plan.[43] Certain consultants on whom plan clients place a significant degree of reliance when making investment decisions may also be found to be acting in a fiduciary capacity.

---

[41] Interpretive Bulletin 75-8, Question D-2, 29 CFR §2509.75-8.
[42] *Id.*
[43] ERISA §3(21)(A); 29 CFR §2509.75-5, D-1.

Chapter 5 – Participant Level Disclosures

As complex as the rules governing the management of plan assets can be for plan fiduciaries and administrators, understanding the ins and outs of a plan can be even more daunting for participants and beneficiaries.[44] The plan's governing documents provide the rules for how a specific plan is managed, but this material is neither readily available nor easy to understand. Participants need to know their rights under the plan in order to properly exercise those rights. It is also important for participants to understand the investment options available to them so they can devise appropriate asset allocations that meet personal risk/return criteria. Information also serves as a check on fiduciaries. Only by knowing how the plan is being run can participants and beneficiaries be sure that fiduciaries are fulfilling their obligations under ERISA.

In light of the above, ERISA requires plan administrators to disclose important information to plan participants. Disclosure requirements are governed by fiduciary duties, in addition to the regulations promulgated thereunder. DOL regulation § 2550.404a-5 addresses disclosure requirements for participant-directed plans, including 401(k) plans, under which participants can control the investment of their plan accounts. Participant-directed plans make up a significant portion of all current ERISA plans; therefore, these requirements are relevant to many plan administrators.[45]

Beyond the requirements of participant-directed accounts, ERISA mandates that participants be notified of all essential information about the plan and changes to the plan. This includes updates on plan funding, accrued and vested benefits, and significant events, such as plan termination. Providing these notices to plan participants and beneficiaries is a fiduciary duty.

Investment Notices & Other Fees

DOL regulation § 2550.404a-5, finalized in October of 2010 and effective for plan years commencing on or after November 1, 2011, establishes rules for disclosure with respect to participant-directed plans. The disclosure requirement covers two broad areas: (1) plan-related information, such as an explanation of when participants and beneficiaries may give investment instructions, identification of the plan's investment alternatives (including brokerage windows) as well as fees and expenses for plan administration and (2) information about the plan's investment alternatives including historical performance, comparative benchmarks and shareholder fees charged against a participant's account.

The regulation is intended to ensure that participants are made aware of their rights and responsibilities under the plan and that they be given sufficient information to make informed decisions. Under the new rules, plan administrators are required to provide all information

---

[44] For purposes of this chapter, we will use participants, beneficiaries and alternative payees interchangeably as having the same meaning. Both are entitled to the same disclosure notices from plan administrators.

[45] The DOL estimates that there are close to 483,000 participant-directed individual account plans with 72 million participants and assets of almost $3 trillion. 75 F.R 64,910 (Oct. 20, 2010).

before participants can direct their first investment decision and at least annually thereafter.[46] In some cases, expenses must be reported quarterly.[47] Additionally, with any change to plan information, participants must be given a description of the change no earlier than 90 days before the change becomes effective and no later than 30 days before the effective date.[48] All information about investment alternatives must be provided in a comparative format. This includes comparisons on fees, returns, trading options, etc.

Some of the disclosure requirements can be satisfied by passing through information received from plan service providers and issuers of the plan's investment options, such as mutual funds. Doing so may cover the disclosure requirements for how and when investments can be made, administration fees, and individual investment fees.

Investment Options and Fees

The new rules require that before the date participants first have the ability to direct their investments and at least annually thereafter, plan administrators must provide them with certain investment-related information. This includes an explanation of the plan's operational rules regarding the circumstances under which participants may give investment instructions, including any limitations on such instructions, the identification of the plan's investment options and any designated investment managers, and a description of any brokerage window or similar arrangement made available under the plan.

In addition to information on how to exercise investment rights, administrators must disclose an array of information intended to aid participants in selecting investment alternatives. To meet this requirement, a plan administrator must provide the name of each designated investment alternative, the type or category of the investment and a website where participants and beneficiaries can learn more about the investment.[49] Participants must also be informed of the performance data of each investment alternative. Performance data is required to include average annual total returns for the past 1, 5 and 10 calendar years, starting with the last completed year. For investment options with fixed rates of return, information regarding the rate of return, and the extent of the issuer's right to change the rate must be disclosed.

The regulation specifies that the information should be presented "in a chart or similar format that is designed to facilitate comparison."[50] Further, the disclosure with respect to investment alternatives that do not have a fixed rate of return should also include the names and returns of an appropriate broad-based securities market index so that participants can benchmark the performance of the plan's investment options. For example, if participants can purchase a security traded on the S&P 500, returns for the S&P 500 might be provided side by side with the rates of return for the specific security. Benchmarking information should be provided for the

---

[46] ERISA Regulation § 2550.404a-5(c)(2)(i)(A), (c)(3)(i)(A) and (d)(1).
[47] ERISA Regulation § 2550.404a-5(c)(2)(ii).
[48] ERISA Regulation § 2550.404a-5(c)(2)(i)(B).
[49] A specific URL that allows participants to access information is required. The website must provide information on: the investment alternative's issuer, investment objectives, principal strategies, portfolio turnover rate, performance data, and fee and expense information. 29 CFR 2550.404a-5(d)(1)(v).
[50] 29 C.F.R. § 2550.401a-5(d)(viii)(2). For an example of comparative chart, see Appendix to §2550.404a-5, 75 FR 64942.

same periods for which performance data must be provided with respect to a plan investment option.[51]

Plan administrators must also provide participants annually with a description of the fees and expenses of the plan's various investment alternatives that may be charged against a participant's individual account and disclose the amount of such fees and expenses. Such shareholder-type fees may include commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees and should be distinguished from an investment's total annual operating expense. The latter, which includes investment management fees, distribution fees, service fees, separate account expenses as well as mortality and expense risk fees, must be disclosed separately as a flat dollar amount as well as an expense ratio.

In addition to disclosing costs, plan administrators must furnish participants with a statement explaining that investment cost is only one of many factors to consider when making an investment decision and another statement to the effect that investment costs, when aggregated, may become significant.[52]

Administrative Fees

Plan participants must also receive an explanation of general administrative service fees associated with plan participation and any potential individual expenses that may be charged to their accounts. A general explanation of these expenses needs to be disclosed before the date on which a participant can first direct his investments, as well as annually. Specific[53] dollar charges against a participant's account must be included on a quarterly statement. Thus, when money is taken out of a participant's account, the[54] participants must be informed of the exact amount that was spent and the service for which the money was expended. Quarterly reporting does not apply when the expenses are reflected in the total annual operating expenses of one of the plan's investment options. For example, if administrative fees are paid entirely through indirect compensation flowing from a plan's investment in a mutual fund (e.g. 12b-1 fees), the fees would not be subject to quarterly disclosure but, an explanation of the fact that the 12b-1 fees are used to pay administrative services must be provided on the quarterly statement.

The regulation mandates inclusion of administrative expenses, such as legal, recordkeeping and accounting fees on the quarterly disclosure statement. This information only needs to be disclosed to the extent that these expenses have actually been charged against a participant's account.

Administrators must also furnish plan participants with an explanation of expenses charged against a participant's account on an individual rather than a plan-wide basis, such as fees related to processing loans or qualified domestic relations orders, as well as charges for investment advice, sales charges, redemption fees and investment management fees. While the

---

[51] ERISA Regulation § 2550.404a-5(d)(1)(iii).
[52] ERISA Regulation § 2550.404a-5(d)(1)(iv).

actual charge for such individual expenses must also be reported to a participant quarterly, a confirmation statement after the charge is deducted from the participant's account would satisfy this requirement, thereby eliminating the need to include the charge on a subsequent quarterly statement.

Information Available upon Request

In addition to required annual disclosures, administrators of participant-directed plans must also furnish certain information if requested by a participant or beneficiary. Accordingly, upon request, participants must be provided copies of fund prospectuses as well as any financial statements, shareholder reports and similar materials related to a plan's investment alternatives.

The participant-level disclosure requirements are applicable for plan year beginning on or after November 1, 2011. However, a special transition rule postpones the date that initial disclosures must be furnished no later than 60 days after this applicability date or 60 days after the effective date of plan-level disclosure required under the new Section 408(b)(2) regulations. Since plan-level disclosures have been delayed until April 1, 2012, the first set of initial disclosures to plan participants (i.e., all disclosures other than quarterly disclosures) for a calendar year plan will be due no later than May 31, 2012. The first quarterly disclosures for the second quarter of 2012 will be due August 14, 2012.[55]

QDIA Disclosures

As with investment alternative disclosures, participants must be informed of the consequences of failing to choose an investment option. If such a failure occurs, contributions made to a participant's account may be invested in a qualified default investment alternative ("QDIA").[56] To obtain relief from liability for losses resulting from such an investment, the plan must provide affected participants with a timely QDIA notice. The notice must be furnished (i) at least 30 days in advance of plan eligibility or (ii) at least 30 days in advance of any first investment in a QDIA on behalf of the affected participant. If the participant has the opportunity to withdraw from the QDIA, the notice may be made as late as the date of plan eligibility. Participants must also be given QDIA notices at least 30 days in advance of subsequent plan years.[57]

The requirements for QDIA notices are similar to those of investment disclosures and summary plan descriptions (discussed below). The notice must be written in a manner calculated to be understood by the average plan participant. Participants should be informed of when and the extent to which their account assets will be directed to the QDIA. The notice should describe the right of participants to direct the investment of assets in their accounts (similar to the requirements of the investment notices described above). A description of the QDIA should be provided including a description of its investment objectives, risk and return characteristics, fees and expenses. In addition, participants need be informed of where they may obtain information

[55] See 76 F.R. 42539, at 42541 (July 19, 2011).
[56] QDIA requirements are discussed in ch. 7. For now, we only address the notice requirements for a QDIA.
[57] ERISA Regulation § 2550.404c-5(c)(3).

about other investment alternatives available to them under the plan and their right to direct account assets to the other investment alternatives.

Summary Plan Description

Unless requested, plans are not required to give participants an actual copy of the plan document. Instead, plans are required to distribute a Summary Plan Description ("SPD") which is a written summary of a plan's contents. An SPD must be written so that the average plan participant can understand it, and must clearly apprise participants and beneficiaries of their rights and responsibilities under the plan.[58] For new plans, an SPD must be distributed to each employee covered by the plan within 120 days of the date on which the plan becomes subject to ERISA which generally occurs on the first day an employee is credited with an hour of service under the plan.[59]

The SPD must be furnished to new employees within 90 days of becoming a participant (or within 90 days of benefit commencement for beneficiaries). Additionally, if there are changes made to the plan, an updated SPD that includes all those changes must be furnished every five years. The plan administrator must provide participants with a completely restated SPD every ten years, even if no amendments or changes were made since distribution of the last SPD.

Plans may be required to provide summaries of material modifications ("SMMs") describing plan changes not included in a restated SPD as changes in the plan occur. An SMM must be provided within 210 days after the end of the fiscal year in which the change was adopted. Group health plans are subject to special rules that require furnishing participants and beneficiaries with an SMM no later than 60 days following a change that constitutes a material reduction in covered services or benefits under the plan unless the plan provides SMMs at regular intervals of no more than 90 days. For this purpose, a material reduction in covered services or benefits is any change to the plan that would be considered an important reduction by the average plan participant, such as a reduction or elimination of benefits, or an increase in premiums, deductibles, copayments, coinsurance or other amounts paid by a participant.[60]

SPDs must accurately disclose a large amount of information to participants in order to comply with ERISA. The information to be provided includes:

- The name of the plan and the commonly used name of the plan (if the two are different);
- The name and address of the employer or the employee organization that maintains the plan;
- The employer identification number of the plan sponsor and the plan number;
- The type of pension or welfare plan;
- The type of administration of the plan;

[58] The DOL recommends avoiding using technical jargon as well as complicated sentence structure to ensure this goal. Administrators should base their determinations on the general level of education of participants and act accordingly. The use of clarifying examples is recommended. 29 C.F.R. § 2520.102-2(a).
[59] ERISA Regulation §2520.104b-2(a).
[60] ERISA § 733; ERISA Regulation § 2520.104b-3(d)(3).

- The name and address of the person upon service of process should be delivered;
- The name and address of the plan administrator;
- The date the plan year ends; and
- The name, title and address of each person who serves as a trustee, as well as their principle place of business.

Moreover, participants must be fully informed about plan requirements for eligibility, vesting, distributions and termination of benefits[61] These requirements include descriptions of:

- The conditions under which participants will be eligible to receive benefits, including the normal retirement age;
- Procedures for qualified domestic relations orders;
- The plan's conditions for eligibility;
- For welfare benefit plans that use group health providers, information about any fees, caps and restrictions pertaining to receipt of medical benefits;
- A description of any joint or survivor benefits
- Circumstances, if any, where participants may be disqualified, forfeit or otherwise lose benefits that the participant would expect to receive;
- The circumstances and authority of administrators to change or terminate the plan, as well as the procedures involved in plan termination;
- Rules regarding years of service for purposes of eligibility, vesting, and breaks in service; and
- The sources of contribution to the plan.

Finally, the SPD is also a tool to ensure that participants and beneficiaries are capable of enforcing rights they have otherwise been denied. The SPD must describe the means through which participants may apply for benefits and pursue grievances. Thus, the SPD must publish the process that participants must utilize to claim benefits, including time limits and available remedies. This requirement need not be part of the SPD but can be given separately, so long as the SPD has a statement stating that participants may receive a copy of this information without any fee. The SPD also must contain a description of a participant's rights under ERISA.[62]

Notice of Significant Reduction in Benefit Accruals

ERISA § 204(h) and Code § 4980F require that participants be provided with advance written notice of a pension plan amendment that would significantly reduce the rate of future benefit accruals. Plans affected by this requirement include defined benefit pension plans and individual account plans that are subject to the Code's minimum funding standards, such as a money purchase pension plan. The notice requirement would be triggered by, among other actions, a plan termination as well as a reduction of an early-retirement benefit or retirement-type subsidy. Conversion of a money purchase plan into a profit sharing plan or any other plan not

[61] All of the SPD's information must be displayed in the same format. Administrators cannot attempt to hide information that may reflect negatively on the plan. ERISA Regulation § 2520.102-2(b).
[62] ERISA Regulation. § 2520.102-3(t)(2) contains a model description of ERISA rights for participants.

subject to the Code's minimum funding rules would also be considered a significant reduction in the rate of future benefit accruals.[63]

A significant reduction in benefits must be disclosed within a reasonable time before the effective date of the proposed amendment which applicable regulations construe as 45 days.[64] As with an SPD, a Section 204(h) notice must be written so that the average plan participant will understand the effects of the plan amendment. The notice must provide a narrative description of the benefit or formula being amended both before and after the amendment's effective date. While it may be provided in written or elective form, plan administrators must ensure that the delivery method results in actual receipt.

[64] Current regulations define a reasonable time as, generally, 45 days before a reduction becomes effective, for plans with fewer than 100 participants and multiemployer plans the notice is 15 days. 26 C.F.R. § 54.4980F-1(Q&A-9).

Chapter 6 – Managing Your Fiduciary Duties

In Chapter 1, we discussed what makes a person a fiduciary and the nature of fiduciary duties. Failure to meet these duties creates liability for fiduciaries, but there is more to the fiduciary requirements than fulfilling your personal duties. There are a variety of mechanisms available when designing an employee-benefit plan that will limit the personal liability of both formally designated plan fiduciaries and those who are deemed to be plan fiduciaries because of the functions they perform. Nonetheless, fiduciaries may seek to limit their potential responsibilities—and their potential liabilities—they may be liable for the actions of other plan fiduciaries, depending on the circumstances that bring about that liability.

Limiting Personal Liability

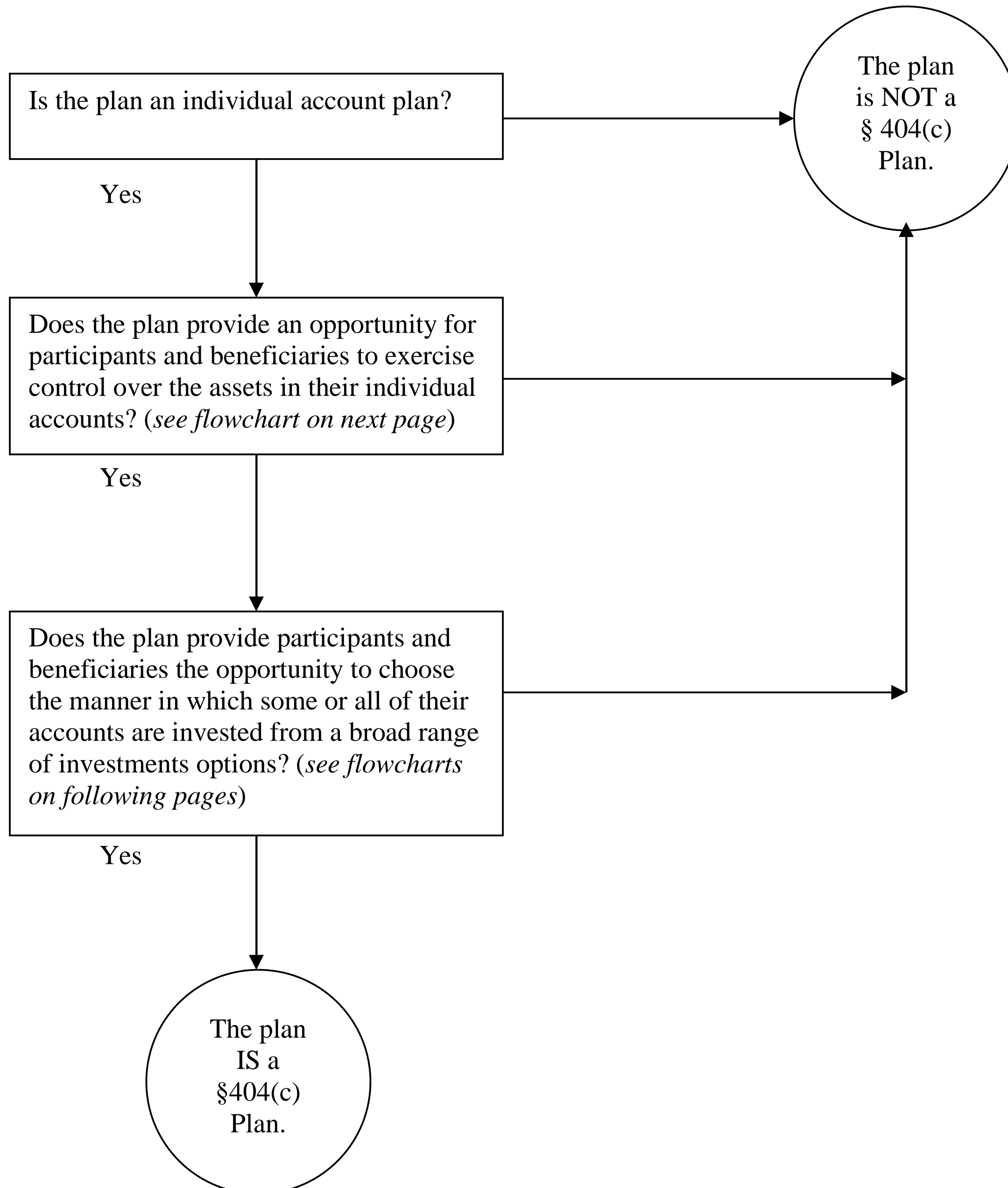
Because of the significant monetary and equitable remedies to which they may be exposed, fiduciaries seek to limit their liability for plan losses. ERISA provides several mechanisms that reduce a fiduciary's exposure to liability for investment decisions. The most significant liability shield, directed accounts controlled by participants, is discussed below.

Participant Directed Accounts

One of the primary ways that fiduciaries can limit their exposure to liability is ERISA § 404(c) which provides relief from liability for losses resulting from participant investment decisions made under an individual account plan. For a fiduciary to be eligible for 404(c) protection, the plan must offer participants "a broad range of investment alternatives" and ensure that participants have sufficient information to make informed investment allocation decisions within the meaning of DOL regulations.

Diagram 2: Determining if a Plan Is a §404(c) Plan

INSTRUCTIONS: Use the flowchart below to determine if a participant-directed account plan is a § 404(c) Plan.



Opportunity to Exercise Control

A 404(c) plan must give participants the ability to exercise control over assets in their accounts. A participant will be deemed to have this power if two criteria are met.[65] First, the participant must have a reasonable opportunity to give investment instructions to an identified plan fiduciary. The plan document must expressly provide for this right, and the fiduciary must be obligated to follow the participant's instructions.

Second, a participant must be given or have the opportunity to obtain enough investment information to make an informed investment decision. Three types of information must be given to participants to satisfy this requirement. First, the participant must be given an explanation that the plan is intended to be a 404(c) plan and that fiduciaries may be relieved of liability for losses resulting from the participant's investment instructions. Additionally, fiduciaries must provide participants with the required disclosures prescribed in §2440.404a-5 of the Department of Labor's regulations. Finally, if the plan offers employer stock as an investment alternative, the participants must be provided with a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale of employer securities, and the exercise of voting rights. The name, address and, telephone number of the plan fiduciaries responsible for monitoring compliance with these procedures must also be provided.

A plan may still qualify as a 404(c) plan even if it imposes certain restrictions upon participant choice.[66] For example, as long as there are procedures in the plan document that inform participants of actual expenses incurred on their individual accounts, the plan may charge participants for reasonable expenses related to carrying out investment instructions. Further, under certain circumstances, a plan may permit a fiduciary to decline investment instructions without jeopardizing the plan's status under § 404(c). Thus, fiduciaries may decline investment instructions that would result in a prohibited transaction or an instruction which would generate taxable income for the plan.[67]

Plans may also impose restrictions on the frequency of investment instructions, provided the restrictions meet certain criteria. The restrictions must allow a participant to give investment instructions with a frequency appropriate for the market volatility of an investment alternative.[68] In addition, a participant must be permitted to give investment instructions no less frequently than once every three months for at least three investment alternatives, each of which must be part of a broad range of investment alternatives.[69] If there are other investment alternatives for which participants can give instructions at a faster rate than once every three months, at least one of the selected three investment alternatives must allow participants to give instructions as frequently as allowed for that investment. Finally, participants must also be able to direct investments from such alternatives into an income producing low risk fund or account at the

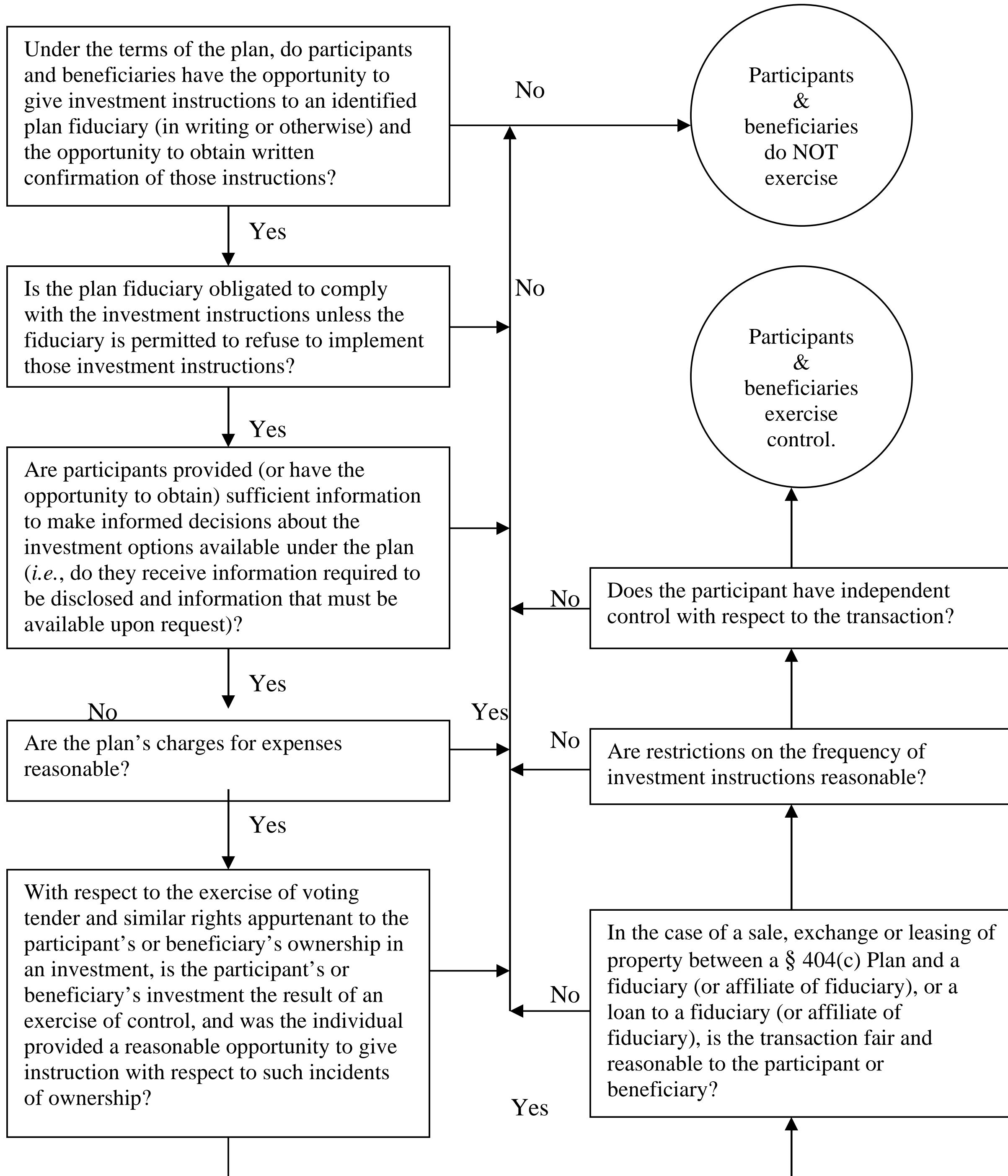
[65] ERISA Regulation § 2550.404c-1(b).
[66] ERISA Regulation § 2550.404c-1(b)(2)(ii)(C).
[67] ERISA Regulation § 2550.404c-1(b)(2)(ii)(B).
[68] ERISA Regulation § 2550.404(c) (b)(2)(ii)(C).
[69] ERISA Regulation § 2550.404(c)-1(b)(2)(ii)(C)(i). A definition of a broad range of investment alternatives is provided in the next subsection. See ERISA Regulation § 250.404c-1(b)(3).

same frequency or as frequently as they are permitted to give investment instructions with respect to each such alternative.[70]

[70] ERISA Regulation § 2550.404c-1(b)(2)(ii)(C)(2)(ii).

Diagram 3: Determining if a Plan Provides an Opportunity to Exercise Control Over Assets

INSTRUCTIONS: Use the flowchart below to determine if a plan provides an opportunity for participants and beneficiaries to exercise control over the assets in their individual accounts.



Broad Range of Investment Alternatives

In order to qualify for relief under 404(c), participants must be given the opportunity to invest in a broad range of investment alternatives.[71] This requires that participants must have a reasonable opportunity to materially affect the potential return and the degree of risk on their individual accounts.[72] When determining whether a plan provides a reasonable opportunity to diversify participant assets, fiduciaries should consider the nature of the investment alternatives and the size of the portion of the participant's account over which he is permitted to exercise control.

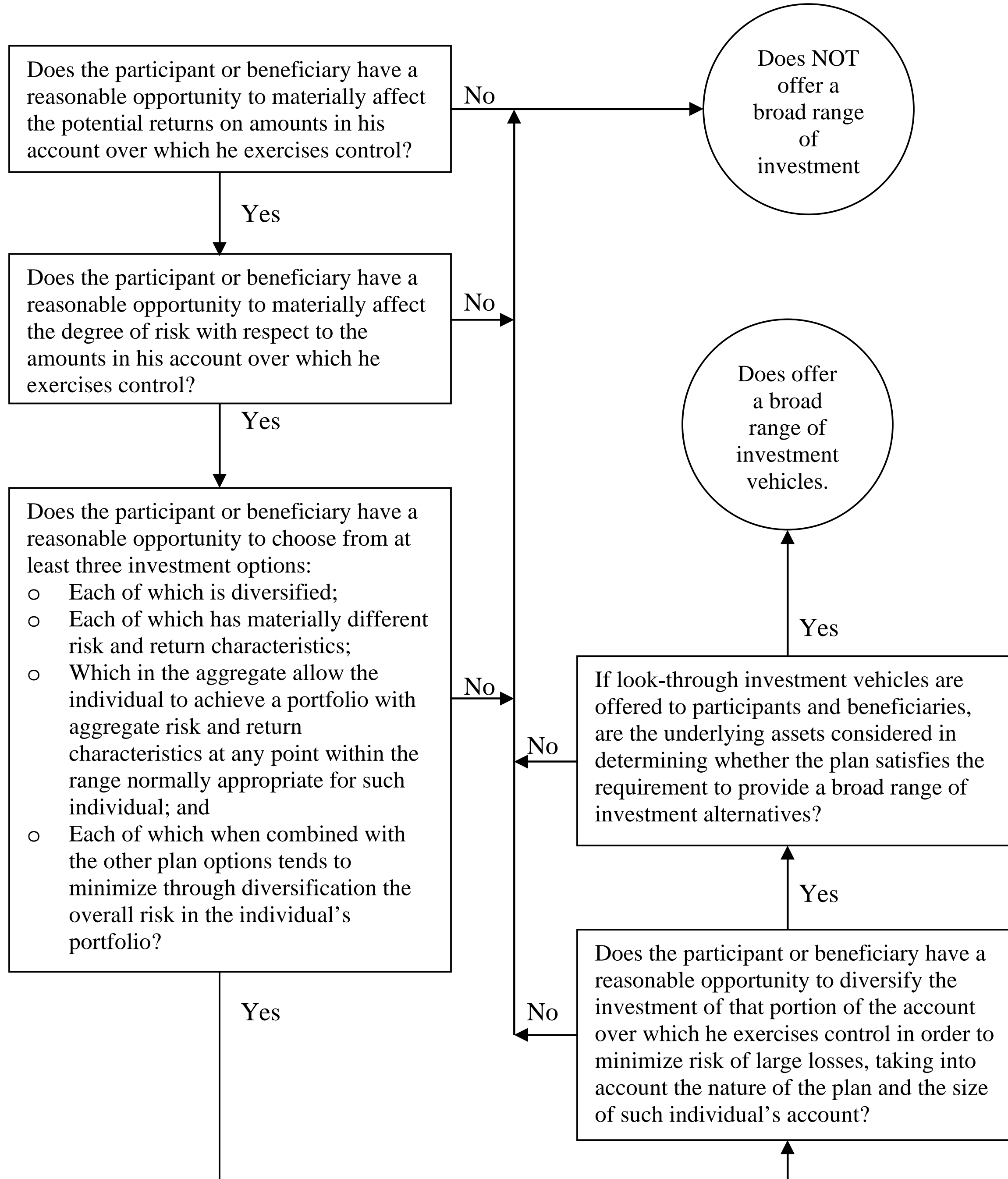
The investment alternatives have specific requirements as well. There must be at least three core alternatives into which participants may direct their account funds. Each of these alternatives must be diversified and have materially different risk and return characteristics.[73] The core alternatives must, in the aggregate, enable the participant to achieve a portfolio with aggregate risk and return characteristics at any point along the range normally appropriate for the participant. Finally, each of the core alternatives, when combined with investments in the other core alternatives, must tend to minimize, through diversification, the overall risk of a participant's portfolio.[74]

---

[71] ERISA Regulation § 2550.404c-1(b)(3)
[72] Id.
[73] ERISA Regulation § 2550.404c-1(b)(3)(i)(B).
[74] ERISA Regulation § 2550.404c-1(b)(3)(i)(B)(4).

Diagram 4: Determining if a Plan Provides a Broad Range of Investment Options

INSTRUCTIONS: Use the flowchart below to determine if a plan provides a broad range of investment options to participants and beneficiaries.



Exercise of Control

The last requirement for qualification as a 404(c) plan is that participants in fact exercise independent control over their plan account. Fiduciaries are only relieved from liability for those plan assets that are managed by the individual participants. For example, if a plan allows participants to direct the investment of half of their plan account but the plan fiduciary directs the other half, the normal level of liability exists for the portion of the account that remains under the fiduciary's control. Fiduciaries may only be relieved of liability for the plan assets over which the participant has discretionary control.

§ 404(c) relief applies only when a participant's exercise of control over account assets has been independent. The determination as to what constitutes independent control is a fact specific question, based on the circumstances of the particular case. ERISA Regulation § 2550.404c-1(c)(2) lists three circumstances that can cause the loss of such independence. Thus, improper influence by a plan fiduciary will negate independence. In addition, if a fiduciary conceals a material non-public fact regarding an investment, the investment will lack independence unless the fiduciary is prohibited by federal or state law from revealing the information. Finally, independent control cannot be exercised when the participant is legally incompetent and the fiduciary accepts the instruction knowing the participant is legally incompetent.

Other Means of Limiting Liability

In addition to designing the plan to provide for participant-directed accounts that qualify under Section 404(c), fiduciaries have other methods of limiting liability. Following best practices for fiduciaries will significantly lower the odds of a claim for breach of fiduciary duty. Reading and following the terms of plan documents and properly documenting all decisions and the process by which those decisions came about will also lower exposure to liability.

Plans can also establish qualified default investment alternatives ("QDIA") that can reduce the risk of fiduciary liability. If the QDIA is selected and monitored prudently, participants who default into that investment alternative[75] will be treated as having selected the investment themselves. Thus, these participant accounts would be treated like an independent investment decision in a 404(c) plan.

Delegating authority to other fiduciaries is a further means of limiting the liability of any individual fiduciary.

Delegating Fiduciary Duties

Plans may divide authority among various fiduciaries so that a fiduciary will only be responsible for the sphere of activity over which that fiduciary has authority. ERISA § 405(c)

---

[75] Participants will default into an investment alternative when they have the power to make investment decisions and do not make any such decision. For example, if a participant opts into a salary reduction program or is automatically enrolled in such a plan, but does not pick amongst the menu of investment alternatives, his lack of decision is treated as if he decided to invest in the QDIA for 404(c) purposes.

provides rules by which plan documents may prescribe a procedure for the delegation of fiduciary authority. Fiduciary authority cannot be delegated without following this procedure. Even if fiduciaries informally delegate authority, the transfer of authority will not be treated as legally relevant.[76] These procedures may also allow named fiduciaries to cause other individuals to become fiduciaries. On the other hand, there is an express prohibition against delegating trustee responsibilities.

A delegation of authority will generally relieve a fiduciary of liability for matters beyond his or her control. However, this will not be the case if a fiduciary is otherwise liable through co-fiduciary liability (discussed in the next subsection). Additionally, a named fiduciary will not typically be held liable for the actions of a person they appoint to be a fiduciary through plan procedures, except in one of three circumstances. Thus, if the named fiduciary violates the duty of prudence and loyalty imposed by ERISA § 404(a)(1)[77] with respect to (i) the allocation or designation, (ii) the establishment or implementation of the delegation procedure, or (iii) the continuation of the allocation or designation, then the named fiduciary will retain responsibility for the actions of the person appointed to act in his place. Thus, if a named fiduciary designated a person to perform a fiduciary function but failed to prudently monitor the designee's performance of that function, the named fiduciary would be potentially liable for the designee's negligent performance.

Co-Fiduciary Liability

Fiduciaries are responsible for their own conduct but may be responsible for the conduct of other fiduciaries as well. There are three circumstances that will cause a fiduciary to be liable for the breach of another fiduciary. These e circumstances are in addition to any liability the fiduciary may incur himself.[78] For the purposes of clarity, we will refer to the breaching fiduciary as "Fiduciary B" and the fiduciary who would become liable because of Fiduciary B as "Fiduciary A." First, if Fiduciary A participates knowingly in or knowingly attempts to conceal an act or omission of Fiduciary B that constitutes a breach of fiduciary duty, Fiduciary A is liable for the acts of Fiduciary B if he knows such an act or omission is a breach. Second, if a Fiduciary A enabled Fiduciary B to commit a breach through Fiduciary A's failure to comply with his own fiduciary duties, then Fiduciary A will be responsible for Fiduciary B's breach. Third, if Fiduciary A knows of a breach by Fiduciary B, Fiduciary A is liable for that breach unless Fiduciary A makes reasonable efforts to remedy the breach.

Liability Insurance

Under ERISA § 409(a), fiduciaries are personally liable for their breaches of fiduciary duty; accordingly, if a plan participant makes a claim, any damages are paid by the breaching fiduciary, not by the plan. Fiduciaries may be indemnified against potential damages through insurance contracts. ERISA § 410(b) explicitly permits fiduciaries to acquire such contracts and allows for plan sponsors to purchase such insurance on behalf of employees who serve as fiduciaries. However, a plan may purchase insurance for its fiduciaries to cover liability or

---

[76] ERISA Reg. § 2509.75-8; FR-13.
[77] Discussed in full in Chapter 1.
[78] ERISA § 405(a).

losses occurring by reason of the act or omission of a fiduciary, only if such insurance permits recourse by the insurer against the fiduciary for a breach of fiduciary duty.[79]

The plan itself cannot relieve a fiduciary from liability. No provision of a plan instrument that purports to relieve a fiduciary from responsibility or liability will be upheld by a court of law, as ERISA § 410(a) specifically states that such provisions are void as against public policy.

[79] ERISA § 410(b)(1).

Chapter 7 – Consequences of Failing to Meet your Fiduciary Duty

ERISA fiduciaries are personally liable for breaching their fiduciary duties. The breaching fiduciary is responsible for making on any losses that result from the breach and for returning to the plan any profits the fiduciary may have made through the use of plan assets.[80] A breaching fiduciary also may be subject to court approved equitable remedies. Aside from being subject to those remedies, there are additional civil penalties, imposed by the DOL and IRS that a breaching fiduciary may face. While the costs associated with restoring the plan to normality are unavoidable once there has been a breach, fiduciaries may, in certain circumstances, avoid further penalties through corrective action.

Types of Violations

ERISA imposes numerous requirements on fiduciaries, as demonstrated throughout this book, and failure to fulfill these obligations is a breach of duty. Part 5 of Subtitle B of ERISA provides for civil enforcement and criminal penalties related to fiduciary violations.

Civil Violations

ERISA requires plan administrators to furnish participants with certain information, such as a summary plan description, and gives participants a cause of action against administrators under § 502(c)(1) for failure to comply with a request to provide such information. The statute authorizes a penalty of $110 per day and "such other relief as [the court] deems proper.[81] However, this relief may be limited due to the fact that the court may only order relief if the plan administrator fails to provide appropriate documentation within 30 days after a participant requests it.[82] On the other hand, a request for information is not required for standing to sue if the administrator has failed to provide the information.

It is also a violation of ERISA to interfere with protected rights of a participant or potential participant.[83] Accordingly, it is unlawful to discipline or discriminate against a participant for exercising any right to which he is entitled under the employee benefit plan. Such actions will give rise to the same civil liabilities as violations of ERISA § 502, discussed below.

Any breach of the core fiduciary duties of prudence, loyalty, diversification of assets and following plan documents that causes the loss of plan assets violates ERISA. For example, if a fiduciary fails in his duty to diversify plan assets, and it can be demonstrated that the plan lost money because of this failure, the breaching fiduciary would be required to pay the plan the difference between what the plan should have earned and the amount the plan actually earned. Similarly, engaging in a prohibited transaction by using plan assets to benefit parties related to the plan is a violation under ERISA and will result in fiduciary liability. Actions of co-

---

[80] ERISA § 409.

[81] The Department of Labor has adjusted the statutory amount from $100 per day to $100 per day to account for inflation. 62 Fed. Reg. 40696, (July 29, 1997).

[82] ERISA § 502(c)(1)(B).

[83] ERISA § 510.

fiduciaries, as discussed in the previous chapter, can also create liability for other fiduciaries, assuming the standards for co-fiduciary liability are met.[84]

Despite these potential violations, fiduciaries are excused from liability for fiduciary breaches committed before they became a fiduciary or after their service as a fiduciary ends.[85] While successor fiduciaries are not liable for a fiduciary breach by a predecessor, if they become aware of an ongoing breach, they are obligated to correct it.[86] Although fiduciaries may terminate their service as a fiduciary and thereby terminate their fiduciary obligations they cannot abandon the plan without following plan procedures. Moreover, a departing fiduciary must ensure that another fiduciary will assume his responsibilities.[87]

Criminal Violations

In addition to civil liabilities, ERISA also imposes sanctions for criminal violations. First, criminal penalties may be imposed on any person who willfully violates a provision of Part 1 of Subtitle B of ERISA,[88] which concerns the reporting and disclosure requirements of fiduciaries, including furnishing the summary plan description and annual reports. Criminal penalties may also be imposed for the use of violence, fraud, threat of force, etc. as a means of coercing a participant into not exercising rights under ERISA or the plan that the participant is entitled to exercise.[89] Further, it is a criminal violation for a person, in connection with a multi-employer plan, to knowingly make a false statement to an employee or beneficiary about the financial condition, benefits provided, or regulatory status of such a plan.[90]

ERISA also prohibits certain persons from holding plan positions. The list of those who cannot serve the plan in a fiduciary capacity includes persons convicted of: fraud, burglary, arson, felony violation of state or federal drug laws, perjury, murder, rape, violation of § 302 of the Labor-Management Relations Act, felony abuse of a person's position or employment in a labor organization, or conspiracy to commit any such crimes.[91] No person with any of these convictions may serve as a fiduciary, administrator, officer, trustee, consultant, or advisor to an employee benefit plan. The prohibition lasts for 13 years after the conviction or the end of imprisonment, whichever comes later.

The United States Criminal Code also includes certain ERISA-based violations. Thus, it is unlawful to knowingly make a false statement in any document required under ERISA Title I.[92] Concealing a required fact or a fact that would aid in verifying or explaining the document, is also a criminal violation.

---

[84] For more information on co-fiduciary liability, see Ch. 6.
[85] ERISA § 409(b).
[86] This is not a separate fiduciary duty, but founded in ERISA § 404(a)(1)(B)'s duty of prudence. *See also* DOL Adv. Op. 76-95.
[87] see Employee Benefits Security Administration, *Meeting your Fiduciary Responsibilities*, Department of Labor (Jul. 26, 2011) http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html
[88] ERISA § 501(a).
[89] ERISA § 511.
[90] E.g. ERISA § 501(b); ERISA § 519.
[91] The full list of disqualifying criminal convictions is listed in ERISA § 411.
[92] 18 U.S.C. §1027.

ERISA and Tax Code Penalties

Fiduciaries are liable for the losses they cause the plan. For example, if imprudent investment management results in $1 million of losses to the plan, the breaching fiduciary would be liable to the plan that amount. For any such breach of fiduciary duties, the Secretary of Labor is obligated to assess an additional penalty upon breaching fiduciaries and any other person who knowingly participates in such a breach. The penalty is 20% of the applicable recovery amount due to the plan. For example, if a fiduciary fails to diversify plan assets, and this causes a $100,000 loss to the plan, the fiduciary would be required to pay the plan $100,000 to restore plan assets and the fiduciary would also owe an additional $20,000 penalty to the Department of Labor.[93]

Fiduciaries and parties in interest may also be assessed with penalties for their participation in a prohibited transaction. This penalty may not exceed 5% of the applicable amount. If a plan were to lose $100,000 from investment in a business venture controlled by parties related to the plan, a party-in-interest could be fined $5,000 for being part of a prohibited transaction.[94]

These penalties may be reduced or waived on a discretionary basis. The Director of the Office of Exemption Determinations is delegated the authority to make such determinations for the DOL. The Director can decide to waive or lower a penalty upon a finding that an individual acted reasonably and in good faith when engaging in the fiduciary breach.[95]

The criminal penalties for ERISA violations are more severe. Any willful violation of the disclosure requirements in Part 1 of ERISA may result in a fine of up to $100,000 and a sentence of not more than 10 years imprisonment, or both. The same penalties apply for making a false statement to an employee of a multi-employer plan. Any person who intentionally violates the prohibition against hiring a prohibited person may be fined up to $10,000 and/or subject to imprisonment for up to five years.

Tax Code Penalties

In addition to the civil and criminal penalties that the DOL may impose, excise taxes under the tax code may be imposed on certain plan actions. The ERISA and tax code prohibited transaction rules mirror on another and committing what ERISA defines as a prohibited transaction will generally result in an excise tax imposed on the responsible fiduciary. There is a 15% excise tax for each prohibited transaction in which a plan engages.[96]

Who May Bring Lawsuits For a Breach?

In order to encourage compliance, ERISA creates standing for certain plaintiffs to bring suits for breaches of fiduciary duty. ERISA § 502(a) sets forth the persons who are empowered to bring a civil action. Any participant or beneficiary may bring a civil action for failure to

---

[93] ERISA § 502(l).
[94] ERISA § 502(i).
[95] *EBSA Enforcement Manual*, Ch. 35
[96] 26 U.S.C. §4975(a).

furnish required information, to recover benefits owed under the terms of the plan, to enforce any violation of the plan terms or to clarify the right to future benefits under the plan.[97] Participants, beneficiaries, and plan fiduciaries may also seek injunctive relief against acts or practices which violate ERISA or the terms of the plan, such as a prohibited transaction. These parties may also seek other appropriate equitable relief to redress violations and enforce the terms of the plan. In *CIGNA Corp. v Amara*, the U.S. Supreme Court indicated that a wide range of traditional equitable remedies is available to ERISA participants.[98]

The DOL posses similar enforcement mechanisms. The DOL is empowered to sue to enforce plan provisions, to obtain relief for loss of plan assets, to enforce any appropriate equitable relief, to and enforce any provision of ERISA. The DOL is also uniquely given the authority to seek and collect applicable civil penalties, as defined in ERISA § 502.

Correcting Breaches

The Employee Benefits Security Administration ("EBSA"), a division of the DOL, permits fiduciaries to correct certain types of breaches without incurring the penalties associated with the violation. Fiduciaries may apply for relief under the Voluntary Fiduciary Correction Program ("VFCP"), provided they meet the program's qualifications.

Eligibility

Eligibility for the VFCP is conditioned on the plan or other applicant meeting certain requirements. In addition to specific requirements relating to the type of action being corrected and the available means of correction, the applicant/plan must meet each of the following three conditions.

First, the application cannot contain evidence that would lead EBSA to determine that there is a potential criminal violation involved in the action that the plan is seeking to correct. Second, an action is not eligible for correction if EBSA has conducted an investigation which resulted in written notice to a plan fiduciary that it has been referred to the IRS. Finally, EBSA requires that neither the plan nor the applicant be under investigation by a government agency. In the notice describing the VFCP, EBSA indicates that a plan or participant is considered to be under investigation if EBSA is investigating the plan or a participant in connection with an act directly related to the plan. In addition, if any other government agency is conducting a criminal investigation of the plan or a participant for actions directly related to the plan, the plan is under investigation.[99] Further, a plan is under investigation if an examination of the plan is being conducted by the Tax Exempt and Government Entities division of the IRS. Finally, if the Pension Benefit Guaranty Corporation or any state attorney general or state insurance commissioner is conducting an investigation of the plan or plan sponsor for actions related to the

---

[97] ERISA 502(a)(1). For example, plan participants may bring claims for the recovery of losses that resulted when the plan administrator failed to follow instructions to change the investment of a participant's plan account, resulting in investment losses. *See LaRue v. Dewolf, Boberg & Associates Inc.*, 552 U.S. 248 (2009).
[98] *Cigna Corp. v Amara,* 131S.Ct. 1866 (2011).
[99] *Voluntary Fiduciary Correction Program under the Employee Retirement Income Security Act of 1974,* 71 Fed. Reg. 20270 (Apr. 19, 2006).

plan, then the plan is under investigation, unless the applicant has notified EBSA in writing of such an investigation.

There are also certain circumstances that do not qualify as being "under investigation." If EBSA merely contacts a plan or applicant for correction in connection with a participant complaint, such contact will not meet the criteria for being under investigation unless the participant complaint concerns the same action for which correction is being sought and the plan has not received the correction amount due under the VFCP as of the date EBSA contacts the plan. A plan is also not under investigation if the plan is undergoing a work paper review by EBSA.

Application Procedures

Applications under VFCP must be submitted to EBSA and must adhere to particular rules. An application must be prepared by a plan official[100] or his authorized representative, such as an attorney or an accountant. There must also be a contact person listed in the application, as well as the contact's address and telephone number. The contact must be familiar with the contents of the application and have authority to respond to inquiries. The application needs to include a penalty of perjury statement and a completed checklist.[101]

The primary requirement for voluntary correction is a detailed narrative describing the breach and the corrective action. The narrative must include a list of all persons materially involved in the breach, the employer identification number, the date that the plan's most recent Form 5500 was filed, an explanation of how the breach was corrected and who corrected it and the specific calculations that were used to determine how the principal amount and lost earnings were calculated.

Documentation that supports the narrative description must also be included in a VFCP application. This includes the plan document and any other pertinent documents related to the plan. Each type of breach that may be corrected has its own supporting documentation that is necessary for a valid application. In addition to specific corrective requirements, documentation establishing the amount of profits to be restored, if applicable, or the amount of lost earnings needs to be provided, as well as proof that such amounts have been paid to the plan.

Types of Actions That May be Corrected

Only certain types of breaches may be corrected through the VFCP. EBSA lists six different actions that may be corrected through the program. Each type of breach has its own method of correction and each method is strictly applied. General descriptions of the types of actions that may be corrected are given below.

---

[100] A plan official is a plan fiduciary, plan sponsor or party in interest with respect to the plan, or any other official with the capacity to correct a breach. 71 F. R. 20271 (April 19, 2006).
[101] The checklist may be found in Appendix B of the notice of the Voluntary Fiduciary Correction Program. 71 F. R. 20282 (Apr. 19, 2006).

Delinquent Participant Contributions

The first type of fiduciary breach that may be corrected is a delinquent remittance of participant funds. This occurs when an employer receives or withholds money from a plan participant but retains that money for longer than allowed by ERISA standards or the plan documents. This will apply when an employer withholds money from an employee paycheck to be contributed to his retirement account or to repay a plan loan.

Loans

Certain breaches regarding loans to parties-in-interest may also be voluntarily corrected. There are three types of loans that are eligible. First, a loan made to a party-in-interest at a fair market interest rate may be corrected. Plans also may correct loans made at a below market interest rate to parties-in-interest. Finally, a plan may correct a loan made to a person who is not a party in interest if the rate of interest is below market rate.

Additionally, there are separate rules for loans made to plan participants. There are two types of participant loan breaches that may require correction. If a participant is loaned money in a manner that is inconsistent with plan documents, the loan is a prohibited transaction but may be fixed under VFCP. The other type of breach related to a participant loan that may be corrected, is the failure by a plan administrator to withhold loan repayments from the participant's paycheck.

Transactions Involving Plan Assets

A plan's sale or purchase of an asset to or from a party-in-interest, if it is otherwise a prohibited transaction, can be remedied through the VFCP. Similarly, the sale and leaseback of property between a plan and an employer may be corrected. Lastly, the sale of an asset to person who is not a party-in-interest for less than fair market value or the purchase of an asset for more than fair market value, is a transaction that may be corrected through the VFCP.

Improper Valuation of Benefits

Defined contribution plans may violate ERISA by paying benefits without properly valuing plan assets on which such payment is based. If assets are not correctly valued, distributions will be excessive or insufficient and in such cases, the plan may be eligible to correct the resulting breach under the VFCP.

Duplicative or Excessive Plan Expenses

The last type of breach which may be corrected concerns plan expenses. Wasting plan assets on certain expenses constitutes a breach of fiduciary duty that may be corrected in certain circumstances. Three types of plan expense violations may be corrected: 1) duplicative or excessive compensation for services; 2) improper payment of expenses that the plan sponsor should pay;[102] and 3) paying a fiduciary for services with plan assets when doing so is a prohibited transaction.

---

[102] See Ch. 1 for more information on settlor functions.

DOL Investigative Authority

ERISA authorizes the Department of Labor to investigate any violations of ERISA. Under this authority, the DOL can require the submission of reports, books, records, and the filing of data that supports required disclosure to the DOL. Thus, if the DOL is suspicious of a plan activity after reviewing the plan's Form 5500, it may require the plan to turn over all documents used to prepare the Form 5500. This authority can be exercised no more than once in a 12 month period.

Chapter 8 – Fiduciary Responsibility and the Management of Plan Assets

Investment Procedures

The types of investments available to employee benefit plans have evolved since ERISA's enactment and the statute wisely refrains from establishing lists of specific securities or other assets that are either permitted or prohibited. Instead, ERISA requires fiduciaries to select investments in accordance with the duty of prudence, that is, with the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Whether they are involved in selecting mutual fund options for a 401(k) plan's investment menu or choosing a mix of assets intended to fund lifetime pensions for a specific group of pension plan participants, the duty of prudence is seen by the courts as requiring fiduciaries who have investment duties to engage in a process whereby the merits of each proposed investment are examined before it is acquired and thereafter continuously monitored to ensure that the investment remains suitable.[103]

A fiduciary with investment authority must also diversify the plan's investments so as to minimize the risk of large losses and discharge his or her duties for the exclusive purpose of providing benefits or defraying reasonable expenses, all in accordance with plan documents to the extent consistent with ERISA. Thus, even where a particular investment is otherwise permitted by plan documents, if making such an investment would violate these standards or constitute a prohibited transaction under ERISA, a plan fiduciary would be prevented from making the investment.

Benefits and/or Investment Committee

ERISA provides that a plan's named fiduciary and trustee have the power to manage plan assets. If a named fiduciary or trustee delegates investment authority to another person, such as a benefits or investment committee, the person to whom such authority is delegated will have full liability as a fiduciary under ERISA for that person's acts or omissions. In addition, the named fiduciary or trustee who appoints such a person will be responsible for the person's conduct unless the appointee is a trustee or an investment manager meeting the requirements of Section 3(38) of ERISA.

Thus, members of a benefits and/or investment committee are fiduciaries if investment responsibilities are delegated to the committee. Therefore, such a committee should carefully document all meetings where actions are taken with respect to the management or disposition of plan assets. Written minutes should describe the investigation of proposed investments or investment courses of action, decisions taken and how members voted on each issue. If any members of the committee object to a proposed action because it might violate ERISA's fiduciary standards, those members objecting to the action should insist that their objections and the responses to their objections be documented in the minutes of the meeting.[104]

---

[103] See e.g., *Donovan v. Cunningham*, 716 F2d 1455 (5th Cir. 1983), cert. denied, 469 U.S. 1072 (1984).
[104] 29 ERISA Regulation §2509.75-5, FR-10.

A benefits and/or investment committee member may need to resign if another member persists in a course of action that constitutes a breach of fiduciary responsibility. However, the resignation alone may not be sufficient to discharge the member's duty to make reasonable efforts under the circumstances to remedy the breach.[105]

Trustees as Fiduciaries

ERISA requires all assets of an employee benefit plan to be held in trust by one or more trustees who are to be named in the plan or trust instrument or appointed by a person who is a named fiduciary.[106] Under the statute, the plan trustee or trustees have the exclusive authority and discretion to manage and control plan assets so that a trustee will, by definition, always be a plan fiduciary. Accordingly, a trustee's responsibilities must be discharged prudently and solely in the interest of the plan's participants and beneficiaries.

Different trustees may have varying levels of authority or discretion to manage or control plan assets. Thus, the plan document may provide that a trustee is subject to the direction of a named fiduciary. Such a "directed trustee" must follow the directions of the named fiduciary, provided that such directions are consistent with the terms of the plan and are not contrary to ERISA. A trustee's authority over plan assets may also be limited to the extent that the plan's named fiduciary has delegated the power to manage, acquire or dispose of plan assets to one or more investment managers.[107]

While directed trustees are fiduciaries, the scope of their fiduciary duties is significantly narrower than the duties generally ascribed to a discretionary trustee. On the other hand, to the extent that a directed trustee's authority and discretion to manage plan assets has been limited, the named fiduciary's role and legal responsibility will be correspondingly broadened.

Where the assets of a plan are held in more than one trust, a trustee is responsible only for the assets of the trust that the trustee controls. Similarly, if multiple trustees of a single trust have been allocated specific duties (*e.g.*, investment of a specified pool of assets), the trustee to whom certain responsibilities, duties or obligations have not been allocated will not be liable for any loss resulting to the plan from acts or omissions on the part of another trustee to whom such matters have been assigned.

The DOL has indicated that plan trustees should document actions taken in the management or control of plan assets by preparing written minutes and, where applicable, by recording votes.[108]

Investment Manager

As noted above, authority to manage and control plan assets may be delegated by a named fiduciary to an investment manager, if a plan so provides. Such an appointment relieves the plan's trustee of responsibility for investment matters. Similarly, a named fiduciary will not

---

[105] Id.
[106] ERISA §403(a).
[107] See ERISA §§ 3(38) and 402(c)(3).
[108] See 29 CFR §2509.75-5, FR 10.

be liable for the investment manager's investment decisions, although selection of the investment manager is a fiduciary act and even after the investment manager has been appointed, the named fiduciary remains obligated to monitor the investment manager's performance.[109] In order to constitute a proper appointment, the investment manager must acknowledge in writing that it is a fiduciary with respect to the plan and must itself be a registered investment adviser under the Investment Advisers Act of 1940, or, if not so registered, be registered under the laws of the state in which it maintains its principle office. Alternatively, the investment manager may be a bank, as defined under the 1940 Act, or an insurance company qualified in more than one state to manage, acquire or dispose of plan assets.

Statement of Investment Policy

Although ERISA does not require a plan to have one, DOL guidance indicates that the establishment and maintenance of an investment policy designed to further the purposes of the plan and its funding policy are consistent with fiduciary obligations under ERISA (*i.e.*, in the opinion of the Department, fiduciaries should maintain plan investments in accordance with an investment policy).[110]

An investment policy is a written statement that provides fiduciaries who are responsible for plan investments with guidelines or general instructions about various types or categories of investment management decisions. An investment policy statement may cover matters such as (i) the plan's investment objectives, (ii) the roles and responsibilities of particular plan fiduciaries, (iii) standards for selecting, monitoring and changing investment options and (iv) participant communications and investment education. DOL guidance indicates that a statement of proxy voting policy would also be an important part of a comprehensive investment policy statement.[111] An investment policy generally does not include directions relating to the purchase or sale of a specific investment.[112]

If a named fiduciary appoints one or more investment managers who are responsible for managing the investment of plan assets, the named fiduciary may condition such appointment on the acceptance of an investment policy. The named fiduciary, therefore, may require that the investment manager comply with the terms of the plan's investment policy which contains guidelines for plan investments and investment courses of action that the investment manager is authorized or not authorized to make. If an investment manager is not required to comply with an investment policy, the authority to manage the plan assets placed under the control of the investment manager would lie exclusively with the investment manager.[113]

An investment manager who has the authority to make investment decisions, including proxy voting decisions, is not relieved of his fiduciary responsibility even if he follows directions regarding specific investment decisions from the named fiduciary or any other person.[114] Thus,

---

[109] Id.
[110] 29 ERISA Regulation §2509.08-2(2).
[111] Id.
[112] Id.
[113] Id.
[114] Id.

an investment manager should not comply with the terms of an investment policy if it would cause a breach of his fiduciary duty.[115]

Continuous Monitoring

In accordance with the written investment policy, fiduciaries should continuously monitor plan investments. Ideally, investments should be reviewed periodically at fixed intervals. Monitoring should be guided by the plan's investment policy and apply an appropriate mix of qualitative and quantitative benchmarks to the performance and expenses of each investment fund and/or manager. Fiduciaries must make an effort to understand what their analysis means for the plan and the participants. Thus, investment performance must be correlated with current market conditions and compared to the performance and expenses of peer investment providers.

Utilization of An Independent Third Party Investment Expert

According to the Department of Labor, "a failure exists in the market for services for employee benefit plans" where vendors are able to maintain an "information advantage over their plan sponsor clients."[116] This reference is to the inherent conflict of interest that exists when a vendor renders advice that leads to a plan's investment in the vendor's proprietary funds or even nonproprietary funds where the vendor has a favorable business relationship with the fund sponsor. Accordingly, while vendors may furnish reports and analyses and make recommendations as to retaining or replacing specific plan investments, plan fiduciaries should understand that this information may be biased. Where a fiduciary does not have the training or experience to recognize this bias, it may be advisable to seek out the advice of an independent third party investment expert. Indeed, it may be necessary to take this step to ensure compliance with the plan fiduciary's duties under ERISA, and the incorporation of such a requirement in the plan's investment policy statement should be considered for the same reason.

Replace Funds That Do Not Meet Investment Criteria

One of the key functions of an investment policy statement is to provide specific standards that a plan investment must satisfy in order to assist plan fiduciaries in deciding whether actual investments should be retained or replaced. The failure to replace funds that have performed poorly can be used as evidence that a fiduciary has failed to act prudently resulting in personal liability. Nevertheless, many fiduciaries remain reluctant to take action with respect to such funds, sometimes merely adding funds as a substitute. The existence of objective investment guidelines in the form of the investment policy statement assists fiduciaries in the decision-making process and forces a plan fiduciary to act when necessary.

Conflicts of Interest

ERISA requires plan fiduciaries to discharge their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose" of providing them with plan

---

[115] Id.

[116] Preamble to interim final regulations under ERISA Section 408(b)(2), 75 F.R. 41600 (July 16, 2010).

benefits.[117] The exclusive purpose requirement is supplemented by a rule that "the assets of a plan shall never inure to the benefit of any employer …"[118] and a comprehensive set of prohibited transaction rules designed to prevent self-dealing.[119] Together, these provisions impose an overarching duty of loyalty that requires plan fiduciaries to avoid conflicts of interest.

Among other things, the duty of loyalty requires a plan administrator, including a plan sponsor when it is acting in the capacity of an administrator, to refrain from misleading participants.[120] In addition, a plan fiduciary, such as a corporate plan sponsor, must not use plan assets for its own purposes in a corporate control contest by investing in the plan sponsor's stock without making an independent and diligent investigation of available investment alternatives.[121] In the same vein, a plan fiduciary will be found to have breached his duty by investing plan assets in a troubled entity that is unable to obtain conventional financing in which the fiduciary has a significant ownership interest.[122]

The heightened scrutiny given to fee arrangements for individual account retirement plans has resulted in a proliferation of legal actions by plan participants against plan sponsors, as well as investment and service providers, charging them with a conflict of interest resulting from excessive fees that, in certain cases, are shared by service providers without the knowledge of plan fiduciaries or participants. While a number of courts have rejected such claims, many similar cases remain ongoing.[123] At the same time, the DOL has revised plan reporting rules and issued regulations that enhance the means for monitoring fees paid to plan service providers. As explained by the DOL, "plan fiduciaries have a duty to consider a service provider's compensation from all sources."[124]

The DOL's initiatives in the area of fee disclosures include changes to Schedule C of the annual Form 5500 that have, since 2009, required the identification of persons that provide investment management, recordkeeping, participant communication and other services to a plan if they received, directly or indirectly, $5,000 or more in reportable compensation. In addition, effective April 1, 2012, the Department's regulations will require certain service providers to

---

[117] ERISA §404(a)(1)(A).
[118] ERISA §403.
[119] ERISA §406.
[120] In *Varity v. Howe*, 516 U.S. 489 (1996), for example, the U.S. Supreme Court held that a fiduciary breach occurred when an employer, acting in the capacity of plan administrator, misled participants as to the security of future benefits.
[121] See *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984) and *Donovan v. Bierwirth*, 680F. 2d 263 (2d Cir. 1982).
[122] *Nagy v. DeWese*, 2011 WL 679333 (E.D. Pa. 2011); but see *Greenlee v. Commissioner*, 72 T.C.M. 394 (1996) in which the loan of plan funds to a business in which the plan administrator had an 18% interest was held not to be a prohibited transaction where an independent trustee reviewed the transaction and made the decision to make the loan.
[123] The landmark case of *Hecker v. Deere & Co*., 556 F. 3d 575 (7th Cir. 2009), *reh'g denied*, 569 F.3d 708 (7th Cir. 2009), *cert. denied*, 130 S. Ct. 1141 (2010) found no breach of fiduciary duties by the sponsor of a 401(k) plan based on its failure to inform participants of revenue sharing between affiliated service providers that provided investment advice to mutual funds on the one hand and trustee and recordkeeping services to the plan on the other. See also *Renfro v. Unisys Corp*., No. 10-2447 (3d Cir. 2011). However, not all courts are in agreement with the reasoning of the *Deere* case and issues raised by plan fees continue to work themselves through the courts. See *e.g*., *Braden v. Wal-Mart Stores, Inc*., 2009 WL 4062105 (8th Cir. 2009).
[124] Preamble to interim final regulations under ERISA §408(b)(2), 75 F.R. 41600 (July 16, 2010).

furnish fee disclosures prior to entering into or extending any service contract or arrangement.[125] Plan sponsors, in turn, would be required to use such information to make disclosures to plan participants.[126] The net result of these changes may be to shift onto plan sponsors the burden of detecting whether fee arrangements are burdened by conflicts of interest.

Selecting an Adviser

Selecting and Monitoring Pension Consultants

In carrying out their responsibility to prudently manage benefit plans for which they are responsible, fiduciaries often rely heavily on pension consultants and other professionals. However, questions have been raised concerning whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice they are providing to their benefit plan clients.[127]

Under the Investment Advisers Act of 1940 ("Advisers Act"), an investment adviser providing consulting services has a fiduciary duty to provide disinterested advice and disclose any material conflicts of interest to its clients. In this context, SEC staff examined the practices of advisers that provide pension consulting services to plan sponsors and trustees. These consulting services included assistance in determining the plan's investment objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Many of the consultants also offered, directly or through an affiliate or subsidiary, products and services to money managers. Additionally, many of them also offered, directly or through an affiliate or subsidiary, brokerage and money management services that were often marketed to plans as a package of "bundled" services. The SEC examination staff concluded that the business alliances among pension consultants and money managers can give rise to serious potential conflicts of interest under the Advisers Act that need to be monitored and disclosed to plan fiduciaries.

To encourage the disclosure and review of more and better information about potential conflicts of interest, the Department of Labor and the SEC have developed the following set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant.

1. Are you registered with the SEC or a state securities regulator as an investment adviser? If so, have you provided me with all the disclosures required under those laws (including Part II of Form ADV)?

   Note: Plan sponsors and other plan fiduciaries can view Part I of the firm's Form ADV by searching the SEC's Investment Adviser Public Disclosure website. The investment adviser must furnish you with a copy of Part II of Form ADV.

---

[125] 29 ERISA Regulation §2550.408b-2; DOL Announcement, 75 F.R. 42541 (July 19, 2011).
[126] 29 ERISA Regulation §2550.404a-5.
[127] Staff Report Concerning Examination of Select Pension Consultants, May 16, 2005, The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.

At present, the IAPD database contains Forms ADV only for investment adviser firms that register electronically using the Investment Adviser Registration Depository. In the future, the database will expand to encompass all registered investment advisers – individuals as well as firms – in every state. If you can't locate an investment adviser in IAPD, be sure to contact your state securities regulator or the SEC's Public Reference Branch.[128]

2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships?

   Note: When pension consultants have alliances or financial or other relationships with money managers or other service providers, the potential for material conflicts of interest increases, depending on the extent of the relationships. Knowing what relationships, if any, your pension consultant has with money managers may help you assess the objectivity of the advice the consultant provides.

3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your other income (revenue)?

   Note: Payments from money managers to pension consultants could create material conflicts of interest. You may wish to assess the extent of potential conflicts.[129]

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?

   Note: Probing how the consultant addresses these potential conflicts may help you determine whether the consultant is right for your plan.

5. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not over-pay its consulting fees?

   Note: You may wish to avoid any payment arrangements that could cause the plan to pay more than it should in pension consultant fees.

6. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?

---

[128] In contrast to 2005 when this note to the questions was written, at the present time, Part II of the ADV is generally available electronically and most registered investment advisers are listed in the IAPD database.

[129] The interim final regulations under Section 408(b)(2) of ERISA that are scheduled to take effect April 1, 2012 require full disclosure of the circumstances under which an adviser will be receiving compensation from parties other than the plan or plan sponsor. While the regulations do not require an adviser to provide the plan with a written description of the adviser's conflicts of interest, the required identification of the parties paying such compensation, as well as the compensation that is expected to be received, is intended to give the plan sponsor and other plan fiduciaries the ability to assess potential conflicts of interest on the part of the adviser. See 29 ERISA Regulation §2550.408-2(c)(1)(iv)(3).

Note: Where and how brokerage orders are executed can impact the overall costs of the transaction, including the price the plan pays for the securities it purchases.

7. Do you have any arrangements with broker-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?

   Note: As noted above, you may wish to explore the consultant's relationships with other service providers to weigh the extent of any potential conflicts of interest.

8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment adviser to the plan while providing the consulting services we are seeking?

   Note: All investment advisers (whether registered with the SEC or not) owe their advisory clients a fiduciary duty. Among other things, this means that advisers must disclose to their clients information about material conflicts of interest.

9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?

   Note: If the consultant is a fiduciary under ERISA and receives fees from third parties as a result of its recommendations, a prohibited transaction under ERISA occurs unless the fees are used for the benefit of the plan (*e.g.*, offset against the consulting fees charged the plan) or there is a relevant statutory or class exemption permitting the receipt of such fees.

10. What percentage of your plan clients utilizes money managers, investment funds, brokerage services or other service providers from whom you receive fees?

Selecting and Monitoring Plan Service Providers

The Department of Labor has developed the following guidelines to assist plan sponsors in carrying out their responsibilities under ERISA to prudently select and monitor plan service providers, including investment advisers.

1. Consider what services you need for your plan – legal, accounting, trustee/custodial, recordkeeping, investment management, investment education or advice.

2. Ask service providers about their services, experience with employee benefit plans, fees and expenses, customer references or other information relating to the quality of their services and customer satisfaction with such services.

3. Present each prospective service provider identical and complete information regarding the needs of your plan. You may want to get formal bids from those providers that seem best suited to your needs.

4. You may also wish to consider service providers or alliances of providers who provide multiple services (*e.g.*, custodial trustee, investment management, education, or advice, and recordkeeping) for a single fee. These arrangements are often called "bundled services."

5. Ask each prospective provider to be specific about which services are covered for the estimated fees and which are not. Compare the information you receive, including fees and expenses to be charged by the various providers for similar services. Note that plan fiduciaries are not always required to pick the least costly provider. Cost is only one factor to be considered in selecting a service provider. More information on pension plan fees and expenses can be found in *Understanding Retirement Plan Fees and Expenses and the 401(k) Fee Disclosure Form*, located at www.dol.gov/ebsa.

6. If the service provider will handle plan assets, check to make sure that the provider has a fidelity bond (a type of insurance that protects the plan against loss resulting from fraudulent or dishonest acts).

7. If a service provider must be licensed (attorneys, accountants, investment managers or advisers), check with state or federal licensing authorities to confirm the provider has an up-to-date license and whether there are any complaints pending against the provider.

8. Make sure you understand the terms of any agreements or contracts you sign with service providers and the fees and expenses associated with the contracts. In particular, understand what obligations both you and the service provider have under the agreement and whether the fees and expenses to be charged to you and plan participants are reasonable in light of the services to be provided.

9. Prepare a written record of the process you followed in reviewing potential service providers and the reasons for your selection of a particular provider. This record may be helpful in answering any future questions that may arise concerning your selection.

10. Receive a commitment from your service provider to regularly provide you with information regarding the services it provides.

11. Periodically review the performance of your service providers to ensure that they are providing the services in a manner and at a cost consistent with the agreements.

12. Review plan participant comments or any complaints about the services and periodically ask whether there have been any changes in the information you received from the service provider prior to hiring (*e.g*., does the provider continue to maintain any required state or Federal licenses).

Documenting Plan Operations

As previously discussed, the process for selecting and monitoring plan investments should be reduced to writing and consistently followed. Similarly, whenever possible, fiduciaries should implement and follow written procedures that can demonstrate compliance with ERISA's fiduciary standards in other areas. For example, a plan sponsor should prepare procedures for selecting and retaining auditors and other service providers in order to demonstrate that the sponsor has taken the necessary care in selecting and retaining such service providers. Written minutes of actions taken should be kept describing the nature of the action and the process (*e.g.*, vote) by which the decision was made.[130]

---

[130] See 29 ERISA Regulation §2509-75, FR-10.

Chapter 9 – Prohibited Transactions

In addition to their stated duties, fiduciaries are prohibited from permitting the plan to engage in certain transactions. Congress has made these prohibitions explicit and, unless there is an exception, prohibited transaction is a per se violation of ERISA. While the actual per se violations are straightforward, these are extensive exceptions and exemptions as embodied in DOL regulations and other administrative guidance. Fiduciaries are liable engaging in or enabling prohibited transactions and thus, should be keenly aware of what may get them into trouble.

What Is A Prohibited Transaction?

There are two broad categories of prohibited transactions: transactions between the plan and a party- in-interest and transactions involving the plan and a fiduciary. Identification of parties-in-interest is essential for determining whether a prohibited transaction may occur. ERISA § 3(14) set forth a list of all people/organizations that constitute a party- in- interest:

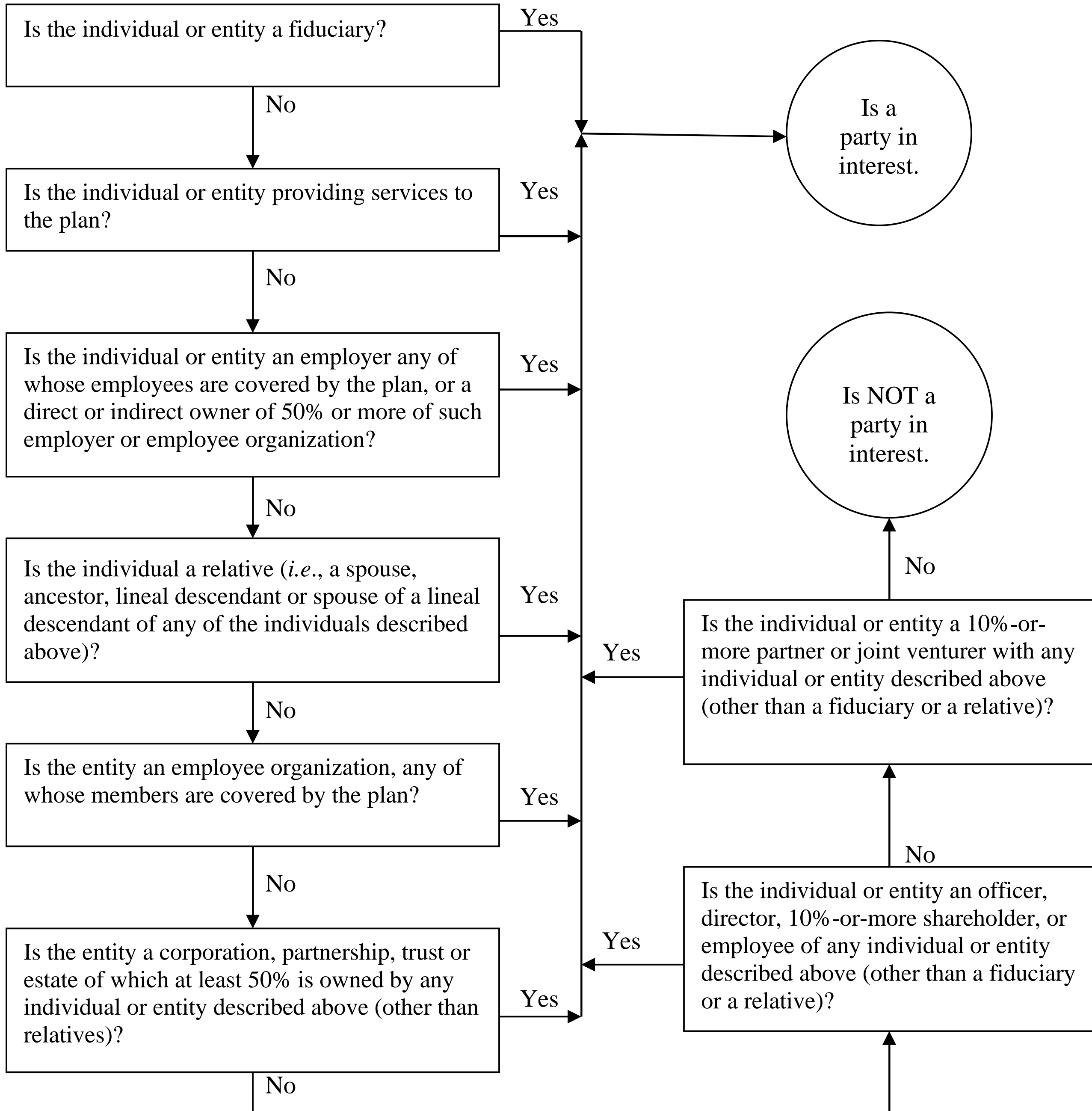
- Any fiduciary, counsel or employee of the plan;
- Any person providing services to the plan;
- Any employer that has employees covered by the plan;
- Any employee organization that has employee members that participate in the plan;
- The owner of 50% or more of (measured by voting power or total value) shares in a corporation, or capital interest in a partnership, which is an employer or employee organization that is otherwise a party-in-interest;
- A relative of a party-in-interest;[131]
- A corporation , partnerships, trust or estate in which any party-in-interest owns 50% or more of the corporation;
- An employee, officer, director, or 10% owner of any party-in-interest.

Persons described as "parties in interest" by Section 3(14) of ERISA are, with certain exceptions, the same as "disqualified persons" under Section 4975(e)(2) of the Internal Revenue Code.

[131] ERISA § 3(15) defines a "relative" as a spouse, ancestor, lineal descendant or spouse of a lineal descendant.

Diagram 5: Determining if an Individual Is a Party in Interest

INSTRUCTIONS: Use the flowchart below to determine if an individual or entity is a party in interest.



Note: The IRS definition of a disqualified person is slightly different.

The prohibited transaction rules are set forth in Section 406 of ERISA. Excise tax rules mirroring these provisions are set forth in Section 4975 of the Internal Revenue Code. ERISA plan fiduciaries are subject to both sets of rules. Section 406(a)(1) of ERISA defines a prohibited transaction to include the following actions by or between a plan and a party-in-interest:

- a sale, exchange, or lease of property; [132]
- lending of money or other extension of credit;
- furnishing of goods, services or facilities; [133]
- a transfer to, or use by or for the benefit of, a party in interest of the income or assets of the plan, and
- acquisition on behalf of the plan of any employer security or employer real property if it is a violation of Section 407 of ERISA for the plan to acquire or hold such securities or property.

The prohibited transaction rules applicable specifically to fiduciaries preclude them from engaging in any type of self-dealing. A plan fiduciary must not deal with the assets of the plan in the fiduciary's own interest or for his own account. [134] This is particularly the case when it comes to providing advice as to the selection of a plan investment and precludes a fiduciary from steering a plan toward investments that will generate higher fees for the fiduciary. ERISA also provides that, when engaging in any transaction that involves the plan, a fiduciary must not represent or act on behalf of any party whose interests are adverse to those of the plan. FN2[135] Finally, a fiduciary may not receive any consideration (*i.e.*, kickbacks) from any third party dealing with the plan.[136]

[132] Under ERISA § 406(c), a transfer to a plan of property subject to a mortgage or lien is treated as a sale or exchange of the property.

[133] Since anyone providing services to a plan is a party-in-interest, all service provider arrangements are potentially a prohibited transaction. However, as discussed in Chapter 2, ERISA § 408(b)(2) also provides an exemption from party in interest restrictions for contracting or making reasonable arrangements with a party in interest for services necessary for the establishment or operation of a plan if certain conditions are met.

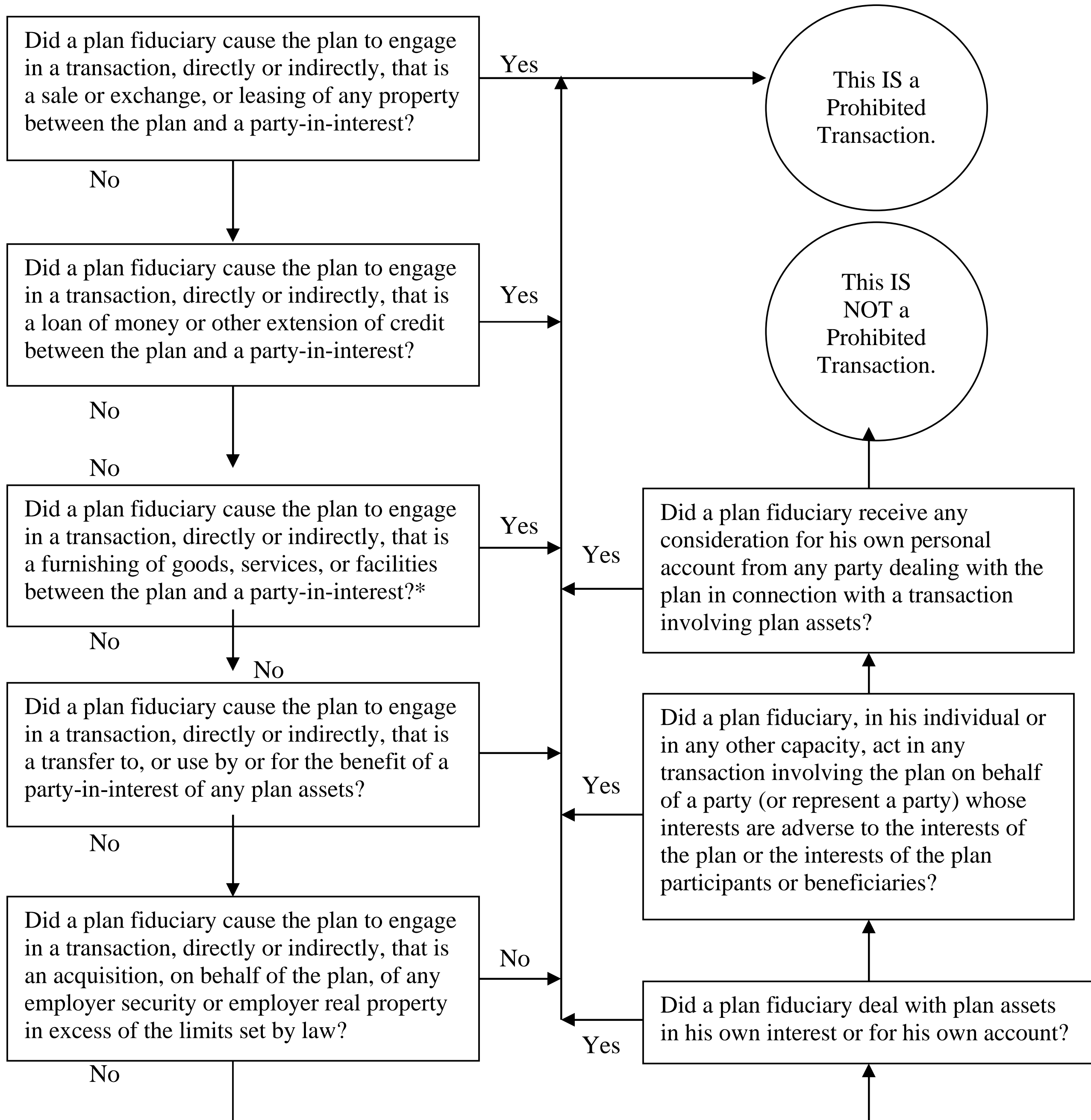
[134] ERISA § 406(b)(1) provides that a fiduciary with respect to a plan shall not "deal with the assets of the plan in his own interest or for his own account."

[135] - ERISA § 406(b)(2) provides that a fiduciary with respect to a plan shall not "in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries." Code Section 4975(c)(1) does not include a provision that specifically mirrors this rule under ERISA.

[136] ERISA §406(b)(3) provides that a fiduciary with respect to a plan shall not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."

Diagram 6: Identifying Prohibited Transactions

INSTRUCTIONS: Use the flowchart below to determine if a transaction is a prohibited transaction.



Note: Certain transactions are exempt from the prohibited transaction rules.

*In practice, this prohibited transactions rarely occurs because a service provider exemption provides relief from this prohibited transaction.

Typical Exemptions

The long list of prohibited transactions is supplemented by a list of exempt transactions contained in ERISA § 408. Plans may also petition the Department of Labor for an individual or class exemption for what would otherwise be a prohibited transaction.

408(b)(2) Exemption and Regulation

ERISA § 408(b)(2) ("408(b)(2)") creates a significant exception to the prohibited transaction rules. As noted earlier, the use of a service provider is itself a prohibited transaction if the service provider is paid with plan assets.

Section 408(b)(2) of ERISA provides a statutory exemption from the prohibited transaction rules for "reasonable arrangements" with a party-in-interest, for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor. Without this exemption, any fees paid by a plan to a service provider would be a prohibited transaction as a transfer of plan assets to a party-in-interest. To qualify for the statutory exemption, any payments by a plan to a party-in-interest for any service must satisfy three basic requirements: (1) the service must be necessary for the establishment or operation of the plan; (2) such service must be furnished under a contract or arrangement that is reasonable; and (3) no more than reasonable compensation may be paid for such service.

As noted, in order for a service provider contract to be exempt from the prohibited transaction rules, the service must be necessary for the operation of the plan. DOL regulations indicate that this requirement is satisfied if the service is appropriate and helpful.[137]

Exemption from the prohibited transaction rules is also conditioned on the reasonableness of the arrangement. In order for the contract or other arrangement under which a party in interest provides services to a plan to be "reasonable," the plan must be able to terminate the arrangement (1) without penalty, and (2) on reasonably short notice under the circumstances. The purpose of this requirement is to prevent a plan from becoming locked into a situation that becomes disadvantageous. In order to satisfy this requirement, the service arrangement should be in writing and have a relatively short duration, even though subject to renewal at the end of each period. [138] As discussed below, the DOL has expanded the requirement so that in order for service contracts or arrangements to be reasonable, a covered service provider must disclose specified information about its compensation to the responsible plan fiduciary.

The third requirement for exemption is the reasonableness of the compensation that the service provider is to receive from the plan. As to the amount of the compensation, the most important factor is whether it is comparable to compensation paid to other providers of similar services by other plans of similar size

---

[137] ERISA Regulation § 2550.408b-2(b).
[138] ERISA Regulation § 2550.408b-2(c)(3).

Service Providers are Covered by Fee Disclosure Requirement

While most service providers are covered by the new fee disclosure rules that are effective April 1, 2011, not all are. Only service providers who reasonably expect to receive $1,000 or more in compensation (either direct or indirect) from the provision of plan services must make the necessary disclosures under the regulation. Welfare plans, IRAs, simplified employee pensions and simple retirement accounts are not covered by the new rules. The regulation also limits covered service providers to three broad categories of service: services as a fiduciary, recordkeeping or brokerage services, and any services that are reasonably expected to be compensated indirectly. For a more complete discussion of the compensation disclosure requirement, see Chapter 3.

Other Typical Exemptions

There is a long list of statutory exemptions from the prohibited transactions rules. Plans may, for example, make certain loans to plan participants, who are considered parties-in-interest, so long as five criteria are met: (1) the loan must be available to all participants on a reasonably equivalent basis; (2) the loan cannot be available to highly compensated employees in an amount greater than the amount made available to other employees; (3) the loan is made in accordance with specific provisions regarding such loans as set forth in the plan; (4) the loan bears a reasonable rate of interest and; (5) the loan is adequately secured.[139]

There are also times when the plan can invest assets with certain plan fiduciaries. A plan may invest its assets in a bank that is a fiduciary when such investment is clearly authorized by the plan or the plan only covers employees of that bank.[140] Insurance contracts have a similar exemption. Thus, any contract for life or health insurance or an annuity is exempted if the insurer is the employer maintaining the plan or if the insurer is wholly owned by a party-in-interest and if the total premiums and annuity considerations written by such insurers do not exceed 5% of the total premiums for all lines of insurance in that year by such insurers.[141] Such contracts and arrangements (for both banks and insurers) are permitted on if no more than adequate consideration is paid.

Further Exceptions to Prohibited Transaction Rules.

Notwithstanding ERISA's prohibition on self-dealing, a fiduciary will <u>not</u> be treated as dealing with the assets of a plan in his own interest or for his own account under ERISA § 406(b) if the fiduciary does not use any of the authority, control, or responsibility that makes him a fiduciary to generate additional fees payable by a plan for a service furnished by the fiduciary or a party related to the fiduciary. The rationale for this rule is to require the fiduciary to exercise the fiduciary's best judgment in rendering advice or making decisions on behalf a plan.[142] The applicable DOL regulation explains that preservation of a fiduciary's best judgment may occur

---

[139] ERISA § 408(b)(1).
[140] ERISA § 408(b)(4).
[141] ERISA § 408(b)(5).
[142] ERISA Regulation § 2550.408b-2(e)(2).

when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, the regulations further provide that the mere involvement of a second fiduciary is not a guarantee that the retained fiduciary has not impermissibly used its authority to benefit itself. Therefore, fiduciaries generally seek to assure themselves that they are not violating the prohibited transaction rules by qualifying for other exceptions.

While a plan investment adviser generally would not be permitted to use its fiduciary authority to direct a plan client to invest in investment alternatives that resulted in additional fees for the adviser, another exception to categorizing such an arrangement as a prohibited transaction involves "fee leveling" whereby a prohibited transaction violation can be avoided as long as the overall compensation of the fiduciary adviser and its affiliates remains level. This can be accomplished if indirect compensation the adviser receives from mutual funds or other investment providers is used to offset on a dollar-for-dollar basis the service fees that plans would otherwise pay the adviser.[143] The reasoning that underlies this approach is that the leveling of a fiduciary's compensation eliminates any incentive to recommend or select investment options on a basis other than the best interests of the plan and plan participants.

The DOL's "SunAmerica" advisory opinion outlines an additional type of exempt arrangement in which plan clients participating in a fiduciary investment program were directed or advised to invest in investment vehicles which included proprietary investment products advised by the program sponsor or its affiliate. Although the SunAmerica opinion assumed that the services provided by the program sponsor caused it to be a fiduciary with respect to plan clients, the DOL concluded that where investment decisions or recommendations are actually made pursuant to a computer program maintained by an independent fiduciary that is unaffiliated with the program sponsor, the receipt of varying levels of fees by the program sponsor and its affiliates (resulting from the independent fiduciary's decision or recommendation to invest in the sponsor's proprietary investment vehicles) was permissible under the prohibited transaction rules.

Prohibited Transaction Exemption Requests

Under ERISA § 408(a), Congress granted authority to the Secretary of Labor to gran individual and class exemptions with respect to prohibited transactions. Thus, plans may file for DOL approval of proposed transaction that would otherwise be prohibited. The statute provides that the Secretary cannot grant an exemption unless such exemption is (1) administratively feasible; (2) in the interests of the plan and of its participants, and; (3) protective of the rights of plan participants and beneficiaries of the plan.

When filing for exemption, the DOL considers each application on its own merits; the facts of a unique application are reviewed for what they are, so plan administrators should provide as much information as possible to help their case. At a minimum, the DOL recommends providing a description of the transaction and procedures safe-guarding participant interests, the percentage of plan assets that are involved in the transaction, the names of fiduciaries with investment discretion, the extent of the plan assets already invested in securities,

[143] Department of Labor Advisory Opinion 1997-15A.

loans and property issued or owned by the parties-in-interest involved in the transaction, copies of all relevant contracts and agreements, information on plan participants in pooled funds, and a declaration attesting to the truth of all statements.

The DOL may require specific information based on the exact nature of the potential prohibited transaction. For example, if the plan wishes to sell property to a party-in-interest, the parties should provide an independent appraisal to demonstrate that the plan is receiving a fair value for the property. The DOL has provided five different examples of common transactions and the information to be furnished by the parties in requesting request for an exemption.[144]

[144] For the full list of examples and more information on how to apply for a prohibited transaction exemption, see Employee Benefits Security Administration, *Exemption Procedures Under Federal Pension Law*, Department of Labor http://www.dol.gov/ebsa/publications/exemption_procedures.html.

Limits on Plan Acquisition

There is a quantitative limit on the amount of qualified employer securities or real property that a plan may purchase for its participants. Plans are limited to investing 10% of total plan assets in employer securities or real property.[145] The value of these assets is measured immediately after acquisition. Thus, if the assets appreciate in value such that they constitute more than 10% of plan assets, this does not violate § 407.[146] For example, if a plan has $10,000,000 in assets and purchases $500,000 in employer stock, this would be acceptable. If the plan purchased $2,000,000 in employer stock, the purchase would exceed the 10% limit. If the plan purchases $500,000 in employer stock and it appreciates to $2,000,000, the plan will not have violated any ERISA rules.

The 10% rule only applies for plans where individuals cannot choose their asset allocations. Participants in participant directed plans may choose to invest up to 100% of their accounts in qualified employer securities. ERISA fiduciary duties will still apply to the choice of employer securities as an option in an investment alternative menu.

---

[145] ERISA § 407(a)(2).
[146] ERISA § 407(a)(2).

Chapter 10 – Investment Advice vs. Investment Education

ERISA's regulatory scheme envisions a system where participants in a plan that permits investment direction can make fully informed decisions about their investment options. The problem, however, is that fiduciaries are wary of giving information to participants beyond what is required. They worry that they may be held liable for participant investment choices when that information is given, because providing investment advice makes a person a plan fiduciary.[147] This prospect may restrain investment and other service providers from providing such advice out of fear of the potential liability.

The DOL has created an exception to the definition of investment advice that enables advisers to furnish investment education without incurring fiduciary responsibility. If a person is only providing investment education, he is not considered to be a fiduciary and will not incur liability as a result of furnishing such information.

What is Investment Advice?

ERISA § 3(21) defines an investment advice fiduciary as a person who renders investment advice for a fee or other compensation. The compensatory requirement can be satisfied directly or indirectly and may be met by a payment from a third party. Under the current DOL regulation, a person is deemed to provide investment advice if he makes recommendations as to the advisability of investing in securities or other property or gives advice as to their value. In addition, the advice must be rendered on a regular basis, made pursuant to an agreement (written or otherwise), serve as a primary basis for investment decisions and be individualized based on the needs of a particular plan or participant.

What Constitutes Investment Education?

DOL Interpretive Bulletin 96-1 clarifies the definition of investment advice by carving out an exception for investment education. The DOL lists four categories of information that is considered investment education but indicates that the list is not exhaustive and that there may be other examples of information that does not constitute investment advice. Administrators and fiduciaries may draw inferences from the examples given to help determine whether other actions are investment education. Careful reference should be made to the rules for investment advice to ensure that educational activity does not actually constitute investment advice.

Plan Information

The first type of information that constitutes investment education is plan information. This allows plan sponsors and service providers to inform participants and beneficiaries about the benefits of plan participation, the benefits of increasing plan contributions, the effect of preretirement withdrawals on retirement income and the terms of the plan or its operation. Participants can also be informed of facts about different investment alternatives, such as their investment objectives, risk and return characteristics and historical returns.

---

[147] ERISA § 3(21)(A)(ii).

This sort of information is acceptable as general education because it is not advising participants on the appropriateness of particular investment options. They are only being informed of the options they may exercise, without being steered to a particular course of action.

General Financial and Investment Information

Advisers are also permitted to inform participants about general financial and investment concepts that help them formulate investment strategies. Thus, it is permissible to explain the concepts of risk and return, diversification, compound returns, dollar cost averaging and tax deferred investment. Education may also include furnishing information about the effects of inflation, estimating retirement income needs, determining investment time horizons, and assessing risk tolerance. These matters bear no direct relationship to a plan's actual investment alternatives and, therefore, do not constitute investment advice. More general economic data may also be provided, such as historic differences in the rate of return among various asset classes.

Asset Allocation Models

Making available model asset allocation portfolios for hypothetical individuals is another means of providing investment education to participants. Along with such models, relevant data, pie charts, graphs or case studies may be presented. If model portfolios are provided, they must be accompanied by additional information about the models. Participants must be given all material facts and assumptions on which the models are based and they must also be provided with a statement that, when using a particular asset allocation model, participants should consider their assets outside the plan in addition to their plan assets. Additionally, if a model identifies any specific investment alternative that is available under the plan, the model must be accompanied by a statement indicating that other investment alternatives with similar qualities may be available under the plan and identify what they are and how to obtain more information about such alternative investments. Finally, all asset allocation models must be based on generally accepted investment theories, for example, modern portfolio theory.

Furnishing asset allocation models to participants, provided that they are accompanied by the additional materials described above, is not regarded as a recommendation that would constitute investment advice, because it allows a participant to assess the model's relevance to his or her individual situation.

Interactive Investment Materials

The final example of investment education is the provision of materials that enable participants to estimate future retirement income needs for themselves and see the effects of different allocations on their retirement income. This may be done through questionnaires, worksheets, software, or other similar materials. If these materials are provided to participants, they must meet certain requirements similar to those applicable to the asset allocation models. Thus, the materials must be based on generally accepted investment theories. All material facts and assumptions must be stated and if the interactive investment materials identify a particular plan investment alternative, participants must be informed that other alternatives fitting the same

risk and return characteristics may be available and information must be provided as to how those alternatives may be obtained.

In addition, there must be an objective correlation between asset allocations that the interactive materials generate and the data supplied by the participant. Thus, investment materials must have a basis in fact to ensure that participants are being properly educated. Finally, as with asset allocation models, the materials should be accompanied by a statement indicating that asset allocations should also consider the participants non-plan assets, investments and sources of income.

Related Prohibited Transaction Rules

Hiring a service provider to give either investment advice or investment education is a fiduciary act. If such a provider were to render conflicted investment advice, it could result in a prohibited transaction. Under the Pension Protection Act of 2006, Congress intended to encourage the availability of participant-level investment advice by enacting a new prohibited transaction exemption to provide relief from fiduciary liability for providing such advice, provided certain conditions are met. To qualify for fiduciary relief under the terms of the statutory exemption (the "PPA Statutory Exemption"), a fiduciary adviser (e.g., an investment adviser) is required to ensure that either (i) the fiduciary adviser's fees for its investment advice will not vary based on any investment options that are selected by participants, or (ii) the investment advice will be provided through an objective computer model that is independently certified not to favor investment options that would result in greater fees for the fiduciary adviser.[148] See Chapter 2 for a discussion of the proposed regulation that would implement this relief.

[148] ERISA §§ 408(b)(14) and 408(g).