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## The Importance of 404(c) Compliance and QDIAs in Minimizing Fiduciary Liability

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The responsibilities of an ERISA fiduciary have been described as “the highest known to the law.”<sup>1</sup> Given this high level of responsibility, fiduciaries need to take every precaution to minimize fiduciary liability. While fiduciaries will always be responsible for the selection and ongoing monitoring of investments, they can protect themselves against imprudent investment decisions made by a participant by complying with 404(c).

**I**n today's world, most plans offer participant investment direction as a plan provision. That feature carries with it the risk that a participant may invest unwisely and potentially initiate a lawsuit, hence the need for fiduciary protection.

According to a recent survey, 94% of plan sponsors believe that their plans are structured to comply with 404(c)<sup>2</sup>; however, industry experts suggest that the vast majority fail to successfully meet all the requirements.<sup>3</sup> The objective of this article is to summarize the importance of compliance with Section 404(c) and the use of a qualified default investment alternative (QDIA) in reducing fiduciary liability as well as the requirements for each.

Historically, 404(c) protection was only garnered when a participant made an affirmative investment election (*i.e.*, it was not available when a default fund was used in the absence of an affirmative election). However, the Pension Protection Act of 2006 extended 404(c) protection to default funds which satisfy the QDIA requirements.

Under the DOL final regulations, a QDIA is an investment vehicle that must meet certain investment, disclosure and notice requirements.



The use of a QDIA provides protection from fiduciary risk from market fluctuations and losses when plan fiduciaries choose investments for participants who are automatically enrolled or who do not make their own investment decisions.

If all the relevant criteria are met, the fiduciaries will be protected from fiduciary liability when making such investment decisions on behalf of a participant. The use of a QDIA completes the 404(c) fiduciary protection for the direction process of participant investments.

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### Section 404(c)

ERISA Section 404(c)(1) provides protection for plan fiduciaries against lawsuits where participants have made investments that result in losses. For Section 404(c) protection to apply, the participant must have the ability to make an investment election and the participant must have exercised this right. In the absence of a participant investment election, the QDIA rules may apply and are discussed later in this article.

Section 404(c) requires compliance with a long list of key steps. Plan fiduciaries are wise to follow a checklist detailing these steps and to ask their service providers to demonstrate compliance. Fiduciaries may elect to comply with all or part of 404(c) and, while not required to adopt all provisions, true protection is only achieved if all criteria are met.

The requirements of Section 404(c) can be summarized in the following categories—requirements regarding the range of investments the plan must offer, required disclosures to participants and disclosures that must be provided to participants upon request.

### Investment Requirements

The plan must offer a broad range of investment alternatives. The objective is to enable the participant to create a diversified portfolio appropriate for him or her that should minimize the risk of loss. There must be at least three materially different investment alternatives. Each investment must be diversified in and of itself and each must have materially different risk and reward characteristics (core investments).

Instructions on how to make investment elections must be provided. Transfers must be permitted frequently enough and in small enough increments appropriate for the volatility of the fund. The requirement is that transfers of any portion of the investment be at least quarterly (note that four transfers per year does not satisfy the requirement, but once a quarter is fine), but many plans allow for daily transfers in 1% increments, thereby satisfying this requirement.

Certain restrictions regarding how participants invest in the core funds are not permitted if the plan wishes to be compliant with 404(c). For example, the plan may not impose a maximum percentage of a participant's account balance that may be invested in a given core fund.

In the event that the employer wishes to include employer securities as an investment option for a qualified plan, limited 404(c) protection is available. In order to retain relief, the employer securities must be publicly traded on a national exchange or recognized market. Frequency of trading must enable the plan to buy and sell stock promptly. All voting rights must be passed through to participants

and/or beneficiaries. In addition, the employer securities may not be one of the three core investments. Courts are still wrestling with exactly how much fiduciary protection 404(c) provides for employer security investments.

### Required Disclosures to Participants

The following information must be provided to participants automatically:

- The plan must state that it intends to qualify as a 404(c) plan and that the fiduciary may be relieved of liability due to adherence to the provisions of 404(c). This intent is generally documented in the Summary Plan Description (SPD). In addition, the Form 5500 will be coded as to whether the plan intends to qualify for 404(c) protection.
- The plan must state the name, address and phone number of the plan fiduciary responsible for disseminating the information required for 404(c) compliance.
- If the plan designates an investment manager, the participants must be notified.
- Participants must be given a copy of the most recent prospectus for the fund in which they are investing immediately before or after the participant initially invests in the selected fund.
- Any transaction fees that are charged in connection with the purchase or sale of investments alternatives must be disclosed (*e.g.*, if the plan charges a redemption fee, it must be disclosed).

### Information that Must Be Provided Upon Request

Participants have the right to the following information upon request:

- A description of the annual operating expenses of each investment alternative provided in the plan. This description includes all fees such as management fees, administrative fees or transaction costs. The description relates to all expenses which reduce the rate of return for the participant's account.
- Copies of any prospectuses, financial statements and reports. These items are in addition to providing prospectuses as participants actually invest in a particular investment.
- A list of assets comprising the portfolio of each investment, the value of the asset and the proportion of the investment which it comprises. If the investment is a fixed rate investment contract, then relevant details regarding the contract must be provided. These details include the name of the issuer of the contract, term of the contract and rate of return on the contract.

- Information regarding the value of the shares or units in a designated investment alternative as well as past and current investment performance, net of expenses. In addition, the participant must be given the value of the shares held by his or her account.

### Investment Advice or Education

Section 404(c) does not require the plan fiduciaries to provide investment advice for participants in order to be afforded protection. While not required, it would behoove plan sponsors to provide some form of education (whether in training materials or investment tools online), investment advice or investment management products.

The greater the level of services provided to participants, the stronger the case for the plan fiduciaries should a participant exercise his or her right to sue. By having a more educated workforce (*i.e.*, more investment savvy), the participants will be better invested, that is, better diversified and thus be less exposed to dramatic losses in the market and, one could therefore conclude, constitute a workforce less likely to sue. Advice may help get participants to that point.

Should one fall short of full compliance with 404(c), the plan may have some protection from liability by having provided investment education or advice.

### Qualified Default Investment Alternative (QDIA)

While 404(c) may provide protection for participant investments directed by participants, situations will arise where a participant does not make an election. As mentioned, ERISA 404(c)-1 will not protect in situations where the participant does not affirmatively make an election.

The Pension Protection Act of 2006 created ERISA Section 404(c)(5), which was effective on December 24, 2007. This section effectively created the QDIA and defined the requirements to be afforded fiduciary protection. The most likely scenario, and one of the driving reasons for the QDIA, is the automatic contribution arrangement. Other situations include plan designs where there are nonelective contributions such as a profit sharing and the participant has not made an investment election. Given that plans may fund a profit sharing contribution and that 401(k) automatic enrollment is gaining in popularity, the situation exists for an employer to be faced with depositing contributions on behalf of a participant without investment direction from the participant.

Under ERISA 404(c)(5), a fiduciary of a qualified plan will not be liable for any losses resulting from the investment in a QDIA if the following criteria are met:

- Assets must be invested in an investment that qualifies as a QDIA. Investments that qualify as QDIAs include:
  - A product designed to provide varying degrees of equity and fixed income exposure based on the participant's age or planned retirement date (*e.g.*, life cycle or target date funds);
  - An investment management service such as professionally managed accounts under which the fiduciary allocates assets to equity and fixed income exposures based on the participant's age; or
  - A product with a mix of investments that addresses the characteristics of the participant group as a whole (*e.g.*, a balanced fund).

For assets held prior to December 24, 2007 in a stable value fund, the QDIA protection status is grandfathered.

- Participants must be furnished a written notice containing information regarding how to direct investments and an explanation of the QDIA including investment objectives, risk and return. The notice must be provided prior to the participant being defaulted into the QDIA and must be provided annually at least 30 days prior to the start of the plan year. The notice must be provided separately, unless being provided with the safe harbor 401(k) plan notice. While the QDIA information may be provided in the SPD, this method may not be the only form of communication.
- The participant must be provided prospectuses for the QDIA and all relevant information required to be provided under 404(c).
- The QDIA must allow frequent transfers not less frequently than once in any three-month period. Contributions deposited in the QDIA within the first 90 days must not be subject to any restrictions or expenses such as redemption fees or exchange fees. Fees that do not relate to the decision to transfer or withdraw from the QDIA, such as investment management or plan administrative fees, may be charged. Following the 90-day period, any fees normally charged to a participant for withdrawal or transfer transactions may be applied as long as they are the same for any participant who would have actually selected the QDIA.

### Ongoing Satisfaction of 404(c)

On an ongoing basis, the plan's investment fiduciaries must monitor the investment vehicles to ensure that each continues to meet the criteria for the asset class and style and is performing well


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enough to continue to be offered to the participants. In addition, the investment options should be monitored for issues such as expenses and management turnover.

If one or more of the investment vehicles fails to meet the plan's criteria or ERISA's requirements, the investment fiduciaries must remove and replace the problem investment(s). Failure to remove an underperforming fund may be a fiduciary breach under ERISA and can make plan fiduciaries personally liable for any losses that result. While 404(c) can protect fiduciaries if the fund options are properly selected and monitored, that protection is lost for any investment option that should have been removed if the plan fiduciaries had done their jobs. To this regard, it would be wise to make sure an Investment Policy Statement is created and followed.

### Summary

All the requirements of 404(c) provide participants with information to make better decisions. While adherence to 404(c) is completely voluntary, the requirements of 404(c) make good business sense and are important for the success of the plan. Employers are encouraged to review their fund lineup, employee education programs and communications to participants. A discussion with the recordkeeper and a review of a 404(c) checklist will determine if true compliance is really happening.

Many employers select code "2F" on the Form 5500 believing that they are compliant, but they may be surprised to realize that they are not. Now would be a good time for a 404(c) checkup. 



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- 1 Donovan v. Bierwirth 680F. 2nd 263, 272 (2nd Cir. 1982).
- 2 2008 401(k) Benchmarking Survey, Deloitte Consulting, July 2008.
- 3 2006 ERISA Advisory Council, Reish Luftman Reicher & Cohen, September 2006.