Satisfying Section 404(c) Requirements — An Ongoing Effort

Many retirement plans that allow employees to direct the investment of their own accounts are set up to comply with ERISA Section 404(c) in order to limit the employer's potential liability for investment losses. If you are counting on the protections that 404(c) compliance offers, your plan's operations should be reviewed routinely to ensure that all bases are covered.

Section 404(c) offers plan fiduciaries — including employers — a means of shielding themselves from liability for losses that may result when employees exercise control over the investment of their plan accounts. While retirement plans are not required to comply with Section 404(c), many employers have decided that compliance is worth pursuing.

Broad Range of Investments

One of the key requirements of the Section 404(c) regulations is that participating employees and beneficiaries be given the opportunity to choose from among a broad range of investment alternatives. The regulations spell out how this is to be accomplished.

- At a minimum, the plan must offer three core investment alternatives.
- Each of these must be diversified and have materially different risk and return characteristics.
- By choosing from among the three core options, the participant (or beneficiary) must be able to put together a portfolio with aggregate risk and return characteristics at any point that is within the "range normally appropriate" for the participant.
- Each of the three options, when combined with investments in the other alternatives, must tend to minimize through diversification the overall risk of the participant's or beneficiary's portfolio.

Does a plan that offers a stock fund, a bond fund, and a money market fund satisfy these requirements? Not necessarily. For example, if one of the three core funds is very narrow in its investment holdings — a stock fund that concentrates in a single industry sector, for example — participants may not be able to construct portfolios with appropriate risk/return characteristics or minimize their overall risk by investing in a combination of the three core funds.

Diversification

Another requirement of the regulations is that participants and beneficiaries be given the opportunity to diversify the investment of their accounts (or the portion of their accounts over which they exercise investment control). Since most plans have participants with small account balances, a plan will meet this requirement only if it offers mutual funds or similar "look-through" investments. The reason: An investor with only a small amount to invest won't be able to buy enough individual securities to diversify adequately.

Investment Instructions

Participants and beneficiaries also must have a reasonable opportunity to give investment instructions to an identified plan fiduciary. However, a plan may impose reasonable restrictions on the frequency with which the instructions may be given. What is considered reasonable? That depends on the expected market volatility of each investment alternative. A small-cap stock fund, for example, may be very volatile. To satisfy Section 404(c), participants might have to be able to move money in and out of the fund daily.

At a minimum, investment instructions for core investments must be accepted at least once every three months. However, if a plan accepts instructions with respect to non-core investments more frequently, it generally must allow transfers into a core investment at least as frequently. Alternatively, the plan can allow money to be moved from the non-core option into a low-risk cash equivalent and from that low-risk option into one of the core alternatives.

Access to Investment Information

Several types of information must be provided, including:

- An explanation that the plan is a 404(c) plan and that the plan fiduciaries may be relieved of liability for any losses that result from the participant's investment instructions;
- Identification of any designated investment managers;
- A description of all investment alternatives offered by the plan (plans that don't restrict investments to a particular menu of choices can simply state that they allow any administratively feasible investment); and,
- An explanation of the circumstances under which investment instructions may be given.

These are just some of the highlights of the regulations. If your plan is seeking compliance, it may be time for a checkup. Please contact us for assistance.