Top 10 ERISA Fiduciary Duty Exposures – And What To Do About Them

Understand your fiduciary duties under ERISA and take steps now to protect yourself from future liability

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This chapter discusses some of the most pressing issues affecting employee benefit plan sponsors and their managers with respect to their fiduciary responsibilities under the Employee Retirement Income Security Act (ERISA). It provides an overview of new developments and offers some practical advice aimed at managing an organization's fiduciary liability risks in 2007. Keep in mind that the following offers general information and is necessarily limited in scope given the complexity of the topic. Experienced ERISA legal counsel should be consulted for further information relevant to the specific needs of your organization and benefit plans.

Introduction

It is fair to say that today's employee benefit plan fiduciaries are under closer scrutiny than ever before. This is due to a convergence of certain legal, corporate, and governmental trends.

First, recent years have seen an increase in ERISA fiduciary litigation. Perhaps this trend reflects the apparent increase in litigation overall, or perhaps it's been spurred on specifically by the corporate scandals that rocked Enron, Worldcom, Tyco, Global Crossing, and Adelphia, among others. Regardless of the reason, existing lawsuits against plan fiduciaries are plentiful and new lawsuits are being filed at an alarming rate. All of these lawsuits revolve around allegations that plan fiduciaries have breached their duties under ERISA, and many of them touch upon the issues discussed below.

In the pension arena, the current trend is the widely noted shift away from defined benefit pension plans (plans that promise a specific benefit at retirement, funded by the employer) to participant-directed 401(k) plans (which are funded, at least in part, by the employee, and significantly controlled by the participant's actions). Under a 401(k) plan, employees must make a host of financial decisions they did not have to

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make under the defined benefit structure, including deferral elections, investment elections, and distribution, withdrawal and loan decisions.

The shift, however, brings with it a host of problems. Distressingly, recent studies show that many employees will fail to secure an adequate financial retirement through their 401(k) plans if they continue to manage their retirement accounts as they do today. This forecast reflects the finding that many employees lack the necessary expertise, experience, time or inclination to manage their accounts. Nor can these participants count on the stock market boom of the 1990s repeating itself to bail out their lackadaisical approach to account management. Unfortunately for fiduciaries, in today's new retirement paradigm, employees who fail to secure an adequate retirement may look to the underlying plan and plan fiduciaries for recompense, since those parties have certain responsibilities to protect plan participants under the law.

Additional trends relevant to plan fiduciaries include Sarbanes-Oxley internal control compliance initiatives, which mandate a more formal process-oriented approach to benefit plan administration. At the same time, employee benefit plan auditors conducting annual examinations for purposes of filing Form 5500 are also ratcheting up their scrutiny. These auditors are increasingly focused on examining underlying fiduciary and tax qualification issues in performing their annual audits, motivated in part by recent regulatory changes affecting accounting and auditing firms. Further complicating the environment, ERISA compliance is a dynamic field, affected by a steady stream of legislation, governmental guidance, court decisions and marketplace changes, making navigating this field an increasingly complex endeavor.

It is critically important for today's fiduciaries to monitor, anticipate and manage the plethora of participant litigation and governmental audit trends as well as other risks facing them. Complacency is a poor and ultimately expensive strategy.

Although fiduciary liability management is hardly a one-size-fits-all endeavor, certain issues apply to most organizations and plans. Accordingly, this chapter focuses on the "Top 10" areas of potential fiduciary responsibility exposure — and offers some suggestions for action.

Fiduciary Exposure #1: Identifying and Training Plan Fiduciaries

The most basic fiduciary exposure that can be addressed is ensuring that those entities and individuals who are charged with fiduciary responsibility under the employee benefit plan are aware of their status as plan fiduciaries. If a fiduciary is unaware of his or her status as such, or if an employee is not provided with guidance as to what acts or omissions make him or her an ERISA fiduciary, it is unlikely that he or she is doing everything possible to address his or her responsibilities under the law.

Fiduciary status is determined under ERISA and related regulations, with ERISA providing a functional approach toward determining who qualifies as an ERISA fiduciary. In other words, fiduciaries are not limited, as common sense might dictate, to those individuals or entities that have a certain title, such as "Plan Administrator" or "Plan Trustee." Rather, ERISA provides that a person is a fiduciary of an employee benefit plan to the extent that the person:

1) exercises discretionary authority or control respecting management of such plan or management or disposition of its assets;

2) renders or has authority or responsibility to render investment advice for a fee; or

3) has discretionary authority or responsibility in the administration of such plan.

This means that some individuals, such as a pension plan trustee, by definition will be considered a fiduciary just by having a title that is identified in the plan document as having fiduciary responsibility. However, HR professionals, employee benefits professionals, and members of the board of directors of an employer can also be fiduciaries to the extent they perform fiduciary functions under the plan.

Somewhat complicating this issue is the fact that not every act relating to an employee benefit plan is a fiduciary function. Many functions performed by benefit managers are purely ministerial in nature and are not deemed to be fiduciary functions.

What to do Now

Employers should identify plan fiduciaries and those employees who might become fiduciaries and then assess whether there are any gaps in the fiduciaries' approach to meeting their responsibilities.

For example, employers should closely examine whether their employee benefit plans are operating in accordance with their stated terms, as required by ERISA. For retirement plans, this endeavor should involve a thorough review of the plan document as well as plan operations, including a look at the plan's operations from several different corporate perspectives, including the HR, benefits, and IT functions. The value of this approach has been validated by a recent report of the IRS' Employee Plan Team Audit group. They stated that many plans lack sufficient internal controls to ensure that data provided to third party recordkeepers is accurate (data such as dates of hire or termination, ages of employees, amount of compensation). Their findings indicated that poor internal controls contributed to inaccuracies in data reports and testing prepared by third parties, resulting in errors computing vesting or employer matching allocations by the plan administrator.

The report also indicates that the IRS' new audit initiatives represent an expanded approach by them as compared to past audit scopes, signaling that they are concerned with the entirety of the plan and may examine how any company component touches the process of plan administration.

Furthermore, all employees involved in benefit plan administration should be trained to understand basic ERISA fiduciary responsibility, including the duty to act prudently, the duty of loyalty and the duty to defray plan expenses, as discussed below. And finally, with respect to any employee benefit plan, employers should determine whether they have adequate fiduciary liability insurance and ensure that their insurance policies cover the identified fiduciaries and potential breaches.

Fiduciary Exposure #2: Plan Investments, Generally

ERISA requires that plan fiduciaries act prudently in performing fiduciary functions. This is defined under ERISA as acting "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This is generally a high standard for plan fiduciaries to meet, especially so for pension plan fiduciaries charged with the responsibility for selecting and monitoring pension plan investments. Many pension plan fiduciaries lack the proper training, experience or time to properly select and monitor pension plan investments.

As a mitigating factor however, DOL regulations emphasize that it is the *process* of fiduciaries acting prudently that is important, and not necessarily the outcome of the action. In other words, as long as the fiduciaries have utilized prudent procedures to select, for example, a plan investment, the performance of that plan investment (even a negative performance), should not give rise to fiduciary liability. Importantly, ERISA does not require that pension plan fiduciaries become experts themselves in selecting and monitoring plan investments but they can get expert help to fulfill their responsibilities in these areas.

Thus, pension plan fiduciaries must establish a formal mechanism for selecting and reviewing the investment options under the plan. For this purpose the fiduciaries can hire outside advisors. In fact, in today's environment, obtaining proper help in making fiduciary decisions may be an essential element of acting prudently under the law.

Fiduciaries of 401(k) plans have further opportunities to insulate themselves from liability by meeting specific standards in regard to participant directed plans. Specifically, if a plan complies with Section 404(c) of ERISA, then fiduciaries are protected from liability for losses resulting from a participant's or beneficiary's investments under the plan. Section 404(c) requires that the plan supply or make available certain information to participants. Section 404(c) also requires that the underlying investments in the plan constitute a broad range of investment options, defined as a minimum of three diversified investment alternatives, each having materially distinct risk and return characteristics from the others.

Other important aspects of Section 404(c) provide that participants must be advised that plan fiduciaries may have no responsibility for losses resulting from the participants' investment instructions; and that participants must receive a description of all designated investment alternatives under the plan and a description of any transaction fees or expenses charged to the participants' accounts. Additionally, participants must have access to a copy of the most recent prospectus (or a profile of the prospectus) for the investment options under the plan.

What to do Now

Employers should examine plan documents to identify the entity responsible for selecting and monitoring investments under the plan. This might be the Board of Directors of the company, the company generally, a committee of individuals or individuals named under the plan. If the entity identified in the plan document as having fiduciary responsibility for the administration of the plan is not functioning properly, it may be appropriate to form (or re-form) an administrative and investment committee for the plan in accordance with the terms of the plan document. The committee should meet periodically during the year, and as often as needed. For pension investment committees, quarterly meetings should be held to review investment results.

For retirement plans, consideration should be given to adopting an investment policy that sets forth objectives for the plan's investments, establishes benchmarks against which to evaluate them and otherwise formalizes the process for selecting and replacing investment alternatives. An independent investment advisor is often indispensable to this process. All too often, plans may be relying on an investment advisor who is not truly independent, and this would necessitate a change. It may be advisable to have legal counsel present at meetings to ensure that minutes fully document the steps considered and taken by the plan fiduciaries. Pension plan fiduciaries may also ask their recordkeepers to assist in an ERISA Section 404(c) review, for plans that provide participant-directed investments.

Fiduciary Exposure #3: Company Stock

Offering company stock as an investment alternative under a 401(k) plan poses greater risk to plan fiduciaries and, therefore, heightens their fiduciary responsibilities. The risk stems, for the most part, from the plethora of litigation involving company stock. Litigation against fiduciaries has increased across the board, but it is safe to say that there is a veritable onslaught of litigation involving plan investments in company stock. The fact of litigation involving company stock is unsurprising, given that individual securities are subject to far more drastic fluctuations in value than a typical diversified mutual. Furthermore, many plans and participants are heavily invested in company stock because there is no limit on the amount of company stock that can be held by most individual account plans.

Although the facts and circumstances of each lawsuit against a plan's fiduciaries vary a great deal, a lawsuit will usually involve an individual account plan, such as a 401(k) plan, that has a company stock fund in its investment lineup. The company stock fund usually holds company stock exclusively, except for, perhaps, a small portion of cash for liquidity purposes. Another common factual element among many of the lawsuits is that the company has suffered some type of financial distress and, as a result, the value of the company's stock has dropped gradually or precipitously. Claims raised by plan participants (who have now become plaintiffs) also vary, but generally speaking, the plaintiffs assert that the plan fiduciaries should have known of the impending stock drop and either eliminated or reduced the plan's holding in company stock, or warned the plaintiffs that facts exist that could lead to a stock drop. Also typically, the plaintiffs ask the court to impose personal liability on the fiduciaries to make the plan whole for the losses suffered. When one considers that a large plan may hold company stock valued at hundreds of millions of dollars, the risk attendant to a plan's investment in company stock becomes clear.

What to do Now

As suggested earlier, procedural prudence, and not the ultimate performance of the investment, is key. Therefore, the first step in determining whether to offer company stock as an investment alternative is to evaluate whether the company stock is a prudent investment. This process should be thoroughly documented and should include a review of the financial health of the company, its past performance and future prospects, and an evaluation of the company's stock based on similar methods that are used for evaluating the plan's mutual funds, including performance against a benchmark and a peer group of stocks. It is also wise to consider the reports of independent investment analysts, the buying and selling trends of company insiders, and the investment decisions of institutional shareholders.

If the plan fiduciaries decide that it is prudent to offer company stock as an investment alternative, they must, of course, monitor the investment. To relieve themselves from the rigors of monitoring, plan fiduciaries may appoint an independent fiduciary to act on their behalf. To limit their exposure to liability, the plan fiduciaries should consider imposing a limit on the amount of company stock that participants may hold in their plan account. The employer should also consider amending the plan to require that a company stock fund be included in the investment lineup, rather than leaving the decision to the discretion of the plan fiduciaries.

Finally, in the event that a company runs into financial distress, the plan fiduciaries should immediately contact their legal counsel about their responsibilities with regard to the company stock fund.

Fiduciary Exposure #4: Mutual Fund Fees

In contrast to a stock drop, where a significant portion of a participant's account can seemingly disappear overnight, mutual fund fees eat away slowly at a participant's account. Over time, mutual fund fees, if they are excessive, can have just as dramatic an effect as a stock drop.

A booklet produced by the DOL's Employee Benefits Security Administration explains the impact of excessive mutual fund fees as follows: Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. *The one percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.* Recognizing the impact of mutual fund fees on account balances, the DOL believes that is incumbent on plan fiduciaries to consider fees when selecting a mutual fund and to monitor those fees periodically.

What to do Now

There are many types of fees associated with plan investments that should be evaluated, including 12b-1 fees, sub-transfer agent fees, and wrap fees. Evaluating them can sometimes be an arduous task and, therefore, plan fiduciaries are encouraged to seek outside assistance. Nevertheless, a good place to start is the mutual fund's stated expense ratio, which reflects management and other expenses, such as 12b-1 fees, and is deducted from the mutual fund on a regular basis. To determine whether the expense ratio of a mutual fund is reasonable, it should be compared to the expense ratio of other mutual funds. If the conclusion is reached that the fees of a mutual fund are excessive, the plan fiduciaries should consider methods for lowering the cost, such as switching to a different share class offered by the same mutual fund, or replacing the mutual fund altogether.

Fiduciary Exposure #5: Employee Communications

Generally speaking, plan fiduciaries have the obligation to communicate truthfully to plan participants, and to not mislead them. Thus, if a participant who is considering retirement approaches a plan fiduciary to inquire about early retirement programs, the plan fiduciary must disclose the existence of any such program that is being given serious consideration by the employer. The failure to communicate truthfully, however, does not result in strict liability for the fiduciary. Innocent misstatements and unintentional errors are usually forgiven by the courts. For example, if a benefits statement sent to a participant incorrectly states that his or her pension is to be $10,000 per month, when the correct amount is actually $1,000 per month, courts will generally not require the participant to be paid the greater amount, except in extreme circumstances, such as if the employer intentionally misrepresented the monthly pension amount.

HR personnel whose job functions do not cause them to be plan fiduciaries should also take care to communicate truthfully to participants, and to not mislead them. If they should fail in this regard, their incorrect statements could be imputed to the employer or another fiduciary, forming the basis for a claim of breach of fiduciary duty.

What to do Now

As a matter of common sense, but also because of the legal considerations discussed above, plan fiduciaries should ensure that they are sufficiently informed about plan benefits to respond to inquiries from plan participants and that participants receive correct information about their benefits. HR staff whose job functions may not make them plan fiduciaries should be trained to not respond to questions from participants, unless it is ascertained that they are sufficiently knowledgeable or trained. Many times, the best choice for the HR staff will be to refer the inquiring participant to the plan's summary plan description. Participant questions that are beyond the rudimentary aspects of the plan should be discussed with outside vendors or legal counsel.

Fiduciary Exposure #6: Service Providers

As noted above, plan fiduciaries often seek and obtain help from outside service providers, such as investment consultants, plan actuaries and others to assist in plan administration. Selecting service providers and monitoring them after they are selected is considered to be a fiduciary function. Therefore, ERISA requires that plan fiduciaries engage in a "prudent" process and document that process when selecting and monitoring service providers. The DOL has stated with respect to selecting providers that "the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided." Once this is completed, the plan fiduciary must monitor the provider to ensure that services are being performed as promised and to determine that their retention is still prudent.

Additionally, pension plan fiduciaries should be sensitive to other regulatory concerns that relate to selecting pension plan consultants. The Securities and Exchange Commission (SEC) recently examined the pension consulting field and questioned whether some pension consultants have conflicts of interest in providing their services. The SEC was especially concerned with certain conflicts that some of these consultants had with money managers. In response, the SEC and DOL have published a "Top 10" list of questions that plan fiduciaries can pose to service providers in this field (see http://www.dol.gov/ebsa/newsroom/fs053105.html).

What to do Now

Before retaining a service provider (and perhaps even periodically during the engagement process), fiduciaries should perform proper due diligence on the provider's credentials to determine if the provider is most appropriate for the task at hand. This may require that fiduciaries implement a request-for-proposal process before selecting a provider. Pursuant to this, the fiduciaries might interview provider candidates to uncover relevant information, such as experience in the field, expertise, litigation history and references. Fiduciaries should also examine whether the service provider's fees are reasonable and whether there any direct or indirect conflicts of interest. Further, plan fiduciaries should ask the "Top 10" questions compiled by the DOL and the SEC of their pension plan service providers and obtain answers in writing. In some cases, plan fiduciaries should insist that a service provider candidate acknowledge that the service provider itself would be a plan fiduciary in performing services if, in fact, this will be the case (some service providers hesitate acknowledging this in writing, and may represent that they do not consider themselves to be a fiduciary under the plan). Fiduciaries should work closely with experienced ERISA legal counsel to deal with these issues.

Checklist for Fiduciary Compliance

1) Identify employee benefit plans subject to ERISA
2) Examine plan documents to determine fiduciaries named under plan
3) Identify functional ERISA fiduciaries
4) Provide fiduciary training to plan fiduciaries
5) Hold fiduciary meetings and document meetings and other decisions in detail
6) Determine which fiduciary responsibilities have been delegated and monitor delegates
7) Examine whether fiduciary liability insurance is adequate
8) Perform an ERISA Section 404(c) analysis with respect to 401(k) plan
9) Examine plan fees, including those paid out of plan assets
10) Consult with experienced ERISA legal counsel

Note: This checklist should be tailored for each organization, preferably under the guidance of ERISA counsel.

Fiduciary Exposure #7: Late Deposit of 401(k) Deferrals and Loan Repayments

Under DOL rules, an employer engages in a prohibited transaction if it is delinquent in forwarding employee contributions, including 401(k) deferrals and 401(k) plan loan repayments, to the plan trust. Some employers may be under a misconception regarding the time frame within which employee contributions must be deposited into a 401(k) plan in order to avoid a prohibited transaction. Ironically, the DOL's own regulation on this topic may be the source for this confusion. It provides, in essence, that employee contributions must be deposited in the plan's trust "as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets." The regulation also states that the deposit must be made "not later than the 15th business day of the month following the month in which the amounts would otherwise have been payable to the participant." The popular misconception misapplies this second standard as a "safe harbor," under which deferrals are still considered to be timely deposited into the plan trust if those amounts are deposited by the 15th business day of the next month. This mythical "safe harbor" ignores the first part of the regulations, which provides that deferrals must be deposited as of the earliest date which the amounts can be segregated from the company's general assets, and is incorrect.

The DOL has made it clear that it is focused on penalizing employers that deposit deferrals late. The DOL will generally engage in a facts-based analysis to determine if an employer has been delinquent in depositing employee contributions. In this process it will typically examine an employer's historical payroll practices to highlight those payroll periods that are atypical and may identify those deferrals as being deposited late. Moreover, in addition to analyzing the employer's payroll practices there are reports that the DOL may also be applying a strict minimum time period by which deferrals must be deposited. While the DOL has not provided much guidance on a uniform standard for forwarding employee contributions, it is clear that in today's age of electronic remittances the DOL is focused on the shortest time frames. Plans are especially vulnerable on this issue inasmuch as late deferrals must be reported on a plan's Form 5500 annual report and some believe that reporting the late deferrals increases the plan's likelihood of being audited by the DOL and IRS.

What to do Now

Employers should examine their internal procedures for forwarding employee deferrals to the plan trust (including loan repayments). This may be especially tricky for employers that have several related companies participating in the same plan or several classes of employees paid at different time intervals, as those employers may be improperly holding money for one group while waiting for the rest in order to forward deferrals to the plan trust at one time. Additionally, companies that have been delinquent in depositing deferrals should ensure that they have made reimbursing contributions to the plan for lost earnings (including earnings on those earnings) and promptly pay the applicable excise tax to the IRS.

Fiduciary Exposure #8: Who Gets the Float?

Plan fiduciaries are required by ERISA to act prudently and solely in the interest of plan participants and beneficiaries, and they must act for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan. Under this standard, a plan may pay expenses out of plan assets to service providers provided that those expenses are reasonable. To uphold this standard, the plan fiduciary is obligated to closely examine the fee structure of prospective service providers as part of the selection process. Relevant to the standard, the DOL has recently highlighted a particular aspect of service provider compensation with regard to managing the "float" (cash parked in short-term investments) incidental to plan transactions such as distributions and deferrals. In some cases, the trustee may be retaining the earnings on these accounts while they are technically still part of the plan trust. Similarly, in the event of uncashed distribution checks, the trustee may be benefiting from the float held in disbursement accounts for extended periods of time.

The issue of float is often addressed in the service agreement between the parties or in separate disclosures to the plan.

What to do Now

Fiduciaries should ask their service providers to identify the instances in which the service provider retains float as part of their services. It may be appropriate to ask for a report from the provider as to the estimated annual amounts that are generated through the float. Fiduciaries should carefully examine the overall provider fee structure, including that which is float related, to determine its reasonableness as compared to other providers. Fiduciaries should review with their advisors recent DOL guidance that provides further details on the steps that a reasonable fiduciary should take in the selection and monitoring process for service providers that are entitled to float related fees.

In any event, plan fiduciaries should anticipate and address the various float-related events service providers may be involved in and set policies on which such events, if any, represent appropriate fees to the provider.

Fiduciary Exposure #9: Investment Advice to Pension Plan Participants

The Pension Protection Act of 2006 (PPA), enacted in August 2006, includes a number of significant changes to the ERISA fiduciary and prohibited transaction rules. (See Chapter 24.) Included among the changes are provisions that address how certain investment advisors may provide investment advice to participants in participant-directed plans, such as 401(k) plans, without running afoul of the ERISA and Internal Revenue Code prohibited transaction rules. The PPA's change relating to investment advice addresses a long-standing concern that 401(k) plan participants do not have the proper expertise or inclination to manage their retirement accounts. Before the enactment of the PPA, there were legal restraints on certain advisors that prevented them from providing investment advice to plan participants.

Although third-party advisors were okayed by the DOL prior to the PPA under certain conditions, many plan sponsors were previously hesitant to offer any investment advice to participants due to concern for potential liability in connection with investment losses. The PPA addresses many of those concerns by providing a new exemption from the prohibited transaction rules. Under the new prohibited transaction exemption, investment advice provided by a "fiduciary adviser" must be provided in accordance with an "Eligible Investment Advice Arrangement," as defined under the PPA. There are generally two alternative structures for offering advice under an Eligible Investment Advice Arrangement (the differences generally relate to the fee arrangement between the advisor and the plan and whether advice is provided through a computer model). If an employer adheres to the requirements of the PPA, plan fiduciaries will be provided protection from investment advice related liability. Plan sponsors are still obliged to prudently select and monitor fiduciary advisors.

What to do Now

Plan sponsors should determine whether they desire to have investment advice provided to plan participants and must engage in a prudent process to select an advisor. If a plan sponsor wishes to offer such advice, it should carefully review the PPA's requirements with their counsel when interviewing potential investment advisor candidates and ask how the advisors will comply with the law's requirements. Plan sponsors should examine differences in details of the advice programs being offered and ask pertinent questions before employing an advisor. For example, the plan sponsor should understand whether the advisor will be providing advice while taking into account a participant's investments outside the plan or whether advice will only relate to plan investments. Also, the plan sponsor should understand that there are different forms that an "Eligible Investment Advice Arrangement" can take, and different requirements under each form. The plan sponsor should also understand that the PPA's requirements may differ depending on whether advice is being provided by a third-party advisor or by an advisor that is otherwise a party-in-interest to the plan. Plan sponsors must monitor the advisor's activities after the selection is made.

Fiduciary Exposure #10: Automatic Enrollment and Default Investments

The PPA includes rules that make it more attractive for a pension plan to automatically enroll participants and provides broad relief regarding potential fiduciary issues relating to default investments. The automatic enrollment change has been welcomed by many who are concerned that a significant number of employees fail to take the crucial initial step of enrolling in a retirement plan.

Automatic enrollment takes advantage of employees' inertia since they are automatically enrolled at a pre-set participation level (e.g., 3 percent of compensation) and the participation level may be automatically increased over time unless they take the affirmative step of opting out. Automatically enrolled participants have their deferrals invested in a "default" investment fund selected by the plan fiduciaries (i.e., an investment election applies unless they make an affirmative election to the contrary). Previously, some employers hesitated to offer automatic enrollment out of state law concerns and concerns for fiduciary liabilities arising from default investment decisions.

The PPA preempts applicable state laws that would apply to automatic enrollment processes and provides liability relief to plan fiduciaries for default investments. It addresses the topic of default investments broadly, its scope not limited to default investments resulting from automatic enrollment. The default investments approach may be found in many pension plans today. For example, employers that sponsor profit-sharing plans and make non-elective employer contributions may need to select a default investment for participants that do not have an investment election on file. Plan administrators who meet all of the applicable requirements to be issued by the DOL will be deemed to have complied with Section 404(c) of ERISA, which provides certain protection against fiduciary liability.

What to do Now

Plan sponsors should consider adopting an automatic enrollment feature for their 401(k) plans, taking into account their plans' current participation levels. Plan sponsors will also need to determine whether to structure their automatic enrollment feature (or restructure, for those employers that already provide for automatic enrollment) to meet additional qualification requirements to obtain relief from certain IRS nondiscrimination testing (the qualification requirements relate to the automatic deferrals; related matching or non-elective contributions; and notices to employees). Additionally, plan sponsors that select default investments for their plan participants, under automatic enrollment or otherwise, must comply with the DOL regulations to obtain fiduciary relief.

Bonus Fiduciary Exposure: Paying Expenses from Plan Assets

As noted previously, under ERISA's fiduciary responsibility rules, plan assets can only be used for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan. The DOL provides that a determination as to whether to pay a particular expense out of plan assets is a fiduciary act governed by ERISA's fiduciary responsibility provisions. The DOL states that, as a general rule, reasonable expenses of administering a plan include direct expenses incurred in the performance of a fiduciary's duties to the plan. However, the DOL also provides that there is a class of discretionary activities which relate to the formation, rather than the management, of plans, called "settlor functions." Expenses incurred in connection with the performance of settlor functions are not deemed to be reasonable expenses of a plan. However, reasonable expenses incurred in connection with the implementation of a settlor decision (see examples in the following paragraph) would generally be payable by the plan.

While the DOL does not provide much detailed guidance for determining which expenses are settlor expenses, the DOL has provided guidance in the form of hypothetical examples. The examples provide that common expenses payable from a plan include the plan's annual discrimination testing expenses, expenses incurred to amend a plan in compliance with an applicable law and expenses associated with plan communications. Examples of disallowable expenses include those related to the initial decision to establish a qualified plan, plan design studies and plan amendments other than required amendments. Additionally, the DOL has issued guidance relating to how a plan may allocate plan expenses among plan participants. For example, some expenses that may be charged to a participant individually rather than to the plan as a whole are those incurred in processing a qualified domestic relations order, expenses incurred when processing a hardship withdrawal and those associated with processing a distribution.

What to do Now

Fiduciaries should examine which plan expenses are being paid out of plan assets and determine whether such payments are permitted under the terms of the plan and applicable law. In all cases, plan document terms must authorize the payment of expenses out of plan assets. Plan amendments to specify allowable charges should be adopted if necessary.

