The Goofy Doctor Plan

Brokers, Self-Direction, and Fiduciary Duty in Qualified Plans

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<u>The Goofy Doctor Plan</u>:
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By Pete Swisher, CFP

Some qualified plans are goofy. Some give plan sponsors what they want within a framework of prudent fiduciary management, while others are risky and non-compliant—"goofy." The purpose of this article is not to pick on physicians: doctors are just one example of employers who favor potentially imprudent plan designs. The focus of this article is on ***how to accommodate their wishes within a prudent framework***.

Here are samples of goofy plans:

<u>Goofy Doctor Plan</u>

Dr. Smith	Dean Witter account
Dr. Jones	Merrill Lynch account
Dr. Johnson	Charles Schwab account
Dr. Doe	Fidelity account
9 employees	group annuity contract

<u>Goofy CPA Plan</u>

Bob Smith, CPA, curmudgeon	Vanguard mutual fund account
27 other CPA's and employees	Fidelity self-directed brokerage accounts

<u>Goofy Computer Consultants' Plan</u>

Core fund menu	Provided through a TPA
Brokerage Window	Available through same TPA (trades are placed direct with brokerage firm online but contact information and costs do not appear on participant 404(c) notice)

The theme of these plans is "do your own thing." The presumption is that each participant is best served by finding a financial advisor or service provider that best meets his or her needs.

<u>Who Wants Goofy Plans, and Why?</u>

Small to mid-sized professional groups, especially doctors but also CPA's and even attorneys (but not employee benefits attorneys!) are the primary users of these plans. Some small business owners also favor such designs. There are many potential reasons:

- Doctors and other professionals often have relationships with advisors such as stockbrokers and financial planners, and they want these advisors managing their qualified as well as nonqualified assets.
- They are accustomed to being in authority (and getting their way!)

- They are the focus of intensive marketing and a steady stream of vendors who tell them what they want to hear.
- There is a general lack of understanding of fiduciary duty in the small to mid-sized plan marketplace. Few financial salespeople understand fiduciary duty or can explain the requirements for compliance with ERISA §404(c).

Behind these wants there are several important needs as well:

- The professionals and business owners who favor these plans have no time, often working seventy hours per week or more. This time pressure can be a problem because fiduciary oversight of qualified plans is expected to be timely, consistent, and frequent (quarterly).
- Years of schooling + student loans + cost of lifestyle = a high need for planning and forced savings.
- Because these employers recognize their needs and time constraints they turn to personal financial advisors and want those advisors to manage all of their assets, including the qualified plan assets.

A Glaring Discrepancy

It is noteworthy that the types of employers named above who favor open option plans include only smaller employers. With few exceptions (the author knows of not one single exception, though surely one exists), large companies stay away from such plans. Larger companies tend to have attorneys and benefits consultants who advise their clients on the duties of plan sponsors and on the legal risks for failing in those duties. Larger plans understand that they cannot afford the potential liability of breaching their fiduciary duty. This discrepancy between the management of large vs. small plans is a useful indicator of the need for caution concerning self-direction.

Why Are Self-Directed Plans Usually "Goofy"?

What makes these plans goofy is best stated by Thomas Hoecker, an attorney specializing in retirement plan law with Snell & Wilmer, LLP, in Phoenix, Arizona. In *Applying ERISA's Fiduciary Standards to 401(k) Plans*, Mr. Hoecker says of "open option" plan procedures (where participants choose whichever investment provider they want):

> "This common, prevailing practice is not in compliance with the regulations and is ill-advised."[1]

Strong words. The regulations Hoecker refers to are the Department of Labor's regulations concerning the application of ERISA §404(c)[2], which provides limited relief from liability for plan fiduciaries with respect to the investment decisions made by plan

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[1] Hoecker, Thomas R., *Applying ERISA's Fiduciary Standards to 401(k) Plans* (Snell & Wilmer, LLP, Phoenix, Arizona, 1999), p. 23. The quoted passage refers to the fact that investment instructions should be given through named fiduciaries, but as is discussed later in this article this requirement is virtually never met in open option plans, calling the entire structure into question.

[2] 29 CFR 2550.404c-1

participants in directing their own accounts. The reason why plan sponsors and many benefits professionals believe the open option design provides protection from liability is that the regulations do in fact contemplate such a design. The problem is that such liability relief is conditional and the conditions for achieving it are rarely, if ever, met.

Definitions

Two terms that are often confused are "self-direction" and "participant-direction." The convention in the pension industry is to reserve use of the term "participant-direction" to refer to an individual account plan as described under §404(c):

- Self-Direction: a plan option allowing participants to select any investment from a broad universe of investments such as all publicly traded securities.
- Participant-Direction: a plan feature that allows participants to allocate funds among three or more investment options selected by the plan fiduciaries. The "menu" of investments typically consists of five to 25 mutual funds or other options. Technically an individual account plan can include a self-directed plan, but for our purposes we will maintain the distinction.

"Self-direction" can be further divided into two approaches. The following distinction between "open option" and "self-directed brokerage" is again somewhat arbitrary, but will be used as a convention hereafter:

- Open Option: all participants may choose the investment provider of their choice. Every participant, for example, can choose a different broker or investment advisor.
- Self-Directed Brokerage (SDB): the plan sponsor allows participants to direct funds within a brokerage account from a single provider. All participants taking advantage of this option therefore use the same provider.

Without ERISA §404(c) Protection, Plan Sponsors are Crazy to Allow Self-Direction

ERISA §404(c) is crucial to any plan sponsor who wishes to offer either an open option plan or a self-directed brokerage option ("SDB" hereafter)—the two common forms of self-direction in retirement plans. ***Without 404(c) relief, a plan sponsor is fully liable for each and every investment decision made by every participant and would therefore be crazy to offer self-direction***.

Consider an example: The Acme Co. allows participants access to a brokerage window in which they may buy and sell any publicly traded stock, bond, or mutual fund. In 1999 Participant Dr. Burnside invested his account solely in the stock of three companies: Enron, WorldCom, and AOL/Time Warner, and his account subsequently shrank from $100,000 to $5,000. Assume further that you are the plan fiduciary. How would you feel if you knew you were personally liable for Dr. Burnside's poor investment decisions?

Without §404(c) relief, this is exactly the situation—the fiduciary is ***personally responsible*** for every bad decision. In 1999 you had no idea that Dr. Burnside would make such disastrous decisions and no idea you were personally liable for his decisions. If you had known you were responsible, would you have allowed Dr. Burnside so much

rope with which to hang himself? The answer is obviously no—you would never allow someone else to put you at risk without reasonable assurance that you would be protected.

Understanding this fundamental concept—that without 404(c) protection no sensible employer would sponsor a self-directed plan—requires an understanding of 404(c) itself. Yet before one can understand the relief from liability offered in 404(c) one must first understand the basic fiduciary duty to which such relief applies.

Understanding Basic Fiduciary Duty Under ERISA §404(a)

A qualified plan participant's account is his own money and he should be able to do with it what he wants, right?

Wrong. The money in a qualified plan is held in trust and managed by a trustee who is governed by the laws of fiduciary responsibility[3]. The money does not belong to the participants, it belongs to the trust, and the participants are beneficiaries. This is an important point, and one, which can be illustrated using the example of a personal trust.

Assume that a bank trust department is the trustee of several trusts created by two parents, now deceased, for the benefit of their heirs. One of the children (who is an heir and a beneficiary of the trusts) is a successful stockbroker and insists on directing the trustee as to which securities to buy and sell (no trustee would allow such a thing, but suppose for a second that this one does). The account loses money, the stockbroker gets hit by a truck, and the stockbroker's widow sues the bank for breach of fiduciary duty in allowing her husband to direct the trustee's actions. Could the widow actually win the case? Yes, she could.

Carry the example one step further and assume the husband lives and himself sues the bank—could he, a successful stockbroker, hope to win the case, even though he himself made the investment decisions whose prudence he is challenging? The answer under trust law is "yes" unless the terms of the trust specifically directed the trustee to act in this fashion.

The example given above is extreme, but consider a different scenario. The same bank trust department is trustee of a trust whose beneficiary is a 62-year-old widow. The trust is her only financial security, created from the proceeds of a life insurance policy on her deceased husband. The widow has a stockbroker she has worked with for over twenty years and tells the bank that she will move the account unless the bank allows the stockbroker to buy and sell securities in the account.

Every bank trust department in the country, understanding basic fiduciary duty, would of course refuse to carry out the widow's request and would likely lose the account to the brokerage firm. But what if the bank gave in to her request and let the stockbroker have a

[3] Such as ERISA, the Uniform Prudent Investor Act, the Restatement of Trust (Third), and the Uniform Trust Code

hand in managing the assets? What if this occurred during a big market downturn, and the widow became disenchanted with the stockbroker due to very high market losses? Would the bank trustee be liable for the stockbroker's imprudent management of the assets? ABSOLUTELY. The trust document names the bank as trustee, not the stockbroker and not the widow. If the trustee wants to allow a stockbroker to manage the money, the trustee had best have a very prudent reason for doing so.

One of the most important precepts of fiduciary law is that fiduciaries are personally responsible—and therefore liable—for the prudent management of the assets in their care.[4] The common law that governs personal trusts—especially the Uniform Prudent Investor Act and the Third Restatement of Trust—is quite clear on the duties of fiduciaries.

Retirement plan law—namely the Employee Retirement Income Securities Act of 1974 (ERISA) and the regulations that arise from it—arguably represents a higher standard of fiduciary care than that embodied in the common law of trusts (though some commentators believe the standards are merely equal). Furthermore the standard of performance to which ERISA fiduciaries are held, the "prudent man" rule, is often known as the "prudent expert" rule since the standard is "not that of a prudent lay person but that of a prudent fiduciary with experience dealing with a similar enterprise."[5]

Now consider a retirement plan example: is the plan sponsor prudent to name as trustee a committee consisting of doctors? Could a divorced partner's former spouse sue the plan sponsor on the grounds that such a delegation was imprudent? Richard Holt, JD, ERISA Counsel for Unified Trust Company and a thirty-year veteran of employee benefit law, has this to say: "I would hate to have to defend a lawsuit in which the plaintiff [the estranged spouse] was arguing that my client [the plan sponsor—a doctor group] acted imprudently in appointing as trustee a heart surgeon or other professional." The same argument applies to self-direction: is it prudent for a plan sponsor to allow individuals to manage their own accounts? In the absence of legal protection from liability for those individuals' poor decisions, it would seem risky at best to allow participants' such a free hand.

The Fiduciary Monitoring Cycle

The heart of fiduciary duty can be described as the fiduciary monitoring cycle. Fiduciaries are expected to:

1. ***Set prudent criteria*** for the initial selection and ongoing retention of plan investments—generally recorded in an Investment Policy Statement (IPS).
2. ***Monitor*** the plan quarterly to ensure that it is being managed in accordance with policy and that all investments continue to meet the IPS criteria.

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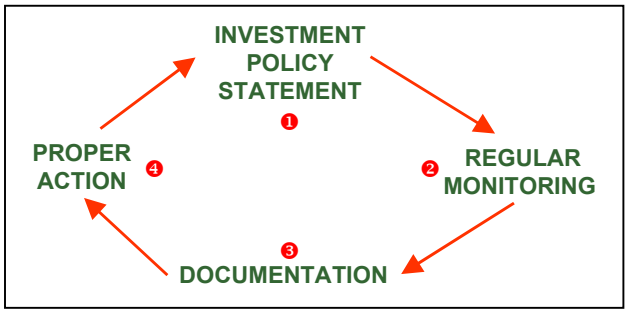
[4] ERISA §404(a)(1) and §409(a)

[5] *Marshall v. Snyder*, 430 F.Supp. 1224 (E.D. NY 1977); *Donovan v. Mazzola*, 716 F.d 1226 (9th Cir. 1983)

3. ***Take action*** when required by replacing investments that fail to meet IPS criteria.
4. ***Document*** the process.



In other words, the starting point for a plan fiduciary is that he or she is personally liable for the prudent management of the assets in the plan. Prudent management consists of prudent criteria in an IPS, quarterly monitoring, appropriate action to enforce the IPS, and documentation. The source for these basic requirements is ERISA §404(a)(1), which lists the four primary duties of an ERISA fiduciary:

1. Loyalty: acting in the exclusive benefit of participants and beneficiaries.
2. Prudence: managing the plan with the "care, skill, prudence, and diligence" of a prudent person.
3. Diversification.
4. Following all plan documents, including the IPS.

Thus a plan fiduciary who seeks relief from liability is seeking to be relieved of responsibility for one or more of these basic fiduciary duties. In the absence of delegating these duties to a professional, discretionary fiduciary (an institution such as a trust company that takes full responsibility and discretion for managing the plan), there is only one source of relief available under law: ERISA §404(c).

Understanding ERISA §404(c)

When a plan complies with the 404(c) regulations, plan fiduciaries are not liable for any participant losses that were a direct consequence of those participants' exercise of control over their investments.[6] The relief offered under 404(c) is only available in participant-directed plans[7], in which each participant is offered the ability to choose among a range of investments to create his or her own portfolio.

An example of how 404(c) is designed to operate: suppose that a qualified plan offers twelve mutual funds as choices to participants, who can allocate their money among these options as they see fit. So long as the requirements for 404(c) compliance have been met, the plan fiduciaries are not liable for the participants' investment decisions. Note, however, that the fiduciaries remain liable for the prudent selection, monitoring, and retention of each mutual fund under ERISA §404(a).

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[6] 29 CFR 2550.404c-1(a)(1)
[7] As defined in 29 CFR 2550.404c-1(b)(1)

In this sample plan, assume that participant Judy Jones invested 100% of her account balance in the Radical Internet Aggressive Leveraged Growth Fund, and subsequently suffered losses of 80% in her account. Are the plan fiduciaries liable for her losses? As long as the fiduciaries can demonstrate that they followed a prudent procedure for selecting, monitoring, and retaining the fund, they are not liable for Judy's silly decision to invest 100% of her assets in this fund. On the other hand, Judy could sue the fiduciaries for breach of duty under 404(a) based on the argument that the Radical fund was not a prudent choice for the plan in the first place. If the courts agreed, Judy would win the case based on the breach of duty under 404(a) and 404(c) would offer no protection.

How useful is 404(c)? One measure is to compare the number of ERISA lawsuits to the number of cases successfully employing a 404(c) defense. Here are some statistics to illustrate the comparison:

How Well Does 404(c) Protect Plan Sponsors?

Year	# of Sponsors who won fiduciary breach lawsuits with 404(c) defense
2001	None
2000	None
1999	None
1974-1998	1

(Source: none. 404(c) commentators seem to agree that the law, regulations, and case histories are of little help. *In Re: Unisys*[8] is virtually the only case with even partial guidance, and is the only example known to the author or the author's sources of a successful 404(c) defense.)

[8] In re: Unisys Savings Plan Litigation, 74 F.3d 420, 435-36 (3d Cir. 1996). Cert. denied 519 U.S. 810, 117 S.Ct. 56 (1996)

Note the recent leap in the number of ERISA lawsuits:

Annual ERISA Lawsuits

	Number of Cases	% Increase
2002	38,000+	369%
2001	10,292	12.8%
2000	9,124	1.8%
1999	9,268	3.2%
1998	9,609	4.3%

Source: Administrative Office of the U.S. Courts

So out of tens of thousands of lawsuits, only one resulted in a successful 404(c) defense. Perhaps this explains why some have called 404(c) a "shallow shield."[9]

Applying 404(c) to Open Option Plans and SDB's

The regulations for 404(c) offer a series of examples like the Judy Jones example above to help illustrate how 404(c) protection is expected to be applied. One of those examples describes a plan in which the sponsor does not designate any investment managers but instead allows each participant to select his or her own investment manager—an "open option" plan.[10] The example states that the plan fiduciaries are not liable for the prudent selection and retention of the participant-selected investment managers and are not liable for the investment managers' errors in managing the accounts. There is one critical term in this illustration that requires definition: "investment manager."

An investment manager under ERISA is not simply one who manages investments. Under ERISA §402(c)(3) an investment manager is:

- A bank, Registered Investment Advisor, or insurance company (NOT a broker/dealer or its registered representatives; i.e., a broker) who
- Accepts fiduciary status and discretion over the assets to be managed, in writing.

This is the crux of the open option problem: the "investment managers" selected by the participants are virtually never investment managers as defined by ERISA, for two reasons:

- Wrong type of entity: most participants select a favorite stockbroker or brokerage firm, which are not eligible to be investment managers;
- Even when the providers selected are the right type of entity, they virtually never accept fiduciary status, and discretion, in writing.

Thus, participants are selecting investment providers who do not qualify as investment managers, but plan sponsors still believe they are protected by 404(c). Plan fiduciaries

[9] An informal term. See the message boards on www.benefitslink.com for some practitioners' insights on 404(c).
[10] 29 CFR 2550.404c-1(f)(9)

are managing the plan as if they have no liability for selection and retention of investment providers and as if 404(c) protects them from liability for participants' decisions within their individual accounts. In reality, they are liable for each investment and each decision in every participant's account—the exact opposite of the entire point of an open option plan.

Is this fair? Perhaps not. Some observers might view it as unreasonable that a participant can't be held responsible for his or her own actions. The reality, however, is that investing is not as easy as the financial media made it out to be in the 1990's, and prudent investing is both art and science. Most participants—including even the most educated members of a group—are not equipped to judge whether any one investment manager is good or bad, expensive or cheap, honest or crooked. The rules exist to protect the participants and beneficiaries of trusts, whose money is being managed for them by the trustees. It makes sense to follow those rules.

So What Types of Accounts ARE Protected Under 404(c)?

It is certainly true that open option plans are contemplated by the regulations, so how can such plans be structured to comply with those regulations? Here are examples:

- Participants can be offered unlimited choice of investment managers with the understanding that the managers must qualify as ERISA investment managers under §402(c)(3): banks, insurance companies, and RIA's who agree in writing to be discretionary fiduciaries of the plan, appointed by the participants instead of the plan sponsor (darned unlikely).
- The plan sponsor can stick to more traditional methods such as the offering of various mutual fund choices (i.e., give up on the idea of true self-direction).
- The plan sponsor can designate certain investment managers under ERISA §402(c)(3) and thereby retain liability for prudent selection and retention of each manager, yet preserving 404(c) protection with respect to the participants' choice of managers.

The problem, of course, is that the professional groups and small businesses to whom these plans appeal want what they want—to hire their personal stockbrokers or manage their own assets through their favorite brokerage outlet. And, as noted, this approach is "not in compliance with the regulations and is ill-advised."[11]

404(c) in Self-Directed Brokerage Accounts—The "Agent SDB"

In my office we use the term "agent SDB" to describe a self-directed arrangement that is (theoretically) compliant with the requirements of the ERISA §404(c) regulations, which include the following:

[11] Hoecker, Thomas R., *Applying ERISA's Fiduciary Standards to 401(k) Plans* (Snell & Wilmer, LLP, Phoenix, Arizona, 1999), p. 23.

- Investment instructions should be given through a named fiduciary, or an agent of a named fiduciary, in order for participants to be viewed as having the opportunity to exercise control.[12,13]
- This named fiduciary and his/her agent must be clearly identified in a ***notice to participants***, which should include contact information and trading costs, among other things[14].

These requirements seem simple but the compliance checklist is actually quite complex. Consider the difficulty of a notice to participants in an open option plan: who is the fiduciary (i.e., which doctor, CPA, or business partner) who wants to be responsible for personally implementing trades? If agents are named, how are they selected? (404(a) prudence requirement applies) How are multiple agents listed in the notice to participants? This is not a practical plan structure.

On the other hand, a ***single brokerage provider for the entire plan***, chosen by the plan sponsor to be an agent of a named fiduciary, has a much better chance of complying with the regulations. The notice to participants for such an arrangement could name this provider as an agent of the named fiduciary and direct participants to give trade instructions to this provider directly—thereby satisfying the "opportunity to exercise control" requirement. The notice must also include any trading or other costs as well as a long list of other information, but so long as the notice requirement and the other requirements of 404(c) are met, the plan should retain 404(c) protection. This "agent SDB" approach is therefore the only method for implementing self-direction in which a plan sponsor has reasonable control over 404(c) compliance.

<u>An Unquantified Risk Even With Agent SDB's</u>

The premise behind naming an "agent" for trading purposes is that the regulations seem to allow it without loss of §404(c) protection. Participants must have a "reasonable opportunity to give investment instructions…to an identified plan fiduciary."[15] The problem is in determining what the courts will believe constitutes "reasonable opportunity." Is it in fact permissible to allow instructions to flow through an agent, or must the fiduciary itself receive the trading instructions in order for "reasonable opportunity" to exist? No court has ruled on the issue, the regulations are silent on the issue, and DOL has declined to offer its guidance on the issue.

Hoecker's firm of Snell & Wilmer, LLP, requested clarification from DOL as to whether investment instructions may pass through an agent. He notes that "DOL has never agreed

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[12] It is plans' failure to fulfill this requirement that Hoecker warns against in *Applying ERISA's Fiduciary Standards to 401(k) Plans*. The regulation states that participants must have a "reasonable opportunity" to place trades through a fiduciary, but as Hoecker observes, "Participants utilizing a plan's Open Option feature frequently work directly with the broker of their choice and plan fiduciaries rarely, if ever, know of the participants' decisions as they are made. This common, prevailing practice is not in compliance with the regulations and is ill advised. Instead, a plan that includes an Open Option feature should implement procedures to assure that all investment instructions are channeled through a plan fiduciary."

[13] 29 CFR 2550.404c-1(b)(2)(i)(A)

[14] 29 CFR 2550.404c-1(b)(2)(i)(B)(1)

[15] 29 CFR 2550.404c-1(b)(2)(i)(A)

to that. We asked them to agree to that and they never responded." In the absence of a court case or other precedent, therefore, practitioners have no idea whether it is in fact permissible for investment instructions to flow through the agent of a Named Fiduciary instead of directly through the Named Fiduciary. This uncertainty is simply one more layer of risk atop the other risks of self-direction.

Outside Trading Authority Given to a Broker in an SDB

One of the most important reasons why plan sponsors pursue open option arrangements is that the principals recognize their need for personal advice, have formed relationships with advisors, and want those advisors helping them with qualified as well as nonqualified assets. One way to allow those relationships to continue is to have brokers or advisors accept a fee for their advice rather than trading the participant's funds in a proprietary brokerage account.

For example, Dr. Smith has a broker who works for Morgan Stanley Dean Witter whose advice he values. The group decides to eliminate the open option in its profit-sharing plan in favor of a core fund menu plus a discount brokerage account through Vanguard (an "Agent SDB"). Dr. Smith signs a limited power of attorney for his broker, who is then given the identification and password to Dr. Smith's Vanguard account and can place trades for him online. Dr. Smith still gets the benefit of his broker's assistance but within a prudent framework for the plan as a whole.

Note that this relationship probably makes the broker a fiduciary regardless of whether he accepts that status in writing—something most broker/dealer firms are reluctant to allow. Also, to accept a fee, the broker must be affiliated with his firm's Registered Investment Advisor. Not all brokers have such an affiliation and continue to do business solely on a commission basis. Finally, brokers are understandably reluctant to lose control over client assets and to have their compensation change from a commission to a fee basis. If the participant can overcome the broker's reluctance, however, this can be a useful arrangement.

The Doctrine of Co-Fiduciary Liability

Another legal principle is important to our discussion of self-direction: co-fiduciary liability, or the "brother's keeper rule." Under ERISA§405(a), a fiduciary is liable for his fellow fiduciaries' breaches of duty under certain circumstances:

- If your co-fiduciary commits a breach and you know about it or help hide it, you're liable (such as if you know a fellow trustee is not fulfilling his due diligence monitoring requirements);
- If you fail in your overall 404(a) fiduciary duties, thereby enabling the breach, you're liable;
- If you are aware of a breach and fail to take action to correct it, you're liable.

Co-fiduciary liability is important because in an open option plan, principals are likely to be quite aware of whether or not their fellow principals are staying on top of the prudent

selection and monitoring of the plan assets. If a stockbroker is hired, the principals are likely to know if the hiring was not the result of a prudent, well-documented search process—which would be a breach of duty. If there are no quarterly reviews, regular documentation, performance comparisons, etc., there is a breach of duty, and all of the principals are likely to know it. Knowing about a breach and failing to take action to correct it makes one liable for the breach.

Co-Trustee Liability

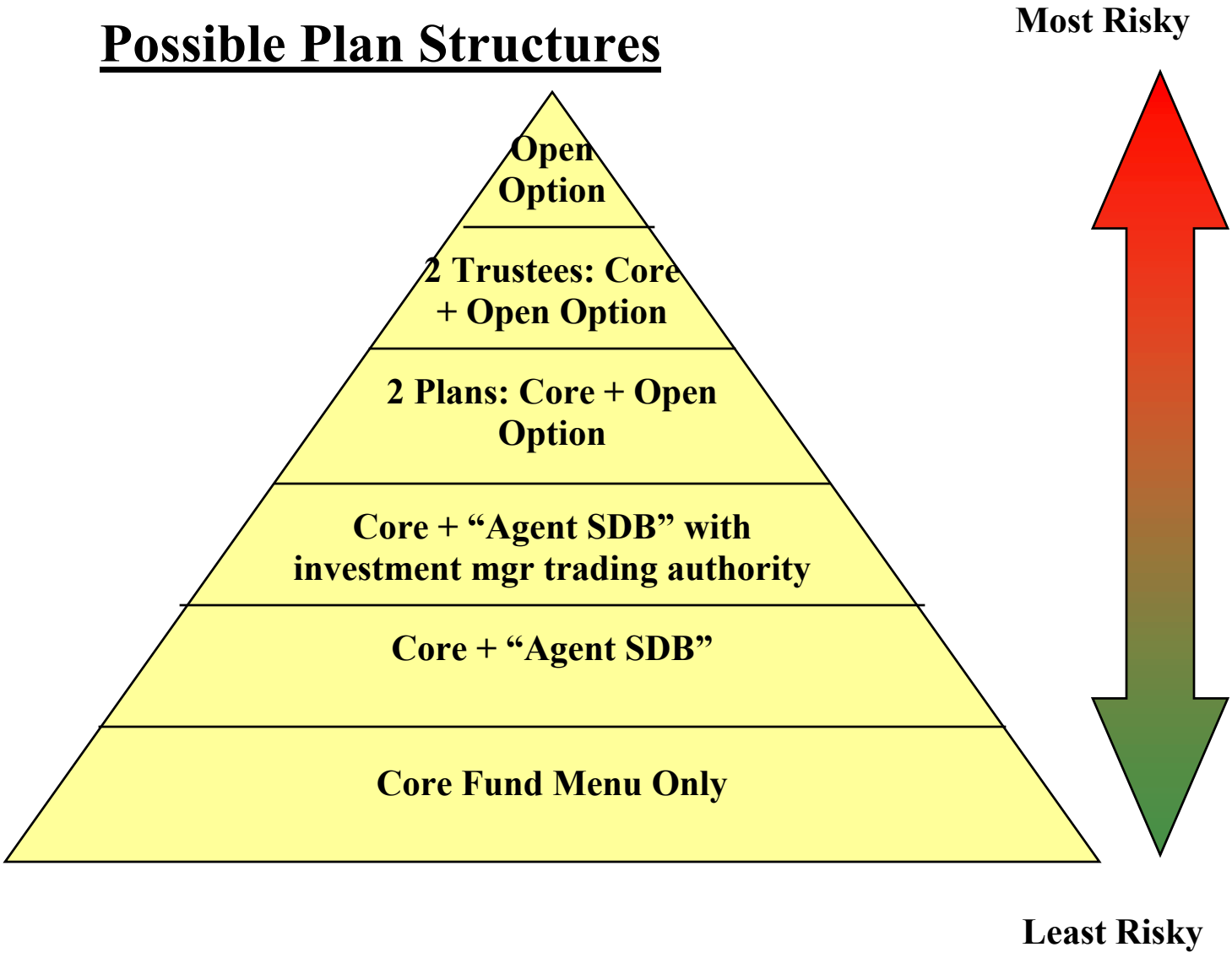
Another key principle, which is similar to co-fiduciary liability, is liability for the breaches of fellow trustees. Under ERISA §405(b):

- Trustee #1 is not liable for assets held exclusively by Trustee #2, BUT,
- Each trustee is still subject to the rules of co-fiduciary liability (as opposed to co-trustee liability).

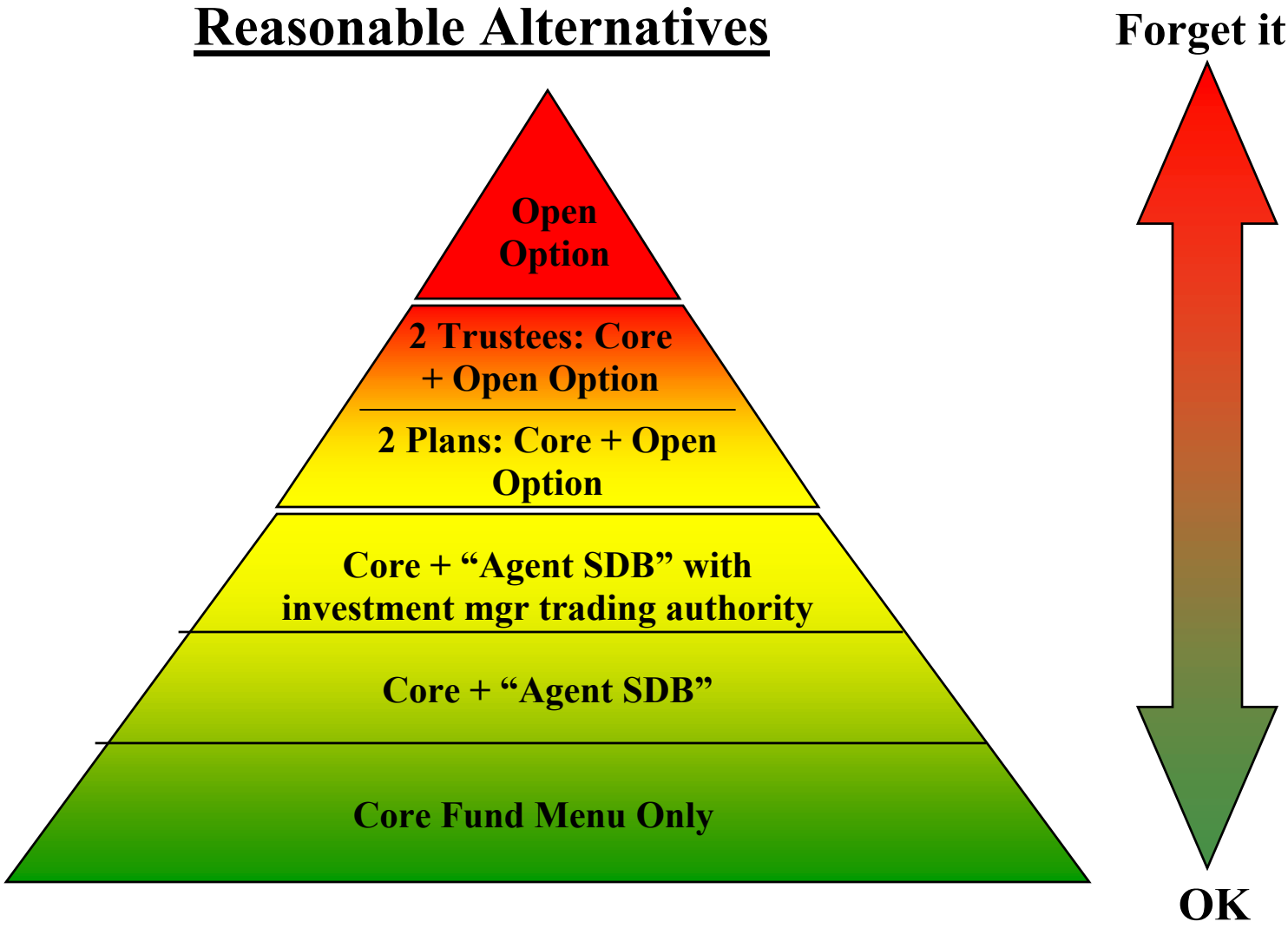
Designing Plans That Meet Client Desires in a Prudent Framework

There are ways to give clients what they want. See the inset diagrams of possible plan structures, arranged vertically from least risky to most risky.

Possible Plan Structures



Reasonable Alternatives



The first illustration shows multiple design possibilities, then the second illustration shows which designs make the most sense from a fiduciary standpoint. As the figures show, there are three designs that make sense, plus a fourth that represents a reasonable compromise that may be employed when some of a group's principals insist on an open option feature:

Plan Designs that Preserve Self-Direction Within a Prudent Framework

1. ***Core funds only***. With this design the plan sponsor designates investment options from which participants may select. Participants are not given access to the investment managers of their choice nor are they given access to a self-directed brokerage option (SDB). This is the least risky option but does not permit self-direction.
2. ***Core funds plus "Agent" SDB***. Adds an SDB option to the previous design. So long as the SDB provider has been prudently selected and monitored, and as long as the other requirements of 404(c) are met, fiduciaries *should be* protected against liability for participant investment decisions within the SDB. ("Should" is a big word, which is why this option is riskier.)
3. ***Core funds plus "Agent" SDB with Investment Manager trading authority***. In this case the design is the same as in option 2 but with the addition of one or more Investment Managers, designated by the plan sponsor, who can manage participant accounts. The plan sponsor is liable for the prudent selection and monitoring of the Investment Manager(s) but not for their acts and omissions (i.e., mistakes).

The Compromise—Separate Plans

When Dr. A insists that his Merrill Lynch broker trade his account, what should his partners do? Technically they are perfectly justified—and may in fact be required—to vote him down. Unless the group is willing to perform due diligence and quarterly monitoring of every investment in that Merrill Lynch account and take action when appropriate, they could be guilty of a breach of duty for even allowing the arrangement, however officiously bureaucratic that may seem. They could name Dr. A trustee over his own account (which is better than being trustees themselves), but the other partners would be Dr. A's co-fiduciaries at the plan sponsor level and as such could still be liable for prudence.

A common question is as follows: "So what if we're liable—Dr. A will never sue us, right?" Probably not. Most plan sponsors never get sued, just as most houses never burn down and most taxpayers never get audited. Suppose, however, that Dr. A gets divorced, and that his wife is upset when she discovers that her account (i.e., her husband's account) is half what it was three years ago. As Hoecker says, "What about a QDRO [Qualified Domestic Relations Order—a court order dividing a participant's account in a divorce]? The former Mrs. A has also lost money." Is it conceivable she might sue the plan sponsor (i.e., her husband and his partners) to make up the loss? Case law is full of far crazier scenarios, and prudence to some extent consists of preparing for the worst.

But there is a middle ground—riskier than the three "reasonable" plan designs mentioned above, but potentially less risky than an open option plan or co-trustee arrangement. The middle ground is to create a separate plan with a single participant: Dr. A. Dr. A would be sole participant and Trustee of the Dr. A Retirement Plan, while the remaining partners and participants would be in the "core" plan, which is managed prudently using one of the three less risky plan types. Alternatively, a single plan can be delegated to separate trustees with separate pools of money for which they are responsible. The co-trustee approach is sometimes cheaper to administer but carries slightly higher risk due to the potential for co-fiduciary liability.

There is still the issue of prudent selection and retention of the plan trustee—Dr. A—and the doctors who share the discretion to decide on this separate plan approach are liable for that appointment. At least with a separate plan there is a greater deal of control over who is liable and what they are liable for. Note that there is no limit to the number of plans an employer may sponsor, but that nondiscrimination testing rules do still apply.

Here is an example of a situation where this "two plan" approach might make sense. A medical practice has five physicians and ten employees in an open option plan. The group has been informed of its responsibilities by its ERISA attorney and is changing plan designs. Dr. Smith is the founder and President and is the only principal who insists on keeping his outside money manager, which is not an ERISA Investment Manager. The group could arrange the practice so that Dr. Smith is the sole member with discretion over the appointment of trustees and other service providers. He can then create two plans—a core plan and his own personal plan. Both must be tested for nondiscrimination as a single plan, but for fiduciary purposes they are separate. Under this arrangement the other four physicians will have only limited fiduciary exposure, if at all.

Does this dual plan make sense? It makes a lot more sense than the typical open option plan. Is it a good structure? Not really—the group is still better off with one of the three "safer" approaches. For example, if Dr. Smith in the example above could convince his investment advisor to sign on as an ERISA Investment Manager, then the group could employ option three above—a very reasonable approach, and less expensive as well (separate plans require separate administrative charges).

The Importance of a Core Fund Menu

Plans with an open option feature or SDB should always have a "core" menu of funds that have been selected by the plan sponsor. The reason comes, again, from attorney Thomas Hoecker: "If no designated investment funds are offered by a plan, some participants will decline to give any investment instructions, eliminating any 404(c) relief for the plan fiduciaries."[16]

[16] Hoecker, Thomas R., *Applying ERISA's Fiduciary Standards to 401(k) Plans* (Snell & Wilmer, LLP, Phoenix, Arizona, 1999), p. 23, footnote 58.

The reason, again, is "exercise of control." The regulations stipulate that participants must in fact exercise control in order for the plan to be defined as participant-directed.[17] Thus when a participant fails to exercise control by refusing to designate investment choices, the plan is not a 404(c) plan and 404(c) protection does not apply *to the entire plan.* Since one obvious explanation for why a participant might fail to make such a designation is confusion caused by infinite choice, it makes sense to ease the decision-making process by designating a "core" fund menu.

<u>One More Potential Pitfall: Advice</u>

When participants are offered investment advice, 404(c) may not apply. Why? Under the regulations a plan fiduciary is not obligated to give "investment advice" to participants.[18] But what happens when a fiduciary does offer advice to participants? ERISA says that anyone providing investment advice for a fee or other compensation is a fiduciary—a status that plan sponsors hope to avoid with respect to 404(c) plan transactions.[19]

In an Interpretive Bulletin the Department of Labor gave guidance on a "safe harbor"[20] a plan sponsor can use to avoid being classified as offering advice.[21] In the bulletin DOL says that a sponsor offering ***general investment education*** on topics such as asset allocation and diversification is not offering advice. On the other hand, a sponsor that offers participants advice (such as through an online advice provider like Mpower or MorningStar ClearFuture) is offering more than just general education and may be considered a fiduciary with respect to that advice. While the Department does not comment on whether 404(c) applies when advice is offered, it does say the following:

- That it is the belief of the Department that the provision of investment education (but advice is not mentioned in this statement), in and of itself, does not eliminate relief under 404(c)[22];
- That the determination as to whether a participant has in fact exercised independent control is based on facts and circumstances.[23] (i.e., if advice is given and a participant follows it without question, has he exercised control?)

In other words, the Department does NOT offer the opinion that 404(c) protection is affected by the offering of advice to participants, but instead tells us the availability of such protection depends on the circumstances (i.e., maybe 404(c) will apply, maybe it won't). On the other hand the Department does offer that it believes 404(c) protection is

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[17] 29 CFR 2550.404c-1(d)(2)(i)
[18] 29 CFR 2550.404c-1(c)(4)
[19] 29 CFR 2510.3-21(c)
[20] DOL does not itself use the term "safe harbor" with respect to 404(c). The use of the term comes from *ERISA Facts 2002*, Bitzer, Frank, and Nicholas Ferrigno (The National Underwriter, Cincinnati, OH, 2002).
[21] 29 CFR 2509.96-1, or IB 96-1
[22] 29 CFR 2509.96-19(b)\3\
[23] 29 CFR 2550.404c-1(c)(2)

not affected by the offering of education. Plan sponsors are therefore at an increased risk of losing 404(c) protection when they offer advice to participants.

This does NOT mean that plan sponsors should avoid giving advice to participants. In fact, the author believes all plan sponsors should offer investment advice to participants regardless of the implications for 404(c), but that discussion is beyond the scope of this article. The point is that self-directed plans are too risky without 404(c) protection, and anything that can cast the availability of that protection into doubt—such as the offering of advice—requires careful attention.

One final point on the advice issue: models and lifestyle funds. Models are portfolio models in which participants may invest. Specific percentages of specific funds make up the model, which may take the form of a paper description or an actual portfolio managed for the participant. Models are a form of advice unless they remain "generic" and follow certain rules.[24] A harder question is this: are lifestyle funds a form of advice? A lifestyle fund is a portfolio model within a mutual fund. The concept is virtually identical, so it could be argued that lifestyle funds are a form of model—and therefore may constitute advice. The counter to this argument (and a more reasonable seeming approach) is that lifestyle funds are simply diversified investment options, which are among those from which participants may select. Again, the point is not that lifestyle funds are bad—on the contrary they fill a critical need—but that sponsors wishing to allow self-direction in their plans must carefully consider the impact of every decision on the availability of 404(c) relief.

The Conflict Between the Need for Advice and the Desire for Self-Direction

There is tremendous demand among participants for professional advice. Unlike doctors or other principals who may have large account balances, most participants have very small balances and cannot attract the interest or attention of an advisor—they must fend for themselves, and are ill equipped to do so. Furthermore, true advice appears to work: a recent survey by the Institute for Management and Administration indicated that participants who got investment advice outperformed non-advised portfolios 86% of the time, and the average outperformance was 1.48%[25]. Other studies confirm the basic premise that people tend to invest poorly when left to their own devices[26]. If the statistics in these studies are to be believed, plan sponsors should be rushing to get professional advice for their participants.

Yet when advice is offered, 404(c) protection may be at risk, calling into question the wisdom of allowing self-direction. Are advice and self-direction therefore mutually exclusive? No. Yet if the average participant is favored more by a core menu with advice than by an open option arrangement, and if the offering of advice might interfere with 404(c) protection, the case for "safer" designs is that much stronger.

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[24] 29 CFR 2509.96-1(d)(3)
[25] IOMA's *Report on Managing 401(k) Plans*, 2002.
[26] See studies by DALBAR, for example, or Bernartzi et al. at UCLA.

Reasons to Avoid Self-Direction: A Summary

While there is nothing inherently wrong with self-direction, and while in some cases self-direction might be a fantastic way to manage a qualified plan, the weight of logic is against allowing a self-directed option in most cases.

1. ***Compliance with 404(c) is not easy, and without it fiduciaries are liable for each participant's investment decisions***. The range of opinion in the legal community covers a spectrum: at one end are those who believe that, with careful attention to detail, compliance with 404(c) is not too difficult. At the other end of the spectrum are those who believe it is nearly impossible. The author knows of no commentators who suggest that compliance is easy.
2. ***404(c) can be "all or nothing."*** A plan either meets the definition of a 404(c) plan or it does not. Consider just a few of the many ways a plan could fail to comply:
    a. An outdated or incomplete notice to participants
        i. Incorrect/missing contact data for the named fiduciary and his/her agent(s).
        ii. Trading costs associated with implementing investment instructions not included.
    b. Failure to deliver the notice to participants at the appropriate times.
    c. Failing to satisfy "opportunity to exercise control" through having investment instructions pass direct to brokers.
3. The requirement that participants have the "opportunity to exercise control" is especially problematic since ***investment instructions should be delivered through a named fiduciary or his/her agent***—a very difficult requirement to meet when the nature of the plan is that participants are going direct to their favorite brokers.
4. Since there is ***no clear guidance stating that investment instructions can pass through an agent*** instead of directly through a Named Fiduciary, the use of an agent adds a layer of uncertainty. Yet eliminating the uncertainty calls for a significant burden for the Named Fiduciary who must accept and implement investment directions.
5. Most of the investment providers chosen by participants in an open option plan are brokers—either full service firms such as Merrill Lynch or discount firms such as Charles Schwab. Yet ***brokers are not eligible to be ERISA Investment Managers***.
6. ***If a plan offers investment advice, either by design or by accident, 404(c) may not apply***, and without 404(c) protection self-direction is too risky. Yet investment advice is arguably a necessary feature for many qualified plans.

In short, compliance with 404(c) relies on near perfect execution of a number of tasks. A simple administrative oversight can lead to loss of 404(c) protection for the entire plan. Since self-direction by its nature entails a high degree of risk as to the investment decisions participants might make, it is critical to preserve 404(c) protection in a plan with self-direction. Yet the ease with which a sponsor may fail to comply with the regulations means that such protection is by no means assured. Thus even a relatively

"safe" approach to self-direction—the use of an "agent SDB"—is arguably too risky. Most plan sponsors are best served by using a menu of core investments only.

Conclusion

A qualified plan is not an IRA (Individual Retirement Account) that participants may invest as they please. The money in the plan belongs to the trust, and the plan fiduciaries are responsible for its prudent management. If plan sponsors set up their "open option" plans correctly, they can potentially enjoy relief from liability from participants' losses under ERISA §404(c). Yet the reality of open option plans and self-directed brokerage accounts is that they are rarely compliant with the regulations and the desired protection does not exist. The prudent course for plan sponsors is to stick to reasonable plan designs that accommodate the desire for flexibility without incurring unnecessary risks:

- Core funds only
- Core funds with an "agent" self-directed brokerage option
- Core funds with an "agent" SDB and access to ERISA Investment Managers

In those cases where principals simply cannot agree on one of these relatively safe designs, the best alternative is to "carve out" separate plans—one "core," one or more open option.

Ultimately it is neither fair nor reasonable for a principal to demand that his business associates accept a solution that puts them at risk, however slight that risk may be. The good news is that once plan sponsors are educated on how their wishes can be honored while still doing the right thing, they usually choose to do the right thing.