

Message From The Firm

The mutual fund scandals continue to be in the headlines. As a result, it is still the "hot topic" for the 401(k) world.

However, the discussion has evolved from whether to remove or keep implicated funds. The new concern is whether the trading restrictions being imposed by recordkeepers and mutual funds are overdone and whether they will reduce the attractiveness of 401(k) plans—or impose greater burdens on plan fiduciaries. For example, if your plan offers 20 investment options to participants and if each of those mutual funds has its own set of redemption fees and trading restrictions, how will you educate your employees on 20 separate sets of time periods, redemption fee amounts and so on.

While that scenario may seem extreme beyond belief, there is at least some chance that the major mutual fund companies will come out with significantly different restrictions and, therefore, that your plan will be forced to deal with a high level of complexity—in terms of communicating with your employees and in terms of employees inadvertently incurring redemption fees. In addition, different mutual funds may impose fees on different transactions. For example, at least one major mutual fund management company is proposing to charge redemption fees where the triggering event is a hardship withdrawal, a participant loan or even a retirement distribution. Obviously, that goes far beyond any restrictions needed to reasonably manage the problems of market timing.

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Participant Investing: Forewarned is Forearmed



By Fred Reish (FredReish@Reish.com)

The popular thinking about 401(k) investments seems to be that, if fiduciaries offer a well-selected lineup of mutual funds, their ERISA obligations are satisfied. However, that is changing. And, if fiduciaries aren't paying attention, they could fall into a trap for the unwary.

According to a recent study by John Hancock Financial Services, many participants lack a basic understanding of mutual funds, money market accounts, equities and bonds. They don't know how they work or why they work. For example, many participants think that money market accounts hold stocks and do not understand that they only hold short-term debt instruments. Also, based on this and other surveys, participants don't understand the difference between the concepts of value and growth; don't understand that company stock is non-diversified and, therefore, riskier than mutual funds; don't understand that when interest rates go up, bonds go down; and so on. Without basic investment knowledge, it is likely that many participants will not be able to invest successfully. The 401(k) industry has, for years, tried to deal with that problem through employee education, communication materials and even investment advice. Unfortunately, none of those efforts have proven to be effective for most participants.

That raises two key questions. The first is whether fiduciaries are legally responsible for the prudence of participant investments. The second is, if they are responsible, whether fiduciaries can take steps to fulfill that duty.

In answer to the first question, yes, fiduciaries are responsible for the prudence of participant investment decisions. The decision of the Enron court on September 30, 2003 made it clear that, if a plan does not comply with the 20 to 25 conditions of 404(c), the fiduciaries (for example, the committee members) are responsible for the prudence of the participant investment decisions. To put that in context, our experience is that very few plans actually comply with 404(c). It is probable that most (perhaps as high as 90%) 401(k) plans do not comply with 404(c) and, as a result, the fiduciaries of those plans are personally responsible for the prudence of the investment decisions made by participants. (A copy of the Enron opinion has been posted on our web site under Current Developments at www.reish.com/practice_areas/empbenefits.cfm. As a word of caution, the decision is 124 pages long.)

And, even if a plan complies with the 404(c) requirements, the pressure is not taken off the fiduciaries. Fiduciaries have a legal obligation to offer investments that are "suitable and prudent." That raises the

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Hopefully, mutual fund complexes and recordkeepers will jointly develop common standards for all 401(k) plans. As a practical matter, that is the only solution that will work well for plan sponsors and participants. However, if they do not, plan sponsors may be faced with eliminating mutual funds from their line up if those funds are outliers in the imposition of restrictions. It is probable that most mutual fund complexes and recordkeepers will reach a common ground. But, some may go their own way. In that case, plan sponsors and fiduciaries will need to decide whether they want to deal with the extra complexity caused by having those funds in their plans.

On another issue, as the 401(k) marketplace continues to mature, plan fiduciaries need to focus on their duty to monitor service providers. Typical of any maturing market, the issues gradually become better understood and the expectations are for fiduciaries to be more knowledgeable. Unfortunately, many plan sponsors do not realize that investment education and employee enrollment are services that need to be prudently selected and monitored. In other words, plan sponsors need to understand the enrollment process and approve of it. In addition, they need to understand the investment education process and to approve of that. Then, as time goes by, the plan fiduciaries need to monitor those services. Among other things, they need to be monitored for effectiveness. Are the employee enrollment meetings working? Are an adequate number of employees enrolling in the plan as the result of those programs? Is it improving from year to year? If not, why not?

There are similar issues for investment education and for the effect of those services on participant investment behavior. Are your employees investing reasonably well—both in the aggregate and individually? Are the participants properly using the lifestyle funds? For example, do they have their entire account balances invested in only one lifestyle fund? If not, why not—since lifestyle funds are intended to be used that way?

Make sure your providers are giving you the data necessary to understand whether their services are effective--and then review that information and work with your providers to improve their services. Monitoring is an ongoing process--and the goal is constant improvement.

I hope you enjoy the articles in this newsletter. If you have any questions, please feel free to contact any of the ERISA attorneys in the firm.

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Fiduciary Responsibilities

The DOL has recently issued a brochure entitled "Meeting Your Fiduciary Responsibilities." A copy can be obtained from the DOL's Employee Benefits Security Administration's (EBSA) website at www.dol.gov/ebsa. I recommend that you read the brochure and, if you are an advisor to plans that you provide copies to your clients.

The brochure is a good overview of the responsibilities of plan fiduciaries, including their duties to:

- prudently select and monitor service providers;
- carefully evaluate the fees being charged to ensure that they are reasonable relative to the particular services and investments; and
- inform participants, for example, the summary plan description (SPD).

While the brochure is too basic for an experienced fiduciary, it provides a good starting point for new committee members to learn about the responsibilities of their job. In fact, in the brochure the DOL notes that, "An employer..., when using [a]... committee, should educate committee members on their roles and responsibilities." If your company does not have such a program in place, it should develop a fiduciary education program for its committee.

The link to the brochure is: www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

Mutual Fund Scandals

The primary guidance issued by the DOL on the mutual fund scandals is a Statement by Ann L. Combs, Assistant Secretary, EBSA. The title of the statement is "Duties of Fiduciaries in Light of Mutual Fund Investigations."

I recommend that you read the paper to better understand the fiduciaries issues related to the mutual fund scandals and their impact on participant-directed plans.

The paper is on our employee benefits web page under Current Developments at www.reish.com/practice_areas/empbenefits.cfm.

To pique your interest, two of the statement's conclusions are:

- "Without expressing a view as to any particular plan or particular investment options, we believe that these two examples [of trading restrictions] represent approaches to limiting market-timing that do not, in and of themselves, run afoul of the "volatility" and other requirements set forth in the Department's regulation under section 404(c), provided that any such restrictions are allowed under the terms of the plan and clearly disclosed to the plan's participants and beneficiaries."
- "The imposition of trading restrictions that are not contemplated under the terms of the plan raises issues concerning the application of section 404(c), as well as issues as to whether such restrictions constitute the imposition of a 'blackout period' requiring advance notice to affect participants and beneficiaries."

The Adequacy of Investment Choices Offered by 401(k) Plans

We have established a goal of assisting plan sponsors, fiduciaries and service providers to better understand employee behavior in participant-directed retirement plans. We also hope to increase the awareness of plan fiduciaries about the legal standard of prudence in the selection and monitoring of investment options.

As a part of those efforts, we sponsor academic research at UCLA about employee behavior in participant-directed plans. Professor Shlomo Benartzi, a leading academic in behavioral finance, oversees the research and analysis.

In addition to sponsoring the work done by UCLA and Dr. Benartzi, we are posting significant academic studies on our website... to increase awareness of research projects within the benefits community. We have recently posted a paper entitled "The Adequacy of Investment Choices Offered by 401(k) Plans." The authors of that article are Edwin J. Elton, Martin J. Gruber and Christopher R. Blake, professors at the University of New York and Fordham University. This study analyzes the adequacy and characteristics of the investment choices offered to 401(k) participants in over 400 plans. The authors conclude that, for 62% of the plans, the choices offered are inadequate and that, over a 20-year period, that inadequacy could result in a difference in terminal wealth of over 300%. We encourage you to visit our website and to read the paper. It is posted under Current Developments at www.reish.com/practice_areas/empbenefits.cfm.

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fundamental question of whether investments are suitable and prudent if a participant lacks the basic skills needed to properly use those investments. In turn, that raises a follow-up question of whether it is sufficient to "lead the horse to water" even if the horse doesn't drink. Is it enough to offer investment education, even if the education doesn't work? Is it prudent to continue to offer investment education that isn't working... or should the fiduciaries insist that their providers offer workable solutions? Those questions have not been answered in court cases or DOL guidance, but they are significant issues for plan fiduciaries.

Because of the lack of answers, the conservative course for fiduciaries is to accept a greater responsibility for the prudence of participant investment decisions. How can that be done? Here are some ideas:

- The summary plan description should have a clear statement that, if participants are concerned that they do not know how to invest properly, or if they simply do not want to take on that responsibility, the fiduciaries will manage their accounts. If participants communicate that they would rather have their accounts managed, in most cases the best choice would be to provide professionally managed accounts through an investment advisory firm. A number of advisory firms are offering those services. As a second choice, fiduciaries could use aged-based (or "target") lifestyle funds (for example, a 2010 fund, 2020 fund, a 2030 fund, and so on, where the date on the fund roughly corresponds to the participant's anticipated retirement age under the plan). The third choice might be a moderate risk-based lifestyle fund or a balanced fund.

- As a second step, fiduciaries should consider offering managed accounts (or target or risk-based lifestyle funds) as a part of their investment lineup. The purpose of offering managed accounts is obvious--it is a solution for participants who want help from a professional investment firm. While the purpose of lifestyle funds is essentially the same (although not as individualized), many participants mis-use those

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Summary Plan Descriptions and Foreign Languages

This is a reminder that plan sponsors have a legal obligation under ERISA to provide notices in foreign languages -- where certain conditions exist.

As a starting point, if either of these criteria are met, a foreign language notice must be delivered:

- If a plan covers fewer than 100 participants and 25% or more of the participants are literate only in the same non-English language, or
- If a plan covers 100 or more participants and if the lesser of: 500 participants or 10% of the participants are literate in the same non-English language.

In those two cases, there is a significant risk that the non-English speaking employees will not adequately understand the rights and obligations under the plan. As a result, when the English version of the SPD is distributed to those employees, they must also be given a notice in their native language, offering them assistance in understanding their rights and obligations under the plan.

While plan sponsors are not obligated to provide a Summary Plan Description in the non-English language, they are required to hand out the notice. Plan sponsors may also distribute native language SPDs to the non-English speaking participants. That may be the easiest way to provide the requested assistance.

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vehicles. In our experience, participants often divide their accounts among several lifestyle funds or even combine lifestyle funds with individual funds. While that does not necessarily cause any damage, it is nonetheless a mis-use of a vehicle that is designed to be a prudent and well-balanced investment option in its own right.

- As a third step, fiduciaries should consider an arrangement under which their plans automatically offer managed accounts for participants. That is, the plan would provide that, unless participants decide otherwise, they will be invested in an account managed by an investment advisor. The management of the account would be based on information readily available to the plan such as account balance, participant's age, deferral rate, and so on. (As an aside, I would not be surprised if 50% or more of the participants allowed their accounts to be professionally managed in this circumstance.) Since the ultimate objective of ERISA's fiduciary responsibility rules is for participants to be well invested, that would relieve fiduciaries of concern about their legal responsibilities for the prudence of the investments of those participants.

ERISA requires that fiduciaries act for the exclusive purpose of providing retirement benefits and with the prudence, care, skill and diligence of a knowledgeable investor. The easiest way to satisfy those two requirements is for fiduciaries to take greater responsibility for the success of participant investing by emphasizing lifestyle funds and managed accounts. If participants are left to flounder, there is a significant risk that many will invest improperly and, as a result, their retirement benefits may be inadequate. ❖

PLAN SPONSOR WEBCASTS

Bruce Ashton and I, together with Mark Davis (an investment advisor in Los Angeles), have been working with Nevin Adams of Plan Sponsor magazine to develop a series of webcasts for plan sponsors. The webcasts will provide information and education about issues that impact plan sponsors and their fiduciaries and participants.

In addition to the regular program, Mark, Nevin and I will discuss one or two "hot topics" at each monthly webcast. Finally, there will be an opportunity at the end of the webcast for you to ask questions.

Two successful webcasts have already been presented. The first of these programs covered participant investment advice and featured Jeff Maggioncalda of Financial Engines and Sherrie Grabot of GuidedChoice.

I encourage you to sign up to receive information about future webcasts. You can do that by registering for the free NewsDash daily email newsletters. Program information is also available at www.plansponsor.webex.com.

This is a lively and interesting way for plan sponsors to receive valuable information about topical issues and 401(k) services and investments. The webcasts are free to plan sponsors. There is a small charge for all others.

Department of Labor Conference

The U.S. Department of Labor is developing a national conference focused on Title I of ERISA. The conference will cover areas such as fiduciary responsibility, prohibited transactions, health and welfare plans, ERISA litigation and DOL investigations. The first conference will be held in Washington, D.C. in late April of 2005.

Fred Reish has been named to the Steering Committee for the conference. Bruce Ashton is also working on the conference in his capacity of the President of the American Society of Pension Professionals and Actuaries.

Bruce Ashton Completes Term as ASPA President

The firm congratulates Bruce on his successful service as President of ASPA, an association dedicated to education and advocacy for quality retirement plan practices and governance. At the organization's annual conference in late October, Bruce will complete his term of office.

Bruce's accomplishments as ASPA's president include:

- Completion of ASPA's new strategic plan, which charts the organization's course for the next decade.
- Overseeing the difficult process of changing the name, effective November 1st, to American Society of Pension Professionals & Actuaries (ASPPA).
- Installing a new management structure, which strengthens the structure of the staff and which, through its implementation, has broadened and improved the capabilities of the senior staff as well as the volunteer members of ASPA.

Congratulations to Bruce on a job well done. His service has contributed to ASPA and the benefits community.

Around the Firm

Speeches: Fred Reish will present a workshop entitled “Key Fiduciary Issues for 401(k) Plans in 2004” at the ASPA Annual Conference, October 24-27 in Washington, D.C. Bruce Ashton will also present a workshop at the Annual Conference on “Abusive Tax Practices.” As President of ASPA, Bruce will also be giving opening remarks at the Conference. In addition, Marty Heming and Nick White will be co-presenters at the Conference at a workshop entitled “Case Studies in Correction Under EPCRS.” In July and August, Nick Waddles gave a series of presentations for Manulife on “Fiduciary Liability for 401(k) Brokers” in Los Angeles and San Francisco. In August, Fred co-presented a web seminar with Nevin Adams, editor of *Plan Sponsor* magazine on the recent mutual fund scandals. This was the third installment in a series of such web seminars for plan sponsors that address current “hot topics.” The next webcast will take place in October, so be on the lookout for announcements.

Quotes: Fred was quoted in the article “Are You Sure You’re 404(c) Compliant?” in the September issue of *HR Magazine*. Fred was also quoted in the August issue of *Plan Sponsor* magazine in the article “Even If You Build It, They Don’t Always Come: How Plan Sponsors Motivate Participants to Use Retirement Tools?” In addition, Fred was recently quoted on two web sites: on August 11th on 401kExchange.com in the article “Mutual Fund Platforms May Be Prohibited Transactions Under ERISA” and on August 5th on Ignites.com, a mutual fund industry web site, in the article “Survey: Demand for 401(k) Advice Rising.”

Articles: Fred co-authored an article with Pat Byrnes in the *Journal of Financial Service Professionals* on “Retirement Plan Fiduciary Liability and Its Abatement under ERISA Sec. 404(c).” Fred’s column in the August issue of *Plan Sponsor* magazine addressed the topic of “Question Air: Prudent Questions and the Right to Answers.”

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