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Fiduciary Liability

It's Getting Personal

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he issue of fiduciary liability in qualified retirement plans is becoming increasingly important to plan sponsors. As lawsuits involving fiduciary failures emerge, both sponsors and plan participants are becoming keenly aware of the responsibilities assigned

to the role. For many sponsors — and fiduciaries — this is the first time they've confronted the issue and they often are surprised at the depth and complexity of the rules.

Section 404(a) of the Employee Retirement Income Security Act of 1974 (ERISA) creates fiduciary liability for everything from selecting the investment options available in a retirement plan to individual participant investment decisions. ERISA Section 404(c) provides a degree of relief from liability for what is generally considered the most troubling element of 404(a): participant investment decisions.

The 404(c) Enigma

To understand why people struggle to make sense of Section 404(c) regulations, one needs to first recall how long it took the Department of Labor (DOL) to issue the regulations: 20 years. Though former President Gerald Ford signed ERISA in 1974, the DOL didn't issue the 404(c) regulations until 1992, and they didn't become effective until 1994 — and a lot changed in the intervening years.

The 404(c) regulations with which plan sponsors and fiduciaries currently attempt to comply are reflective of a different time in the United States; a time when there were relatively few participant-directed retirement plans, and cutting-edge technology was an electronic calculator. To put it mildly, the regulations are not contemporary.

But complying with Section 404(c) is becoming increasingly important to plan sponsors, and compliance responsibility typically falls on the shoulders of human resources professionals. While a seemingly daunting task, compliance need not be overly complicated if sponsors establish sound internal processes, and then adhere to them — strictly.

Fiduciary Liability: What Is It and Why Is it?

Section 404(c) states that each retirement plan fiduciary is “personally liable for each investment alternative and each participant investment decision” made under a qualified retirement plan.

When the 404(c) regulations were issued in 1994, the world of investing was not nearly as complicated as it is today. Stock markets were generally moving in a positive direction and the economy was headed into the high-growth dot-com era. In general, plan participants were experiencing positive investment returns. Then the dot-com bomb exploded.

By 2002, many retirement plan participants were experiencing their third consecutive year of declining retirement plan account values, and some participants were looking for someone to blame for their losses. Enter ERISA Section 404(a) and its aforementioned requirements.

Employees who had lost years of retirement savings as a result of losses in company stock and poor investment choices were becoming vaguely aware of their employer's potential liability. Eventually, their interests were represented by law firms, which began filing class action lawsuits on behalf of disgruntled participants. At the time of this writing, there are at least 19 suits pending against major companies for fiduciary failures.

Enter Section 404(c), which provides a degree of relief for liability stemming from participant investment decisions. Compliance is more complicated than simply declaring the plan to be compliant and offering several investment options. Enron executives sought relief from their fiduciary liability by arguing that their retirement plan was intended to be 404(c) compliant. However, the DOL quickly dispensed of this argument by pointing out several fundamental flaws in Enron's alleged compliance — not the least of which was that the

plan never declared to be compliant with 404(c). In June 2003, the DOL filed its own suit against Enron executives for failing to protect plan participants. On Sept. 30, 2003, the judge in *Tittle v. Enron* confirmed the DOL's position on virtually all counts.

QUICK LOOK

- ⇒ The depth and complexity of fiduciary liability often surprises plan sponsors and fiduciaries.
- ⇒ 404(c) regulations are not exactly contemporary, as they were first developed 20 years ago.
- ⇒ Taking a few cautionary steps now can help employers avoid landing in legal hot water for 404(c) compliance issues.

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The Compliance Process

So, what do fiduciaries have to do to avoid personal liability for participant investment decisions? Unlike the Internal Revenue Service (IRS), the DOL offers few safe harbors or “bright lines.” However, the following steps may be a procedurally prudent method for fulfilling fiduciary responsibilities.

Step 1: Identify the Fiduciaries

A person can either be named fiduciary or function as one. Functional fiduciaries have the same responsibilities and liabilities as named fiduciaries. For example, if the board of directors appoints a three-person committee to act as plan trustees and the administrative committee, these individuals would be named fiduciaries. But, if a senior executive who is not on the committee makes a decision to transfer the retirement plan to a new vendor, that executive is a functional fiduciary and has the same liability as named fiduciaries.

Step 2: Educate Fiduciaries — Learn the Rules

Most retirement plan fiduciaries do not understand their roles, responsibilities and personal liabilities under 404(a), how to abate the personal liability for participant investments under 404(c), or the co-fiduciary liability rules. It may be a good idea to put together a summary of the roles and responsibilities and have all plan fiduciaries sign to acknowledge that they have read and understand their responsibilities under Section 404(c).

Step 3: Monitor Vendors and Compensation

One of the important roles of a fiduciary is to hire and hold accountable the vendors providing services to the plan, with

particular attention paid to expenses. Is the plan fulfilling its duty to be exclusively for the purpose of providing benefits for participants? In doing so, the fiduciaries are charged with the duty of making sure everyone servicing the plan is being paid within norms. Be careful of asset-based compensation schedules that are on automatic pilot. As the value of assets increases, compensation levels can quickly exceed the services for which they are paying. Look for vendors and service providers who provide real value to plan participants at fees that are well disclosed.

Step 4: Selecting and Monitoring Investments

Another critical responsibility of fiduciaries in an individual account plan is to select, monitor, remove and replace a diverse selection of investment alternatives. To do so, the committee should develop a written course of action (often known as an investment policy statement) that stipulates both the criteria and format for evaluating investment performance against benchmarks and taking action when needed. In essence, an investment policy is a philosophy, a set of standards and a disciplined approach to investment monitoring.

Step 5: Internal Processes

Processes that properly integrate ERISA 404(a) and 404(c) are vital. Compliance with both of these sections can be reduced to a series of processes that should be repeated at least annually.

Some argue that compliance with ERISA Section 404(c) is too difficult. In its simplest terms, though, 404(c) compliance involves appointing a “404(c) fiduciary” who is responsible for coordinating participant information. The following must be included in the compliance process:

- Investment alternatives and service providers must be monitored.
- Participants must be notified that the plan intends to comply with 404(c) and that the fiduciaries may be relieved of liability for participant investment decisions.
- The distribution of certain required information, as well as additional information that must be provided upon request. The distribution of prospectuses either immediately before or immediately after a participant’s initial investment in a specific fund is one of the more vexing requirements of 404(c). The logical progression has been an increasing interest in group annuity products since, in part, there is no SEC requirement to deliver a prospectus to the plan and, thus, no requirement for a prospectus to be delivered to participants.

There are other items that need to be addressed in the compliance process, but what’s important to understand is that compliance need not be overly labor intensive if it is

