

Morgan Lewis

webcast

404(c) Compliance

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Presenters:

Lisa Barton, Esq.
Marianne Yudes, Esq.

www.morganlewis.com

Overview – What We Will Cover

- 404(c) Compliance
 - Overview of 404(c) fiduciary relief
 - Basic requirements to obtain relief
 - Mapping relief
 - Default Investment Options/“QDIA” safe harbors
 - Participant fee disclosure regulations
 - Scope of relief
 - Case law developments and implications

404(c) Relief – Overview

- 404(c): “In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account:

...

no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control.”

404(c) Relief – Overview (continued)

- Applies to defined contribution plans that permit participant-directed investment
- Upon satisfaction of procedural requirements, plan fiduciaries are relieved of fiduciary duty with respect to participant investment elections
- Some uncertainty as to the scope of this fiduciary relief
- Full, or at least substantial, compliance required

404(c) Relief – Requirements

- Basic 404(c) Requirements (Current Requirements):
 - Plan and SPD must say the plan is a 404(c) plan
 - Explanation that fiduciaries are relieved of liability
 - Broad range of choices, so participants can diversify/limit risk (at least three choices, each diversified – range of risk/return characteristics)
 - Must be able to exercise control and make affirmative investment elections and changes freely (at least once a quarter; daily is clearly compliant)
 - Participants must be provided “sufficient information” regarding plan and investments

404(c) Relief – Requirements

(continued)

- Providing sufficient information includes:
 - Description of investment alternatives
 - Explanation of investment election process and any restrictions on elections (e.g., day-trading limits)
 - Description of fees and expenses
 - Fund prospectuses (subject to fee disclosure regulation changes)
 - Plan account information

404(c) – Safe Harbors

- 404(c) relief generally predicated on participants making affirmative elections and exerting control over their accounts
- 404(c) originally did not contemplate “negative” or “deemed” elections
- Pension Protection Act of 2006 added two safe harbors for negative elections – the “Mapping” safe harbor and the “QDIA” default safe harbor

404(c) – Mapping Safe Harbor

- 404(c) relief preserved in situations where a plan is changing investment funds if:
 - Participants are provided notice within the 30-60-day period before the change
 - Notice must include information about the funds being added and eliminated
 - Notice explains the nature of the negative election
 - Replacement funds have investment characteristics that are “reasonably similar” to the investment funds being replaced (investment characteristics include “risk” and “rate of return”)

404(c) – Mapping Safe Harbor (continued)

- Facts and circumstances aspect of the mapping safe harbor can make 404(c) relief uncertain
- In some situations (e.g., phasing out a particular “sector” fund without a similar replacement), mapping safe harbor is not available
- Preferred approach by recordkeepers because of ease of administration

404(c) – Mapping Safe Harbor (continued)

- Pre–safe harbor mapping legacy may lurk in plans
- Special issues when replacing a stock fund

404(c) – QDIA Safe Harbor

- 404(c) relief preserved in situations where amounts are defaulted into a “qualified default investment alternative” (QDIA)
- This QDIA safe harbor is available if:
 - Participants provided at least 30 days’ advance notice
 - Participants provided annual notice thereafter
 - Plan provides a broad range of investment alternatives (at least three diversified funds)

404(c) – QDIA Safe Harbor (continued)

- Participants have opportunity to elect to transfer amounts into and out of QDIA fund at least quarterly
- Any restrictions on transfer rights must be no more onerous than those that apply to individuals who affirmatively elected to invest in the QDIA
- No unusual fees/expenses shall be imposed on such transfers

404(c) – QDIA Safe Harbor (continued)

- Amounts defaulted into a recognized QDIA (target or life-cycle fund, balanced fund, individually managed fund or, for grandfathered amounts, stable value fund)
- QDIA safe harbor is broader and more certain, but potentially results in more drastic change than mapping safe harbor
- QDIA safe harbor is more of a challenge for recordkeepers
- QDIA safe harbor generally includes Target Date Funds and Balanced Funds

Target Date Fund Disclosures

- Target Date Funds
 - Proposed regulations will require additional disclosures regarding target date funds, including
 - *The age group for which the investment is designed*
 - *The relevance of the date in a fund's name*
 - *Asset allocation and changes in asset allocation*
 - *Any assumptions about contribution and withdrawal intentions on or after such date*

Target Date Fund Disclosures (continued)

- *How the asset allocation will change over time*
- *The point in time when the investment will reach its most conservative asset allocation (including a graphic representation)*

Fee Disclosure Regulations 404(c) Changes

- Fee disclosure regulations change requirements under ERISA Section 404(c)
 - Many of the requirements in the final regulations are duplicative of the existing 404(c) disclosure requirements
 - Some, such as the requirement to send participants prospectuses relating to investment options, have been supplanted and are no longer applicable (prospectuses still must be provided on request)
 - DOL takes the position that 404(c) does not relieve a plan fiduciary of its duty to prudently select and monitor the plan's service providers and designated investment alternatives

Fee Disclosure Regulations 404(c) Changes (continued)

- Fee disclosure regulation changes generally effective May 31, 2012

404(c) – Scope of Relief

- Originally, scope of 404(c) relief thought to be relatively narrow:
 - Only protect against claims for imprudent investments in available options
 - No protection against claims for the failure to exercise due care in selection and/or monitoring of an investment fund
- Recent case law suggests that the scope of the 404(c) relief may be much broader and may extend to selection and monitoring of funds
 - DOL also “clarified” in fee regulations that 404(c) protection does not extend to selection and monitoring of funds

404(c) – Scope of Relief (continued)

- *Hecker v. John Deere* (Seventh Circuit, 2009) (case litigated by Morgan Lewis):
 - Court held that 404(c) insulated fiduciaries from participants' claims that the fiduciaries breached their fiduciary duties by selecting investment funds with excessive fees
 - Court took a very literal reading of 404(c) provision:

“no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control.”

and concluded that participants could not hold plan fiduciaries responsible for selecting a fund with excessive fees if participants had an opportunity to invest in other available funds
 - Court placed a lot of emphasis on the presence of a brokerage link

404(c) – Scope of Relief (continued)

- Similar holding in *Langbecker v. Electronic Data Systems Corp.* (Fifth Circuit, 2007):
 - Court rejected DOL’s long-standing position that section 404(c) is never a defense to the selection of investment alternatives

404(c) – Scope of Relief (continued)

- *Renfro v. Unisys Corp.* (Third Circuit, 2011) (case litigated by Morgan Lewis):
 - Case dismissed; holding included that employer did not breach its fiduciary duty to prudently and loyally select and maintain a broad mix and range of investment options
 - Case related to the offering of retail mutual funds in a 401(k) plan for purposes of determining whether lowest fee/share classes were offered to participants
 - Case also argued that section 404(c) was a defense to selection of investment options; court did not address 404(c) claim, as the case was dismissed without this argument

404(c) – Scope of Relief (continued)

- *Howell v. Motorola* (Seventh Circuit, 2011):
 - The court held that section 404(c) precluded the plaintiffs from proceeding with their claims that (i) the plan fiduciaries did not disclose sufficient information regarding Motorola's financial condition; and (ii) those who appointed the plan fiduciaries did not sufficiently monitor their appointees
 - The court did, however, adopt the position long taken by the DOL that section 404(c) does not apply to claims based on the plan fiduciaries' selection of imprudent investment options

404(c) – Scope of Relief (continued)

- *DeFelice v. US Airways* (Fourth Circuit, 2006):
 - Court of Appeals affirmed judgment for US Airways in stock drop suit brought after the plan sponsor filed for bankruptcy.
 - *“U.S. Airways offered twelve diversified, and less risky, alternatives for investment and allowed participants to transfer their investment funds freely between these diversified options, always allowing participants to remove funds from the Company Fund without restriction.”*

404(c) – Scope of Relief (continued)

- *DeFelice v. US Airways* (Fourth Circuit, 2006) (cont'd)
 - “Although the Plan comported with section 404(c) of ERISA, which limits the liability of fiduciaries for actions undertaken as a direct result of investment instructions given by participants . . . **this safe harbor provision does not apply to a fiduciary’s decisions to select and maintain certain investment options within a participant-driven 401(k) plan.**”

404(c) – Scope of Relief (continued)

- Department of Labor (DOL) takes a contrary position to 404(c) defense for selecting/monitoring investments:
 - Plan fiduciaries ought not to be able to hide behind section 404(c) and avoid responsibility for selecting and monitoring investment funds
 - DOL updated regulations, but it is not clear whether interpretation in any such regulations will be binding
- Take-away – under current interpretation of section 404(c), there is a real possibility of increased relief/protection for plans that obtain and maintain 404(c) relief; however, courts are still split on this issue

404(c) – Scope of Relief

Hard-Wiring Investment Options

- “Hard-wiring” Investment Options in Plan Document
 - *In Re Citigroup ERISA Litigation (Second Circuit)*
 - *A district court in the Southern District of New York dismissed the case during the pleadings stage; the claim related to imprudently permitting participant investment in the company stock fund of two Citigroup 401(k) plans because the plans required that the stock fund be permanently maintained as an investment option*

404(c) – Scope of Relief

Hard-Wiring Investment Options (continued)

- *The plans provided that “the Trustee shall maintain . . . the Citigroup Common Stock Fund” and the “Citigroup Common Stock Fund shall be permanently maintained as an Investment Fund under the Plan”*
- *Also provided that other investment options could be eliminated or added at any time by Investment Committee without the consent of the employer*
- *Court concluded that the defendants had no discretion as to whether to remove the stock fund as an investment option in the plans*

404(c) – Scope of Relief

Hard-Wiring Investment Options (continued)

- The *Citigroup* case is currently on appeal to the U.S. Court of Appeals for the Second Circuit
 - The DOL and other interested entities have filed amicus briefs; the DOL has taken the position that the district court erred by concluding that fiduciaries have no duty with respect to an investment in company stock if the plan terms mandate continued investment in company stock
 - The DOL argument includes that ERISA expressly provides that statutory duties override plan terms inconsistent with ERISA

Questions?

Presenters

- **Lisa Barton**
 - **412.560.3375**
 - lbarton@morganlewis.com
- **Marianne Yudes**
 - **215.963.5490**
 - myudes@morganlewis.com

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