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ERISA PLANS

What Is Your Fiduciary Responsibility?

By Betsy Piper/Bach, JD, CIMA®, CFP®, CTFA

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ERISA PLANS

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WHY SHOULD YOU CARE ABOUT ACTING AS A FIDUCIARY TO AN ERISA PLAN?

The liability due to failure in carrying out the role as a fiduciary can be very harsh and result in multiple possible penalties, which may be imposed personally on the individual fiduciary, not just the employer. The penalties are imposed in order to make the plan whole. If applicable, additional civil penalties follow. Clean heart but empty mind is no excuse.

This informational document will provide insight regarding the following:

- What is an ERISA plan?
- Who is a fiduciary?
- What are the duties of a fiduciary?

WHAT IS AN ERISA PLAN?

QUALIFIED AND NONQUALIFIED RETIREMENT PLANS

Retirement plans can be considered either qualified retirement plans or nonqualified retirement plans. Qualified plans are created are created under various sections of the Internal Revenue Code §401 (Code) and are governed by the Employee Retirement Income Security Act of 1974 (ERISA). Nonqualified plans also may be governed to some extent by both the Code and ERISA. By combining the Code and ERISA you have the world of employer-provided retirement.

Qualified plan. A qualified ERISA plan is a plan that meets both the applicable Internal Revenue Code requirements as well as numerous requirements of Title I of ERISA. These plans generally provide a combination of certain favorable tax treatments, including deductible contribution and tax-deferred growth.

Nonqualified plan. A nonqualified ERISA plan is a plan that does not meet the applicable qualified plan requirements of the Code. These plans still may be regulated to some extent by Title I of ERISA. These are nonqualified deferred compensation plans and generally are exempt from ERISA. An unfunded rabbi trust is one example of a nonqualified deferred compensation plan.

There are plans that meet the Code requirements but are not ERISA plans, i.e., individual retirement accounts (IRAs), 403(b) plans, and 457 plans. For purposes of this document, we will be speaking specifically to qualified ERISA plans.

WHY WAS ERISA ENACTED?

ERISA was enacted to "protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by:

- requiring the disclosure and reporting to participants and beneficiaries of financial and other important information with respect to the plans,
- establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and
- providing for appropriate remedies, sanctions, and access to the Federal courts."[1]

It all began with the Studebaker Corporation. Early in the 1950s, both the House and Senate were conducting investigations into abuses occurring within employee benefit plans. The Douglas-Ives bill resulted and became the basis for the Welfare and Pension Plans Disclosure Act. The Act was the first attempt at requiring full disclosure to participants and beneficiaries of the provisions of their plans and the plans' financial operations. In 1962, U.S. President John F. Kennedy formed a cabinet-level committee known as the Committee on Corporate Pension Funds and other Private Retirement and Welfare Programs that he challenged with the task of reviewing the influence that the growing retirement and welfare funds would have on the economy. It was while this committee was in place that the Studebaker plant closed and poured oil on the fire.

Studebaker closed its automotive manufacturing plant in South Bend, Indiana, in 1963 after a long period of losing money. Before closing, 2,000 workers already had lost their jobs; an additional 5,000 lost their jobs at the time of the closing, and 1,800 more lost their jobs afterward. The termination plan put the workers into three categories: (1) over 60 years of age who received full claim to assets; (2) 40–59 year-olds who received 15 cents on the dollar; and (3) all of the rest who received nothing. One worker who was a few months short of 60 received 15 cents on the dollar and had worked at Studebaker for 43 years.

How can this happen? In this situation the collectively bargained agreement included unfunded liabilities for past service. Each time the agreement increased benefits to current employees, it resulted in increasing past service credits to former employees, which then were amortized over the ensuing 30 years. This would have worked well for an ongoing viable entity, but Studebaker was not one of those entities. It closed the auto plant and terminated the plan. It should be duly noted that Studebaker, the corporation, was solvent; it was the plan that did not have the funds to meet the demand.

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The pension promise ran from the plan, not from the plan sponsor, Studebaker.

This event was the crowning blow. Congress became deeply involved in attempting to rectify the condition of the pension industry. Committees and legislation began to flow. Two weeks after Chairman Sen. John McClellan of the Senate Permanent Subcommittee on Investigations investigated a union plan diversion of $4 million into two so-called charitable corporations in Liberia and Puerto Rico, Sen. Jacob K. Javits of the Government Operations Committee introduced a bill to impose fiduciary standards on public employee-benefit funds. Sen. McClellan followed with a bill that amended previous legislation and applied fiduciary standards on all plans, both public and private.

In 1967, the Welfare and Pension Plan Protection Act provided for both fiduciary roles and disclosure requirements. Then Javits introduced a bill that addressed: vesting, funding plan-termination insurance, and voluntary allowance of portability of the funds. A Securities and Exchange Commission (SEC)-type independent commission would administer the regulation.

Five years later the proposed bill still was being debated. Consumer advocate Ralph Nader condemned private pensions and recommended creating SEC-type funds that would manage employee and employer contributions alike. He felt the previously proposed congressional bill was the result of the pension industry and organized labor crafting legislation to promote their own agendas. After many further debates the Committee on Labor and Public Welfare began working with the Joint Committee on Taxation, and the Department of Labor (DOL) assumed oversight from the SEC. Leadership from both sides of the aisle led the various aspects of legislation-creation through the administrations of U.S. Presidents Kennedy, Lyndon Johnson, Richard Nixon, and finally Gerald Ford. It was Ford's timing in history that allowed his signature on the Employee Retirement Income Security Act of 1974 (ERISA).[2]

WHAT PLANS ARE COVERED BY ERISA GUIDELINES?

Pension and welfare benefit plans are covered by ERISA.

Pension plans can be:

- 401(k) plans
- Defined benefit plans
- Defined contribution plans
- Money purchase pension plans
- Profit sharing plans
- Target benefit plans

Welfare benefit plans are:

- Day care plans
- Death and disability funds
- Dental plans
- Medical plans
- Prepaid legal service plans
- Scholarship funds
- Unemployment plans
- Vacation benefits plans
- Workers' compensation

IRAs, 403(b) plans, and 457 plans are not ERISA plans and are subject only to the prohibited transactions guidelines of the Internal Revenue Service (IRS) Code.

Government plans, churches, and non-qualified compensation plans are exempt from the ERISA guidelines, but they may have state-specific guidelines that will apply.

WHO IS A FIDUCIARY?

The role of a fiduciary is guided by statutes, rules, advisory opinions, private letter rulings, technical releases, all overseen by the DOL, the IRS, and the Pension Benefit Guaranty Corporation as well as case law provided by the courts.

A full scope 3(21) fiduciary is the role of the fiduciary who:

- Exercises discretionary authority or control with respect to the management of a plan,
- Exercises any authority or control respecting management or disposition of plan assets,
- Has discretionary authority or responsibility in the administration of the plan, or
- Provides investment advice for a direct or indirect fee with respect to money or property of the plan.[3]

Named fiduciary. Other terms are linked to this definition of fiduciary. A named fiduciary is a fiduciary named in the written plan document that governs the ERISA plan. This individual may be directly named or the plan might provide a procedure whereby the individual later can be identified by a person who is an employer or employee organization with respect to the plan.[4] The named fiduciary directs other fiduciaries in areas in which the named fiduciary is not able to function as an "expert."

Functional fiduciary. An individual may become a fiduciary as a result of the functions he or she performs for the plan. That is, individuals who have discretionary authority over the management of the plan, its assets, or provides investment advice for a fee, directly or indirectly, are fiduciaries.[5] A consultant may become a functional fiduciary quite easily in carrying out day-to-day responsibilities in regard to plan assets.

An investment consultant may become a fiduciary if the consultant renders individualized advice based on the particular needs of the plan regarding:

- investment policies or strategies,
- overall portfolio composition, or
- diversification
- when there is an understanding with the client that the consultant's services will serve as the primary basis for the investment decision in relation to the plan.

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ERISA states that a person will be a fiduciary to an ERISA plan in which participants are directing their own investment choices if they provide advice "for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority to do so."

SO WHAT CONSTITUTES INVESTMENT ADVICE?[6]

1. Advice to the participant or beneficiary is in regard to the value of securities or other property

   OR

   Recommends the advisability of investing in, purchasing, or selling securities or other property;

   AND

2. The person, either directly or indirectly:

   Has discretionary authority or control as to purchasing or selling securities or other property

   OR

   Renders the advice on a regular basis according to a mutual agreement or understanding (written or otherwise) that the advice will serve as a primary basis for the investment decisions with respect to plan assets;

   AND

3. That such person will render individualized advice based on the particular needs of the individual.[7]

WHAT IS *NOT* INVESTMENT ADVICE?[8]

Avoiding "advice" and recommendations" are the key terms to avoiding providing investment advice. Providing education is acceptable. For purposes of ERISA, education is defined as:

1. Plan information regarding the terms of the plan and the description of the investment choices
2. General financial and investment information as to investment concepts and economic information
3. Asset allocation models
4. Interactive investment materials

A real-life court decision regarding a broker who unwarily became a fiduciary through his day-to-day relationship with a trustee may serve as some bright-line guidance to consultants. An Edward Jones broker had been meeting with a trustee of a small plan for more than twenty years. The broker would discuss the assets in the plan with the trustee, notify the trustee to invest when cash had built up, and lastly, occasionally would discuss rebalancing. All investments were completed only upon the direction of the trustee. The court found that the trustee had learned to rely on the advice of the broker and, as such, the broker had become a fiduciary.[9]

An investment consultant, therefore unwittingly, may become a functional fiduciary by providing regular advice, without a written agreement, upon which the client relies.[10]

Co-fiduciary. This is the result of a plan having more than one fiduciary. For instance, a plan might have three co-fiduciaries if there is a plan administrator, an investment adviser, and a trustee. If each carries discretionary authority over some part of the plan, they will be fiduciaries for their specific role and co-fiduciaries for the other roles. If they become aware of a breach of fiduciary liability by another fiduciary, ERISA states that the fiduciary can be jointly liable for the breach if they knowingly undertake to conceal it or do not make reasonable efforts to remedy it. Additionally, if they fail to comply with their own duties under ERISA and it further enables another fiduciary to commit a breach, there will be liability on the part of the co-fiduciary.[11]

THE FIVE DUTIES OF A FIDUCIARY

- Duty #1: Loyalty
- Duty #2: Documentation
- Duty #3: Prudence
- Duty #4: Diversification
- Duty #5: Reasonable Plan Expenses

These responsibilities must be carried out in accordance with the documents of the plan.[12]

DUTY #1: LOYALTY

The duty of loyalty, also called the "exclusive benefit rule," means the fiduciary's actions must be solely in the interest of the participants and beneficiaries and must be for the sole purpose of providing benefits to the individual participants and their beneficiaries as well as ensuring that expenses for administering the plan are reasonable.

The duty of loyalty further prohibits a fiduciary from receiving a benefit as a result of its relationship with an ERISA client. The prohibited transactions rule provides guidelines about what types of activities result in a transaction being found to be for the fiduciary's own benefit and to the detriment of the client. Prohibited transactions apply to a party-in-interest.

What is a party-in-interest?

Dealing with a party-in-interest is a prohibited transaction. A party-in-interest is any individual or corporate entity that is acting as a plan fiduciary:

- Service providers
- Officers and directors of an entity that is a party-in-interest
- Named fiduciaries
- Lawyers
- Investment managers
- Brokers
- Investment consultants
- Accountants
- Administrators
- Relatives of the above

What is a prohibited transaction?

In general, a prohibited transaction may occur when a fiduciary does the following:

- Deals with the plan assets in their own interest
- Represents anyone with an interest adverse to the plan or its beneficiaries in any transaction involving the plan
- Receives consideration from any person dealing with the plan and in connection with plan assets

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- Receives direct or indirect benefits from the assets of the plan

A few specific examples of possible prohibited transactions include:

- Lending money between plan and a party-in-interest
- Self-dealing by a fiduciary
- Trustee as fund administrator receiving administrative fees and not offsetting the plan expenses
- Fiduciary receiving 12b-1 fees in addition to regular administrative fees
- Service provider providing administrative services and whose affiliate receives commissions on brokerage services

What is not a prohibited transaction?

A few transactions that are not prohibited include:

- Certain short-term investments by a plan with parties-in-interest such as investing in the commercial paper of the company of the plan[13]
- Affiliate trust company and brokerage firms are hired to be a trustee to plan assets and receive directed commissions when the assets are under the control of an independent fiduciary[14]
- Reasonable arrangements such as legal and accounting services[15]
- Receiving 12b-1 fees and reducing fees to the plan by the amount of 12b-1 fees received[16]
- Broker-dealer providing advice will not cause the broker-dealer to be considered an investment adviser or having control over the plan[17]
- Lending securities by plans to banks and broker-dealers who are parties-in-interest to the plan[18]
- Exemptions allow plan fiduciaries, usually broker-dealers (who are not plan administrators or sponsoring employers), to execute securities transactions on behalf of a plan, subject to certain conditions. An amendment now permits plan fiduciaries that are discretionary trustees (previously excluded from relief) to execute securities transactions on behalf of a plan.[19]
- Various transactions involving employee benefit plans with assets that are managed by in-house managers.[20]

What about directed commissions and soft-dollar payments?

Directed commissions and soft-dollar payments also may bring DOL scrutiny. As to the investment manager, they are allowed to receive research services from a broker-dealer and "pay" for those services through directing transactions to that broker-dealer when the commissions paid are reasonable for those services. The manager must disclose these arrangements in its investment advisory filing (ADV). These are the requirements of the 1934 Exchange Act Section 28(e), also called the "28(e) safe harbor."[21]

This safe harbor also requires the benefit of the services to inure to the client and not solely to the money manager. Items such as parking, meals, travel, and accounting expenses of the manager inure solely to the money manager and will not be considered to fall under the safe harbor.

This safe harbor does not apply to plan sponsors. Under ERISA the plan sponsor limits their liability as to soft dollars and directed commissions by:

- Making the decision prudently and solely in the interest of the participants and beneficiaries
- Determining whether the broker-dealer can provide best execution
- Monitoring the transactions to ensure the fees are reasonable[22]

DUTY #2: DOCUMENTATION

What parts of the plan should be in writing? The benefit plan must be in writing. The investment policy statement should be in writing. The DOL has said that "the maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA."[23] It should provide general guidelines concerning various types or categories of investment management decisions.[24]

The investment policy statement should be in writing as a way for a fiduciary to meet obligations and legally defend future actions. Although investment policies and investment manager guidelines are not required by law, every plan will be asked for them during a DOL audit because they are recommended through DOL Interpretive Bulletins. The investment policy statement is the foundation upon which investment goals, manager evaluation, and monitoring will be based. The policy should be specific enough to establish the basis upon which the performance of the plan assets will be measured and evaluated.

What should an investment policy statement include?

During a DOL audit, the policy will be reviewed for the following:[25]

- Specific needs of the plan and its participants
- Statement of investment objectives and goals
- Standards of investment performance/benchmarks
- Classes of investments authorized
- Styles of investments authorized
- Diversification of portfolio
- Restrictions of investments
- Directed brokerage, if part of the trading procedure
- Standards for reports by investment managers and consultants
- Policies and procedures for hiring investment managers
- Disclosure of actual and potential conflicts
- Risk tolerance factors
- Time horizon
- Liquidity requirements
- Asset allocation guidelines
- Cash-flow requirements of the plan
- Proxy voting policy
- Procedure for selecting "prudent experts"
- Procedure for monitoring "prudent experts"

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Best practices takes this list a step further and recommends to include the following in an investment policy:[26]

- Executive summary
- Mission and purpose
- Scope of investment policy
- Delegation of authority for trustees, investment committee, consultants, and investment managers
- Goals of the institution
- Section of alternative assets
- Asset allocation guidelines including inputs documentation and rebalancing policy
- Investment manager selection and evaluation process
- Investment policy monitoring
- Fees and operating cost analysis
- Investment policy review

Who votes the proxies?

Defined benefit plans. ERISA does not specifically lay out fiduciary responsibilities regarding proxy voting, but the DOL does consider the voting of the proxies a fiduciary act of the management of the plan assets. Proxies are considered an asset of the plan and need to be voted in a manner that supports the shareholders of the company. The named fiduciaries are required to vote the proxies for the benefit of the shareholder; in this case the plan itself is the shareholder. If an investment manager has been appointed, then the investment manager is assigned the voting responsibility within the management agreement. The investment policy statement will provide guidelines to the investment manager regarding the voting of the proxies.

An investment fiduciary of the plan must have the ability to review the voting acts and the procedures of the investment manager. In completing this review the fiduciary will want to review how proxies are voted, the basis for the decisions, and whether the manager's voting was influenced by an interested party, i.e., the management of the company whose proxies the investment manager is voting. The investment manager must always vote proxies on behalf of the interests of the plan, not in his own interests. A system of voting oversight and policies is the best way to ensure compliance with ERISA. Proxy voting guidelines are available from investment managers. The proxy voting record related to a specific plan is available upon request. The investment consultant with access to in-depth research tools can be of great value to a retirement plan by being able to provide this oversight.

Defined contribution plans. Defined contribution plans pass the fiduciary responsibility for voting proxies on to participants for mutual funds. Should company stock be an investment election, the responsibility for voting is charged to the named fiduciary. Oftentimes there is an inherent conflict with company stock as an asset in the company's retirement plan. Voting of proxies always should be in the interest of the participants, but because management may be the named fiduciary of the plan for voting proxies, management may find it difficult to vote for only the interest of the participants. By creating proxy guidelines as part of the plan documents and voting per the guidelines, the named fiduciary can provide itself some protection. Another alternative is to ensure that the company's management is not on the investment committee responsible for voting its own company's proxies.

As in defined benefit plans, an investment fiduciary of the plan must have the ability to review the voting acts of the named fiduciary. Company stock voting records should be scrutinized carefully.

DUTY #3: PRUDENCE

The prudent investor rule traces its history to the Supreme Court of Massachusetts and an 1830 case, *Harvard College v. Amory Trustees*. The decision instructed the trustees to "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[27]

ERISA applies a revised and restated version of the prudent investor rule to pension and profit-sharing portfolios. Actions must be discharged "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims."[28]

The words "familiar with such matters" were added and have become known as the "prudent expert rule" of ERISA. To fiduciaries this means that if they are unable to carry out their responsibilities at the level of someone familiar with such matters, they need to prudently hire someone familiar with such matters and prudently oversee them as they carry out those job functions.

It is this prudence standard that incorporates trust-investment law into ERISA and requires the application of the Uniform Prudent Investor Act to ERISA plans.[29]

Applying the prudent expert rule to investment functions, the fiduciary hires an investment manager who will accept, in writing, fiduciary responsibility for investment decisions, but the fiduciaries responsible for hiring the investment manager do not give up their entire liability for the investments; they must prudently oversee the investment manager, which they can do through monitoring and reporting on the actions of the investment manager.[30]

Choosing an Investment Manager

Much of the fiduciary's liability can be avoided if a professional investment manager is appointed. If an investment manager, as defined by ERISA under §3(38), is prudently selected in accordance with a written investment policy statement, assumes discretion as to investment management of plan assets and then is prudently monitored, the trustees' liability should be minimized for investment decisions.[31]

Other fiduciaries generally are not liable as co-fiduciaries for any acts or

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omissions of the investment manager when an investment manager has been prudently delegated discretionary authority over the investment of plan assets and the fiduciaries prudently monitor the investment manager through a reporting, monitoring, and evaluation procedure. Liability will remain if the fiduciary knowingly takes part in or conceals a breach of fiduciary responsibility by the manager.

Monitoring the investment manager

At reasonable periods the performance of the appointed third-party fiduciaries should be reviewed in a manner that can be expected to ensure compliance to their fiduciary responsibilities. The facts and circumstances guide the method by which the review should occur.[32] We can apply this to investment managers who are hired as third parties to accept the fiduciary responsibility for the investments of the plan. In order to determine if they are conducting their responsibility appropriately, a review should include, at a minimum, the following:

1. Manager's performance compared to the benchmark and peers
2. Commission rates charged
3. Soft-dollar usage
4. Best execution
5. Material changes in the investment manager's firm both in personnel and assets
6. Proxy voting record
7. Fair valuation issues
8. Regulatory exams
9. Policy or procedures changes
10. Code of ethics changes
11. Conflicts of interest
12. Disaster recovery plan/business continuity plan
13. ADV Part 2A and 2B
14. Account losses/gains

Keep in mind that an investment consultant is one of those third-party delegates and also will have their performance monitored by the trustees.

DUTY #4: DIVERSIFICATION

Investments must be diversified to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.[33] Diversification must be considered in the context of the entire portfolio and as a part of the overall strategy considering the appropriate risk and return. Consider the following elements as applied to the assets being managed:

1. Purpose of the plan
2. Size of the account
3. Type of investments
4. General economic conditions
5. Distribution as to geographical area
6. Distribution as to industries
7. Time horizon

The investment policy statement will set forth specific asset classes to be included in the investment portfolio. Once these asset classes have been chosen, it is important to then diversify within the asset class. ERISA does not outline the requirements of diversification, but the House Conference Report regarding the statute does say "a fiduciary usually should not invest the whole or an unreasonably large proportion of the trust property in a single security."[34] Case law continues to provide the best guidance on what is not construed to be diversification.

What impacts diversification?

The concept of risk versus return is pervasive in the investment business and nowhere is it weighed more heavily than in the management of employee benefit plans. The duty to act prudently applies to the entire portfolio, not each single investment. Thus, one stock that turns out to be disastrous should not present a problem. The key is whether the impact on the total portfolio is appropriate for the plan and its objectives.

The DOL specifies the following three basic criteria to use in evaluating the risk and return characteristics of investment alternatives that are appropriate to the total portfolio:

1. Liquidity
2. Diversification
3. Return and safety

To evaluate alternatives, objective standards must be set forth against which to measure the alternatives. Effectively, this is a two-step process. First, the investment policy must be developed and each asset class determined. These decisions should be in writing as a method for future evaluation for meeting predetermined investment objectives. Second, the most suitable investments or, alternatively, the choice of a qualified investment manager must be selected.[35]

Suitable investments

Criteria for choosing the investments are based on the facts and circumstances you should know are relevant for each defined benefit plan.[36]

1. What is the purpose of the plan?
2. How many assets are in the plan?
3. What are the financial and industrial conditions that apply to this plan and these participants?
4. What types of asset classes of investments will be in the plan (e.g., mortgages, bonds, blue chip stocks, or international stocks)?
5. Where are all the investments geographically located?
6. Across how many industries do the investments reach?
7. What are the dates of maturities of the bonds?
8. What is the prevailing rate of return in the market for each asset class?
9. Is there a concentration in any single security?

In choosing alternative asset classes for diversification (stocks, bonds, etc.), the fiduciary should rely on general financial and investment concepts, accepted investment theories including historic returns between asset classes over various time periods, and effects of inflation. For each investment made, another investment cannot be made. Thus, in choosing an investment for each asset class a choice impacting diversification would not be prudent if it is commensurate in risk with another choice but its returns are lower.[37]

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Guidelines suggest a minimum of election choices that allow diversification with materially different risk and return characteristics and minimize the risk of large investment losses.[38] From this level the additional choices become a choice of preference of the plan.

Most plans offer:

- Stock funds
- Bond funds
- Money market funds

Other plans offer:

- Sector funds
- Employee stock funds
- Brokerage window accounts

What is the fiduciary role under ERISA 404(c) as to defined contribution plans?

Fiduciaries have full responsibility for the operation and administration of a plan. But ERISA carves out an exception to this responsibility under ERISA 404(c) for self-directed defined contribution plans, which includes many 401(k) plans. When a plan provides for individual accounts and a participant or beneficiary exercises control over these assets by being able to invest in a broad range of investment alternatives (and the other requirements of ERISA section 404(c) are satisfied), the plan fiduciary will not be liable for any loss as a result of the participant or beneficiary controlling the assets in the account.

Exercising control. The participant must have the opportunity to receive sufficient information to enable them to make informed decisions. Secondly, they must have a reasonable opportunity to give the plan fiduciary investment instructions to be carried out on the participant's behalf.

Broad range of investment elections. The participant must be able to choose from investments that do the following:

1. Materially affect the potential return of the investments
2. Materially affect the degree of risk to which the investments are subject
   a. A minimum of three different investment alternatives is required, "each of which has materially different risk and return characteristics," which allows for diversification[39]
   b. In the aggregate, the participant should be able to create a risk and return characteristic that, when the investments are combined, should be able to minimize the overall risk of the portfolio
3. Diversify the portfolio so as to minimize the risk of large losses taking into consideration the nature of the plan and the size of the participant's account

DUTY #5: REASONABLE PLAN EXPENSES

In order to determine whether the fees being charged to the plan are reasonable, it is necessary to create a process by which you can determine the services needed by your plan and review the fees and expenses related to these services, both direct and indirect. That is, will you need accounting services, legal services, recordkeeping, compliance, custody, and/or fiduciary services? How many reports, educational meetings, or onsite visits? Will there be electronic delivery or paper delivery of documents? The service agreement with your providers will disclose the services the record-keeper or third-party administrator will be providing. The DOL issued two new rules in 2013 in order to aide in the transparency of fee disclosures.

Service Provider Disclosure Rule 408(b)(2)

Rule 408(b)(2) establishes, for the first time, specific disclosure obligations for plan service providers to ensure that responsible plan fiduciaries are provided the information they need to make better decisions when selecting and monitoring service providers for their plans.

The rule, which was effective July 1, 2012, requires covered service providers (CSPs) to provide responsible fiduciaries with information they need to:

1. Assess reasonableness of total compensation, both direct and indirect, received by the CSP, its affiliates, and/or subcontractors;
2. Identify potential conflicts of interest; and
3. Satisfy reporting and disclosure requirements under Title I of ERISA. The disclosure must describe the services to be provided and all direct and indirect compensation to be received, and it must be furnished in writing to a responsible plan fiduciary for the covered plan.

The rule applies to the following covered service providers:

1. ERISA fiduciary service providers to a covered plan who expect at least $1,000 in compensation to be received for the services provided to the plan;
2. Plan asset vehicle in which a covered plan invests;
3. Investment advisers registered under federal or state law;
4. Recordkeepers or brokers who make designated investment alternatives available to the covered plan (e.g., a platform provider);
5. Providers of one or more of the following services to the covered plan who also receive indirect compensation in connection with such services: accounting, auditing, actuarial, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities brokerage, third-party administration, or valuation services.

Ongoing disclosure obligations generally must be disclosed as soon as practicable, but no later than 60 days from when the CSP is informed of such change. Disclosures of changes to investment-related information are to be made at least annually.[40]

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Participant Disclosure Rule 404(a)(5)

The participant disclosure rule was effective August 30, 2012, and provides that the investment of plan assets is a fiduciary act governed by the fiduciary standards in ERISA. The rule is designed to assist a participant or beneficiary to be able to make informed decisions regarding the plan and investment fees as they invest their contributions into their retirement plan. The types of plan and investment-related expenses fall into the following categories:

1. Plan-related information
2. Statements of actual charges or deductions
3. Investment-related information

Plan-related information must be given to participants on or before the date they can first direct their investments, and then again annually thereafter. This information includes:

1. General plan information includes the structure of the plan and list of the investments;
2. Administrative expenses are expenses that may be charged to individual accounts such as legal, accounting, recordkeeping; and
3. Individual expenses are fees caused by the participant/beneficiary such as charges related to a loan.

Statements of actual charges or deductions must be furnished up front and annually. Participants also must receive statements, at least quarterly, showing the dollar amount of the plan-related fees and expenses actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made.

Investment-related information must be furnished concerning each investment option on or before the date the participant can first direct their investments, and then again annually thereafter. This includes:

1. Performance data;
2. Benchmark information for the variable returns;
3. Fee and expense information;
4. Internet website address for additional investment information;
5. Glossary or Internet access to a glossary for investment-related terms.
6. Comparative format requirement must be furnished, which provides the investment-related information in a chart or similar format designed to facilitate a comparison of each investment option available under the plan.[41]

PROVIDING INVESTMENT ADVICE AND THE PENSION PROTECTION ACT OF 2006

ERISA does not require a fiduciary to provide investment advice to a participant participating in a plan under ERISA 404(c).[42] But, if it is provided , as with any designation of a service provider to a plan, the designation of a person(s) to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan. Therefore, persons making the designation must act prudently and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s).[43]

See appendix A for a 404(c) checklist.

ELIGIBLE INVESTMENT ADVICE ARRANGEMENT

The Pension Protection Act (PPA) of 2006 allows a plan sponsor to hire a fee-paid adviser affiliated with the investment vehicle to provide investment advice to participants in defined contribution plans that are participant-directed. The adviser may receive additional compensation directly or indirectly to provide the investment advice as long as the advice is offered under an “eligible investment advice arrangement” that meets the following criteria:

1. Advice must be fee-neutral (i.e., compensation cannot vary based on the advice given); or
2. Advice must be based on a computer model that is certified by an “eligible investment expert” that has no affiliation to the adviser and that meets requirements to be developed by the DOL, and
   a. applies generally accepted investment theories, and
   b. uses the participant’s information, and
   c. or its affiliate’s products.
3. Advisers may develop the model, but it must be certified by the “eligible investment expert.”
4. The adviser is required to submit to an annual audit by an outside auditor.
5. The plan fiduciary must authorize the service.
6. The following disclosures must be provided in a format based on the DOL model:
   a. The adviser must acknowledge fiduciary status to the plan participants.
   b. The roles of all parties involved in developing the program or selecting investments.
   c. Past performance of investments.
   d. Any fees or other compensation received by the fiduciary adviser.
   e. How participant information will be used.
7. Compensation must be reasonable, as in an arms-length transaction.
8. Investment transactions may occur only at the direction of the recipient of the advice.
9. Alternatively, participants may arrange for their own advice from another adviser.

As in other ERISA relationships, the plan sponsor or plan fiduciary remains responsible for prudent selection and periodic monitoring of the adviser, but neither is responsible for the advice provided by the adviser.

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WHAT IS INVESTMENT ADVICE?[44]

A person will be considered to be rendering investment advice to an individual if:

1. The advice is particularized to needs of the individual, and
2. The advice is about the value or recommendation of investing in securities or other property, and
3. The person, either directly or indirectly, has discretionary authority over purchasing or selling these securities for the individual or
4. The person renders the advice on a regular basis to the individual pursuant to a mutual agreement (written or otherwise), and
5. The individual uses the information as the primary basis for investment decisions.

WHAT EDUCATION CAN BE PROVIDED TO PARTICIPANTS THAT IS NOT INVESTMENT ADVICE?[37]

Education should provide participants with the tools to make appropriate decisions. This education will not be considered investment advice if it's provided under DOL guidelines regarding plan information, general investment information, asset allocation models, and interactive investment materials.

Plan information informs a participant or beneficiary about the benefits of plan participation as well as the impact of contributions or withdrawals. This is not considered advice.

General investment information allows participants or beneficiaries to take the next step on their own. It is information regarding investment objectives and philosophies, risk and return, diversification, dollar-cost averaging, compounded return, tax-deferred investment guidelines, and effects of inflation; estimating future retirement income needs, determining investment time horizons, or assessing risk tolerance.

Asset allocation models and interactive investment materials can be provided to a participant or beneficiary and not be considered investment advice. The models must be made available to all plan participants and beneficiaries, describe hypothetical individuals with various time horizons and risk profiles, and be based on generally accepted investment theories. All the material facts and assumptions underlying such models need to be included.

The interactive investment materials must be based on generally accepted investment theories that take into account the historic returns of different asset classes, include all assumptions, and correlate to the information and data supplied by the participant or beneficiary.

A disclosure statement must be provided in both the asset allocation model and the interactive materials situation. The statement will indicate that other investment alternatives having similar risk and return characteristics may be available under the plan. It will identify where information on those investment alternatives may be obtained. Lastly, it will direct participants or beneficiaries to consider their other assets, income, and investments in addition to their interests in the plan.

WHAT HAPPENS WITH PARTICIPANTS THAT DON'T PROACTIVELY CHOOSE THEIR INVESTMENTS?

The DOL contends that 404(c) only applies to transactions where participants exercise active control over their accounts.[46] PPA has added a safe harbor for fiduciaries from liability for investment outcomes when participants fail to exercise control over their accounts. In order for this safe harbor to apply the fiduciary is required to follow specific guidelines:[47]

1. Assets must be invested in a qualified default investment alternative (QDIA).
2. Participants and beneficiaries were provided an opportunity to elect their investments, but did not.
3. Participants must be provided a notice prior to the first investment in the QDIA and annually thereafter.
4. Material provided to the plan regarding the investment election must be provided to the participants and beneficiaries.
5. Participants and beneficiaries must be able to change their elections at least as often as they can change the other elections, but at least quarterly.
6. Fees that can be imposed upon the participant are limited should they opt out or later decide to actively direct their investments.
7. The plan must offer a "broad range of investment alternatives" per 404(c).
8. The regulation continues to require the fiduciary to prudently select and monitor the QDIAs.

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

A QDIA either must be managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary or a registered investment company. Four types of QDIAs are provided for under the PPA:

1. A product with a mix of investments that is based on the individual's age or retirement date. Life-cycle funds and target-date funds are examples of this type of vehicle.
2. An investment service that actively allocates assets among plan options providing an asset mix, again taking into consideration the individual's age or retirement date. An example of this is a professionally managed account.
3. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole. This would be a balanced fund.
4. A capital preservation fund may be used for the first 120 days of participation.

A QDIA may be offered through variable annuity contracts or other pooled-investment funds. Collective funds are an example of a pooled-investment fund.[48]

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AVOIDING PERSONAL LIABILITY

Any fiduciary that breaches ERISA's fiduciary obligations can be held personally liable for losses caused by the breach of duty. Liability could mean that you would need to restore the profits to the plan. As discussed earlier, the definition of a fiduciary is broad, and the responsibilities may not be mitigated by simply delegating fiduciary duties. A person may be a fiduciary for one function and not for another. For instance, the investment manager fiduciary will not be the administrative fiduciary unless they have accepted that job function and responsibility. Once the fiduciary function has been accepted, the fiduciary becomes liable for their own duties of loyalty and honesty to the participants and the beneficiaries, but the fiduciary also may be personally liable if they know or should have known of a breach by another fiduciary for this fiduciary function.

When might one fiduciary become responsible for another fiduciary's action? An investment consultant is paid a fee to assist a trustee in hiring an investment manager. The consultant, in their role of monitoring the performance of the investment manager, notes that commissions are being directed to an affiliate of the trustee at a commission rate that seems higher than reasonable. Three fiduciaries are liable for noting this activity should they become aware of it: the trustee, the consultant, and the investment manager. The plan administrator is not an investment fiduciary and would not be found to be a co-fiduciary for the investment function.

Penalties may be imposed for up to six years after the fiduciary violation or three years after the party bringing suit had knowledge of the breach. A willful violation can carry personal criminal penalties of up to $5,000 ($100,000 for corporations) and up to one year in prison. Civil actions can be initiated by plan participants, beneficiaries, other fiduciaries, as well as the DOL. Additionally, losses to the plan as well as profits made from the improper use of plan assets must be restored. The DOL also can remove the fiduciary and take control of plan assets.[49]

Pleading ignorance, bad communications, or inexperience will not be adequate legal defenses. Delegation to prudent experts and prudent oversight of them may be the only defenses a fiduciary can rely upon.

Note that federal law requires that each fiduciary (such as directors and officers of the employer) and every other individual who "handles" plan assets (such as the individuals who transmit contributions to the trustee) obtain a fidelity bond (ERISA fidelity bond).[50] It protects the plan against loss by reason of acts of fraud or dishonesty on the part of persons required to be bonded. These acts include, but are not limited to, larceny, theft, embezzlement, and forgery. It protects the plan, not the fiduciary. An individual providing investment advice and who is able to cause a loss to a plan through fraud or dishonesty should be bonded.

If a firm renders investment advice with discretion for a plan, the firm will need to be bonded for 10 percent of the amount handled.[51] A fiduciary also may purchase insurance against liability for breaches of fiduciary liability or may be insured by the plan sponsor or indemnified by the sponsor.[52]

So how do you avoid this risk? Follow the five standards required of a fiduciary:

1. Actions must be solely in the interest of the participants and beneficiaries and the actions must be for the sole purpose of providing benefits to the individual participants and their beneficiaries as well as defraying reasonable expenses of administering the plan.
2. The benefit plan must be in writing. The investment policy statement should be in writing. It should provide general guidelines concerning various types or categories of investment management decisions.
3. Actions must be discharged "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims."
4. Investments must be diversified to minimize the risk of large losses unless under the circumstances it clearly is prudent not to do so. These responsibilities must be carried out in accordance with the documents of the plan.

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Betsy Piper/Bach, JD, CIMA®, CFP®, CTFA, is president of ASAE Business Services, Inc. in Washington, DC. She earned a BS in special education from St. Cloud University, an MEd from The George Washington University, and a JD from CUA Columbus School of Law. Contact her at bpiperbach@asaecenter.org.

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APPENDIX A: ERISA SECTION 404(C) CHECKLIST[53]

INVESTMENT MENU REQUIREMENTS

1. __________ The investments available under the plan are sufficient to provide the participant a chance to materially affect (a) the potential return in his or her account and (b) the degree of risk to which it is subject.
2. __________ The plan offers at least three investment options that:
    a. __________ are diversified.
    b. __________ have materially different risk and return characteristics.
    c. __________ enable the participant to achieve a portfolio with aggregate risk and return characteristics at any point within the range appropriate for the participant each of which, when combined with the others, tends to minimize risk to the portfolio through diversification.
3. __________ Participants are given the opportunity, appropriate to the nature of the plan and size of the participant accounts, to diversify their accounts sufficiently to avoid large losses.

PLAN DESIGN AND ADMINISTRATION REQUIREMENTS

1. __________ Participants are given the opportunity to give investment instructions to an identified fiduciary who is obligated to follow those instructions (except in certain legal circumstances such as a prohibited transaction).
2. __________ Participants are provided a summary plan description and are able to request further information to make informed decisions (see "Information and Disclosure Requirements," below).
3. __________ If participants do not give investment instructions in writing, they must be given an opportunity to receive a written confirmation of their instructions.
4. __________ Participants have the ability to change investments with a frequency appropriate in light of the volatility of the investments.

REQUIREMENTS OF A COMPANY STOCK ELECTION

1. __________ The company stock is publicly traded.
2. __________ The company stock is traded with sufficient frequency and volume such that participants' instructions to buy or sell can be executed promptly.
3. __________ Participants are provided information that generally is given to shareholders of company stock.
4. __________ Participants are able to vote and conduct other similar rights available to shareholders.
5. __________ The plan designates a fiduciary to ensure information regarding purchase, sale, holding of company stock, and the exercise of voting as well as other shareholder rights is maintained with procedures to keep it confidential.
6. __________ An independent fiduciary is appointed to address any situations where the fiduciary responsible for confidentiality determines there is a potential for undue influence on a participant's decision to vote or tender shares.

INFORMATION AND DISCLOSURE REQUIREMENTS

There are two categories of information and disclosures: (1) items required to be provided to participants automatically in advance of investment; and (2) items required to be provided only on participant request.

Information and Disclosures Required to be Provided Automatically[54]

1. __________ A statement that the plan is intended to be an ERISA 404(c) plan, with an explanation that this will relieve plan fiduciaries of liability for losses resulting from the participant's investment directions. This can be provided in the summary plan description.
2. __________ Information required under 29 CFR Section 2550.404(a)5 Participant Disclosure Rule, Effective July 2, 2012.
3. __________ If company stock is an investment fund, a description of the procedures established to protect the confidentiality of information regarding participants' purchase, sale, holding, voting, or tendering of company stock, as well as contact information for the fiduciary responsible for monitoring those procedures.
4. __________ For mutual funds in which the participant invests for the first time, a copy of the prospectus provided to the plan (may be provided before or immediately after the investment).

This checklist is provided for informational purposes only. It is not intended to provide authoritative guidance or legal advice. Consult an attorney or other adviser for guidance on your particular situation.

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APPENDIX B: HIRING A PENSION CONSULTANT[55]

TIER I QUESTIONS

1. Are you registered with the SEC or a state securities regulator as an investment adviser? If so, have you provided me with all the disclosures required under those laws (including Form ADV, and brochure)?[56]
2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships.
3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your other income (revenue)?
4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?
5. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not overpay its consulting fees?
6. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?
7. Do you have any arrangements with broker–dealers under which you or a related company will benefit if money managers place trades for their clients with such broker–dealers?
8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment adviser to the plan while providing the consulting services we are seeking?
9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?
10. What percentage of your plan clients utilize money managers, investment funds, brokerage services, or other service providers from whom you receive fees?

TIER II QUESTIONS

1. What type of experience have you had working with entities such as ours?
2. Please list a representative sample of your clients.
3. To what manager database/research do you have access?
4. What are the qualitative and quantitative processes you use to screen new managers?
5. What are the qualitative and quantitative processes you use for monitoring managers?
6. What factors would impact the termination of a manager?
7. What is a representative example of available reports on managers?
8. Describe the communications you expect from a consultant and ask whether this consultant is able to meet these requirements.
9. What other sources of information and support do you provide?
10. Please provide a listing of professionals providing services to our account.
11. Please provide any measurements you implement that measure how you add value for your clients.

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ENDNOTES

1. ERISA § 2(b), 29 U.S.C. §1001(b) (2000).
2. See John H. Langbein, David A. Pratt, and Susan J. Stabile. *Pension and Employee Benefit Law*, 5th edition (Foundation Press, 2010): 78093.
3. ERISA §3(21) (A), 29 C.F.R. 2510.3-21(c).
4. ERISA § 402 (a)(2), 29 U.S.C. § 1102 (a)(2) (2000).
5. Joseph L. Paller, Jr., "Fiduciary Investment Issues in Defined Contribution Plans," *Benefits and Compensation Digest* 43, no. 8 (August 2006). http://www.gslaw.org/_pdfs/paller/8-06_fudiciary.pdf.
6. ERISA § 3(21)(A)(ii), 29 U.S. C § 1002 (21)(A)(ii) (2000).
7. 29 CFR 2510.3-21(c).
8. 29 CFR 2510.3-21(c)(1)(i).
9. *Ellis v. Rycenga Homes, Inc.*, 40 Employee Benefits Cas. 2579, split op. at 1 (W.D. Mich., April 2, 2007).
10. ERISA § 404(a), 29 U.S.C. §1104(a) (2000).
11. http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.
12. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (200).
13. PTE 1981-08, DOL (1981).
14. PTE 1981-127, DOL (1981).
15. ERISA § 408(b)(2), 29 U.S.C. § 1108(b)(2) (2000).
16. DOL Advisory Opinion 97-15A (1997).
17. http://www.dol.gov/ebsa/regs/fedreg/notices/2006001484.htm.
18. PTE 1981-06, DOL (1981).
19. PTE 1986-128, DOL (1986).
20. PTE 1996-23, DOL (1996).
21. SEC 1934 § 28(e).
22. ERISA Technical; Release No. 86-1, U.S. DOL
23. DOL Interpretive Bulletin 08-2. http://www.sutherland.com/files/upload/ShareholderRights2509082.pdf.
24. See id.
25. See "Report of the Working Group on Guidance in Selecting and Monitoring Service Providers" (November 13, 1996). www.dol.gov/ebsa/adcoun/srv-pro.htm.
26. The University of Chicago Booth School of Business, Investment Management Consultants Association certified Investment Management Analyst Certification Program, Scott Thayer, Graystone Consulting.
27. *Harvard College v. Amory Trustees*, 26 Mass. 446, 461 (Mass. 1830).
28. American Law Institute, Restatement of the Law, Third, Trusts: Prudent Investor Rule (1992).
29. Ibid.
30. Public Service Co. of Colorado v. Chase Manhattan Bank, 577 F. Supp. 92, 104 (S.D.N.Y. 1983).
31. ERISA § 3(38), 29 U.S.C. § 1002 (38) (2000) (defining an investment manager as someone who has the power to manage, acquire, or dispose of any asset of a plan, who is registered as an investment advisor under the Investment Advisers Act of 1940, and has acknowledged in writing that he is a fiduciary with respect to the plan).
32. 29 C.F.R. § 2509-75.8 (1975).
33. ERISA § 404(a)(1)(C), 29 U.S.C. §1104(a)(1)(C) (2000).
34. H.R. Conf. Rep No. 93-1280 (1973).
35. Diversified Financial Advisors, A Guide to Understanding Fiduciary Liability in 401(k) Plans. http://www.diversifiedfa.com/resources/Guide_to_FiduciaryResponsibility.pdf.
36. H.R. Conf. Rep. No. 93-1280 (1973); see also ERISA § 404, supra note 31.
37. 28 ERISA 404(a)(1)(A)(i); 29 U.S.C.A. 1104(a)(1)(A)(i).
38. ERISA § 404(a)(1)(C) (2000); DOL Interpretive Bulletin 29 C.F.R 2509.96-1.
39. DOL Reg § 2550.404(c)(3), 29 CFR § 2550.404(c)(3).
40. ERISA § 404(c)(1), 29 U.S.C. § 1104(a)(1) (2000).
41. http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html.
42. See DOL Interpretive Bulletin, supra note 36.
43. http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html.
44. Bloomberg BNA July 9, 2013 EBSA's 2013 Calendar Includes Final Rules in Target Date Funds, Funding Notices. http://www.bna.com/ebsas-2013-calendar-n17179875059/.
45. ERISA § (3) 21, 29 CFR 2510.3-21(c).
46. See DOL Interpretive Bulletin, supra note 38.
47. See Joseph L. Paller, Jr., supra note 5.
48. Regulation Relating to Qualified Default Investment Alternative Participant-Directed Individual Account Plans. http://www.dol.gov/ebsa/newsroom/fsQDIA.html.
49. ERISA § 502, 29 U.S.C. §1132 (2000).
50. ERISA § 412, 29 C.F.R. § 2580.412-1.
51. Field Assistance Bulletin No. 2008-04.
52. ERISA § 410(b)(1), 29 C.F.R. § 2509.75-4.
53. See ERISA § 404(c)(1), supra note 36.
54. ERISA § 101; ERISA § 404(c); DOL Reg. 2550.404(c); and DOL Reg. 2550.404(a)(5).
55. For more information about Form ADV, see http://www.sec.gov/answers/formadv.htm.
56. From "Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries," http://www.sec.gov/investor/pubs/sponsortips.htm.

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INVESTMENTS & WEALTH INSTITUTE®
formerly IMCA

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org

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