

Section 404(c) compliance: Added protection makes it worth the effort

“Basically, 404(c) is a relatively inexpensive insurance policy. Plan sponsors and fiduciaries should make every effort to obtain its protections.”

*Fred Reish
ERISA specialist*

Section 404(c) of ERISA dates all the way back to 1974, but plan sponsors and fiduciaries are still trying to figure out what it means for their defined contribution plans. While the protection it provides to plan fiduciaries is valuable, the list of requirements can be intimidating.

Plan sponsors who follow the requirements for 404(c) compliance give themselves an additional level of protection. When followed down to the details, Section 404(c) provides a safe harbor for fiduciaries related to the investment actions of participants. Fiduciaries of self-directed retirement

plans which follow the 404(c) requirements are relieved of liability for what may later be determined to be employees' poor investment choices.

Some companies feel the cost of compliance is not worth the protection. While cost is always a valid concern, be sure to consider the long-term relief from the risk of liability for making investment decisions for participant retirement dollars in a 404(c) compliant plan and not simply the short-term costs of complying.

Other plan sponsors simply find the requirements too confusing to implement — with too many gray areas that don't provide the certainty they would like. Throughout this paper, you'll find that the 404(c) framework is distilled into an understandable summary with a practical approach. In addition, the passage of the Pension Protection Act offers clarification regarding some of the most controversial aspects of plan administration and 404(c) compliance. Armed with this information, almost any plan sponsor can become 404(c) compliant — it's an investment of time and effort that can offer important protection in the future.

An overview of section 404(c)

To be 404(c) compliant, a plan must meet two general requirements.

- 1) **The plan must offer a broad range of investment options.** A broad range is defined as at least three investment alternatives. Each option must be diversified, offer risk/return characteristics different from the others, and offer diversification for a participant's overall portfolio when combined. Most defined contribution plans today meet this requirement without a problem.
- 2) **The plan must allow participants to become informed about and to direct their investments.** This opportunity to exercise control (as the current requirements call it) must allow participants to give reasonable investment instructions to make their elections, have an opportunity to obtain written confirmation of such instructions, and receive sufficient information to make informed investment decisions.

In addition, participants must be able to make changes to their investments at least quarterly. However, if an

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investment option is sufficiently volatile, more frequent opportunities to change investments may be required. If your plan allows daily transfers for all options, you'll fulfill this requirement without needing to quantify "sufficient volatility."

Section 404(c) goes on to define — with an extensive list — what it means to give participants "sufficient information" for making informed decisions. These requirements are described in the table on the next page.

In addition to the information that must be provided, the following information must be made available upon participant request:

- For each designated investment option, a description of the annual operating expenses, which reduce the rate of return to participants and beneficiaries (e.g., investment management fees, administrative fees, transaction costs). These expenses should be expressed as a percentage of average net assets of the investment.
- Copies of any prospectuses, financial statements, and reports, and any other materials relating to the investment options available under the plan, to the extent such information is provided to the plan.
- For designated investment options that constitute plan assets, a list of the assets comprising the portfolio of each investment and the value of each asset (or its proportion). In the case of a fixed rate investment contract issued by a bank, savings and loan association, or insurance company, the name of the issuer of the contract, the term of the contract, and the rate of return on the contract must also be provided.
- Information concerning the value of shares or units of each investment option, as well as the past and current investment performance of each option (determined net of expenses, on a reasonable and consistent basis).

Special requirements for employer stock funds under 404(c)

- Employer stock must be publicly traded on a national exchange or similar market with sufficient frequency and volume to ensure prompt action on buy and sell orders.
- Information provided to shareholders must be passed through to participants.
- Voting and tender rights must be passed through to participants.
- Procedures regarding the confidentiality of participant actions with regard to employer stock must be established and a description of the procedures must be given to participants. A fiduciary must be designated to ensure such procedures are met.
- An independent fiduciary must carry out responsibilities involving situations with potential for undue influence by employers (e.g., tender offers).
- Either each core fund or a money market fund must accept transfers from the employee stock fund as frequently as transfers can be made from other core funds.
- Participants must be provided with the name, address, and phone number of the plan fiduciary responsible for monitoring compliance with these procedures.

- Information concerning the value of shares or units in the investment options held in the account of the participant or beneficiary.

The Pension Protection Act and section 404(c)

Signed into law on August 17, 2006, the Pension Protection Act of 2006 contains several provisions relevant to 404(c) plans. With this legislation, several gray areas related to 404(c) plan protection have been made clearer for fiduciaries.

Investment transfers caused by mapping and blackouts

The Pension Protection Act clarifies that a qualified change in investment options, such as with a fund change, retains protection for plan fiduciaries under 404(c). This provision allows 404(c) plans to map funds from one investment to another, if the new investment is reasonably similar in characteristics. Other conditions must also be met, including a notice to participants. 404(c)

protection is also available for fiduciaries during blackout periods if the fiduciaries follow ERISA's requirements related to blackout periods.

Investment default safe harbor

A regulation promulgated as a result of the Pension Protection Act also offers relief to plan fiduciaries by providing a default investment safe harbor. The regulation deems a participant to have exercised control of his or her account if, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a qualified default investment alternative (QDIA). The regulation specifies three main categories of investments for QDIAs, from which a plan sponsor or plan administrator will select one. The categories are target date funds, balanced funds, and professionally managed accounts. The default investment option must meet certain criteria for plan fiduciaries to take advantage of the safe harbor. First, participants and beneficiaries must have been given

an opportunity to provide investment direction, but failed to do so. The QDIA chosen by the plan sponsor or plan administrator must be in accordance with guidance from the Department of Labor. Also, a participant notice must be distributed within certain time periods.

This legislation and the proposed regulation were designed for the plan sponsor who wants both 404(c) protection and an automatic enrollment feature for their plan. Following the safe harbor for a QDIA allows the plan sponsor or plan administrator to place participant retirement dollars into a default investment option within the plan while still otherwise maintaining a 404(c) plan.

How to comply and remain in compliance (hint: you're not on your own)

While the protection of 404(c) can be quite valuable to your plan, it can also mean a great deal of additional work and expense. Thankfully, most plan sponsors are not on their own. Your plan provider has probably set up automatic controls to help you fulfill at least part of your 404(c) responsibilities.

Your next step should be to initiate a detailed discussion with your plan provider to make sure you are taking advantage of the services it offers. Find out which of the 404(c) requirements the plan provider offers and whether it creates a paper trail.

After this important step, examine what requirements remain to be fulfilled and implement a process for completion. The process should include ongoing needs and creating the documentation to substantiate what you have done.

By taking advantage of what may already be in place for your plan, the task of 404(c) compliance may be much less daunting than tackling the initial list on your own.

Digging deeper: information that must be provided

404(c) requirement	Suggested action
Provide a statement to participants explaining that the plan is intended to be a 404(c) plan and that the fiduciaries may be relieved of liability for participant-directed investment actions.	At a minimum, 404(c) language should be included in the Summary Plan Description and in enrollment materials. For reference, see the "Sample statement of 404(c) intent" language in the callout box located on page 4. The plan's intention to be administered as a 404(c) plan should also be included in the client service agreement.
Describe each investment alternative available under the plan and, for designated options, the characteristics of each.	Participants should receive fund fact sheets which include: <ul style="list-style-type: none"> • A general description of the investment objective • Risk and return characteristics • The type and diversification of assets in the portfolio
Identify any designated investment managers.	This information could be disclosed in the Summary Plan Description or enrollment materials for plans with investment managers operating investment portfolios.
Provide an explanation of the circumstances under which participants may give investment instructions (including limitations and restrictions on transfers and voting rights) and information on penalties or adjustments related to fund transfers.	Typically found in the Summary Plan Description or enrollment materials.
Describe transaction fees and expenses.	Typically included in the fund fact sheet and/or the prospectus.
Provide the name, address, and phone number of the plan fiduciary responsible for providing information upon request (and, if applicable, the person or persons designated by the plan fiduciary to act on their behalf).	Typically found in the Summary Plan Description. See "Sample plan fiduciary contact language" in the callout box on page 4.
Provide information regarding investments in employer securities including a description of the procedure to provide for confidentiality, and the name of the fiduciary charged with monitoring compliance with the confidentiality requirement.	See "Special requirements for employer stock funds under 404(c)" on page 2.
Provide a copy of the most recent prospectus provided to the plan if the investment is subject to the Securities Act of 1933.	A prospectus should be delivered to participants upon request.
Describe voting, tender, or similar rights of an investment to the extent that such rights are passed through to participants.	Since the vast majority of plans do not pass on the voting rights to participants (other than for employer stock), this requirement typically does not call for a specific action.

At first glance, plan sponsors tend either to overestimate or underestimate the amount of work it will take to be 404(c) compliant. Some plan sponsors feel that solely sending out prospectuses qualifies their plan for 404(c) protection. Others see the lengthy list of information that must be provided as a deterrent to becoming a 404(c) compliant plan.

One thing that most plan sponsors do agree upon is that being in compliance with 404(c) offers them an extra level of protection that is hard to find in other aspects of plan management. By understanding the requirements and putting the practices in place to fulfill these requirements, 404(c) compliance merely becomes a matter of routine housekeeping. For most plan sponsors, the long-term protection it provides easily outweighs the additional effort and costs.

Sample statement of 404(c) intent

“Your plan is intended to constitute a plan described in Section 404(c) of the Employee Retirement Income Security Act of 1974 and Title 29 of the Code of Federal Regulations Section 2550.404.c-1. This means that you control the investment of your account. Generally, as a result, your employer, your trustee, and other fiduciaries of the plan are relieved of liability for any losses that your account experiences as a direct and necessary result of investment choices you make.”

Sample plan fiduciary contact language

“Besides the information that the Plan Administrator provides to you, you may request certain other information from the Plan Administrator [include contact information for the Plan Administrator]. Requested information can include annual operating expenses, financial statements, reports or other materials relating to the investments available, a list of assets contained in each investment fund or portfolio that are plan assets, the value of investment funds, the value of shares of investments available, the past and current performance of investments available, and information concerning the value of investments held in your account.”

For more information, please contact Wells Fargo at 1-800-690-9721.

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