Feature Article

Set and Forget?

A Self-Directed 401(k) Plan Sponsor's Investment Fiduciary Obligations Under ERISA

By Janet E. Lanyon

The retirement plans offered by many corporate clients are 401(k) plans in which each employee who elects to participate in the plan decides how to invest his/her retirement account by selecting from a menu of investment options offered by the plan's investment provider. Many smaller companies favor such "self-directed" plans because they believe the responsibility for plan investment choices belongs solely to the employee/participant. The client may pick the investment provider based upon word of mouth, existing business relationships or the relative cost to the client. Counsel may be asked to review and bless the service contracts for such an arrangement within a short time before services are scheduled to begin. Nonetheless, a client that sponsors a self-directed 401(k) plan for its employees continues to have significant obligations as an investment fiduciary under the Employee Retirement Income Security Act[1] (ERISA), which include its decisions regarding the selection and monitoring of the investment options to be offered to participants and the selection of investment providers and investment professionals to provide services to the plan.

Employers Sponsoring Self-Directed 401(k) Plans are Investment Fiduciaries under ERISA

A 401(k) plan is considered an "employee pension benefit plan" covered by ERISA.[2] Under ERISA, the employer who sponsors a 401(k) plan is typically a "functional" fiduciary to the plan, either because it retains discretion as the plan administrator[3] or because it exercises discretionary authority or control regarding the management of the plan or any authority or control over the management or disposition of the plan's assets.[4] It is also likely that the employer is a "named" fiduciary[5] because it is named as a fiduciary or plan administrator in the plan document.

An ERISA fiduciary must perform his/her duties as to the plan solely in the interest of plan participants and beneficiaries, and for the exclusive purpose of providing benefits to them and defraying reasonable plan administration expenses.[6] A fiduciary must also act prudently, diversify the plan's investments and act in accordance with the plan document(s).[7] These general duties, which have been amplified in U.S. Department of Labor regulations and numerous federal court opinions, result in placing upon the plan sponsor the overall fiduciary obligation to prudently manage the

investment of plan assets as would a quasi-professional.[8]

A fiduciary also has the obligation to refrain from engaging in "prohibited transactions" or causing the plan to engage in such transactions.[9] A prohibited transaction generally involves one of several conflicts of interest between the plan and a "party in interest," including the plan sponsor, a fiduciary to the plan, a plan service provider and others who may have a financial interest in the plan.[10] The plan sponsor's obligations under the prohibited transaction rules are beyond the limited scope of this discussion, but should be considered in advising a plan sponsor as to its obligations under ERISA.

Limited Relief from Investment Fiduciary Obligations under Self-Directed 401(k) Plans

A limitation on the plan sponsor's broad responsibility as an investment fiduciary is available under ERISA if it adopts an individual account plan (including a 401(k) plan) that allows participants to exercise control over the assets in their individual accounts and the participants do, in fact, exercise such control.[11] Under such self-directed individual account plans, the participant is not considered a fiduciary as to his/her own account and the plan investment fiduciary is not liable for any loss or breach that results from the participant's exercise of control over his/her account, other than during a blackout period.[12] Among the many requirements established by the U.S. Department of Labor for a plan to qualify for this exception, participants must be given the opportunity to choose from a broad range of investment alternatives that give the participant the opportunity to materially affect potential return and degree of risk.[13] At least three diverse investment alternatives must be offered that have materially different risk and reward characteristics so as to allow the participant to achieve a reasonable return while minimizing risk.[14] Notably, these regulations provide that a participant's exercise of control over the investment of the assets in his/her account does not relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan.[15]

Liability for Breach of Investment Fiduciary Obligations as to Self-Directed 401(k) Plans

With increasing frequency, plan sponsor decisions regarding the composition of the pool of investment options available to participants in a self-directed 401(k) plan have been the subject of ERISA class action lawsuits alleging breaches of fiduciary duty and violations of ERISA's prohibited transaction rules.[16] Many of the claims involve previously common practices, such as the use high-cost "retail" funds when lower-cost "institutional" funds were available to the plan, limiting available investments to options offered by a single investment provider and including funds that impose additional costs on participants because the fund pays hidden internal fees to record keepers. Although plan sponsors have met with some success in such suits, the highly factual nature of the claims makes it difficult to obtain an early dismissal. Further, the U.S. Supreme Court's relatively recent holding in *Tibble v. Edison International, et al.*,[17] that a plan investment fiduciary's duties include a continuing duty to monitor plan investments and remove imprudent investments after the initial selection process has been completed, has increased the frequency of such suits.

Claims against plan sponsors for breach of fiduciary duty have succeeded when the evidence reflects that the plan sponsor failed to prudently investigate the costs associated with specific investment options or associated services, such as record keeping, before putting the options into place.[18] Some federal circuit courts have held that the plan sponsor's inclusion of high-cost funds among a self-directed 401(k) plan's investment options was not a breach of fiduciary duty when a wide range of investment options with varying risk profiles and expense ratios were made available to participants.[19] Nonetheless, panels within the Sixth Circuit have opined, in cases challenging the inclusion of employer stock as an investment option, that the safe harbor for self-directed 401(k) plans does not relieve the plan

sponsor of its duty of prudence in selecting and monitoring the menu of investment options offered.[20] Also, where only a limited menu of funds was offered and the plan sponsor allegedly failed to prudently monitor and replace underperforming, high-fee funds, the plaintiffs adequately pled a claim for breach of fiduciary duty.[21]

Several of the class action lawsuits filed against self-directed 401(k) plan sponsors have resulted in settlements in excess of $10 million. Under ERISA §409(a),[22] a person who breaches any fiduciary duty imposed by ERISA or who violates the prohibited transaction rules is personally liable to restore to the plan any losses resulting from the breach, as well as any profits the fiduciary may have gained through the fiduciary's use of plan assets. In addition, the fiduciary may be subject to other equitable or remedial relief as a court deems appropriate. Notably, although recovery under this provision belongs to the plan, ERISA's civil enforcement provisions allow recovery for a fiduciary breach that impairs the value of plan assets in a participant's individual account.[23] Thus, self-directed 401(k) plan participants may sue to obtain the restoration of lost investment return to their plan accounts. Prevailing parties in civil enforcement actions may also receive an award of attorney's fees and costs.[24]

The Impact of Reliance upon Investment Professionals on the Plan Sponsor's ERISA Investment Fiduciary Obligations

Many plan sponsors believe they may fully address their investment fiduciary obligations to their self-directed 401(k) plans by retaining and relying upon various types of investment professionals to assist in the performance of those duties. Such an investment professional is typically a sales representative of an investment provider or a registered investment advisor employed by a brokerage firm, insurance company, bank or an affiliate of an investment provider. Nonetheless, most plan sponsors overlook important legal considerations in establishing and maintaining a relationship with such an investment professional.

First, one of the plan sponsor's ERISA fiduciary duties is to prudently investigate potential plan investment advisors before making a selection decision. Such an investigation should include consideration of each advisor's qualifications, services offered, fees for services and investments, and potential conflicts of interest that may constitute a prohibited transaction.[25]

Second, the investment advisor retained by the plan sponsor may or may not be considered an ERISA investment fiduciary and, in many cases, his or her advice likely does not relieve the plan sponsor of its own investment fiduciary obligations. The plan sponsor may delegate specified plan investment duties to an "investment manager" as defined in ERISA §3(38).[26] An "investment manager" is a fiduciary other than a named fiduciary who: 1) has the power to acquire, manage or dispose of any plan asset; 2) is a registered investment advisor under the Investment Advisers Act of 1940 or is a bank or an insurance company; and 3) has acknowledged in writing that it is a fiduciary as to the plan.[27] When investment fiduciary duties are delegated to an ERISA investment manager, the plan sponsor is not liable for the acts or omissions of the investment manager as to the management of the plan's assets.[28] The plan sponsor does, however, continue to have a fiduciary duty to monitor the investment manager. Most investment service providers to self-directed 401(k) plans will not propose that they be retained as ERISA investment managers, and if such services are offered, the fee will be greater than for other investment advice arrangements.

An investment professional may also propose to provide "non-discretionary" investment advisory services for which it acknowledges that it is a functional fiduciary under ERISA §3(21)(A).[29] Typically, the services proposed will fall within the scope of ERISA §3(21)(A) because the advisor either 1) exercises authority or control respecting management or disposition of plan assets, or 2) renders investment advice for a fee or other compensation as to any plan assets, or has any authority or responsibility to do so. An advisor

who actually performs these functions may be liable as a co-fiduciary for any breach of investment fiduciary duty. Nonetheless, the plan sponsor continues to have fiduciary responsibility for its decisions to act on the investment advice provided by such a non-discretionary investment advisor.[30]

Notably, many investment providers and brokers offering platforms of investment options to self-directed 401(k) plans provide investment services that do not rise to the level of investment advice within the meaning of ERISA §3(21)(A). Rather, such investment professionals offer large menus of investment products from which the plan sponsor selects the actual investment options to be offered to participants, as well as fund performance information and generic commentary regarding specific funds or fund managers. Several federal courts have held that engaging in such activities does not make the investment professional a functional fiduciary within the meaning of ERISA §3(21)(A).[31]

Also, service agreements proposed by many investment professionals include disclaimers that are intended to support later arguments that the investment professional is not an ERISA §3(21)(A) investment fiduciary. U.S. DOL regulations currently in effect provide that a person renders "investment advice" if that person gives advice on the value of securities or property, makes recommendations about buying or selling securities or property, or makes a recommendation as to the advisability of buying or selling securities or property, and directly or indirectly 1) has discretionary authority or control, whether or not under an agreement, as to buying or selling securities or property for the plan; or 2) renders such advice to the plan on a regular basis under a mutual agreement that such services will serve as the primary basis for investment decisions as to plan assets and that the person will render individualized investment advice to the plan based upon the particular needs of the plan as to matters including the plan's investment policy or strategy, portfolio composition or diversification of plan assets.[32] Standard services agreements may include provisions stating that the plan sponsor agrees that any investment advice provided will not serve as the primary basis for the plan sponsor's investment decisions or that the investment advice provided will not be individualized to the particular needs of the plan. Often, such agreements provide inadequate indemnification of the plan and plan sponsor for the investment professional's acts or omissions.

Regulations scheduled to become effective on April 10, 2017, will broaden the definition of "investment advice."[33] Nonetheless, the regulations exclude from the definition of investment advice offering a non-individualized investment platform from which the plan sponsor can select or monitor investment alternatives, assistance in identifying investment alternatives that meet objective criteria selected by the plan sponsor, or providing to the plan sponsor objective financial data and comparisons or general market data.[34] Further, in light of the recent change in administration, questions have been raised regarding the future viability of these regulations. Thus, practitioners advising clients regarding the terms of investment professional service agreements should take into account the possibility that the regulations scheduled to take effect on April 10, 2017, may not ultimately govern the parties' relationship.

Conclusion

Counsel advising sponsors of self-directed 401(k) plans should remind clients that they retain investment fiduciary obligations for such plans and that those obligations extend to careful, documented due diligence in the selection and monitoring of the investment options offered to plan participants. Similarly, the selection of plan investment service providers should involve an investigation and an objective, documented comparison of several candidates. The selection decision should also be revisited periodically to confirm that the provider's services and costs continue to represent a prudent choice. Investment professional service agreements should be carefully evaluated by counsel to ensure that contract provisions accurately reflect the proposed services and that appropriate

indemnification and insurance protections for the plan and plan sponsor are included in the agreement.

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Footnotes

1 29 USC §1001, *et seq.*
2 29 USC §1002(2), ERISA §3(2).
3 29 USC §1002(16), ERISA §3(16).
4 29 USC §1002(21)(A), ERISA §3(21)(A).
5 29 USC §1102(a), ERISA §402(a).
6 29 USC §1104(a)(1), ERISA §404(a)(1).
7 *Id*.
8 *See, e.g.,* 29 CFR §2550.404a-1, *Gregg v. Transportation Workers of America International*, 343 F3d 833, 842 (6th Cir, 2008); *Chao v. Hall Holding, Inc.,* 285 F3d 415, 425 (6th Cir, 2002).
9 29 USC §1106, ERISA §406.
10 29 USC §1002(14), ERISA §3(14).
11 29 USC §404(c), ERISA §404(c).
12 29 USC §404(c)(1)(A), ERISA §404(c)(1)(A).
13 29 CFR §404c-1(b)(3)(i).
14 *Id.*
15 29 CFR §404c-1(d)(2)(iv); *Tibble v. Edison International, et al.*, 135 SCt 1823 (2015).
16 *See* 29 USC §1106, ERISA §406.
17 135 SCt 1823(2015).
18 *See, e.g., Braden v. Wal-Mart Stores, Inc.,* 588 F.3d 585 (8th Cir, 2009) [holding that complaint alleging that plan sponsor breached its fiduciary duties by selecting as investment options "retail" funds and funds that charged 12b-1 fees when lower cost "institutional fees" were available to plan]; *Tussey v. ABB, Inc.,* 746 F3d 327 (8th Cir, 2014) [upholding breach of fiduciary duty claim against plan sponsor based on failure to investigate excessive recordkeeping fees before they were allowed]; *Tibble v. Edison International, et al.,* 729 F3d 1110 (9th Cir, 2013), vac'd on other grounds, 135 SCt 1823 (2015) [holding that plan sponsor's decision to include certain "retail" funds as investment options was imprudent based on absence of evidence that plan sponsor investigated the decision].
19 *Hecker v. Deere & Company*, 556 F3d 575, 586 (2009); *Renfro v. Unisys Corporation*, 671 F3d 314, 326-327 (3rd Cir, 2011).
20 *Griffin v. Flagstar Bancorp, Inc.,* 492 Fed Appx 598, 602 (6th Cir, 2012), citing *Pfeil v. State Street Bank and Trust*, 671 F3d 585, 597 (6th Cir, 2012).
21 *Braden v. Wal-Mart Stores, Inc.,* 588 F3d 585, 595-596 (8th Cir, 2009).
22 29 USC §1109.
23 9 USC §502(a)(2), ERISA §502(a)(2), *LaRue v. DeWolff, Boberg & Associates, Inc.*, 552 US 248, 256 (2008).
24 29 USC §502(g)(1), ERISA §502(g)(1).
25 *Gregg v. Transportation Workers of America International*, 343 F3d 833, 841 (6th Cir, 2003).
26 29 USC §1002(38).
27 *Id.*
28 29 USC §1105(d), ERISA §405(d).
29 29 USC 1002(21)(A).
30 *Tibble v. Edison International, et al.*, 729 F3d 1110, 1134 (9th Cir, 2013), vac'd on other grounds, 135 SCt 1823 (2015).
31 *Hecker v. Deere & Company*, 556 F3d 575, 583-584 (2009); *Leimkuehler v. American United Life Insurance Company*, 2012 WL 28608 (SD Ind, 2012); *Walker v. Merrill Lynch & Co.*, 181 F Supp 3d 223, 232-233 (SD NY, 2016).
32 29 CFR §2510.3-21(j)(1)(i).
33 29 CFR §2510.3-21(a). In conjunction with these regulations, the DOL also issued PTE 2016-01, which provides a limited exemption from the prohibited transaction rules for the receipt of certain types of compensation by investment advisors and financial institutions for providing investment advice to retirement investors.
34 29 CFR §2510.3-21(b)(2).