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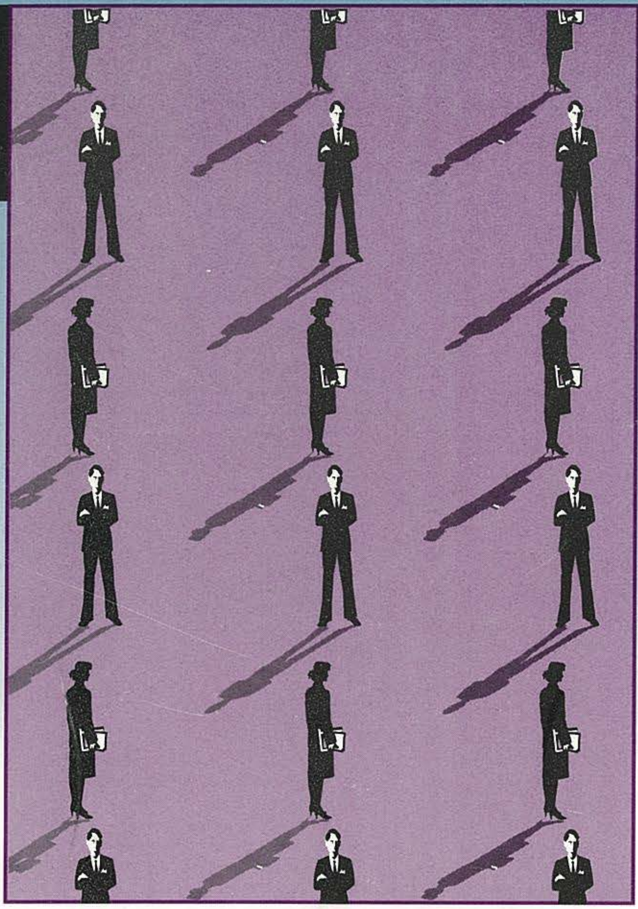

How ERISA Section 404(c) Affects You and Your Firm's Retirement Savings Plan

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An Evaluation of the Effect of the U.S. Department of Labor's Final Regulations on Retirement Savings Plans Offering Participant-Directed Investment Accounts

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CHAPTER 1

Overview

Over the past ten years, a major change has occurred in the way employers' retirement benefits are provided to employees. Use of defined benefit plans, which grant employees a fixed, guaranteed monthly retirement income, has diminished markedly in favor of various defined contribution plans, including the increasingly popular 401(k) plans.

Many defined contribution plans and virtually all 401(k) plans allow participants to direct the investments in their respective accounts. This report focuses on the long-awaited Department of Labor ERISA Section 404(c) regulations which specify requirements for the structure and administration of participant-directed plans.

The Department of Labor's final regulations under Section 404(c) address the key question of who is responsible (and potentially liable) for the investment performance of participant-directed investments. If a plan sponsor is to avoid potential liability for investment losses or substandard investment performance due to an account's imprudent investment by a participant, compliance with the proposed regulations appears to be mandatory.

Chapters 2 and 3 of this report discuss fiduciary liability under the general rules of ERISA and explain how Section 404(c) regulations will effect a fiduciary's duties.

Chapter 4 spells out the investment requirements under the Department of Labor's regulations and provides a basis for interpreting specific Department of Labor wording with respect to investment requirements.

Finally, Chapter 5 provides a step-by-step approach for implementing the regulations and offers suggestions as to how plan sponsors may enhance the value of their retirement savings plans while avoiding unnecessary liability.

Important Notice

The body of this work is an interpretation of the final Section 404(c) regulations, a study which reflects the opinion of the authors and which should not be construed as providing either legal or investment advice. Further, the authors strongly recommend that plan sponsors and fiduciaries consult with their legal and investment counsel as to the specific effect the regulations may have on their firm's qualified retirement savings plans.

CHAPTER 2

Fiduciary Liability Under ERISA

What Is ERISA?

To understand what effect the Department of Labor's Section 404(c) regulations may have on participant-directed retirement savings plans, it is helpful to know the basic premises for liability under the Employee Retirement Income Security Act (ERISA). In this section we will briefly review a retirement savings plan sponsor's or other fiduciary's liability under ERISA.

In 1974 Congress enacted ERISA as a basis for regulating employee benefit plans, particularly pension plans, and to protect the interests of employees and their beneficiaries. This body of legislation came in response to the tremendous growth in employee benefit plans and their significant impact on the financial well being of millions of Americans.

Who Is an ERISA Plan Fiduciary?

ERISA Section 3(21)(A) defines a plan fiduciary as anyone who exercises control over plan assets or plan administration despite title or position. This definition will typically include the plan's sponsoring employer, members of the plan "committee," and if a plan has one, the plan's trustee.

Fiduciary's Duties and Responsibilities

ERISA regulations outline the basic duties and responsibilities of a retirement plan fiduciary in Section 404(a). These duties are to operate a plan for the exclusive benefit of its participants and beneficiaries and to invest the plan's assets prudently and with proper diversification. We'll discuss what "investing prudently and with proper diversification" means in more detail in the next section.

Liabilities For Breach of a Fiduciary's Duties

If a fiduciary violates his or her duties under ERISA, ERISA defines the resultant liability in Section 409(a):

> Any person who is a fiduciary with respect to a plan who breaches any responsibilities, obligations or duties imposed upon fiduciaries shall be *personally* liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made

through the use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. [Emphasis supplied]

Thus a fiduciary who breaches any of his or her ERISA duties can be held *personally* liable for any resulting losses and may be required to reimburse the plan for such losses.

The "Prudent Man Rule" Vs. the Modern View of Prudence In Investment Matters

Prior to ERISA, the courts often interpreted prudence as requiring trustees to make conservative investments for the plan and to avoid investments having a high degree of risk. This rule was applied on an investment by investment basis. Fiduciaries could be held liable for the loss incurred on a single speculative investment made with plan assets even if the portfolio achieved a good total return for the plan. Moreover, the standard of prudence was generally the conduct of "prudent men." The consequence of this legal analysis was that fiduciaries tended to invest in securities that: 1) had little apparent investment risk associated with them; and, 2) were popular among other fiduciaries. [Longstreth, 1986]

The modern view of prudence, based on extensive academic research and reasoning, holds that no particular investment—for example, investment-grade bonds—can be viewed, in isolation from the portfolio as a whole, as prudent. Rather, an investment is prudent if it can be expected to advance the investment objectives of the overall portfolio as a whole.

In interpreting ERISA, the Department of Labor has adopted the modern view of prudence in regulations under Section 404(a)(1) of ERISA. This view has also been embraced, on a much more extensive basis, by the American Law Institute in the *Third Restatement of the Law: Trusts* (*Prudent Investor Rule*).

The modern view of prudence shifts the focus from an individual investment to the way in which the different types of investments in the portfolio work together.

Procedural Prudence Is Also An Issue

In addition to the issue of prudence as it applies to a plan's overall portfolio, the concept of prudence is also applied in the context of process or procedure, as followed by a plan's fiduciaries in their decision making process.

"Prudence," former SEC Commissioner Bevis Longstreth explains in his book, *Modern Investment Management and the Prudent Man Rule,* "should be measured principally by the process through which investment strategies and tactics are developed, adopted, implemented, and monitored." [Longstreth, 1986]

Michael S. Melsinger, Esq. in a recent paper entitled, *Insurance Company Insolvency and Retirement Plans,* states that "the requirement of prudence has evolved into one where fiduciaries must follow a course of *procedural* prudence concerning the decision making process," that is, fiduciaries would be wise to follow a set of established procedures when making decisions and document those decisions. The benefits are real: If the fiduciaries have diligently investigated and documented the alternatives of a decision, the court will not likely challenge that decision. The court in *Katsaros v. Cody*, 744 F.2d 270 (2d Cir. 1984) described the issue as "whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment." [Melsinger, 1991]

CHAPTER 3

How Section 404(c) Affects Fiduciary's Duties

While under ERISA Section 404(a) a fiduciary must invest the plan's assets prudently and with proper diversification, ERISA Section 404(c) provides an exception in the case of defined contribution plans, such as 401(k) plans and profit sharing plans, that permit participants to choose the investments for their accounts. Section 404(c) states:

> In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary),
>
> (1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

Therefore ERISA Section 404(c) may protect a plan fiduciary from liability for losses incurred in a participant-directed account where the *participant* is responsible for having invested his or her account imprudently.

In an article in *Pension World,* one attorney has described how a fiduciary's duties are affected in participant-directed plans: "In general, 404(c) provides that if a participant of an employee retirement plan exercises control over the assets in his or her account, a plan sponsor will not have fiduciary liability for any losses suffered as a result of the investment choices made by the employee." [Guarino, 1992]

History of the Regulations

Regulations Under Section 404(c) First Proposed In 1987

Although Section 404(c) states that the applicability of its protection is to be determined "under regulations of the Secretary [of Labor]," it was not until 1987, some 13 years after the enactment of ERISA, that the Department of Labor first issued proposed regulations under Section 404(c). [Bailey, 1991]

The 1987 proposal was, however, silent or unclear on a number of significant issues and was widely and severely criticized by the private sector.

Modified and Clarified In the 1991 Proposal

On March 13, 1991, the Department of Labor re-proposed regulations under Section 404(c). The new proposal modified and clarified the 1987 proposal by, among other things, attempting to provide plan fiduciaries with greater certainty in determining the circumstances under which they will enjoy protection from liability.

Finalized In October 1992

The Department of Labor released final ERISA Section 404(c) regulations on October 13, 1992. The framework and core provisions of the 1991 proposal were left largely unchanged. The final regulations did, however, expand upon and clarify Section 404(c)'s disclosure provisions as they apply to providing participants with sufficient investment information.

404(c) Regulations Not Intended As a "Safe Harbor"

It is vital to grasp that the Department of Labor's final Section 404(c) regulations are expressly intended as the sole means of compliance with ERISA Section 404(c). The regulations are *not* a mere "safe harbor." (See the explanation of this term in the sidebar, "Safe Harbor–A Definition For Section 404(c).") Thus, compliance with all aspects of the Department of Labor's 404(c) regulations is mandatory to obtain the relief available under Section 404(c). [Bailey, 1992]

This means that, where a participant is permitted to choose investments for his or her account and a loss occurs, there would likely be only two alternatives:

1. If the loss resulted from the participant's exercise of control over his or her account

in a plan meeting the requirements of the Department of Labor's final 404(c) regulations, the fiduciary would be protected from liability under Section 404(c).

2. On the other hand, if the plan did not comply with the Department of Labor's final Section 404(c) regulations, the fiduciary would not be permitted to raise in his, her or its defense that the participant made the investment choices and, therefore, the fiduciary would be liable if the account had been invested imprudently, just as if the fiduciary had had sole control of the account and had made the investment decisions for him, her or itself. Given this, the fiduciary could escape liability only by showing that the investment of the account was prudent.

To better understand this, let's look at a hypothetical case. Suppose that a participant who is nearing retirement age chose to have his or her entire $500,000 account invested in a plan's common stock fund. Suppose that the participant's account suffers a $100,000 (20 percent) loss as the result of a stock market "crash" such as occurred on October 19, 1987. Is the plan's fiduciary exposed to liability for the loss?

If the procedures under which the participant chose to invest his or her entire account balance in the plan's common stock fund met all of the requirements of the Department of Labor's proposed Section 404(c) regulations, the fiduciary would have no exposure to liability. If they did not, then the plan fiduciary could have some exposure to liability, depending on whether, under the circumstances, the participant's allocation of 100 percent of his or her account in the common stock fund was defendable as a "prudent" investment.

"Safe Harbor"– A Definition for Section 404(c)

A regulatory "safe harbor" is a compliance path that is well demarcated in the applicable regulations, but that is not intended as the exclusive means of compliance with the underlying statutory rule. Thus, while compliance with a regulatory safe harbor is automatically viewed by the regulatory agency as compliance with the underlying statute, the regulatory agency makes no claim that the safe harbor is the only basis for claiming compliance with the statute. Other methods of compliance may also exist based on individual facts and circumstances. (In other words, not every ship that strays from the safe harbor will be lost in the storm, but if you venture out, you're on your own.) The Department of Labor's final regulations under ERISA Section 404(c) are *not* intended as a safe harbor. Compliance with them is intended by the Department of Labor to be the sole means of qualifying for the relief available under Section 404(c) of ERISA.

CHAPTER 4

Investment Requirements Under Section 404(c)

Two basic requirements presented in the Department of Labor's final regulations are that the plan offer "a broad range of investments" and that the investment options "must be sufficient to permit the participant to pursue a variety of investment objectives." There are two ways in which a plan can meet the "broad range of investments" requirement.

"Invest In the World" Approach To Self-Direction

One way is to allow for "invest in the world" self-direction; that is, each plan participant is permitted to select from a virtually unrestricted universe of investment instruments. The premise for this approach is that by providing access to virtually any investment vehicle, such as Treasury Bills, stocks, bonds, mutual funds, real estate limited partnerships, etc., participants have the requisite control over their accounts.

While the "invest in the world" approach may be ideal for some firms who wish to provide highly compensated individuals with the flexibility to pursue sophisticated investment strategies, it may be impractical for most companies, both large and small. [Bailey, 1992] Many plan sponsors consider the "invest in the world" approach impractical for reasons of cost, or administrative complexity, or because of the employees' questionable ability to achieve real growth in their plan accounts when given access to an unlimited and bewildering number of investment options.

The alternative to "invest in the world" self-direction is a structure that complies with the final 404(c) regulations' rule to provide "three or more diversified investment alternatives."

Three or More Diversified Investment Alternatives Rule

Under the "three or more diversified alternatives rule," a plan must offer at least three *core* investment options that meet certain requirements under Section 404(c). The word "core" is used here to show that at least three of the investment alternatives must comply with the regulations, whereas additional options, if offered, do not necessarily have to meet all the requirements in order for the plan to comply with the rule.

The Department of Labor avoided naming specific investment alternatives as requirements so as not to "unnecessarily limit the ability of plan sponsors to accommodate changes in employee needs and changes in investment products and markets." Instead, the Department of Labor outlined a number of general requirements that the "three or more diversified investment alternatives" would have to meet.

The investment requirements for the Three or More Diversified Alternatives Rule outlined in the Department of Labor's final Section 404(c) regulations can be ascribed to an approach to investment analysis developed within the academic community forty years ago. This approach is now widely accepted, and it affects the investment decisions of a majority of institutional investors.

Basis For "Three or More Diversified Investment Alternatives" Rule Found In "Modern Portfolio Theory"

The foundation of this approach, which lies in disciplined understanding of the relationship between risk and return, was formalized into a hypothesis, known as *Modern Portfolio Theory.* The theory, first described by Professor Harry Markowitz in an article that appeared in 1952 in the *Journal of Finance* and subsequently in a book in 1959, *Portfolio Selection,* earned him the Nobel Prize. [Malkiel, 1990]

Professor Markowitz started with the simple observation that investors are inherently risk-averse. Given a choice between two investments with an equal rate of return, a rational investor will select the one with less risk. Markowitz found that unnecessary risk could be avoided in an investor's portfolio by diversifying it over a broad range of investment categories with significantly different risk and return characteristics.

Markowitz' subsequent discovery was that for any rate of return an investor was attempting to achieve, there is a commensurate level of risk that must be assumed. The higher the expected return, the greater the risk that must be accepted. Put another way, once an investor has established his or her risk tolerance, it is possible to identify and construct a portfolio that will generate the highest possible return relative to the investor's tolerance for risk. The concept of achieving the highest possible return at a given level of risk by scientifically diversifying an investment portfolio is one of the fundamental principals of Modern Portfolio Theory. [Farrell, 1983]

By embracing Modern Portfolio Theory in its final Section 404(c) regulations, the Department of Labor is attempting to make this accepted basis for investing available to the individual plan participant.

Investment Alternatives Must Have Different Risk and Return Characteristics

The first requirement of the Three Diversified Investment Alternatives Rule is that the investment alternatives offered under the plan must have "materially different risk and return characteristics." To understand this requirement it may be helpful to view an investment alternative as an *asset class* or *investment category.* The plan's three core asset classes should have different long-term *rates of return* and *risk* characteristics.

An example of three investment alternatives illustrates the rates of return possible among different asset classes. Consider the investment benchmarks of 90-Day Treasury Bills, Standard & Poor's 500-Stock Index,[1] and the Salomon Brothers Government/Corporate Bond Index.[2] These three asset classes have achieved very different rates of returns over the twelve year period from December 1979 to December 1991, as shown in figure 1.

[1]Standard & Poor's 500-Stock Index represents shares of the 500 largest corporations in the U.S. and 70 percent of the value of all U.S.-traded common stocks.

[2]The Salomon Government/Corporate Bond Index is an indicator of the overall domestic bond market.

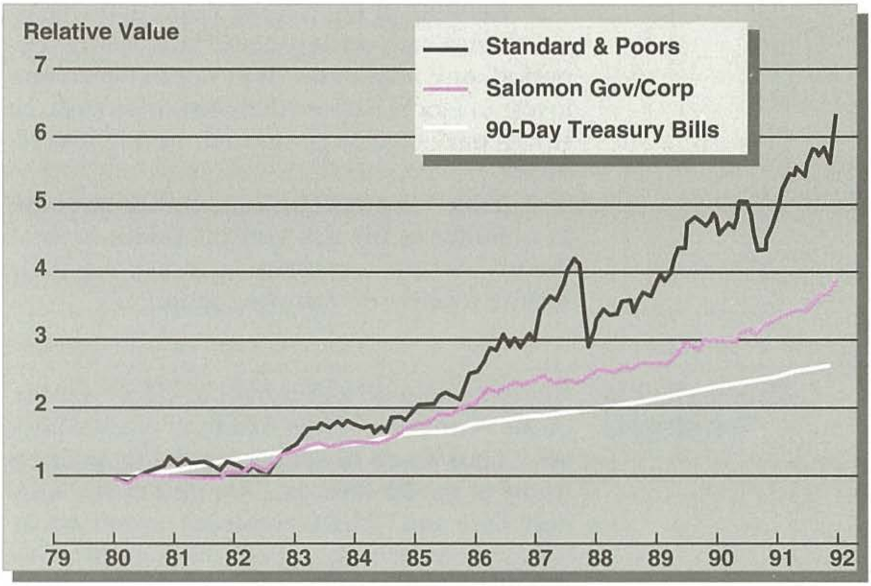

FIGURE 1
Three asset classes, 90-day Treasury Bills, Standard & Poor's 500-Stock Index, and the Salomon Brothers Government/Corporate Bond Index, have achieved very different rates of return over the twelve year period from December 1979 to December 1991.

INVESTMENT INDEX	RATE OF RETURN	STANDARD DEVIATION
90-Day Treasury Bill	8.54%	2.18%
Salomon Government/Corporate Bond Index	12.14%	7.50%
Standard & Poor's 500-Stock Index	16.60%	14.70%

TABLE 1
The standard deviation and rates of return of three asset classes for a twelve year period from December 1979 to December 1991.

Looking at the relative value that stocks, bonds and cash achieved over the twenty year period, one might ask, "Why doesn't everyone invest in stocks, rather than bonds or cash, as stocks have clearly generated the highest returns?"

Table 1 sheds some light on this question by quantifying the risk associated with each of the investment categories by indicating their relative volatility or "standard deviation".

Defining Risk In Investments

It may be helpful at this point to clarify our use of the word "risk." Note that each of the above asset class's rate of return is directly proportional to its risk level as measured by its "standard deviation." This is consistent, as you will recall, with Markowitz's theory that an investor should be rewarded for taking on a higher level of risk by receiving a higher rate of return.

In this context "risk" can be defined as the variability of returns over a given period of time. (The variations of returns are considered "risky" because they make it difficult or impossible to predict with confidence the asset's value, at least over a relatively short period of time.) For example, a one year Certificate of Deposit provides for a specific yield and guarantees a return of principal at the end of twelve months. There is almost no risk of a loss since the rate of return does not change during that period and the principal is guaranteed by the U.S. Government.

A one year investment in the stock market, on the other hand, is anything but predictable. For example, were an investment made in Standard & Poor's 500-Stock Index during the 1990 calendar year, the investor would have lost 3 percent of his or her principal. The same investment made in 1991 would have earned the investor a return of 31 percent. Variations in stock market returns (or in the lack of its predictability) is the reason it is considered inherently risky even though we know that, over long periods of time, the stock market has outperformed other classes of investments such as government bonds.

Modern Portfolio Theory measures the risk of a given asset class by calculating the variability of the asset's returns. This measurement is referred to as the investment's *standard deviation* and is shown as a percentage. The larger the percentage the more volatile (or risky) the asset is considered to be. Note that a standard deviation only takes into account 68.4 percent, or roughly two-thirds, of an asset's possible returns. As such it is best viewed as a relative measure of volatility rather than an absolute one.

The standard deviation for 90-Day Treasury Bills, Salomon Brothers Government/Corporate Bond Index, and Standard & Poor's 500-Stock Index are shown in table 1. The standard deviation refers to the range of returns one can expect from investing in a given asset or asset class at least two-thirds of the time. For example, over the past twelve years, returns from 90-Day Treasury Bills averaged roughly 8.5 percent with the range falling between 6.3 percent and 10.7 percent most of the time.

Over the same period the Salomon Brothers Government/Corporate Bond Index averaged roughly 12.1 percent with a much wider range of returns of 4.6 percent on the low side and 19.6 percent on the high side, at least two-thirds of the time.

Returns from shares in the Standard & Poor's 500-Stock Index, while averaging 16.6 percent, ranged from 1.9 percent to a high of 31.3 percent most of the time and generated even greater extremes on several occasions. Perhaps the best way to grasp the relative volatility of the three asset classes is to see their trailing twelve year returns in figure 2.

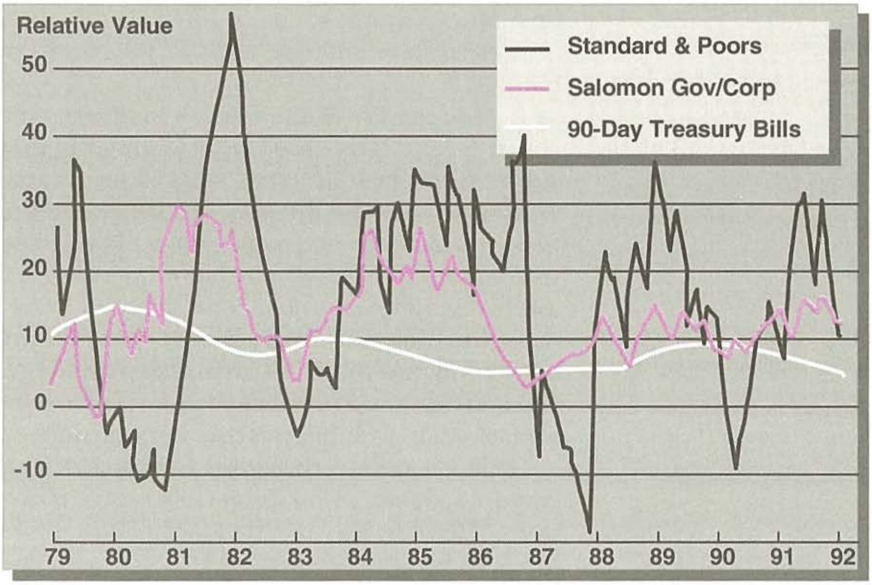

FIGURE 2
One year rates of return for three investment asset classes during a twelve year period from December 1979 to December 1991.

Looking at figures 1 and 2, it becomes clear that, while 90-Day Treasury Bills provided an investor with the smoothest ride in terms of predictability of returns, they also produced the lowest average rate of return of the three asset classes. Alternately, an investor, riding the roller coaster of returns generated by Standard & Poor's 500-Stock Index would have earned, over the same period, significantly higher returns than with investments in Treasury Bills. Taking the middle road in terms of both risk and return was the Salomon Brothers Government/

Corporate Bond Index. Clearly, these three asset classes offer very different risk and return characteristics.

Investment Alternatives Must Be Diversified

The second requirement of a plan's investments is *diversification*. Section 404(c)'s "three or more diversified investment alternatives rule" requires plans to "provide participants and beneficiaries with a reasonable opportunity to choose from a diversified group of investments within each of three categories" and permit participants and their beneficiaries to diversify their accounts "so as to minimize the risk of large losses."

The regulation's "three or more diversified investment alternatives" rule would require two types of diversification—diversification within each of a plan's three or more investment alternatives and diversification among them.

Issuer Diversification: Diversification Within a Plan's Investment Vehicle

Diversification *within* a plan's investment alternative is a "don't put all your eggs in one basket" approach to investing. This type of diversification limits a portfolio's exposure to the risks of a given issuer, industry, geographical region, or, in the case of fixed income obligations, to the risks of a given interest rate and maturity. This type of diversification is sometimes referred to as "issuer diversification."

Section 404(c) addresses issuer diversification with its requirement that a plan provide participants and beneficiaries with the opportunity "to choose among a diversified group of investments within each of three categories" and to diversify their investments "so as to minimize the risk of large losses."

What James B. Cloonan, President of the American Association of Individual Investors wrote about investing in the stock market in the brochure, *A Lifetime Strategy for Investing in Common Stocks*, may help us to understand the benefits of issuer diversification in the context of a stock portfolio. The basic theory also holds true for other types of investment vehicles.

> "In the stock market, two factors will cause a stock's return to vary: changes in the way in which investors perceive the firm and movements in the overall stock market. Thus, there are two components to the risk that an investor faces: market risk, which is inherent in the stock market itself; and firm risk, which is associated with the unique characteristics of any one stock and the industry in which it operates.
>
> "Firm risk accounts for about 70 percent of the total risk that stock investors face. Yet this risk can be eliminated by diversifying among different stocks—investing in, for instance, 10 different stocks rather than just one. Market risk, on the other hand, accounts for about 30 percent of the total risk and cannot be avoided by diversification, since all stocks are affected to some degree by the overall market.
>
> "An investor with a single stock in his portfolio is taking on 100 percent of the risk associated with stock investing, compared with only a 30 percent risk that an investor with a diversified portfolio would take on—in other words, the single-stock investor is taking on three times more risk. Investors who consider themselves conservative but invest in one low-

risk stock actually incur more risk than investors with a portfolio of 10 aggressive growth stocks—and the conservative investors are getting a lower expected return, since they are in lower risk, lower return stocks.

"This illustrates an important concept. The stock market provides higher returns for higher risks, but it only provides those higher returns for *unavoidable* risk. Firm risk is largely *avoidable*. No matter what objectives investors have, no matter what the intended holding periods are, no matter what kind of stock analysis is performed: *If investors do not have diversified portfolios; they are either throwing away return or assuming risk that could be avoided—or both.*" [Emphasis supplied]

Investment Alternatives Must Be Diversified

Asset Class Diversification: Diversification Among a Plan's Investment Alternatives

The second type of diversification required by the final Section 404(c) regulations is *among* a plan's three or more diversified investment alternatives. This type of diversification is achieved when there is a reasonable expectation that, because investments from different asset classes (for example, stocks, bonds, and real estate) are combined in the same portfolio, gains in one part of the portfolio will offset losses in another part of the portfolio. This type of diversification is often referred to as *asset class diversification* or *investment category diversification.* It controls a portfolio's exposure to the unavoidable "market risk," referred to by Mr. Cloonan, by simply exposing the portfolio to different markets, not all of which are synchronized to each other.

The plan sponsor, when selecting investment options for a plan, must take into account the diversification of asset classes so that, in the words of the Section 404(c) regulations, each "alternative when combined with investments in either of the other two categories [tends] to minimize the risk of a participant's portfolio at any given level of expected return."

Consider the example from a Price Waterhouse publication[3] of how asset class diversification can reduce an investor's total risk. Say you buy shares in a mutual fund that invests in only fast-growing companies. To comply with the requirement to diversify, you may also invest in a long-term corporate bond. How do these investments help you to minimize risk?

If inflation should go up, the value of the mutual fund may go up, too. On the other hand, a prolonged recession would probably drive down the value of your mutual find shares.

The hypothetical effects of inflation on the value of your corporate bond would, however, be exactly the opposite. High inflation means your bond is worth less because the bond's purchasing power is being eroded and new bonds issued after yours will probably have higher interest rates. Low inflation improves the resale value of your bond since the interest rate on your bond will likely remain current with the interest rates for new bonds, and the bond's purchasing power will remain relatively constant.

Thus the negative effect of inflation on one of your investments is offset by the positive effect on the other. You've reduced your risk—and increased your chances of building retirement assets—by diversifying among investment categories.

[3]For an example of asset class diversification see *The Price Waterhouse Retirement Planning Adviser,* Pocket Books (1991), pages 103–104.

Modern Portfolio Theory measures the degree to which an asset class, when combined with assets in other categories, will reduce a portfolio's risk at a given level of expected return by calculating the relative "correlation" among asset classes.

Asset classes which have exhibited historically a high degree of correlation will tend to react similarly to a given set of economic and market conditions. Conversely, asset classes exhibiting negative correlation will tend to react differently to a given set of conditions. There is also the possibility that asset classes will exhibit neither positive nor negative correlation, indicating that there is no historical relationship between them.

The correlation between asset classes, or the lack thereof, is a key factor in the diversification of an investment portfolio. An investor who combines asset classes exhibiting a high degree of correlation will derive little benefit from this attempt to achieve portfolio diversification. Correspondingly, an investor who allocates his or her account among investment categories with a small percentage of positive correlation (less than 50%), no correlation or negative correlation will succeed in achieving meaningful diversification.

The Correlation Matrix in table 2 illustrates the historical relationship among five alternative asset classes over the past twenty years (December 1971 through 1991). For example, the relationship between 90-Day Treasury Bills and the Standard & Poor's 500-Stock Index is –0.24 or a 24 percent negative correlation. Combining these two asset classes will tend to reduce the volatility or risk of a portfolio at any given level of expected return. On the other hand, the correlation of the Standard & Poor's 500-Stock Index and Balanced Mutual Funds (funds investing in a blend of stocks, bonds and cash) is a positive 94 percent. Combining these two assets in a portfolio will result in a minimal reduction in the level of overall risk.

INVESTMENT INDEX	30-DAY TREASURY BILLS	BALANCED MUTUAL FUND	INTERNATL MUTUAL FUND	STANDARD & POOR'S 500-STOCK INDEX	SALOMON GOVT/ CORP BOND INDEX
30-Day Treasury Bills	1.00	-0.14	-0.27	-0.24	-0.03
Balanced Mutual Fund	-0.14	1.00	0.77	0.94	0.67
International Mutual Fund	-0.27	0.77	1.00	0.85	0.22
Standard & Poor's 500-Stock Index	-0.24	0.94	0.85	1.00	0.41
Salomon Government/ Corporate Bond Index	-0.03	0.67	0.22	0.41	1.00

TABLE 2
Correlation matrix for five investments for a 20 year period from December 1971 to December 1991.

An example of three investment alternatives that, when combined, would meet the requirement of asset class diversification outlined by Section 404(c) is a money market mutual fund, an intermediate- or long-term corporate bond fund, and a domestic common stock fund. As indicated in the correlation matrix, each of these alternatives—when combined with the other two—will tend to minimize an investor's total risk. This is because historically each of these investment categories has reacted differently to the same market and economic conditions.

An example of three investment alternatives that, when combined, would probably *not* meet the asset class diversification requirement is a Standard & Poor's 500-Stock Index fund, an international stock fund, and a balanced mutual fund investing in both stocks and bonds. The reason that this combination would probably not comply is that, even though each of these asset classes may seem very different, historically (as can be seen from the table) they have reacted in a similar manner to the same market and economic conditions.

Provide Options With Risk and Return Characteristics Appropriate To Participants

The three or more diversified investment alternatives rule requires plans to give participants the opportunity to "achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant," and "allow each participant to construct a portfolio with risk and return characteristics appropriate to his or her financial or personal circumstances."

The regulations go on to state "the purpose of this requirement is to give a participant the ability to allocate his account among the three categories of investments, so as to minimize the risk presented by his portfolio at any given level of expected return."

The just quoted requirements of the final 404(c) regulations are a direct reference to a concept defined in Modern Portfolio Theory as the *efficient frontier.* Assuming an investor has taken steps to avoid unnecessary risk (for example, investing in a basket of diversified stocks rather than the stock of just one company) the "efficient frontier" represents the range of portfolios that achieves the most efficient trade-off between risk and return.

In alluding to the efficient frontier concept, the regulations acknowledge that investors have different financial objectives and risk tolerances and are therefore willing to accept different amounts of risk and levels of expected return within their investment portfolios.

The assumption that investors are risk averse is evident from daily experience. Markowitz observed that investors typically hold diversified portfolios. If investors were not risk averse, then most investors would hold the single security promising the highest return so as to maximize their expected return. Earlier in this section we showed that securities with different degrees of risk differ in their return realized over time, with higher risk accompanied by higher return. This is evidence that investors require a higher return in order to accept higher risk.

James L. Farrell in his *Guide to Portfolio Management* summarizes the basis for the Markowitz Efficient Frontier model as follows: "Rational investors will choose to hold efficient portfolios, which are those that maximize expected returns for a given degree of risk or, alternatively and equivalently, minimize risk for a given expected return." [Farrell, 1983]

The efficient frontier model is illustrated in figure 3. The vertical axis refers to expected returns; the horizontal axis refers to risk as measured by the standard deviation of return. The slanted line running between the two axis is the efficient frontier (risk/return line) which connects those combinations of asset classes (portfolios) that represent the optimal trade-off between risk and return. Inadequately diversified or "inefficient" portfolios will fall below the risk/return line. These combinations of assets are considered inefficient because they assume an inordinate amount of risk relative to their expected returns.

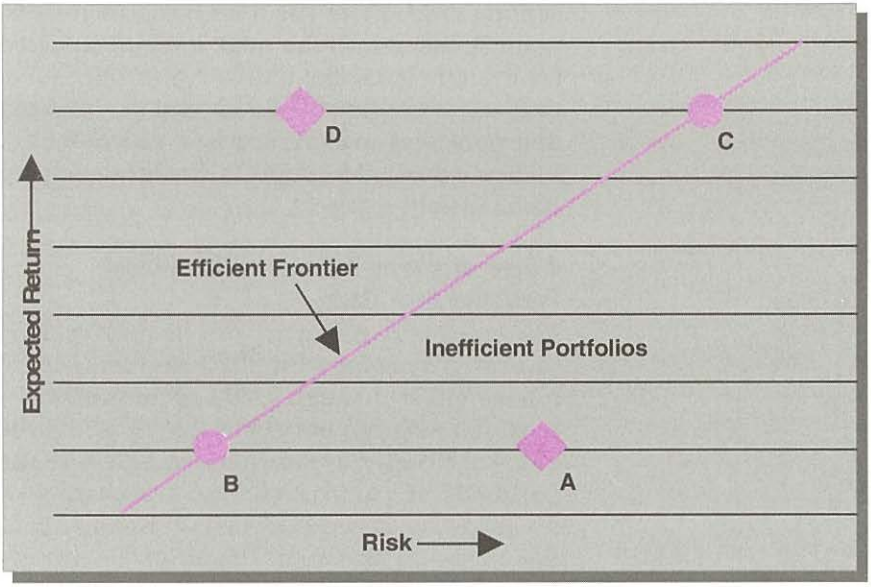

FIGURE 3
The efficient frontier represents the optimal tradeoff between risk and return from investments. Inadequately diversified or "inefficient" portfolios will fall below the diagonal line.

Investors, typically, prefer to hold efficient portfolios—that is, ones on the line and not those below it. The particular portfolio that an individual investor selects from the efficient frontier depends on that investor's degree of aversion to risk. An investor who is highly risk averse will select one on the lower left of the figure, such as the portfolio represented by point B, while an investor with a high tolerance for risk will choose one on the upper end of the frontier, such as that represented by point C.

The risk adverse investor would be foolish to choose a portfolio, such as that represented by point A, because the investor would be accepting much more risk than is represented by point B, but at only the same level of expected return. Of course the ultimate portfolio is one that assumes almost no risk and at the same time generates an extremely high rate of return, such as exhibited by point D. Unfortunately, no such portfolio exists.

A Comparison of Optimal and Inefficient Portfolios Over Time

The concept of efficiency can be further demonstrated by comparing the historical performance (1971 through 1991) of an inefficient portfolio with two portfolios that lie along the efficient frontier, as illustrated in figure 4. The portfolios are constructed from one or more of the following asset classes: 90-Day Treasury Bills, the Salomon Brothers 10+ Years Corporate Bond Index (corporate bonds with maturities of ten or more years) and the Standard & Poor's 500-Stock Index.

In this example the inefficient portfolio (portfolio A) is one that invests exclusively in a fund replicating the Salomon Brothers 10+ Years Corporate Bond Index. This portfolio has achieved issuer diversification by investing in a broad range of corporate bonds but has failed to diversify among asset classes.

The inefficient single asset class portfolio (A) can be compared with an efficient combination of the three asset classes (portfolio B). The efficient portfolio (B) is superior to portfolio A because *it has generated the same level of return while assuming 48 percent less risk* (as measured by the portfolios' respective standard deviation).

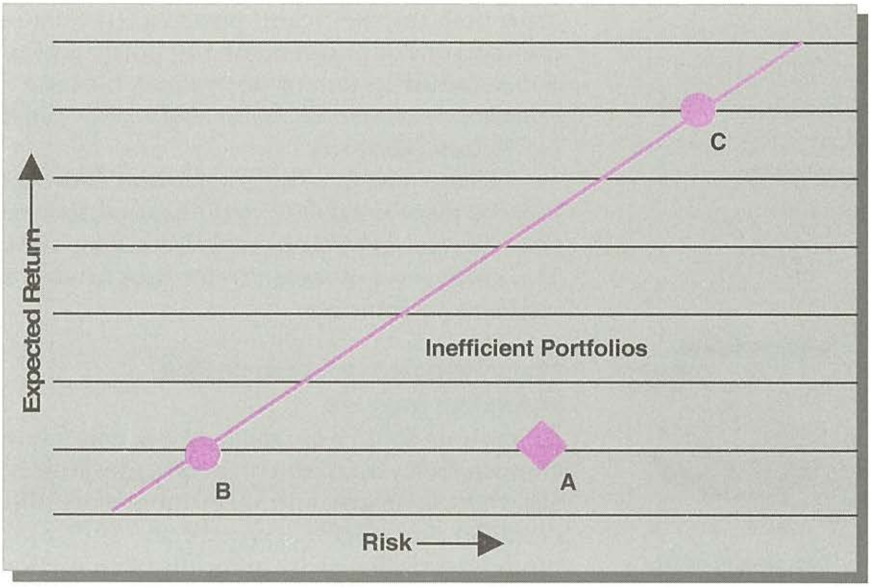

FIGURE 4
Three portfolios discussed in the text that illustrate the relationship of risk and expected return relative to the efficient frontier.

PORTFOLIO	90-DAY TREASURY BILLS	SALOMON 10+ YEARS CORPORATE BOND INDEX	STANDARD & POOR'S 500-STOCK INDEX	RATE OF RETURN	RISK	VALUE OF $10,000 INVESTMENT AFTER 20 YRS
A	0%	100%	0%	9.2%	11.45	$60,501
B	59%	7%	34%	9.2%	6.03	$60,541
C	23%	8.5%	68.5%	10.45%	11.45	$79,954

TABLE 3
Performance comparison of the three portfolios relative to the efficient frontier.

In a similar comparison, a second efficient portfolio (C) generated substantially higher returns than the inefficient portfolio (A). Thus, the investment performance of portfolio C is also superior to that of portfolio A because *it generated a substantially higher return while assuming the same level of risk.*

Please note that this comparison illustrates how the three portfolios would have performed from December 1971 through December 1991. The analysis is not meant to forecast future investment performance.

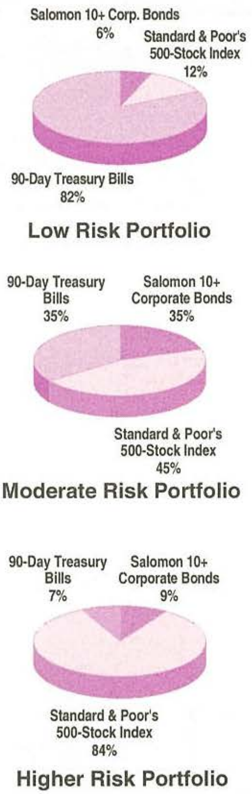

FIGURE 5A
Investment allocations of three model portfolios that have low, moderate and higher risk factors.

Model Portfolios Demonstrate Risk and Return Trade-off

To illustrate further the range of risk and return characteristics from which participants must be allowed to construct an investment portfolio, consider the performance of the following model portfolios over the twenty year period from December 1971 through December 1991.

The model portfolios are constructed from the same three asset classes utilized in the above example: 90-Day Treasury Bills, the Salomon Brothers 10+ Years Corporate Bond Index, and Standard & Poor's 500-Stock Index. These asset classes have been combined to produce portfolios exhibiting low, moderate and high levels of risk. This time, three efficient models are followed by a summary (see table 4) of each portfolio's average return over the twenty year period, the portfolio returns achieved during the best and worst years and the increase in value of an initial $10,000 investment over the twenty year period. It is crucial to realize that, although each of these three portfolios is very different, in contrast to portfolio A in figure 4, portfolios *x*, *y*, and *z* (in figure 5b) are efficient.

Portfolio (*x*) in figure 5b illustrates a combination of investments that exhibit relatively low risk characteristics, as indicated by its position on the efficient frontier and the fact that the Low Risk Portfolio (*x*) did not suffer negative returns during any calendar year from 1971 through 1991, as indicated in table 4.

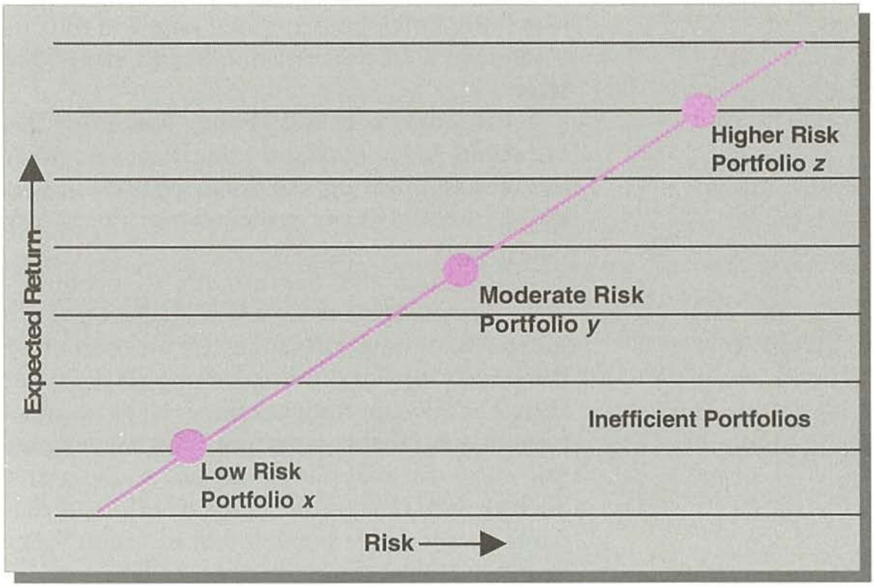

FIGURE 5B
Positions along the efficient frontier of three model portfolios that have low, moderate and higher risk.

	ANNUALIZED RETURNS DECEMBER 1971-DECEMBER 1991			INVESTMENT
PORTFOLIO	AVERAGE	BEST YEAR	WORST YEAR	AFTER PERIOD
Low Risk	8.20%	13.9%	2.8%	$51,219
Moderate Risk	9.78%	26.3%	-10.0%	$70,287
Higher Risk	10.94%	29.9%	-21.8%	$88,311

Table 4
Performance comparison of three model portfolios.

The Moderate Risk Portfolio (*y*) generated substantially higher returns than the Low Risk Portfolio over the twenty year period; however, an investor utilizing the Moderate Risk Portfolio would have been subjected to several years in which the portfolio generated negative returns including a 10 percent decline in 1974 (see table 4).

An investor in the Higher Risk Portfolio (*z*) would have enjoyed the highest returns, at the cost of suffering the greatest variability in the value of his or her principal over the twenty year period.

It is clear that Section 404(c)'s requirement that participants be provided the opportunity to "materially affect the risk and return of their accounts" and that participants have the ability to allocate their accounts so as to minimize risk of a participants' portfolio at any given rate of return" may be interpreted to mean that Section 404(c) requires plans to offer participants a range of investment that will allow them to create efficient investment portfolios.

In addition, Section 404(c) requires fiduciaries to provide three investment alternatives that allow for different "aggregate risk and return characteristics at any point within the range normally appropriate for the participant." This can be achieved by designating options that, when combined, enable participants to build portfolios that have risk and return characteristics along different points of the efficient frontier.

Summary

Modern portfolio theory provides crucial insights that enable a plan fiduciary to translate what initially may seem undefinable regulatory language into concrete and quantitative terms.

Ability to Switch Among Alternatives No Less Frequently Than Quarterly

Another component of a plan's investment structure addressed by the proposed regulations concerns account transfers and valuations. Section 404(c) states that a participant must be permitted to switch among the three or more investment alternatives "no less frequently than once within any three-month period."

Furthermore, the wording of the regulations suggests, at least in some conditions, that the participant may need more frequent transfer capability when the plan provides investment alternatives with a relatively high degree of volatility. Specifically, "the opportunity to exercise control will not exist unless participants and beneficiaries are afforded the opportunity to give investment instructions with the frequency which is appropriate in light of the volatility to which the investment may reasonably be expected to be subject."

The new rule would contrast with the procedures currently followed by many plans, which report to participants and allow account transfers on an annual or semi-annual basis.

Provide Participants With Sufficient Information

One aspect of Section 404(c) which many plan sponsors have failed to address adequately is the requirement that participants be informed so that they are able to exercise control over their investment accounts.

[4]See Participant Directed Individual Account Plans, *Federal Register,* Volume 56, No. 49 (1991), page 10728.

Paragraph (b) (3) (iii) of the 1987 proposal states that an investment option would not be considered to be part of a broad range of investment alternatives unless sufficient information on that investment is made available to a plan's participant.

As stated in the *Federal Register,* "It is the Department's contention that participants cannot exercise meaningful control over their investments unless they have access to information on the basis of which informed investment decisions can be made."[4]

The final Section 404(c) regulations provide extensive clarification as to exactly what the Department of Labor considers sufficient investment information. The required information is outlined in a series of disclosures which must be made to all participants indicating the plan's intent to comply with the regulations and concerning the plan's designated investment alternatives and any other "available" investment options. The Department of Labor also established an additional class of information, which must be made available to participants upon request.

A detailed description of these disclosure requirements may be found in the next chapter. The following section will also include recommendations as to how a plan sponsor can comply with the proposed Section 404(c) regulations and, in the process, benefit from doing so.

CHAPTER 5

How to Enhance Your Plan and Limit Your Liability

Section 404(c) provides a framework for implementing and maintaining an investment structure for participant-directed accounts within a defined contribution plan. If the plan complies with the various requirements of Section 404(c), the plan's fiduciaries will be protected from liability resulting from substandard investment performance due to a participant's imprudent allocation of assets within his or her self-directed account. Compliance with Section 404(c) does not, however, relieve the fiduciary of several important responsibilities imposed by ERISA.

As discussed in the previous chapters, a plan's sponsor or fiduciary must fulfill a number of requirements to enjoy this protection from liability for investment returns. To help limit your liability and enhance your plan, this chapter will:

- Discuss several fundamental responsibilities imposed on plan sponsors and fiduciaries by ERISA that cannot be avoided or delegated away—irrespective of a plan's compliance with Section 404(c).
- Outline a step-by-step approach for fulfilling the requirements of Section 404(c).
- Explain how a plan sponsor, by providing participants with information concerning a plan's investment alternatives, will enhance the overall value of its retirement savings plan.

For a variety of reasons, including the sponsor's desire to offer a manageable group of investments, most participant-directed plans designate the specific investment alternatives in which participants may direct their accounts. While this investment configuration enables participants to choose from investment vehicles that have different objectives, once they have invested in a vehicle, they do not have control over the fund's investment decisions, nor do they have control of the managers who make those decisions.

Responsibilities Retained By Plan Fiduciaries

Therefore, to the extent that a plan designates investment alternatives to the exclusion of other investments, plan fiduciaries retain the responsibility for the following:

1. The prudent selection of investment vehicles;
2. The periodic performance review of investment alternatives; and,
3. The ongoing due diligence determination that the alternatives remain suitable investment vehicles for plan participants.

Fiduciary Considered a Prudent Expert

These fiduciary responsibilities exist because plan participants, lacking the ability to "invest in the world", must be assured that the plan's investment alternatives, individually and in combination, have been reviewed and deemed prudent by an independent fiduciary. In addition, participants must be protected from any substantial deviation in objective or significant deterioration in the performance of a plan's investment alternatives (relative to alternatives with a similar objective) by virtue of the fiduciary's periodic review of the investment's performance and the ongoing determination that the alternative is prudent within the specific requirements cited in Section 404(c).

Steps On How to Comply With Section 404(c)

In this section, we have outlined seven steps to help you to comply with the requirements of Section 404(c). These are:

1. Identify your plan's fiduciaries;
2. Determine your plan's need to comply with Section 404(c);
3. Consider retaining the services of an expert investment adviser;
4. Develop or revise your plan's Investment Policy;
5. Provide participants with a broad range of investment alternatives;
6. Provide the required investment information to plan participants; and
7. Establish a means for participants to give investment instructions.

Step 1: Identify Your Plan's Fiduciaries

The first step is to establish who is responsible for making decisions as to the plan's investments. Is it a single firm executive or a benefits committee, the senior or managing partner, the sole proprietor or majority stockholders?

The person or persons responsible for the plan's investment structure and content, whether they are formally identified as such in the plan document, are the plan's fiduciaries.

While this step may seem simplistic, a poor understanding of exactly who is responsible (and potentially liable) for administering a retirement savings plan and for investing its assets can be the cause of numerous problems. It is important to be aware that it is an individual's function with respect to the plan, rather than a title or position, that will ultimately determine whether he or she is serving as a plan fiduciary.

The term *trustee* is used, often erroneously, as a synonym for fiduciary. Many plans retain the services of a corporate trustee, such as a bank trust department or an affiliate of a mutual fund management company. In most cases, however, the corporate trustee will typically avoid involvement in investment selection and retention decisions, and will not have the responsibility for ensuring a plan's compliance with Section 404(c). If you have any doubt whatsoever about who are your plan's fiduciaries, you should consult your legal counsel.

Step 2: Decide Whether Your Plan Needs to Comply With Section 404(c)

Compliance with Section 404(c) is elective not mandatory. The principal motivation for complying with the regulations is to transfer the liability for investment performance from a plan's fiduciaries to its participants. (It should be noted, however, that for plans offering participant-directed accounts, compliance with Section 404(c) may be the only practical method of ensuring that the plans' fiduciaries may not become liable for a participant's investment losses based on his or her own inappropriate investment decisions.)

To determine whether compliance with ERISA Section 404(c) is either necessary or desirable, plan fiduciaries should consider whether the regulations are:

1. Necessary. For instance, does your plan offer or anticipate offering participant directed accounts? If not, compliance is not an issue for you to consider.
2. Feasible. You may ask whether the number of participants and level of plan assets are sufficient to justify what could be an increase in administrative expense. The potential liability may not be severe enough to make compliance viable.
3. Appropriate. Is the plan structured such that it would be considered prudent under the broader Section 404(a) prudence requirements, possibly making adherence to the rules in Section 404(c) unnecessary?

Once again, any questions you may have concerning the necessity or avoidability of complying with the regulations should be addressed by your legal counsel.

Step 3: Consider Retaining an Expert Adviser

A plan's fiduciaries will be held to a standard which demands a high level of expertise with respect to the selection and retention of a plan's investment alternatives. The selection/retention decisions may require evaluation of technical and statistical data as well as an understanding of investment theory, financial markets and various investment vehicles.

Few plan sponsors will have access to the appropriate technical data and may lack the ability or time to interpret independently such information in a manner that can be described as prudently expert. For these reasons plan sponsors should consider retaining the services of an expert investment adviser.

One of the most important services performed by investment advisers is the preparation of analyses and comparisons that will serve as the basis for documenting the plan sponsor's decision making process, a critical component of "procedural prudence." (For a detailed explanation, see the section, *Prudent Man Rule and the Modern View of Prudence,* pages 11 and 12.)

Equally important, the adviser can assist in monitoring the performance of the plan's investments and will provide the plan's fiduciaries with information necessary to make "due diligence" determinations as to the ongoing suitability of the plan's investment alternatives.

Step 4: Develop or Revise Your Plan's Investment Policy

An Investment Policy is a document which establishes a plan's overall objective and outlines the basis and framework for making decisions concerning the selection and retention of investment alternatives.

Participant-directed plans seeking to protect fiduciaries from responsibility for losses incurred in participant accounts should state their intent to transfer control and responsibility for the plan's investments and its intent to comply with Section 404(c) in the plan's Investment Policy Statement.

The Investment Policy should also describe the various investment categories or asset classes to be offered by the plan and the criteria for selecting a particular investment vehicle to represent each category. Such criteria might include the types of acceptable investment vehicles, the minimum length of time over which the vehicle must have an established track record, the index or average against which the vehicle's performance will be compared, and the specific level of performance the investment alternative will have to achieve relative to the selected average or index.

For example, the selection/retention criteria applicable to a plan's "growth stock" investment alternative might include the following:

1. The investment vehicle will have an investment track record of no less than five years.
2. The fund's annualized rate of return net of expenses, over a three-year time period or more, will average no less than one percent below the returns generated by the Standard & Poor's 500-Stock Index over the same period.
3. The fund will incur risk no more than ten percent above that incurred by publicly traded funds with the same investment objective, as measured by the standard deviation.
4. The fund will invest in no fewer than ten securities and these securities will be distributed over no fewer than three geographical regions and five basic industries and/or services.
5. The median capitalization of the fund will vary no more than 50 percent from the median capitalization of the Standard & Poor's 500-Stock Index.

In the event a plan investment alternative fails to meet the established guidelines, the Investment Policy should state the corrective action that will be taken, such as placing the vehicle on probation or replacing it with a more suitable alternative, and the time-frame in which the action will occur.

While requiring some initial consideration, once a plan's Investment Policy has been established, the process of determining whether a plan's investment alternatives remain suitable becomes a matter of fact rather than opinion. A well written Investment Policy will also assure continuity in the performance of due diligence evaluations over time.

Step 5: Provide a Broad Range of Investments

A central premise of the final Section 404(c) regulations is that plan participants must have the opportunity to materially affect the risk and return of their accounts and the ability to diversify investments so as to minimize the risk of large losses. To accomplish this a plan must offer participants a broad range of investment alternatives.

In evaluating and selecting investment alternatives, fiduciaries will need to consider the Department of Labor's fundamental objectives in requiring a broad range of investments. These objectives are to provide plan participants with:

1. The ability to "diversify investments so as to minimize the risk of large losses."
2. The ability to pursue a variety of investment objectives.
3. "The opportunity to materially affect the risk and return of their accounts" in order to "minimize the risk of the participant's portfolio at any given level of expected return."
4. The means to "construct a portfolio with risk and return characteristics appropriate to the participant's financial and personal circumstances."

Translated into investment terminology, a plan's investment alternatives must allow the participant to construct a portfolio on the "efficient frontier." (See Chapter 3, pages 19-21) Most plans pursue one of two basic methods for providing a broad range of investments.

The "Invest in the World" Approach

As we explained in the previous chapter, one method of offering a broad range of investments is the "invest in the world" approach which allows participants to invest in virtually any publicly traded investment vehicle. This approach is used most often by professional organizations, such as law firms.

To establish an "invest in the world" plan, the sponsor will typically engage the services of a corporate trustee or custodian and an independent recordkeeper. The trustee will establish an earmarked account for each participant, enabling the participant to buy and sell individual stocks and bonds, mutual funds, limited partnerships, and private placements. The trustee or custodian will also provide transaction and valuation data to the plan's recordkeeper—the entity charged with tracking the value of each participant's account.

Besides complying with Section 404(c), a principal advantage of the "invest in the world" approach is its flexibility in allowing participants to pursue sophisticated investment strategies. The system can also facilitate the participant's use of a stockbroker or investment advisor of his or her choice.

The arrangement allowing for the "invest in the world" approach can be costly, particularly if trustee services are provided by an entity unaffiliated with a brokerage or investment firm. The multitude of investment options can also confuse less sophisticated plan participants, causing them to rely on a single "safe" investment vehicle for their long-term investment strategy. These shortcomings notwithstanding, the "invest in the world" approach is a viable means for meeting the broad range of investment requirements in Section 404(c).

Designated Investment Alternatives

Rather than offering an unlimited world of investments, most participant-directed retirement plans make available a limited number of "designated investment alternatives." Participants are given the opportunity to allocate and transfer their account among the specified investment alternatives on a regular basis.

Select Investment Categories. Prior to choosing a number of specific investment vehicles to serve as a plan's designated alternatives, plan fiduciaries and their advisers should first consider which basic investment categories they intend to make available to participants. Once the categories have been determined, an investment vehicle representing each category may be selected.

Observe The Three or More Diversified Alternatives Rule. In selecting the investment categories or asset classes to be utilized by the plan, fiduciaries must adhere to Section 404(c)'s three or more diversified alternatives rule. This rule requires that a plan designate at least three investment categories and the categories exhibit different risk and return characteristics such that one asset class, when combined with either of the other two, will minimize the risk of a participant's portfolio. This latter concept can be described as "asset class diversification."

While it is possible to differentiate among many asset classes, there is a high probability that a pooled fund selected from each of the categories in table 5 will fulfill the asset class diversification requirement of the three or more diversified alternatives rule.[5]

[5]The basis for asset class diversification outlined above can be supported scientifically (statistically) by evaluating the correlation between asset classes. For a discussion of asset correlation and an example of a correlation matrix, see chapter 4, page 34.

CASH EQUIVALENT INVESTMENTS	BOND AND FIXED INCOME INVESTMENTS	COMMON STOCK INVESTMENTS
Investment Objective: Safety of Principal	Investment Objective: Income	Investment Objective: Capital Appreciation (Growth of Principal)
Money Market Funds	Intermediate and long-term U.S. government notes and bonds and investment grade corporate bonds	Large capitalization stocks (Shares issued by larger U.S. corporations)
Treasury Bills	Intermediate and long-term GICs, pooled GIC funds and "synthetic" GICs	Stocks issued by foreign corporations
Short-term Certificates of Deposit (CDs)	Bonds issued by foreign governments	Small capitalization stocks
Short-term (1 Year) Guaranteed Investments	Combinations of corporate bonds, convertible bonds, preferred and common stocks with above average dividend yields	

TABLE 5
Different investment vehicles grouped by asset class that can comprise "three diversified investment alternatives" required by Section 404(c).

Having established the asset classes (investment categories) the plan will utilize for its investment alternatives, the plan's fiduciaries may then turn their attention to selecting an investment vehicle to represent each investment category. Section 404(c) requires that participants must have the opportunity to diversify their accounts within, as well as among, each of the plan's investment alternatives. In other words, a plan's investment options must provide "issuer diversification".

To enable participants with small accounts to achieve diversification within an investment alternative, plans will necessarily utilize pooled investment funds, such as mutual funds, bank commingled funds, insurance company separate accounts or privately managed pooled accounts.

As a general guideline, most advisers agree that plans offering alternatives representing a cash equivalent, such as a money market fund; a fixed income vehicle, such as a corporate or government bond fund; and a growth vehicle, such as a common stock fund, will satisfy the three or more diversified alternatives rule.

A balanced fund investing in a blend of stocks, bonds and cash is often added to these three categories so that fiduciaries failing to receive investment instructions from a participant will have access to a reasonably diversified investment alternative in which the participant's account may be directed by "default."

Step 6: Provide Sufficient Investment Information

Section 404(c) requires that in order for plan participants to exercise control over their respective accounts "they must have access to information on the basis of which informed investment decisions can be made." Certain information "fundamental to making informed investment decisions" is outlined in the disclosure provisions of the final regulations.

What Constitutes "Sufficient Investment Information"?

Section 404(c)'s disclosure provisions can be divided into two categories: The first, which a plan has an affirmative obligation to provide, and a second, which must be made available to participants upon request.

The mandatory disclosure information required by Section 404(c) includes:

1. A statement to participants indicating the plan is intended to comply with Section

404(c) and, as a result, fiduciaries may be relieved of liability for any losses which are a direct result of a participant's investment instructions.

2. A description of the investment alternatives under the plan. With respect to a plan's *designated* investment alternatives, information concerning the vehicle's investment objectives, risk and return characteristics, and information relating to the type and diversification of the assets comprising the portfolio are required. (It should be noted that the descriptive information outlined in this requirement is, or should be, routinely made available by any commingled fund serving as a plan's designated investment alternative. For example, the information in a mutual fund's prospectus and annual report would generally meet this requirement.)
3. Identification of any designated investment managers.
4. An explanation as to how, when and to whom participants may give investment instructions under the plan, with a description of any restrictions on transfers to or from any designated investment vehicle. The explanation should also include a description of any voting or tender rights available to the participant and any limitations thereon.
5. A summary of any transaction fees and expenses, such as commissions, sales loads, deferred sales charges and redemption or exchange fees, which may affect a participant's account.
6. The name, address and phone number of the plan fiduciary responsible for providing investment information and a description of additional information available

upon the participant's request. Note that the plan fiduciary may be identified by name or position (e.g., the designated fiduciary may be the "plan administrator").

7. Where a plan offers employer stock as an investment alternative, a description of the procedures for preserving the confidentiality of the participant's purchase, holding, and sale of the employer security along with the exercise of any voting or tender rights. The name, phone number and address of the fiduciary responsible for compliance with the confidentiality procedures must also be provided.
8. When a plan offers investment alternatives where a prospectus is routinely provided (i.e., investments subject to the Securities Act of 1933), a participant making an initial investment in the alternative must be provided with a copy of the prospectus most recently provided to the plan, immediately prior to or following the initial transaction.
9. In the event a plan offers investment alternatives where voting and tender rights are passed through to the participant, materials concerning these rights must be made available to participants along with a reference to the plan's provisions specifically relating to the exercise of these options.

The following additional information would need to be made available to participants upon request and must be based on the latest information available to the plan:

1. A description of the annual operating expenses of each designated investment alternative including investment management fees, administrative fees and transaction costs which reduce the return on a participant's account. These expenses

must be expressed in an aggregate amount representing a percentage of the investment vehicle's average net asset value.

2. Copies of any prospectuses, financial reports and other materials relating to the plan's investment alternatives, to the extent such information is provided to the plan.
3. A list of the assets comprising the portfolio of a designated investment alternative and the value of the portfolio's assets. Where the plan offers a fixed rate contract, such as a guaranteed investment contract (GIC) issued by any insurance company, the plan must provide the name of the issuer, the term of the contract, and the contract's rate of return.
4. A report concerning the current value of shares or units within the plan's designated investment alternatives as well as the alternative's past and current investment performance, calculated on a consistent basis, net of all expenses.
5. Information concerning the value of shares or units in a designated investment alternative held in the participant's account.

Upon reviewing the disclosure requirements outlined above, plan fiduciaries may come to the initial conclusion that compliance with the measure may involve the sponsor's preparation of extensive explanatory reports concerning the plan's designated investment alternatives. In fact, Section 404(c) states that the required information "should be readily available to plan fiduciaries since it is essentially the same information required to be reported as part of a plan's annual report (form 5500) under ERISA". The Department of Labor goes on to state that "compliance with the disclosure requirements of the final regulations should not impose any significant costs and burdens on plans or plan sponsors.

Step 7: Provide a Way For Participants To Give Investment Instructions

Once a plan sponsor has made and documented the plan's investment selection and retention decisions, the fiduciaries should establish or review their procedures for allowing participant account transfers.

The regulations indicate that transfer procedures should allow for a frequency that is "appropriate considering the investments' relative volatility" and, at a minimum, "no less frequently than once every three month period." The exact frequency of permitted transfers will depend on "the nature of the investment alternatives made available to the participant." Highly volatile investments, for example, may require daily transfer capability.

The fiduciary and the plan administrator are responsible for the accurate and timely execution of the investment instructions. If the fiduciary designates an agent to receive and execute the participant's instructions, the fiduciary must monitor the agent's performance of his or her duty.

The Fiduciary Has the Responsibility To Invest a Participant's "Undirected" Account Savings

If a plan participant fails to provide instructions as to the investment of his or her account, the plan fiduciary has the responsibility for allocating the undirected portion among the plan's designated investment alternatives. Furthermore, the plan fiduciary must also invest the proceeds in a manner consistent with ERISA's prudence requirements, including investment diversification. Consequently, the language of the plan's investment policy should state specifically how undirected account balances will be invested. This may represent a significant departure from past procedure.

Prior to the proposed regulations, sponsors would typically invest undirected assets in the plan's "least risky" alternative. Under the 1991 proposal, sponsors may want to revise their default option to a more balanced vehicle investing in a blend of stocks, bonds and cash equivalents. Although this approach will generally meet ERISA's prudence and diversification requirements, sponsors should be aware of special situations that would make such a default option inappropriate. For example, for accounts of participants about to retire, the probable objective of avoiding the risk of large losses suggests use of a money market or similar fund.

Current Participant Account Information Must Be Provided

An important and often overlooked issue involving participant instruction is that meaningful transfer capability may, in fact, only exist where the participant has access to accurate and reasonably current information concerning his or her account, including its recent investment performance. Employers may incur fiduciary liability for investment performance if current and accurate valuation information is not made available on a timely basis.

How To Enhance The Value of Your Firm's Retirement Plan

While ERISA compliance issues are a concern for plan fiduciaries, there is also the issue of whether a sponsor's retirement savings plan is considered a valuable "employee benefit" by the plan's participants. The degree to which a participant views a retirement savings plan as a positive, and perhaps indispensable, component of his or her compensation package will often depend on the individual's ability to utilize the plan's investment vehicles in a knowledgeable and constructive manner. While Section 404(c) establishes the circumstances in which participants can make productive investment decisions, it cannot assure that participants will have the ability to make use of them.

A recent headline in the *Wall Street Journal* speaks to the issues at stake: "In New Pension Plans, Companies Are Putting The Onus on Workers—But Few Employees Manage Retirement Funds Well; Some Tell Horror Stories."

A related article, appearing in the *San Francisco Chronicle* states: "Over the past ten years, many employers have been gradually shifting the risk and responsibility associated with (investing the assets in) pension plans from themselves to their employees, mainly through the adoption of 401(k) plans. What they haven't been shifting to employees is the expertise needed to manage these increasingly complex plans."

The message here is that, for participants to invest their accounts successfully, they will need at least some understanding of investment principals and financial markets.

Establish a Communication and Education Program

Adopting a communication and education program may yield a number of benefits to the plan sponsor, benefits that will likely outweigh any costs associated with establishing the program.

The employer's objective in implementing a communication and education program is to encourage participants to invest knowledgeably and successfully, while avoiding any appearance of giving investment advice. Accomplishing this, employees will view the firm's plan as an integral component of their future financial security. In return for this significant enhancement of the employees' financial position, the employer may rightfully expect a greater commitment to its goals and objectives.

Correspondingly, uninformed investors tend to make disinterested and ill-advised investment decisions, often resulting in lackluster or even negative investment performance. In turn, poor investment experience can lead to an employee's apathetic or ambivalent attitude towards the plan and by extension the plan sponsor. Ultimately, the potential for financial security implicit in the plan is replaced by an erosion in the employee's morale and disillusionment with the prospect of achieving a comfortable retirement. The "employee benefit" provided by the employer at significant expense is, to a large extent, wasted.

Basic Attributes of a Successful Communication Program

At the outset, plan sponsors should formulate a communications strategy that will provide information to participants on an ongoing basis. The most successful programs are those that seek to raise the knowledge of a plan's participants over time.

To encourage the use of the plan and an appreciation for its unique tax status the employee communication should:

- Convey the need to save;
- Outline the beneficial effect of compound interest;
- Explain the impact of tax deferral;
- Emphasize the benefits of setting aside funds at an early age; and,

- If the employer makes a matching contribution to the plan, demonstrate the impact of the employer's match on the value of each participant's account.

To assist participants in familiarizing themselves with the objectives and characteristics of the plan's investment alternatives, the communication program should explain commonly used investment terminology and provide an introduction to investment principals. To accomplish this, plan sponsors may want to:

1. Distribute easily understood summaries for each investment alternative including a description of the vehicle's investment objective, the strategy it uses in meeting its objective, and, the general and specific risks associated with the investment. Whenever possible, attach to the summary a fund prospectus or equivalent material.
2. Provide graphic presentations of the risk and return characteristics of the plan's designated investment alternatives.
3. Supply definitions and examples of frequently used investment terms and phrases such as yield, total return, capital appreciation, risk, diversification, and asset allocation.
4. Explain the trade-off between short-term volatility and long-term inflation risk.
5. Illustrate how diversification can reduce investment risk.

An optimal communication and education program may be one that enables the participant to invest his or her account in a manner that is appropriate for the participant's *investment horizon* (years left to retirement) and *risk tolerance* (emotional ability to tolerate fluctuations in account value). When faced with a list of investment options, uninformed investors will often tend to select "safe" or "least risky" investment alternatives, irrespective of the number of years left until retirement and their potential for comfortably assuming additional risk. It has often been observed by investment counselors and financial planners that an investor's willingness to accept risk is primarily a function of knowledge, not personality.

In fact, the *real* risk in investing one's retirement account may not be the risk of short-term investment losses incurred by investing in stock mutual funds, but rather the failure of one's account to grow at a rate that is substantially higher than the prevailing rate of inflation over the long-term.

CHAPTER 6

Conclusion

The Department of Labor's final ERISA Section 404(c) regulations provide fiduciaries of participant-directed retirement savings plans with welcome guidance as to how a plan must be structured in order for plan fiduciaries to avoid responsibility for participants' investment decisions. The avoidance of liability, however, may do little to assure the real benefit of the employer's plan.

In his classic book on the pursuit of corporate quality, *Out of the Crisis,* W. Edwards Deming cites fourteen points for the transformation of American industry. One of these points can be expanded upon to include a firm's retirement savings plan:

> Drive out fear... To assure better quality and productivity, it is necessary that people feel secure.

While Deming refers to fear as the employee's misunderstanding of his or her job and the reluctance to ask questions or take a position as to what is right or wrong, the definition of fear could be expanded to include the employee's lack of financial well-being, either now or at some point in the future. By providing employees with the means to invest successfully for retirement, an employer may provide the employee with a significant measure of financial security. In helping to "drive out" one of the most worrisome of fears, an employer may well enjoy a substantive improvement in quality and productivity.

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