



July/August 2000

**Investment Advisory Services
under ERISA**

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Retirement plan participants are increasingly demanding and are in need of investment advisory services as a result of their participation in self-directed plans offering mutual funds and brokerage accounts under their employers' 401(k) and other individual account plans. The section 404(c) "safe harbor" under the Employee Retirement Income Security Act of 1974 ("ERISA"), which relieves plan fiduciaries of liability for any losses which are the direct result of the participant's investment decisions, puts extra importance on the investment education of plan participants. Also, what is often overlooked is the employer's continuing fiduciary responsibility for prudently selecting investment alternatives, disseminating information to plan participants, monitoring the performance of the various investment alternatives and making sure that the participants' investment instructions are carried out properly.

Another employer concern is that the dissemination of investment information to plan participants may give rise to fiduciary status and potential liability under ERISA for the investment decisions of plan participants. Fortunately, the Department of Labor ("DOL") has issued guidance and examples of non-specific investment-related information which does not, in the view of the DOL, result in the rendering of "investment advice" under ERISA.¹ However, this DOL guidance is not sufficient for the ERISA marketplace since participants need investment advice, not just education. In this regard, it is the responsibility of the employer plan sponsor to make sure that investment advice is rendered to participants by a qualified investment advisor. If so, the employer can insulate itself from ERISA fiduciary responsibility.²

Moreover, the DOL has ruled that an employer plan sponsor, as a responsible plan fiduciary, must obtain sufficient information regarding any fees paid directly or indirectly by the Plan and confirm that such compensation is "reasonable." This is particularly important in today's ERISA marketplace where trustees and plan administrators typically receive additional fees from the mutual funds in which Plan assets are invested. Unless such "12b-1 fees" are credited directly to the Plan or offset against other fees the Plan is obligated to pay, the employer could be faced with a breach of fiduciary responsibility for allowing a transaction that violates ERISA's prohibited transaction provisions.³

Investment Education

The DOL has issued an interpretive bulletin on participant education, taking the position that the provision of general financial and investment information and non-specific asset allocation services does

¹ 29 CFR §2509.96-1.

² 29 CFR §2509.75-8, FR-15 and 29 CFR §2509.75-5, FR-6

³ See ERISA Opinion Letter 97-15A, 5/22/97

not cause fiduciary liability under ERISA.⁴ Nevertheless, plan participants are increasingly asking for specific investment recommendations and advice, which are services not subject to DOL's bulletin and which would create fiduciary liability under ERISA.

The DOL bulletin provides guidance for fiduciaries who want to provide investment education and remain protected under ERISA's 404(c) safe harbor from liability for participant investment choices and for liability for providing investment education. ERISA 404(c) conditions relief from fiduciary liability on, among other things, the participant being provided or having the opportunity to obtain sufficient investment information regarding the investment alternatives available under the Plan in order to make informed investment decisions.⁵ However, plan fiduciaries are not required under ERISA or under the 404(c) safe harbor to provide investment education to participants to assist them in making investment decisions.⁶

With both an increase in the number of participant-directed individual account plans and the number of investment options available to participants under such plans, there are increasingly important concerns about the suitability of investment products and services easily accessible to participants whose investment decisions will directly affect their income at retirement and the necessity of supplying them with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations.

As fiduciaries, plan sponsors and trustees are also responsible for selecting and monitoring plan investments. A failure to perform fiduciary responsibilities consistent with ERISA may subject plan sponsors and trustees to potential liability for any damages caused to the plan, as well as for civil penalties. A plan fiduciary may also be liable for another fiduciary's breach.⁷

Growth In Investment Advisory Programs

The private retirement system included as a primary vehicle the traditional defined benefit pension plan. Employers fund defined benefit pension plans, manage plan investments and bear the investment risks associated with the provision of annuity payments over a participant's life. There has been a significant shift in the private retirement system to defined contributions plans, including 401(k) plans. Employers and employees contribute to these plans and employees direct the investment of assets in their individual accounts. There has also been a tremendous growth in assets in Individual Retirement Accounts, principally as a result of rollovers from defined contribution plans.

⁴ 29 CFR §2509.96-1(d)(2) and (3).

⁵ 29 CFR §2550.404c-1 describes the kinds of plans to which ERISA 404(c) applies, the circumstances under which a beneficiary will be considered to have exercised independent control over the assets in his or her account and the consequences of a participant's exercise of such control.

⁶ 29 CFR 2550.404c-1(c)(4).

⁷ 29 CFR §2509.75-8, D-4 and FR-17.

Mutual funds have become the dominant form of investment vehicle available to defined contribution plan participants and IRA holders. It is now common for financial institutions (e.g., brokerage firms) to offer a wide variety of mutual funds to IRA holders and employers sponsoring 401(k) plans. These financial institutions offer affiliated mutual funds as well as unaffiliated mutual funds. Although participants in 401(k) plans are now offered ten or more investment choices, participants in IRAs may have hundreds if not thousands of mutual fund choices.

More recently, brokerage firms have begun offering “brokerage windows” to 401(k) plan participants. These brokerage windows permit participants to invest in an unlimited choice of mutual funds and publicly issued debt and equity securities.

With the growth of defined contribution plan assets and IRA assets, and the expanded choice of investment products, there has been an increasing demand for investment advisory programs.

Investment Advisory Services Under ERISA

The fiduciary responsibility provisions of Title I of ERISA protect plans and participants by imposing special duties and obligations on “fiduciaries” with respect to plans. Fiduciaries must act prudently and for the benefit of plan participants and beneficiaries, and must avoid prohibited transactions.⁸

Under ERISA, a person is a fiduciary to the extent that the person exercises discretionary authority or control over the management of a plan or its assets, renders investment advice for a fee, or has discretionary authority over the administration of the plan.⁹ A determination needs to be made whether the institution providing services to the plan will be a fiduciary through the provision of “investment advice”.

Investment Advisory Services Constitute “Investment Advice”

A person provides advice if he or she makes recommendations as to the advisability of investing in, purchasing, or selling securities, the advice is provided “on a regular basis”, the advice is provided “pursuant to a mutual agreement, arrangement or understanding, written or otherwise”, the advice serves as a primary basis for the participant’s investment decisions, and the advisor will render individual investment advice based on the particular needs of the participant.¹⁰

Early DOL positions suggested that asset allocation services could constitute investment advice. The DOL interpretive bulletin has taken the position that the provision of asset allocation services is not subject to fiduciary liability under ERISA.¹¹ Although the interpretive bulletin provides four “safe

⁸ ERISA §404(a)(1).

⁹ ERISA §3(21)(A).

¹⁰ 29 CFR §2510.3-21(c) and 29 CFR §2509.96-1(c).

¹¹ 29 CFR §2509.96-1(d)(3).

harbors” under which the provision of investment education services will not constitute investment advice, plan participants are demanding more than that which is contemplated by these safe harbors. The safe harbors include plan related information, general financial and investment information, asset allocation models and interactive materials. The interpretive bulletin does not provide as a safe harbor specific investment recommendations.

If a person becomes a fiduciary by providing investment advice, the prohibited transaction provisions under ERISA apply. ERISA prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account.¹² Further, ERISA prohibits a fiduciary from receiving any consideration for his own personal account from any party dealing with a plan in connection with a transaction involving plan assets.¹³

ERISA may prohibit the receipt of 12b-1 fees from a mutual fund to a trustee and/or plan administrator. ERISA prohibits a fiduciary from receiving consideration from a third-party in connection with a transaction involving plan assets. However, the DOL has ruled that if 12b-1 fees received by the trustee/plan administrator attributable to the plan’s investment in a mutual fund is used to benefit the plan (e.g., offsetting such fees against the trustee or record-keeping fees that the plan is obligated to pay), the trustee/plan administrator would not be violating ERISA’s prohibited transaction provisions.¹⁴

ERISA Compliance for the Investment Advisor

Programs involving investment advice may be structured so as to comply with ERISA, without the need to seek an individual exemption or be covered by a class exemption.

ERISA compliance may be achieved by avoiding the provision of investment advice. By relying on the DOL’s interpretive bulletin, an advisor can offer investment education services to 401(k) plan participants without providing “investment advice”.¹⁵ For example, “one-time” recommendations to plan participants would not constitute advice.

An advisor’s potential conflict of interest might also be avoided by eliminating any disparity in fees that the advisor would receive based upon the mutual fund options under the plan. The DOL has indicated that institutions may comply with ERISA by offsetting 12b-1 fees received from mutual funds against fees that would otherwise be payable by the plan for trustee services or recordkeeping services. This would eliminate any financial interest that an advisor would have in recommending one fund over another.¹⁶

¹² ERISA §406(b)(1).

¹³ ERISA §406(b)(3).

¹⁴ ERISA Opinion Letter 97-15A, 5/22/97.

¹⁵ 29 CFR §2509.96-1(d).

¹⁶ ERISA Opinion Letter 97-15A.

An institution may achieve ERISA compliance in the absence of “fee leveling” or an “offset” arrangement by providing investment advice through persons who are independent of the mutual funds. An independent person may also maintain questionnaires that participants complete to receive a recommendation as to which funds are appropriate for that participant.

The Investment Advisor Act of 1940 permits advisors to receive different fees from mutual funds without offsets, provided the fees are disclosed and consented to by clients. This is also permissible under ERISA provided that the advisor is not a fiduciary (e.g., is not a trustee or plan administrator but only provides non-discretionary administrative and recordkeeping services).¹⁷

Managing the Risks: ERISA Compliance

The plan sponsor may properly execute its fiduciary duties by establishing and adhering to its plan documents and investment policy statement. Fiduciaries who lack the requisite education, experience and skill to perform fiduciary functions, including investment decisions, need to seek qualified expert assistance.

Plan sponsors may delegate many of the fiduciary functions, including investment management, to other parties. This delegation is itself a fiduciary function and needs to be effected in a prudent manner. Further, the plan sponsor retains the fiduciary responsibility to prudently monitor those appointed to carry out the delegated functions. Delegation of investment authority to investment managers¹⁸ or to plan participants may shield the plan sponsor fiduciary from liability with regard to investment decisions.

ERISA fiduciaries should establish written procedures to describe the specific processes for plan administration and investment decisions, any delegation of fiduciary responsibilities, the monitoring of those delegated and ERISA compliance with Section 404(c), if applicable.

Section 404(c) of ERISA provides specific rules that limit the liability of a plan sponsor for participant-directed accounts. Before a plan fiduciary may be protected under the Section 404(c) safe harbor, ERISA’s general prudence requirements must be satisfied with respect to all of the following: (1) the actual prudent selection of investment vehicles, (2) the periodic performance review of these investment vehicles, and (3) the ongoing due diligence determination that the alternatives remain suitable investment vehicles for plan participants.

¹⁷ ERISA Opinion Letter 97-16A, 5/23/97.

¹⁸ Under ERISA §§403(a)(2) and 402(c)(3), authority or discretion to manage or control plan assets can only be delegated to persons who are investment managers as defined in §3(38) of ERISA (a bank, insurance company or registered investment advisor under the Investment Advisors Act of 1940). See 29 CFR §2509.75-8, FR-15 and 29 CFR §2509.75-5, FR-6.

The preamble to the proposed regulations governing participant-directed individual account plans notes that only after the foregoing prudence requirements are met, may plan fiduciaries be in a position to move the control of investments to plan participants and the liability associated therewith.

Responsible fiduciaries should familiarize themselves with the provisions of the investment policy statement and adopt a compliance strategy designed to prevent violations and expeditiously identify and correct any violations and any selection or monitoring issues with regard to the mutual funds offered under a participant-directed plan. The employer should conduct fiduciary reviews at least annually to demonstrate that a prudent process is actually followed and that fiduciary actions, such as the selection of service providers (including mutual fund managers), investment decisions and plan administration procedures are documented through written records. These records should include, at a minimum, fiduciary committee minutes or an executed investment policy statement, participant communications, and correspondence confirming decisions made by plan fiduciaries in connection with the plan.

Fiduciary Status

The DOL considers the types of functions performed, or transactions undertaken on behalf of the plan, to determine if these activities are fiduciary in nature. DOL regulations state that an attorney, accountant, actuary or consultant who renders legal, accounting, actuarial or consulting services to a plan fiduciary will not be considered a fiduciary unless he or she exercises discretionary authority or discretionary control respecting plan management, exercises authority or control respecting the disposition of plan assets, renders investment advice for a fee or has any discretionary authority over plan administration.¹⁹

DOL regulations further state that some positions of a plan by their very nature require persons who hold them to perform one or more fiduciary functions. For example, a trustee of a plan must, by the very nature of his position, have discretionary authority or discretionary responsibility in the administration of the plan.²⁰

An investment advisor, including a broker-dealer or an insurance agent, who provides investment advice would be a fiduciary if they render any advice on a regular basis pursuant to a mutual agreement, which services serve as a primary basis for investment decisions with respect to plan assets for a fee or without receipt of an identifiable fee other than broker or insurance commissions.²¹ The DOL has stated that even an entity that is a named fiduciary with respect to a plan who does not exercise any authority or control over plan assets would not have violated ERISA in connection with a breach of fiduciary responsibility.²²

¹⁹ 29 CFR §2509.75-5, D-1.

²⁰ 29 CFR §2509.75-8, D-3.

²¹ 29 CFR §2509.96-1(c).

²² 29 CFR §2509.75-8, D-4.

Under ERISA, those who have or exercise discretion or control over plan assets are considered fiduciaries and therefore must meet certain standards with respect to handling plan assets. ERISA exempts an insurance company general account from ERISA's fiduciary standards to the extent that the company has issued a "guaranteed benefit policy" to fund an ERISA plan. In that instance, the contract would be considered a plan asset, but not the general account assets supporting the contract. As a result of a United States Supreme Court decision, insurance companies need to clarify and disclose when general accounts assets would be considered plan assets as a result of the sale of insurance products to fund ERISA benefit plans.²³

Fee Sharing Arrangements

If an institution is not acting as a fiduciary in the plan's decision to make a mutual fund investment, then the institution should not be subject to ERISA in receiving a fee. However, if the institution is providing services to the plan and would therefore be "a party in interest" to the plan, then the receipt of the fee may be a prohibited transaction under ERISA. In order for a party in interest to be able to provide services to a plan without engaging in a prohibited transaction, the services must be provided for no more than "reasonable compensation". The fiduciary will not violate ERISA if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which this fiduciary has an interest which may effect the exercise of such fiduciary's best judgement as a fiduciary. Also, it is important to emphasize that under ERISA's general standards of fiduciary conduct, a responsible Plan fiduciary must obtain sufficient information regarding any fees or other compensation that trustees, plan administrators or other source providers receive with respect to Plan investments.

The DOL has concluded that where a plan fiduciary acts pursuant to a named fiduciary or participant direction, and does not exercise any authority or control to cause a plan to invest in a mutual fund that pays a fee to that plan fiduciary in connection with the plan's investment, the plan fiduciary would not be treated as self-dealing in plan assets in violation of ERISA. Thus, the DOL has stated that if a fiduciary does not exercise any authority or control to cause a plan to invest in a mutual fund, the mere receipt by the fiduciary of a fee or other compensation from the mutual fund in connection with the investment would not in and of itself violate ERISA. Consequently, a financial institution that does not have investment discretion over plan assets receives fees in connection with the plan sponsor's investments in mutual funds, the institution's receipt of those fees should not violate the fiduciary self-dealing and conflicts of interest provisions of ERISA.²⁴

If a financial institution is acting as a fiduciary by having discretion over plan asset investment in mutual funds or by rendering investment advice, then the institution's receipt of fees may violate ERISA unless

²³ John Hancock Mutual Life Insurance Co. v. Harris Trust & Savings Bank, 510 U.S. 86.

²⁴ See, e.g., ERISA Opinion Letter 97-16A, 5/23/97.

there is an offset or credit of these fees.²⁵ Accordingly, if a financial institution acting as a fiduciary in exercising investment discretion over plan assets, causes the plan to invest a mutual fund that pays a fee to that institution, the institution has engaged in a prohibited transaction. If the institution were not to receive any additional fee from the mutual fund, however, there would be no violation of ERISA.

When an institution has discretion over the investment of plan assets and mutual funds, the institution may avoid an ERISA violation by offsetting any fees it receives against the service fees that the plan is obligated to pay and/or credit these fees directly to the plan. To the extent the plan's legal obligation to pay fees is extinguished by the amount of the offset from mutual fund fees, the institution would not be dealing with the assets of the plan in its own interest or for its own account in violation of ERISA.

Furthermore, because the mutual fund fees would not increase the institution's compensation but rather would benefit the plan, the institution would not be deemed to receive such payments for its own account in violation of ERISA. The only party that would benefit from the institution's receipt of the fees would be the plan, which would be paying reduced fees for services and/or receiving additional income in the form of a fee credit. Accordingly, the institution's interests and the plan's interests are not adverse, and thus there is no violation of ERISA.²⁶

Disclosure of Fees

The DOL has placed a major emphasis on the need for plan participants and employers to have a full and complete understanding of the fees and charges associated with self-directed employee benefit plans. The DOL's recent focus has been particularly on 401(k) plans that include participant-directed investment accounts.

The DOL has developed two brochures advising that fees are just one of several factors that plan sponsors must consider in deciding how to design their plans and the various investment features to be offered thereunder. The DOL advises that all services have costs and that cheaper is not necessarily better. The DOL has identified three types of fees and expenses generally associated with 401(k) plans: the administration fee, the investment fee and the individual service fee.

The administration fee includes recordkeeping, accounting, legal and trustee services. The investment fee includes plan asset management, sales charges, commissions, investment advisory services and mutual fund management services. The individual service fees are charged directly to the plan participant's account for special plan features. For example, loan origination and annual loan maintenance fees are individual service fees.

²⁵ See ERISA Opinion Letter 97-15A, 5/22/97.

²⁶ See ERISA Opinion Letter 97-15A, 5/22/97.

The DOL describes front end loads, back end loads, redemption fees and 12b-1 fees. 12b-1 fees are fees paid by a mutual fund to a broker or other sales person as compensation for the distribution of fund shares. NASD prohibits a mutual fund from describing itself as no load if the fund pays distribution and service fees (i.e., 12b-1 fees) in excess of 25 basis points.

The DOL describes the investment fee typically charged in a variable annuity product to include investment management fees payable to the insurance company and to the manager of the underlying investment vehicles (which may include both mutual funds and insurance company separate accounts). Some variable annuity products include insurance related charges if they provide an insurance related component, as well as mortality charges if they provide death benefits. Some variable annuity contracts include back end surrender charges if the contract is surrendered before a stated number of years. Whereas, other contracts include no back end surrender charges and may be terminated without penalty. These contracts closely resemble trust agreements, and are merely funding vehicles for a multi-fund family program.

DOL, in conjunction with a number of trade organizations, issued a model 401(k) fee disclosure form designed to help employers understand the investment fees and expenses charged to 401(k) plans. The form is also designed to allow employers to compare the investment fees and administrative costs of competing providers of plan services.

The DOL is emphasizing fee disclosure because it is making clear its view that the fiduciary who is charged with taking a written plan document and creating a reality has significant fiduciary responsibility when designing the investment and administrative features of the plan. This DOL position is merely a restatement of the fiduciary's duties under ERISA to act with care, skill, prudence and diligence.

The DOL has noted that fees can have a tremendous impact on asset performance and ultimately the amount of retirement income for each plan participant. Accordingly, a fiduciary cannot comply with his or her duties under ERISA without a basic understanding of the fee structure of various investments and plan administration options.

Similarly, a plan participant cannot exercise effective control over his or her account without a basic understanding of the various fees charged in connection with the investment options offered under the plan. A fiduciary evaluating whether to switch its service provider for the plan's investment vehicles may be deemed to have acted imprudently if he or she did not understand the nature and extent of plan fees and the services associated therewith. The plan fiduciary needs to determine how much the plan is paying for the totality of services, and the 401(k) program should disclose fees to plan participants.

Mutual Fund Supermarket

The method by which mutual funds are distributed has changed rapidly over the last several years with the development of the mutual fund supermarket. This evolution and the concept of a mutual fund

supermarket is described in a Securities Exchange Commission (“SEC”) letter issued to the Investment Company Institute (the trade association of the mutual fund industry). In that letter, the SEC describes a mutual fund supermarket as a program offered by a broker-dealer or other financial institution through which its customers may purchase and redeem a variety of mutual funds, with or without transaction fees to the plan.

The advantage to the plan is that it allows plan participants to consolidate their fund holdings at different fund complexes in a single brokerage account and to receive a consolidated statement listing all of the plan’s mutual fund holdings. Mutual funds pay a fee to participate in the supermarket, avoiding the imposition of transaction fees on plan participants. The broker-dealer sponsored mutual fund supermarket is generally more cost-effective, provides share reporting and includes more funds than other multi-fund family programs.

The SEC found that although the services provided to the mutual fund complexes by the supermarket sponsor are the same in all cases, various fund complexes pay the fee in different manners. Some fund complexes pay the fee entirely through 12b-1 fees. The fee paid by the mutual fund not subject to Rule 12b-1 may be paid by the fund’s investment advisor. A fund advisor’s payment is functionally equivalent to a 12b-1 payment.

Accordingly, the plan fiduciary would receive services from the supermarket or broker-dealer entity without actually being charged by that entity. This arrangement is effectively permitting the plan fiduciary to recapture the 12b-1 fee or other advisory fee payable to the broker-dealer and otherwise offsets plan expenses that would be required to be paid to the supermarket sponsor.

Some supermarket broker-dealer sponsors offer payments directly to a potential plan client if a plan meets certain specifications. For example, a plan may receive a payment if a plan deposits a minimum level of plan assets with the broker-dealer sponsoring the mutual fund supermarket, limits the number of funds it offers in its menu, includes a number of proprietary funds of that broker-dealer, and agrees to retain that broker-dealer’s affiliated trust company for a reduced fee.

It is common for a plan to recapture from a mutual fund supermarket operator the 12b-1 fees generated by its investment of plan assets. In this regard, the DOL has permitted a bank to credit the 12b-1 fees it received from mutual fund complexes in which a client plan invested against trustee fees otherwise due from the plan client, and to apply any excess to the plan.²⁷ This arrangement and DOL’s opinion thereof provide evidence that a prudent plan sponsor may recapture fees if it is in a bargaining position to do so.

404(c) Compliance

²⁷ ERISA Opinion Letter 97-15A, 5/22/97.

Many 401(k) plans allow participants to choose how to invest the money in their 401(k) plan accounts. Since most 401(k) contributions are salary reduction contributions that would otherwise be subject to the participant's investment control outside the plan, plan sponsors permit participants to direct their investments. Further, plan sponsors permit investment direction by plan participants to limit their liability for investment decisions made by plan participants in compliance with Section 404(c) of ERISA.

Section 404(c) serves to relieve plan fiduciaries of liability for any losses which are the direct or necessary result of the participant's investment decisions. An ERISA Section 404(c) plan is an individual account plan permitting plan participants to direct the investment of their account balances among a broad range of investment alternatives.

Nevertheless, ERISA fiduciaries of 404(c) plans remain responsible for prudently selecting investment alternatives, disseminating information to participants and beneficiaries, monitoring the investment performance of the various investment alternatives, and carrying out participants' and beneficiaries' investment instructions.

Adherence to 404(c) rules is voluntary, and noncompliance or improper compliance would result only in a loss of relief from liability for investment losses suffered by participants. Similarly, participants need not be allowed to direct the investment of all funds in their accounts. In this case, protection from liability will exist only with respect to the funds that satisfy 404(c). However, the right to direct investments is a right protected under the Internal Revenue Code. A right that is limited to only certain accounts or individuals may violate the nondiscriminatory requirements and result in a plan disqualification defect.

404(c) regulations require the disclosure of extensive information to plan participants. However the regulations expressly state that they do not require the plan sponsor or fiduciary to provide investment education or advice.

Fiduciary Issues in Changing Recordkeepers

Even if a plan sponsor meets the requirements of ERISA 404(c), different issues arise during a change in 401(k) plan recordkeepers. The most often used means of changing recordkeepers is to temporarily halt a participant's ability to self-direct their account balances and impose a "blackout".

In order to qualify for the protection provided by ERISA Section 404(c), a plan sponsor must provide the opportunity to change investment elections no less frequently than once within any three month period.²⁸ Therefore, it appears that the maximum duration for a blackout without participant investment direction is 90 days without losing 404(c) protection. The DOL has taken the position that a participant

²⁸ 29 CFR §2550.404c-1(b)(2)(ii)(C)(1).

will not be considered to have exercised control when the participant is merely apprised of investments that would be made on his or her behalf in the absence of instructions to the contrary.

Therefore, potential liability may arise where a plan sponsor determines to invest plan assets which are not actively directed by participants either in new investment options closest conforming to the participant's prior investment election or in the most conservative option available.

At a minimum, participant deferrals during a blackout period may not be subject to the participant's investment direction. Failure to adequately invest these new plan assets may likely constitute a breach of fiduciary duty.

ERISA requires plan fiduciaries to discharge their duties solely in the interest of participants and beneficiaries and with the care, skill, prudence and diligence that a prudent person with similar capacity and experience would use under the same circumstances. This duty extends to the selection of service providers for the plan. If a plan sponsor or other fiduciary fails to select a recordkeeper in a prudent manner or selects the particular vendor for improper reasons, the fiduciary may be held liable for breaching his or her fiduciary duties.

A plan sponsor or fiduciary has a duty to ensure that a blackout and transfer is done in a prudent manner. This duty may, and in the majority of cases does, require the fiduciary to monitor the progress of the transition. Failure to keep the transition moving can, at some point, reach a level of imprudence. If a plan sponsor or other fiduciary were to promise that the blackout period would conclude by a certain date when in fact the transition is not completed, and the blackout is not lifted until much later, there may be a violation of ERISA.

In addition to claims that the plan sponsor failed to meet its promises with regard to assets in a plan before a blackout period, a plan sponsor may be sued for failure to fulfill its promises regarding the investment of new, post-blackout plan assets. If participants are able to prove that the plan sponsor had promised certain investments and had failed to do so, and such failure was detrimental to plan participants, plan participants may be able to recover lost earnings.

Plan sponsors face multiple risks in instituting a blackout period. As a result, the prudent plan sponsor is well advised to consider the implications of a blackout or any other action taken in conjunction with changing recordkeepers, and to consult with advisors or other professionals before and during the process.

A plan sponsor will not be liable for the advice provided by a third-party investment advisor if the sponsor acts prudently in selecting and monitoring the advisor, the advisor is licensed to provide advice and the sponsor obtains a writing that the advisor will be acting as a fiduciary. The plan sponsor should advise that the advisor is wholly separate and independent from the sponsor and that the sponsor does not endorse the advisor but merely offers the advisor a source of investment education or advice to

provide information to help plan participants make informed investment decisions. If plan participants choose to use the advisor, they should be advised to review their own sources of information before making any investment decisions. These types of disclaimers help plan sponsors avoid the increase in fiduciary liability associated with the maintenance of participant-directed investment accounts.

ERISA fiduciaries would only be liable for losses of participant accounts during a blackout period that resulted from imprudent decisions. It is not an imprudent decision for plan fiduciaries, including the trustee, to invest plan assets in money market funds during the blackout period. Losses are limited to the declines in principal, and not the opportunity for loss and potential gains that might have been realized by not converting to money market funds. The trustee may direct the investment of plan assets in money market funds even beyond the blackout period to the extent it is a prudent exercise of control over plan assets.

The “liquidation to cash method” in connection with a transfer of plan assets to a successor custodian is a prevalent and preferred method of transferring plan assets. It is the trustee’s responsibility to reinvest plan assets as soon as practicable. The discretionary decision to change 401(k) plan providers is a set law function, and thus the employer and trustees retain responsibility for the proper effectuation of a change in service providers. ERISA requires that a plan be able to terminate a service agreement with recently short notice and without a penalty.

Self-Directed Brokerage Accounts

Some plans permit plan participants to access any investment available through a brokerage account. The plan sponsor may put limits on the available investments, including only publicly traded investments. Usually, these accounts make available any mutual fund, any traded stock, and direct ownership of corporate and government bonds. ERISA Section 404(c) protection is available to plans that include self-directed brokerage accounts.

However, it may be argued that relief from fiduciary liability will not be granted if the participant is permitted to make an “imprudent” investment decision. If a plan sponsor selects mutual funds as available investments, the plan sponsor is responsible for the decision that each of the mutual funds is a prudent investment choice. It is unclear, however, whether this principal extends to brokerage accounts.

The Internal Revenue Code’s nondiscrimination tests, for a brokerage account option or “window” arrangement apply to availability and not users. Accordingly, to the extent that only highly compensated employees who are experienced investors take advantage of brokerage accounts, the plan will not have a plan disqualification defect. The plan sponsor may not limit the brokerage account to a certain size or level of income, which would otherwise result in discrimination and cause a plan disqualification defect. Since all investments must be generally available to all participants, it is not clear whether a plan can offer investments under a brokerage account that have large investment minimums.

Fiduciary Responsibilities

Activities that have been found to give rise to fiduciary status include the following: appointing other plan fiduciaries, delegating responsibility to or allocating duties among other plan fiduciaries, selecting and monitoring plan investment vehicles, giving investment advice to the plan for a fee, selecting and monitoring third-party service providers, negotiating the compensation of third-party service providers, interpreting plan provisions and denying or approving benefit claims.

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