

# **PARTICIPANT-DIRECTED RETIREMENT PLANS**

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## I. INTRODUCTION

ERISA section 404(c)<sup>1</sup> provides relief from certain responsibilities applicable to fiduciaries of individual account retirement plans, if those plans allow participant-directed investments and meet the other requirements of applicable Department of Labor (DOL) regulations (404(c) Plans).<sup>2</sup> In general, if the conditions of the regulations are satisfied, the plan sponsor or other fiduciary responsible for designating the plan’s investment alternatives will not be subject to fiduciary liability under ERISA for plan losses resulting from the participants’ exercise of investment control over the assets in their accounts.<sup>3</sup>

Regulations under Section 404(c) were originally proposed in 1987.<sup>4</sup> Following widespread criticism from plan sponsors and financial institutions, the regulations were repropoed in 1991.<sup>5</sup> After further public comment and an additional hearing, the DOL issued final regulations on October 13, 1992.<sup>6</sup>

This chapter examines the regulatory structure governing 404(c) Plans, under which individual participants assume the power and discretion to make key investment management decisions that otherwise would be undertaken by fiduciaries. Specifically, Section II examines the general effect of Section 404(c) and the associated regulations on the duties of plan fiduciaries. Section III summarizes the basic requirements of the DOL regulations promulgated under Section 404(c). Sections IV through VI treat the regulatory requirements in greater depth. Section IV sets

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<sup>1</sup>ERISA §404(c), 29 U.S.C. §1104(c).

<sup>2</sup>See generally G. E. Jenkins, *Fiduciaries of Participant-Directed Accounts Must Plan to Protect Themselves*, 2 J. TAX EMPLOYEE BENEFITS 116 (Sept./Oct. 1994) (outlining regulations).

<sup>3</sup>29 C.F.R. §2550.404(c)-1(a).

<sup>4</sup>52 Fed. Reg. 33,508 (1987).

<sup>5</sup>56 Fed. Reg. 10,724 (1991).

<sup>6</sup>57 Fed. Reg. 46,906 (1992).

forth the range of investment alternatives that must be made available to participants in 404(c) Plans. Section V discusses the regulations governing the frequency with which participants may issue investment instructions, and Section VI describes the expanded disclosure requirements applicable under the Section 404(c) regulations. Section VII discusses the requirement that Section 404(c) participants provide affirmative investment instructions in order to exercise control over their account assets and safe harbors under which participants will be treated as exercising control even if the participant gives no affirmative instruction. The permissible limitations on participant control are set forth in Section VIII. Section IX examines the relationship of ERISA's prohibited transaction provisions to 404(c) Plans, and Section X describes the requirements applicable when the assets of participant accounts are invested in employer stock. Section XI discusses investment information that may be provided to plan participants without causing the information provider to become a fiduciary under ERISA. Section XII describes the rules that apply during "blackout" periods during which participants are unable to direct investments or receive distributions from their accounts. Section XIII outlines provisions designed to encourage automatic enrollment in participant-directed plans.

## II. SIGNIFICANCE OF SECTION 404(C)

As noted above, persons who exercise authority or control over the investment of employee benefit plan assets are generally considered fiduciaries under ERISA, are subject to specific statutory standards of conduct, and may be personally liable for plan losses resulting from a breach of those standards.<sup>7</sup>

Where individual account plans permit participants to exercise control over the assets in their accounts, however, Section 404(c) affords partial relief from the standards that otherwise govern fiduciary conduct. Provided that participants actually exercise control over the assets in their accounts, plan fiduciaries will not be liable for any losses that are the direct result of the participants' exercise of control.<sup>8</sup> The protections of Section 404(c) are available only to plans that allow participant-directed investments, such as 401(k) plans, group individual retirement accounts, and most profit-sharing plans.

Failure to comply with Section 404(c) itself does not cause a plan to violate ERISA.<sup>9</sup> Failure to comply does mean, however, that plan fiduciaries may continue to be responsible under ERISA for participant-directed investments. Whether or not the final regulations are followed, fiduciaries must act prudently in selecting and retaining designated investment alternatives for the plan.<sup>10</sup>

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<sup>7</sup>See §VII.

<sup>8</sup>ERISA §404(c)(2), 29 U.S.C. §1104(c)(2).

<sup>9</sup>57 Fed. Reg. 46,906, 46,907 (1992).

<sup>10</sup>See *id.* at 46,924 n.27 (noting that designation of investment options is not direct result of participant direction and thus is subject to fiduciary obligation to prudently select such investment options and to residual fiduciary obligation to periodically evaluate performance of such investment options to determine whether such investment options should continue to be available).

The DOL has made clear that the final regulations apply only for purposes of determining whether a plan is a 404(c) Plan.<sup>11</sup> The final regulations are not intended to be applied to determine whether, or to what extent, a fiduciary of a plan that is not a 404(c) Plan satisfies the fiduciary responsibility provisions of ERISA.<sup>12</sup> The preamble to the final regulations indicates that a plan that does not satisfy Section 404(c) may nonetheless have a prudent and well-diversified portfolio.<sup>13</sup> In *Jenkins v. Yager*,<sup>14</sup> the Seventh Circuit concluded that a trustee could be relieved of fiduciary responsibility for investment decisions if investment discretion was delegated to participants in a plan that did not satisfy the requirements of Section 404(c).

### III. SECTION 404(C) REQUIREMENTS

The central requirement of the regulations is that participants exercise meaningful, independent control over the assets in their accounts.<sup>15</sup> In general, to satisfy this requirement a participant must have the opportunity to:

- (1) choose from a broad range of investment alternatives that allow diversification within and among such alternatives;
- (2) give investment instructions with a frequency that is appropriate in light of the market volatility of the investment alternatives; and
- (3) obtain sufficient information to make informed investment decisions.<sup>16</sup>

Each of these criteria is discussed in detail below in Sections IV, V, and VI, respectively.

The Third Circuit's 1996 decision in *Unisys Savings Plan Litigation*<sup>17</sup> addresses the fact that ERISA Section 404(c)<sup>18</sup> insulates a fiduciary from liability only if the three criteria discussed above are satisfied. In that case, participants in Unisys' individual account pension plan who invested in guaranteed investment contracts (GICs) incurred heavy losses when Executive Life Insurance Co. of California became insolvent due to Executive Life's purchases of junk bonds. The participants sued Unisys (among others), alleging various breaches of fiduciary duty relating to the selection of Executive Life as a GIC provider. Unisys argued that, even if it had breached fiduciary duties, it was immune from liability under ERISA Section 404(c) because the participants' losses resulted from their own investment decisions.

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<sup>11</sup>*Id.* at 46,906–07.

<sup>12</sup>*Id.*

<sup>13</sup>*Id.* at 46,907.

<sup>14</sup> 444 F.3d 916 (7<sup>th</sup> Cir. 2006), *reh'g en banc denied* (7<sup>th</sup> Cir. May 22, 2006). The court determined that the trustee had not breached his fiduciary duty in the selection and monitoring of the mutual funds offered in the plan or in the information provided to participants. 444 F.3d at 925.

<sup>15</sup>29 C.F.R. §2550.404c-1(a).

<sup>16</sup>29 C.F.R. §2550.404c-1(b).

<sup>17</sup>74 F.3d 420 (3d Cir. 1996).

<sup>18</sup>29 U.S.C. §1104(c).

The Third Circuit concluded that triable questions of fact existed as to whether (i) Unisys' plan offered participants a broad enough array of investment alternatives,<sup>19</sup> (ii) the transfer restrictions imposed on GIC investments deprived participants of the ability to allocate assets among the various funds,<sup>20</sup> and (iii) Unisys' plans had provided information sufficient for average participants to understand and exercise their control over investments.<sup>21</sup> The decision underscores the need for plan sponsors to provide adequate information on investment alternatives as a matter of course, and to fulfill the applicable statutory and regulatory requirements, in order to take advantage of Section 404(c)'s safe harbor.

#### IV. BROAD RANGE OF INVESTMENT ALTERNATIVES

A plan provides a broad range of investment alternatives only if it affords participants the opportunity to:

- (1) materially affect the potential return on assets over which the participant is permitted to exercise control and the degree of risk to which such assets are subject;
- (2) choose from at least three investment alternatives, each of which is diversified and has materially different risk and return characteristics that in the aggregate enable the participant or beneficiary to achieve a portfolio with risk and return characteristics within the range normally appropriate for the participant or beneficiary; and
- (3) diversify investments so as to minimize the risk of large losses.<sup>22</sup>

Investment alternatives that are intended to satisfy the "broad range" requirement are considered "core alternatives."<sup>23</sup> A 404(c) Plan may offer additional investment alternatives that are not core alternatives if it provides at least three core alternatives.<sup>24</sup> Since each core alternative must itself be diversified, certain types of investment funds, such as employer stock funds, cannot qualify as core alternatives.<sup>25</sup> Plans that do not designate specific investment alternatives, but allow participants to place their funds in any investment vehicle that is administratively feasible under the plan, will automatically satisfy the broad range requirement.<sup>26</sup>

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<sup>19</sup>74 F.3d at 446–47.

<sup>20</sup>*Id.* at 447–48.

<sup>21</sup>*Id.* at 447.

<sup>22</sup>29 C.F.R. §2550.404c-1(b)(3).

<sup>23</sup>*See* 57 Fed. Reg. 46,906, 46,920 (1992) (identifying three mandatory investment alternatives as "core investment alternatives").

<sup>24</sup>*See id.* (noting that regulations do not preclude offering investment alternative with equity wash that does not conform to "broad range" requirement in addition to core investment alternatives).

<sup>25</sup>*Id.* at 46,919.

<sup>26</sup>*Id.* at 46,921.

## V. FREQUENCY OF INVESTMENT INSTRUCTIONS

The regulations contain three requirements concerning the frequency with which participants must be allowed to change investments to and from core alternatives: the general volatility rule, the three-month rule, and the volatile investment rule.

### A. General Volatility Rule

The regulations permit plans to impose reasonable restrictions on the frequency with which participants may give investment instructions.<sup>27</sup> Restrictions are “reasonable” only if they permit participants to give investment instructions with a frequency that is appropriate in light of the market volatility that reasonably may be expected for the investments; this is the essence of the general volatility rule.<sup>28</sup>

### B. Three-Month Rule

Under the three-month rule, each of the core alternatives must afford participants the opportunity to transfer to another core alternative no less frequently than once within any three-month period.<sup>29</sup> This requirement applies only to transfers among the core alternatives, not to transfers between the core alternatives and other investment alternatives.<sup>30</sup>

Because of the three-month rule, certain types of investment vehicles that restrict or prohibit direct transfers to core alternatives cannot themselves qualify as core alternatives. For example, many fixed-rate investment contracts, such as guaranteed investment contracts and bank investment contracts, contain “equity wash” restrictions requiring that transfers from the fixed-rate contract to another fixed-income alternative be made through an equity fund in which the transferred amounts must remain invested for a prescribed minimum time period. If this type of restriction were to preclude direct transfers from the fixed-rate contract to a core alternative (e.g., if the prescribed minimum time period for amounts transferred to the equity fund exceeds three months), the fixed-rate contract could not itself serve as a core alternative, although it could be offered as an investment alternative in addition to the core alternatives.<sup>31</sup> A fixed-rate contract containing an equity wash restriction could be offered as a core alternative if the plan does not have any other fixed-income core alternative.

### C. Volatile Investment Rule

Under the volatile investment rule, participants generally must be afforded the opportunity to move from a more volatile investment alternative to a less volatile investment alternative that

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<sup>27</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C).

<sup>28</sup>*Id.*

<sup>29</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C)(1).

<sup>30</sup>57 Fed. Reg. 46,906, 46,914 (1992).

<sup>31</sup>*Id.* at 46,919–20.

constitutes one of the core alternatives.<sup>32</sup> An investment alternative is considered “more volatile” if it permits transfers more frequently than once every three months. The regulations authorize two alternative methods for meeting this requirement; these methods are discussed below.

### ***1. Designated Core Alternative***

Under the first method, plans may designate any one of the core alternatives (such as a money market fund) to receive transfers from more volatile investment alternatives. Accordingly, the designated core alternative must be able to receive transfers at least as frequently as the participant can transfer amounts out of the more volatile investment alternative.<sup>33</sup> In the case of an investment fund involving employer securities, the participant must be afforded the opportunity to direct investments from the employer securities fund into any of the core alternatives.<sup>34</sup>

### ***2. Interim Funds***

Under the second alternative, plans are permitted to establish income-producing, low-risk, liquid funds, subfunds, or accounts to hold transfers from volatile investments, pending the opportunity to direct investments into one of the core alternatives.<sup>35</sup> The participant must have the opportunity to move out of the interim fund as soon as investment instructions may be given with respect to the core alternatives.<sup>36</sup> Plans may require that transfers from an interim fund (other than one that holds assets transferred from an employer securities fund) be made only to a designated core alternative.<sup>37</sup> In the case of an interim fund that holds assets transferred from an employer securities fund, however, a participant must be able to direct investments into any of the core alternatives.<sup>38</sup>

## **D. Elimination of Uniformity Requirement**

The final regulations eliminated the 1991 proposal that frequency restrictions apply uniformly to all plan participants.<sup>39</sup> According to the preamble, this change was made partly in response to the concern of commentators that the uniformity requirement would conflict with proposed requirements for participant-directed “insider” transactions in employer stock set forth in Rule 16b-3 promulgated under the Securities Exchange Act of 1934, in effect at such time.<sup>40</sup>

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<sup>32</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C)(2).

<sup>33</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C)(2)(i).

<sup>34</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C)(3)(i).

<sup>35</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(C)(2)(ii).

<sup>36</sup>*Id.*

<sup>37</sup>57 Fed. Reg. 46,906, 46,916 (1992).

<sup>38</sup>*Id.*

<sup>39</sup>*Id.* at 46,917.

<sup>40</sup>*Id.*; see 17 C.F.R. §240.16b-3.

Under Rule 16b-3, as currently in effect, a participant-directed intra-fund transfer between an employer stock fund and another investment fund will be exempt from the short-swing profit disgorgement rules of Section 16(b) of the Securities Exchange Act of 1934,<sup>41</sup> unless the election relating to the transaction occurs within six months following an election to make an “opposite way” transaction in the employer stock fund.<sup>42</sup> Although these rules are generally less restrictive than those contained in prior proposals, there may be circumstances where the general volatility rule would require that an insider be allowed to make an employer stock fund transfer at a time when the transfer would not qualify for the Rule 16b-3 exemption (i.e., in less than a six-month period). In a significant departure from the 1991 proposals, however, the final rules do not require that the plan document restrict the frequency with which insiders may make employer stock fund transfers.<sup>43</sup> Accordingly, insider investments in an employer stock fund can satisfy the requirements of Section 404(c).

## VI. EXPANDED DISCLOSURE REQUIREMENTS

Under the regulations, a participant must have the opportunity to obtain sufficient information to make informed investment decisions.<sup>44</sup> According to the preamble, this requirement was expanded from the proposed regulations, due in significant part to comments on the 1991 proposals submitted by the Securities and Exchange Commission’s (SEC) Division of Market Regulation.<sup>45</sup> The regulations identify specific information that must be made available to participants. Certain information concerning the plan and available investment alternatives is required to be furnished directly to all participants, and certain other information must be furnished upon request.

The following information must be furnished to all participants:

- an explanation that the plan is intended to constitute a 404(c) Plan and that plan fiduciaries may be relieved of liability for losses that are the result of participants’ investment instructions;<sup>46</sup>
- a description of all designated investment alternatives under the plan (not merely core alternatives), including a general description of the investment objectives and risk and return characteristics of each alternative;<sup>47</sup>
- identification of any designated investment managers;<sup>48</sup>

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<sup>41</sup> 15 U.S.C. §§78a *et seq.*

<sup>42</sup> 17 C.F.R. §240.16b-3.

<sup>43</sup> *See generally id.*

<sup>44</sup> 29 C.F.R. §2550.404c-1(b)(2)(i)(B).

<sup>45</sup> 57 Fed. Reg. 46,906 at 46,909 (1992).

<sup>46</sup> 29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(i).

<sup>47</sup> 29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(ii).

<sup>48</sup> 29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(iii).

- an explanation of how to give investment instructions, any limits or restrictions on giving instructions (including information as to withdrawal penalties and valuation adjustments), and any restrictions on the exercise of voting, tender, or similar rights;<sup>49</sup>
- a description of any transaction fees or expenses that affect the participants' account balances;<sup>50</sup>
- a description of the additional information available on request (discussed below) and the identity of the person or persons responsible for providing that information;<sup>51</sup>
- a description of the procedures established to provide for confidentiality of participants' directions and identification of the plan fiduciary responsible for monitoring compliance with those procedures, if the plan provides for investment in employer securities;<sup>52</sup>
- a copy of the most recent prospectus, immediately following the participant's initial investment in an investment alternative subject to the Securities Act of 1933, unless the prospectus was furnished immediately prior to the participants' investment;<sup>53</sup> and
- any materials provided to the plan relating to the exercise of voting, tender, or similar rights, to the extent such rights are passed through to participants, as well as information describing the nature of pass through rights available pursuant to the plan subsequent to an investment.<sup>54</sup>

For plans invested in mutual funds, most of this information will be contained in the fund's prospectus.<sup>55</sup> In Advisory Opinion 2003-11A,<sup>56</sup> the Department indicated that the requirement for delivery of the fund's prospectus immediately following the participant's initial investment may be satisfied by delivery of a mutual fund profile, which contains a standardized summary of key information contained in a traditional prospectus. The SEC considers the profile to be a prospectus for purposes of the Securities Act of 1933.<sup>57</sup> In permitting the profile as a substitute for the traditional prospectus, the SEC indicated that investors in participant-directed defined contribution plans may find a profile more helpful in evaluating and comparing funds offered as investment alternatives in a plan than the traditional prospectus filled with excessive detail and technical terms.<sup>58</sup> In addition to the material that must be provided to all participants, the following information must be furnished to a participant on request:

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<sup>49</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(iv).

<sup>50</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(v).

<sup>51</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(vi).

<sup>52</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(vii).

<sup>53</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(viii).

<sup>54</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(ix).

<sup>55</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(viii).

<sup>56</sup>Adv. Op. 2003-11A (Sept. 8, 2003).

<sup>57</sup>Securities Act Rule 498, Securities Act Release No. 7513 (Mar. 13, 1998) ("Rule 498 Release").

<sup>58</sup>Rule 498 Release, text accompanying note 124.

- a description of the annual operating expenses borne by the investment alternatives, such as investment management fees;<sup>59</sup>
- copies of any prospectuses, financial statements and reports, and other information furnished to the plan relating to an investment alternative;<sup>60</sup>
- a list of the assets comprising the portfolio of an investment alternative that holds “plan assets,” the value of such assets, and in the case of fixed-rate investment contracts issued by a bank, savings and loan association, or insurance company, the name of the issuer of the contract, the term of the contract, and the rate of return on the contract. (This information would not be required for mutual fund assets, which are not considered “plan assets” under ERISA.);<sup>61</sup>
- information concerning the value of the shares or units in investment alternatives available to participants, as well as information concerning the past and current investment performance of the alternatives;<sup>62</sup> and
- information concerning the value of the shares or units in investment alternatives held in the account of the participant.<sup>63</sup> In meeting this requirement, plans may establish reasonable procedures limiting the frequency of requests for account balance information.<sup>64</sup>

A plan that uses a mutual fund profile must provide the traditional prospectus only if specifically requested by the participant.<sup>65</sup>

On July 23, 2008, the Department of Labor (DOL) proposed to extend the Section 404(c) disclosure requirements to all participant-directed plans.<sup>66</sup> As proposed, the regulation would be effective January 1, 2009.<sup>67</sup> The proposed regulation contains a model comparative chart that plans could use to show investment returns and fees.<sup>68</sup>

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<sup>59</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2)(i).

<sup>60</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2)(ii).

<sup>61</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2)(iii).

<sup>62</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2)(iv).

<sup>63</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2)(v).

<sup>64</sup>Preamble to Final Regulations, 57 Fed. Reg. 46,906, 46,913 (1992).

<sup>65</sup>Adv. Op. 2003-11A, penultimate paragraph.

<sup>66</sup>Proposed Regulation on Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43,014 (July 23, 2008) (the “Proposed Disclosure Regulation”).

<sup>67</sup>*Id.* at 43,018.

<sup>68</sup>Appendix to Proposed Disclosure Regulation, 73 Fed. Reg. at 43,042. The model chart is also available on the DOL Web site at <http://www.dol.gov/ebsa/modelcomparativechart.doc>.

## VII. AFFIRMATIVE DIRECTION AND DEFAULT INVESTMENTS

### A. Affirmative Direction

The original Section 404(c) regulations provide that a participant will not be considered to have exercised control over account assets unless the participant has provided affirmative investment instructions for the assets.<sup>69</sup> In certain circumstances, a participant who has signed a written agreement indicating how account assets are invested in the absence of a direction will be considered to have provided affirmative investment instructions for those assets.<sup>70</sup> With respect to the exercise of voting, tender, and similar rights, a participant who is given the opportunity and information necessary to exercise such rights will be considered to have exercised them, even if the participant does not in fact do so.<sup>71</sup> This is a departure from the DOL's previous position, taken in litigation, that trustees of an employee stock ownership plan (ESOP) have an affirmative duty to make voting or tender decisions if the ESOP participant is given the opportunity to act but declines to do so.

### B. Mapping

From time to time a plan may change its investment options, either replacing a poorly performing fund with a better performing fund or redoing the entire fund lineup. In these cases, the plan fiduciaries usually “map” participants’ investments from the old funds to the new funds, meaning that the fiduciaries track the transition of the participant’s account from one set of investment options to the new set. Prior to the enactment of the Pension Protection Act of 2006 (PPA),<sup>72</sup> it was unclear whether such mapping continued to reflect the participants’ original investment directions as a matter of law. The PPA added a new Section 404(c)(4) that treats a “qualified change in investment options” as if the participant had exercised control over the assets in his or her account if the participant had originally exercised control in selecting the old investment option.<sup>73</sup> A “qualified change in investment options” occurs if assets are reallocated as a result of a change in the plan’s investment options and the characteristics of the new investment options are “reasonably similar” to those of the old investment options.<sup>74</sup> If there is no reasonably similar option after the change, then plan fiduciaries may elect to provide that the assets previously invested in an option that is being eliminated will be transferred to a qualified default investment alternative, discussed below.

For a participant to be deemed as having exercised control, the participant must be given no-

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<sup>69</sup>29 C.F.R. §2550.404c-1(c)(1).

<sup>70</sup>*Id.*

<sup>71</sup>*Id.*

<sup>72</sup>Pub. L. No. 109-280 (Aug. 17, 2006).

<sup>73</sup>ERISA §404(c)(4)(A), (C)(iii), 29 U.S.C. §1104(c)(4)(A), (C)(iii), *added by* PPA §621(a)(2). For further discussion of the PPA, see Kurt L. P. Lawson, *Pension Protection Act of 2006*, in *ERISA FIDUCIARY LAW: PENSION PROTECTION ACT SUPPLEMENT 5*, Susan P. Serota & Frederick A. Brodie, eds. (2007).

<sup>74</sup>ERISA §404(c)(4)(B), 29 U.S.C. §1104(c)(4)(B).

tice of the proposed mapping at least 30 days and no more than 60 days prior to the change and must fail to provide an affirmative investment instruction. The notice must include:

- information comparing the old and new investment options; and
- an explanation that assets invested in the old investment options will be invested in the new options unless the participant or beneficiary provides an affirmative investment instruction.

### C. Qualified Default Investment Alternatives

The PPA also added a new Section 404(c)(5) permitting defined contribution plans to specify a “qualified default investment alternative” (QDIA) into which participants’ contributions may be allocated if they fail to make investment elections, effective for plan years beginning after 2006.<sup>75</sup> If the plan follows the QDIA requirements described below, then investments in the QDIA are treated as if the participant made the decision to invest in that option. Consequently, fiduciaries would be relieved of responsibility to the same extent as if the participant had made the decision.<sup>76</sup>

The QDIA safe harbor is designed to encourage automatic enrollment in individual account plans,<sup>77</sup> but also can be applied to situations in which a participant fails to provide investment instruction, for example, after an investment alternative is eliminated or the service provider changes.<sup>78</sup> The QDIA safe harbor may be used for both employer and participant contributions and for settlement proceeds.<sup>79</sup> Different QDIAs may be used in the same plan for different purposes.<sup>80</sup>

Generally, a participant will be treated as exercising control with respect to assets in his or her account if the participant is provided an opportunity to choose investment options but fails to do so and the plan invests amounts in a default arrangement that meets the requirements of the DOL regulation defining a QDIA.<sup>81</sup> A fiduciary of a plan that complies with the QDIA regulation will not be liable for any loss that occurs as a result of such investments, to the same extent as if the participant had affirmatively elected to make the investment.

The DOL issued its QDIA regulation on October 24, 2007.<sup>82</sup> Although the statute authorized the DOL to provide regulatory guidance on “the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both,”<sup>83</sup> the final QDIA regulation generally limits QDIAs to investment options “diversified so as to minimize the risk of large losses and . . . designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and

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<sup>75</sup>ERISA §404(c)(5), 29 U.S.C. §1104(c)(5), *added by* PPA §624.

<sup>76</sup>Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452 (Oct. 24, 2007) (QDIA Regulation).

<sup>77</sup>*See* Section XIII.A., below, for other PPA provisions designed to encourage automatic enrollment.

<sup>78</sup>72 Fed. Reg. at 60,453.

<sup>79</sup>DOL Field Assistance Bulletin 2008-03, Q&A 4 (Apr. 29, 2008).

<sup>80</sup>*Id.* at Q&A 16.

<sup>81</sup>ERISA §404(c)(5)(A), 29 C.F.R. §1104(c)(5)(A); *see also* 29 C.F.R. §2550.404c-5(a)(1), 72 Fed. Reg. 60,478 (Oct. 24, 2007) (the QDIA Regulation).

<sup>82</sup>29 C.F.R. §2550.404c-5, QDIA Regulation, 72 Fed. Reg. at 60,478.

<sup>83</sup>ERISA §404(c)(5)(A), 29 C.F.R. §1104(c)(5)(A), 72 Fed. Reg. at 60,452.

fixed income exposures.”<sup>84</sup> The DOL provided three alternatives for obtaining such diversified investments:

- a “target date” fund or portfolio that provides an asset allocation mix “based on the participant’s age, target retirement date (such as normal retirement age under the plan) or life expectancy,” in which the asset mix generally changes to become more conservative as the participant ages;<sup>85</sup>
- a balanced fund or portfolio that provides “a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole,” rather than taking into account the particular age or risk tolerance of any individual participant;<sup>86</sup> or
- an investment management service that allocates a participant’s account among investment options offered in the plan based on the participant’s age, target retirement date, or life expectancy.<sup>87</sup>

The QDIA must be a mutual fund or must be managed by an investment manager (a fiduciary that is a bank, insurance company, or investment advisor), a plan trustee, or a named fiduciary that is the plan sponsor or a plan committee made up primarily of employees.<sup>88</sup>

The QDIA cannot hold employer securities unless it is a mutual fund or similarly pooled vehicle regulated by a federal or state agency, such as a bank or an insurance company, and the investment is made in accordance with the fund’s stated investment objective, free from influence from the plan sponsor or any affiliate.<sup>89</sup> If the QDIA is a service that allocates a participant’s account among investment options offered by the plan, then employer securities acquired as a matching contribution, or acquired before the QDIA was initiated, may be included but only if the allocation service has authority to dispose of such employer securities.<sup>90</sup>

Many employers have chosen target date funds as the QDIA for their plans. Target date funds are a relatively recent phenomena. The first target date funds (the Wells Fargo Stagecoach Funds sub-advised by Barclay Global Investors) were established in 1994.<sup>91</sup> At the end of 2006, the year in which the QDIA safe harbor was added to ERISA, there were 28 different fund companies offering target-date funds, representing 175 different funds.<sup>92</sup> In addition to the lack of a track

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<sup>84</sup>29 C.F.R. §2550.404c-5(e)(4)(i)–(iii), 72 Fed. Reg. at 60,461.

<sup>85</sup>29 C.F.R. §2550.404c-5(e)(4)(i), 72 Fed. Reg. at 60,461.

<sup>86</sup>29 C.F.R. §2550.404c-5(e)(4)(ii), 72 Fed. Reg. at 60,461.

<sup>87</sup>29 C.F.R. §2550.404c-5(e)(4)(iii), 72 Fed. Reg. at 60,462.

<sup>88</sup>29 C.F.R. §2550.404c-5(e)(3)(i)(C), as amended by correcting amendment to the QDIA Regulation, 73 Fed. Reg. 23,349 (Apr. 30, 2008).

<sup>89</sup>29 C.F.R. §2550.404c-5(e)(1)(i)–(ii)(A).

<sup>90</sup>29 C.F.R. §2550.404c-5(e)(1)(ii)(B).

<sup>91</sup>Turnstone Advisory Group, LLC, *Popping the Hood: An Analysis of Major Life Cycle Fund Families* (Oct. 2006), at 3. The Turnstone study covered major target-date funds available in mid-2005. At that time, there were only four fund families with significant target-date fund assets that had at least three years of experience (Barclay Global Investors, Principal, Fidelity, and Wells Fargo). Vanguard and T. Rowe Price were also included in the study because they already had a large percentage of target-date assets. *Id.* at 2, Appendix A.

<sup>92</sup>Turnstone Advisory Group, LLC, *Popping the Hood II: An Analysis of Target Date Fund Families* (July 2007).

record for many fund families, two aspects of target date funds make it difficult to compare target date funds: (1) differences in the funds' current asset allocation; and (2) differences in the "glidepath," the anticipated change in a particular fund as it approaches its target year. As a general matter, target date funds within a family have more equity exposure if they are far from the retirement target date and less equity exposure if the funds are approaching or are past the target date. Funds with the same target date often have very different asset allocation mixes, depending on the manager's philosophy. Those differences in asset allocation can have a significant impact on returns. When the stock market is rising, for example, funds with more equity exposure will tend to do better than funds with the same target date but less equity exposure. The reverse may be true when the stock market is falling.

The glidepath may or may not be described in the portfolio with any specificity and, even when it is described, the fund advisor usually retains flexibility to change the glidepath in the future. Prior to the economic downturn in 2008, some funds had changed their asset allocations to increase their exposure to riskier asset categories in an attempt to improve performance.<sup>93</sup> Target date products that eventually become all fixed income as a participant reaches retirement will not qualify as QDIAs because a QDIA must have a mix of equity and fixed income.<sup>94</sup>

### ***1. Capital Preservation Options***

Investment options designed to preserve capital, such as money market funds and stable value funds, qualify as QDIAs for only 120 days after a participant's first deferral and then only in a plan that permits participants to opt out within the first 90 days and have their contributions returned.<sup>95</sup> Using a capital preservation option in this circumstance allows the plan to return participant contributions with interest, without risk of principal loss. Plans are not required to use a capital preservation option, however, merely because the plan permits participants to opt out.<sup>96</sup>

If the default option before the effective date was a capital preservation product, then all assets in that default option can be transferred to a new QDIA even though some participants affirmatively directed that their funds be invested in the capital preservation product, provided of course that all participants receive the requisite notice before the transfer to the new QDIA is made.<sup>97</sup>

Investments in stable value funds before December 24, 2007, the effective date of the regulation, are grandfathered so that the balance in participants' accounts can continue to be invested in those options after that date and be treated as a QDIA. These grandfathered funds do not qualify as QDIAs with respect to new money added after that date, however.<sup>98</sup> Grandfathered capital preservation products do not qualify as QDIAs until 30 days after the initial QDIA notice is distributed to participants.<sup>99</sup> The grandfather relief was originally granted to only stable value products,

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<sup>93</sup> Bob Frick, *Target Funds Under Fire*, KIPLINGER'S PERSONAL FINANCE (Feb. 2008), available online at [http://www.kiplinger.com/magazine/archives/2008/02/target\\_funds\\_under\\_fire.html](http://www.kiplinger.com/magazine/archives/2008/02/target_funds_under_fire.html).

<sup>94</sup> DOL Field Assistance Bulletin 2008-03, Q&A 18-20 (Apr. 29, 2008).

<sup>95</sup> *Id.* at Q&A 17.

<sup>96</sup> *Id.* at Q&A 19.

<sup>97</sup> *Id.* at Q&A 3.

<sup>98</sup> 29 C.F.R. §2550.404c-5(e)(4)(v)(B).

<sup>99</sup> DOL Field Assistance Bulletin 2008-03, Q&A 21 (Apr. 29, 2008).

although many plans had used money market funds as their default option. The DOL subsequently amended the definition of “capital preservation product” to include “an investment product or fund designed to preserve principal; provide a rate of return generally consistent with that earned on intermediate investment grade bonds; and provide liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives.”<sup>100</sup> This definition does not include money market funds and other capital preservation options. Two additional conditions apply: (1) no fees or surrender charges may be imposed in connection with withdrawals from the product or fund that are initiated by a participant or beneficiary, and (2) the product or fund must invest primarily in investment products that are backed by state or federally regulated financial institutions. For example, the product or fund may be issued directly by a state or federally regulated financial institution. Alternatively, the principal and accrued interest on the product or fund may be backed by contracts issued by such institutions.

## **2. Other QDIA Conditions**

Under the QDIA regulation, fiduciary relief applies to any amounts invested in a QDIA if the following conditions are met, whether or not the plan qualifies as a Section 404(c) plan:<sup>101</sup>

- The participant or beneficiary had the opportunity to direct the investment of the assets in his or her account but did not do so.<sup>102</sup>
- The participant or beneficiary is furnished with advance notice and subsequent annual notices, as discussed below.<sup>103</sup>
- Any material provided to the plan relating to the participant’s or beneficiary’s investment in a QDIA (such as account statements, prospectuses, and proxy voting material) is passed on to the participant or beneficiary in accordance with the pass-through disclosure requirements applicable to Section 404(c) plans.<sup>104</sup> Defaulted participants must automatically be provided with the most recent prospectus or profile prospectus if the QDIA is a mutual fund. Other information concerning the plan’s investment alternatives, such as annual operating expenses and the value of shares or units in QDIA, need be provided only on request.<sup>105</sup>
- The participant or beneficiary is given the opportunity to transfer some or all of the assets to other investment alternatives under the plan with the same frequency as participants who affirmatively elect to invest in the QDIA, but at least once in a three-month period.<sup>106</sup>
- The plan offers participants and beneficiaries the chance to invest in a broad range of in-

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<sup>100</sup>29 C.F.R. §2550.404c-5(e)(4)(v)(A), as amended by correcting amendment to the QDIA Regulation, 73 Fed. Reg. 23,349 (Apr. 30, 2008).

<sup>101</sup>29 C.F.R. §2550.404c-5(c).

<sup>102</sup>29 C.F.R. §2550.404c-5(c)(2).

<sup>103</sup>29 C.F.R. §2550.404c-5(c)(3), (d).

<sup>104</sup>29 C.F.R. §2550.404c-5(c)(4).

<sup>105</sup>DOL Field Assistance Bulletin 2008-03, Q&A 15 (Apr. 29, 2008).

<sup>106</sup>29 C.F.R. §2550.404c-5(c)(5).

vestment alternatives, as defined in DOL's Section 404(c) regulation,<sup>107</sup> which require a minimum of three investment options with different risk and return characteristics.<sup>108</sup>

- During the first 90 days after a participant's assets are first defaulted into the QDIA,<sup>109</sup> transfers or withdrawals cannot be subject to restrictions, fees, or expenses (other than investment management and similar types of fees and expenses).<sup>110</sup> A plan sponsor or service provider may pay the fees or expenses that would otherwise be assessed against a participant's account.<sup>111</sup> Round-trip restrictions, which limit the participant's ability to reinvest in the QDIA after transferring out of the QDIA to another investment option, are permitted.<sup>112</sup>
- After the first 90-day period, transfers or withdrawals may be subject only to those restrictions, fees, or expenses that otherwise apply to plan participants and beneficiaries who elected to invest in that QDIA.<sup>113</sup>

The QDIA safe harbor protects the fiduciary from liability for any loss that is the direct and necessary result of the investment. However, as with Section 404(c) elections made by the participants, the QDIA safe harbor does not relieve the fiduciary from the duty to select and monitor prudently the plan's QDIAs. The QDIA rules also do not provide relief from liability for violations of the prohibited transaction rules.<sup>114</sup>

### **3. QDIA Notices**

In order for the default investment option to be a QDIA, participants and beneficiaries must receive both an initial notice and annual notices thereafter. Each participant must receive, within a reasonable period before the start of the plan year, notice of his or her right to designate how contributions and earnings will be invested, including an explanation of how the contributions and earnings will be invested if the participant fails to make an investment election. The advance notice must inform the participant of his or her rights and obligations and must be written in a manner designed to be understood by the average participant. The notice must contain the following information:

- a description of the circumstances under which a participant's assets will be invested in a QDIA and, if applicable, an explanation of the automatic enrollment features under the plan, including the percentage of the participant's pay that will be contributed and the participant's right to elect to make no contribution or to contribute a different percentage;
- an explanation of the participant's right to direct the investment of his or her account;

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<sup>107</sup>Discussed in Chapter 9, Section IV, of the Main Volume.

<sup>108</sup>29 C.F.R. §2550.404c-5(c)(6).

<sup>109</sup>DOL Field Assistance Bulletin 2008-03, Q&A 12 (Apr. 29, 2008).

<sup>110</sup>29 C.F.R. §2550.404c-5(c)(ii).

<sup>111</sup>DOL Field Assistance Bulletin 2008-03, Q&A 11 (Apr. 29, 2008).

<sup>112</sup>Preamble to the correcting amendments to the QDIA Regulation, 73 Fed. Reg. 23,349, 23,349 (Apr. 30, 2008); DOL Field Assistance Bulletin 2008-03, Q&A 13 (Apr. 29, 2008).

<sup>113</sup>29 C.F.R. §2550.404c-1(b)(3).

<sup>114</sup>29 C.F.R. §2550.404c-5(b).

- a description of the QDIA, including a description of the investment objectives, risk and return characteristics, and fees and expenses associated with the QDIA;
- a description of the participant's right to direct the investment of his or her account assets to any other investment alternative under the plan and any restrictions, fees, or expenses associated with such a transfer; and
- an explanation of where the participant can obtain investment information concerning the other investment alternatives available under the plan.<sup>115</sup>

This notice also satisfies the notice requirements under ERISA Section 514(e), which preempts state antigarnishment or other laws that would prohibit or restrict automatic enrollment (discussed in Section XIII, below).

The IRS has issued a sample automatic enrollment notice that may be used to satisfy the QDIA notice requirement.<sup>116</sup> The sample notice is designed to cover not just the QDIA required information, but also information related to the IRS automatic enrollment 401(k) safe harbor (discussed in Section XIII.B, below) and, if allowed by the plan, permissible withdrawals if the participant opts out within the first 90 days (discussed in Section XIII.C, below). The sample notice will have to be customized for plans that do not include those features, but serves as a useful starting point. Plans are not required to combine all the notices related to automatic enrollment and QDIAs<sup>117</sup> but, because there is significant overlap in the various notice requirements, issuing a single notice will usually make sense.

The participant must be given a reasonable period of time after receipt of the notice and before the assets are invested in the QDIA to make an investment election.<sup>118</sup> The initial notice must be provided at least 30 days in advance of the date of plan eligibility or at least 30 days in advance of any first investment in a QDIA. However, if the participant has the opportunity to make a permissible withdrawal, then the notice may be given on or before the date of plan eligibility.

Participants and beneficiaries must also be given a notice at least 30 days in advance of each following plan year.<sup>119</sup> The notice must be made in a separate document (i.e., not within the SPD or SMM), but may be distributed with other documents.<sup>120</sup> The QDIA notice may be combined with the IRS automatic enrollment and permissible withdrawal notices, however, as was done in the IRS sample notice.<sup>121</sup>

The QDIA notices may be delivered electronically: Plans may use either the DOL's rules on electronic delivery or the Treasury Department rules.<sup>122</sup>

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<sup>115</sup>29 C.F.R. §2550.404c-5(d); 29 C.F.R. §2550.404c-5(f)(3).

<sup>116</sup>Available on the IRS Web site at [http://www.irs.gov/pub/irs-tege/sample\\_notice.pdf](http://www.irs.gov/pub/irs-tege/sample_notice.pdf).

<sup>117</sup>DOL Field Assistance Bulletin 2008-03, Q&A 8 (Apr. 29, 2008).

<sup>118</sup>ERISA §404(c)(5)(B).

<sup>119</sup>29 C.F.R. §2550.404c-5(c)(3)(ii).

<sup>120</sup>Preamble to the QDIA Regulation, 72 Fed. Reg. at 60,454–55 (preamble).

<sup>121</sup>DOL Field Assistance Bulletin 2008-03, Q&A 10 (Apr. 29, 2008).

<sup>122</sup>Preamble to the QDIA Regulation, 72 Fed. Reg. at 60,458. The DOL guidance on use of electronic media is at 29 C.F.R. §2520.104b-1(c) and the Treasury guidance is at 26 C.F.R. §1.401(a)-21.

## VIII. PERMISSIBLE LIMITATIONS ON PARTICIPANT CONTROL

The regulations provide that the plan fiduciary designated to receive and follow participant investment instructions may decline to follow certain instructions.<sup>123</sup> Examples are instructions that, if implemented:

- (1) would not be in accordance with plan documents;
- (2) would cause the indicia of ownership of plan assets to be maintained outside the United States;
- (3) would jeopardize the plan's tax-qualified status;
- (4) could result in a loss in excess of the participant's account balance;
- (5) would cause the plan to engage in certain transactions with the plan sponsor;
- (6) would result in a prohibited transaction; or
- (7) would generate income taxable to the plan.<sup>124</sup>

## IX. PROHIBITED TRANSACTIONS

The regulations clarify that, in general, a fiduciary will not be liable under ERISA for a participant-directed investment that results in a prohibited transaction.<sup>125</sup> This provision provides only limited relief, however, since the fiduciary would be relieved of liability only for losses incurred for the account of the participant whose direction he or she is following and would continue to be liable for any losses incurred with respect to other participants' accounts by reason of the prohibited transaction.<sup>126</sup> Further, the regulations do not provide an exemption from liability for all prohibited transactions.<sup>127</sup> For this reason, as discussed above in Section VIII, fiduciaries are permitted to decline to follow instructions that would result in a prohibited transaction.<sup>128</sup> Also, the regulations indicate that the relief for 404(c) Plans is limited to the prohibited transaction provisions of ERISA and does not extend to the analogous provisions under Code Section 4975.<sup>129</sup> The IRS has not issued similar exemptive relief under Section 4975 but has indicated that it is willing to entertain requests for such relief.<sup>130</sup>

The preamble to the final regulations clarifies that a fiduciary is not relieved from liability for losses caused by a prohibited transaction that results from occurrences other than a partici-

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<sup>123</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(B).

<sup>124</sup>29 C.F.R. §2550.404c-1(d)(2)(ii).

<sup>125</sup>29 C.F.R. §2550.404c-1(d)(2)(i). This is true because the prohibited transactions under ERISA are contained within part 4 of title I of ERISA, the liability for which is excluded under the final regulations.

<sup>126</sup>57 Fed. Reg. 46,906, 46,924 (1992).

<sup>127</sup>29 C.F.R. §2550.404c-1(d)(2)(ii)(E).

<sup>128</sup>29 C.F.R. §2550.404c-1(b)(2)(ii)(B)(1).

<sup>129</sup>29 C.F.R. §2550.404c-1(d)(3).

<sup>130</sup>57 Fed. Reg. 46,906, 46,929 (1992).

pant's or beneficiary's exercise of control.<sup>131</sup> For example, if a participant directs a fiduciary to purchase certain securities, giving the fiduciary a certain amount of discretion in the process, and the fiduciary uses a party in interest to execute the securities transaction, the fiduciary would be liable for the prohibited transaction resulting from that exercise of discretion (unless an exemption is available).<sup>132</sup>

## X. INVESTMENTS IN EMPLOYER SECURITIES

### A. Employer Securities

The regulations extend Section 404(c) relief to participant-directed investments in employer stock if, among other things, the stock is

- (1) a qualifying employer security, as defined in ERISA Section 407(d),<sup>133</sup> which is either a stock or equity interest in a publicly traded partnership;
- (2) publicly traded on a national exchange or other generally recognized market; and
- (3) traded with sufficient frequency and in sufficient volume to assure that directions to buy and sell can be acted upon promptly and efficiently.<sup>134</sup>

### B. Confidentiality Procedures

The regulations also condition the protections of Section 404(c) on:

- the establishment of procedures intended to safeguard the confidentiality of information relating to participant-directed transactions involving employer securities, including the purchase, holding, and sale of securities and the exercise of voting, tender, and similar rights;
- the designation of a plan fiduciary (who need not be independent of the sponsor) responsible for ensuring the adequacy of the confidentiality procedures and for monitoring compliance with the procedures; and
- the appointment of an independent fiduciary to carry out any activities that the designated plan fiduciary views as presenting a potential for undue employer influence on participants or beneficiaries with respect to the exercise of their rights as shareholders (e.g., tender offers, exchange offers, and contested board elections).<sup>135</sup>

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<sup>131</sup>*Id.* at 46,924.

<sup>132</sup>*Id.*

<sup>133</sup>29 U.S.C. §1107(d).

<sup>134</sup>29 C.F.R. §2550.404c-1(d)(2)(ii)(E)(4)(i)–(iv).

<sup>135</sup>29 C.F.R. §2550.404c-1(d)(2)(ii)(E)(4)(vii)–(ix).

Under the disclosure provisions of the regulations, discussed above in Section VI, the plan is required to furnish participants a description of the confidentiality procedures and to identify the plan fiduciary responsible for monitoring compliance with those procedures.<sup>136</sup>

### C. Pass Through Rights

Voting, tender, and similar rights relating to employer securities must be passed through to participants, and participants must receive all information provided to shareholders generally.<sup>137</sup> The pass through of voting, tender, and similar rights is not required for investment alternatives other than employer securities.

A plan that otherwise complies with the final regulations may remain a 404(c) Plan even though an employer security investment alternative fails to satisfy these requirements.<sup>138</sup> In such cases, however, plan fiduciaries will not be relieved of liability for employer security investments, even where such investments are participant-directed.<sup>139</sup>

### D. Overriding Plan Terms and Participant Directions

An ERISA fiduciary must follow the terms of the plan unless doing so would violate ERISA.<sup>140</sup> In the wake of Enron, WorldCom and other bankruptcies, the DOL and the courts have stated that plan fiduciaries have a duty to override plan terms requiring investment in employer securities, if ERISA would require them to do so.<sup>141</sup> Many of these decisions are on motions to dismiss. Therefore there is no clear guidance as to when such an obligation would be triggered.

In many of these cases, the defendants have included the plan's directed trustee. In *Tittle v. Enron*,<sup>142</sup> the district court pointed out that ERISA provides three exceptions to the trustee's exclusive control of plan assets:

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<sup>136</sup>29 C.F.R. §2550.404c-1(b)(2)(i)(B)(1)(vii).

<sup>137</sup>29 C.F.R. §2550.404c-1(d)(2)(ii)(E)(4)(v)-(vi).

<sup>138</sup>57 Fed. Reg. 46,906, 46,928 (1992).

<sup>139</sup>*Id.*

<sup>140</sup>ERISA §404(a)(1)(D), 29 U.S.C. §1104(a)(1)(D).

<sup>141</sup>See *In re Enron Corp. Securities, Derivative & ERISA Litig.* (Tittle v. Enron Corp.), 284 F. Supp. 2d 511 (S.D. Tex. 2003); *In re WorldCom Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003) *further proceeding*, 2005 U.S. Dist. LEXIS 1218 (S.D.N.Y. Feb. 1, 2005) (granting summary judgment to the trustee). Other courts, however, have created a presumption that investments in employer stock by an ESOP are proper. See *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995); *Kuper v. Quantum Chem. Corp.*, 66 F.3d 1447, 1459-60 (6th Cir. 1995); *In re Duke Energy ERISA Litig.*, 281 F. Supp. 2d 786 (W.D.N.C. 2003); *LaLonde v. Textron, Inc.*, 270 F. Supp. 2d 272 (D.R.I. 2003), *aff'd in part and vacated in part*, 2004 U.S. App. LEXIS 8977, Nos. 03-2033 & 03-2039, 2004 WL 1039844, at \*1-5 (1st Cir. May 7, 2004); *Wright v. Oregon Metallurgical Corp.*, 222 F. Supp. 2d 1224 (D. Or. 2002), *aff'd*, 360 F.3d 1090 (9th Cir. 2004); *Crowley ex rel. Corning, Inc. Inv. Plan v. Corning, Inc.*, 234 F. Supp. 2d 222 (W.D.N.Y. 2002); and *In re McKesson HBOC, Inc. ERISA Litig.*, 2002 U.S. Dist. LEXIS 19473, No. C00-20030, 2002 WL 31431588 (N.D. Cal. Sept. 30, 2002). The DOL briefs in the *Enron, WorldCom* and other employer stock cases are available on the Solicitor of Labor's website at <http://www.dol.gov/sol/media/briefs/main.htm> under Division of Plan Benefit Security. For a detailed discussion of the case law, see Rachal, Shapiro and Eichberger, "ERISA Fiduciary Duties Regarding 401(k) & ESOP Investments in Employer Stock," *ERISA Litigation* (BNA 2d ed., forthcoming 2005).

<sup>142</sup>*Tittle v. Enron Corp.*, 284 F. Supp. 2d at 581-602.

- when the trustee is following “proper directions” of a named fiduciary in accordance with the terms of the plan and not contrary to ERISA;
- when the authority to manage the assets is delegated to an investment manager; and
- when a plan participant has authority to direct his or her own account in a Section 404(c) plan.

To determine whether the named fiduciary’s directions are proper and not contrary to ERISA, the district court contrasted the duty of the directed trustee with the limited duty required when the trustee is following the directions of an investment manager or a participant under Section 404(c). The court concluded that “when the plan participant is given control of his individual account, under § 404(c)(1) the participant does not become a ‘fiduciary’ by exercising that control and thus the directed trustee cannot be liable as a co-fiduciary under § 405.”<sup>143</sup> The court concluded, however, that the complaint had raised sufficient question about whether the plan satisfied the requirements of Section 404(c) and therefore was not suitable for resolution on a motion to dismiss prior to discovery.<sup>144</sup>

## XI. INVESTMENT EDUCATION

In an effort to encourage the education of plan participants in matters relating to the investment of their retirement plan assets, the DOL issued Interpretive Bulletin 96-1 (IB 96-1)<sup>145</sup> providing guidance as to the types of investment information that may be provided to participants without causing the information provider to become a fiduciary under ERISA. The principles set forth in IB 96-1 apply to all participant-directed individual account retirement plans under ERISA, including plans that do not qualify as 404(c) plans. According to the DOL, certain categories of investment information, whether provided alone or together, will not constitute “investment advice” under ERISA; therefore, persons who provide such information to participants may avoid fiduciary liability for the results of participants’ investment decisions. IB 96-1 describes four “safe harbor” categories of information that are summarized in Section XII.B below.

### A. Investment Advice

Under ERISA, a person who renders or has authority to render “investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property” of an employee benefit plan is a fiduciary with respect to the plan.<sup>146</sup> The DOL has issued a regulation (29 C.F.R. §2910.3–21) describing the circumstances under which a person will be considered to be rendering “investment advice” within the meaning of ERISA.<sup>147</sup>

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<sup>143</sup>*Id.* at 584.

<sup>144</sup>*Id.* at 655.

<sup>145</sup>29 C.F.R. §2509.96-1.

<sup>146</sup>ERISA §3(21)(A)(ii), 29 U.S.C. §1002(21)(A)(ii).

<sup>147</sup>29 C.F.R. §2510.3-21(c).

Applying that regulation to a person who furnishes investment related information to participants in participant-directed individual account retirement plans, IB 96-1 states that the information provider will be considered to be rendering “investment advice” to the participant only if: (a) advice is rendered as to the value of securities or other property, or recommendations are made as to the advisability of investing in, purchasing, or selling securities or other property; *and* (b) the information provider, directly or indirectly: (i) has discretionary authority or control with respect to purchasing or selling securities or other property for the participant, or (ii) renders advice on a regular basis to the participant pursuant to a mutual agreement or understanding, whether or not written, with the participant that the advice will serve as a primary basis for the participant’s investment decisions for plan assets and that the information provider will render individualized advice based on the particular needs of the participant.<sup>148</sup> According to IB 96-1, persons who provide participants with types of information that fall within one or more of the four safe harbor categories, described in Section XI.B below, will not be deemed to be rendering “investment advice” within the meaning of the regulation and, therefore, will not be subject to fiduciary liability for the participants’ investment decisions.<sup>149</sup>

## **B. “Safe Harbor” Information Categories**

### ***1. Plan Information***

The first safe harbor category of plan information includes information and materials that inform plan participants and beneficiaries about:

- the benefits of plan participation;
- the benefits of increasing plan contributions;
- the impact of preretirement withdrawals on retirement income; or
- the terms or the operation of the plan.<sup>150</sup>

Plan information also includes information on investment alternatives, such as descriptions of:

- investment objectives and philosophies;
- risk and return characteristics; or
- historical return information.

Related prospectuses also fall within this safe harbor.<sup>151</sup> According to the DOL, the above information is general in nature and is provided without reference to the appropriateness of any individual investment option for a particular participant. Therefore, it does not contain either “advice”

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<sup>148</sup>29 C.F.R. §2509.96-1(c) (citing 29 C.F.R. §§2510.3-21(c)(1)(i), 2510.3-21(c) (1)(ii)(A) and (B)).

<sup>149</sup>29 C.F.R. §2509.96-1(c).

<sup>150</sup>*Id.* at (d)(1).

<sup>151</sup>*Id.*

or “recommendations” that would constitute the rendering of “investment advice” for purposes of ERISA.<sup>152</sup>

## **2. General Financial and Investment Information**

The second safe harbor category of information permits the distribution of general financial and investment information. Information and materials in this category include:

- general financial and investment concepts, such as risk and return, diversification, dollar-cost averaging, compounded return, and tax-deferred investment;
- historic differences in rates of return between different asset classes, such as equities, bonds, or cash based on standard market indices;
- effects of inflation;
- estimating future retirement income needs;
- determining investment time horizons; and
- assessing risk tolerance.<sup>153</sup>

IB 96-1 states that this type of information does not contain either “advice” or “recommendations” because it is general and has no direct relationship to any specific investment alternatives under the plan or to particular participants.<sup>154</sup>

## **3. Asset Allocation Models**

The third safe harbor category of information includes information and materials that provide participants and beneficiaries with models of asset allocation portfolios for hypothetical individuals with different time horizons and risk profiles. The same information must be available to all participants; that is, it cannot be individualized. In addition:

- the information and materials must be based on generally accepted investment theories that take into account the historic returns of different asset classes or defined time periods;
- the information must state the material facts and assumptions, such as retirement age, life expectancies, income levels, inflation rates, and rates of return on which the models are based;
- the model must include a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and advising plan participants where information on such alternatives may be obtained, if an asset allocation model identifies any specific investment alternative under the plan; and

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<sup>152</sup>*Id.*

<sup>153</sup>*Id.* at (d)(2).

<sup>154</sup>*Id.*

- asset allocation models must be accompanied by a statement indicating that, in applying particular asset allocation models to their individual situations, participants should consider their other assets, income, and investments.<sup>155</sup>

According to IB 96-1, safe harbor treatment for this category of information is available even if the plan offers only one investment alternative in a particular asset class identified in an asset allocation model.<sup>156</sup>

#### ***4. Interactive Investment Materials***

The final safe harbor category of information includes questionnaires, worksheets, software, and similar materials that provide participants with tools to estimate future retirement income needs and assess the impact of different asset allocations, where:

- the materials are based on generally accepted investment theories that take into account the historic returns on different asset classes;
- there is an objective correlation between the asset allocations generated by the materials and the information and data supplied by the participant;
- all material facts and assumptions that may affect a participant’s assessment of the different allocations either accompany the materials or are specified by the participant;
- the materials generated and identified by the asset allocation are accompanied by a statement indicating that other available investment alternatives may be available under the plan and advising plan participants where information on such alternatives can be obtained; and
- the materials take into account (or state that participants and beneficiaries should take into account) other assets, income, and investments when applying particular asset allocations to their individual situations.<sup>157</sup>

The four safe harbor categories are not the only types of information that may be provided to participants without the information being deemed “investment advice,”<sup>158</sup> although IB 96-1 provides no other examples. In determining whether furnishing participants with investment information that does not fall into one of the safe harbor categories constitutes the rendering of “investment advice,” the criteria set forth in Section 2510.3–21(c),<sup>159</sup> discussed in Section XI.A above, should be applied.

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<sup>155</sup>*Id.* at (d)(3).

<sup>156</sup>*Id.*

<sup>157</sup>*Id.* at (d)(4).

<sup>158</sup>*Id.* at (d).

<sup>159</sup>29 C.F.R. §2510.3–21(c).

## C. Selection and Monitoring

According to IB 96-1, persons who designate others to provide investment advice or educational services to plan participants are exercising discretionary authority or control with respect to management of the plan; therefore, they are required to designate and continue to designate such persons in a prudent manner and in the sole interests of plan participants.<sup>160</sup> Additionally, designating an investment advisor to act as a plan fiduciary may give rise to co-fiduciary liability if the person making and continuing the designation (a) does not act prudently and solely in the interests of plan participants, or (b) knowingly participates in a breach by the investment advisor, conceals such a known breach, or fails to make reasonable efforts to correct the known breach.<sup>161</sup>

Designating persons to provide investment education or fiduciaries to render investment advice under 404(c) Plans will not give rise to fiduciary liability for any loss or breach of ERISA's fiduciary responsibility rules that is the direct and necessary result of a participant's exercise of independent control.<sup>162</sup> In addition, actions of third parties selected by a participant to provide investment education or advice will not give rise to fiduciary liability on the part of a plan sponsor or fiduciary where the plan sponsor or fiduciary did not select, recommend, endorse, or arrange for the investment educator or advisor to provide services to the participant.<sup>163</sup>

## D. Relationship to Section 404(c)

According to the DOL, furnishing plan participants with investment information that falls within one of the safe harbors will not affect the availability of relief under Section 404(c).<sup>164</sup> However, IB 96-1 does not address how other types of information provided to participants may affect a participant's ability to exercise independent control over the assets in his account for purposes of relief from fiduciary liability under Section 404(c).

## E. Observations

IB 96-1 represents a significant step by the DOL in allowing plan sponsors and service providers to supply asset allocation models and interactive investment materials to participants in 404(c) Plans without being subject to potential fiduciary liability. In particular, representatives of mutual fund families or other investment vehicles made available under a plan may provide asset allocation models (including models used together with interactive investment materials) which identify or match specific investment funds available under the plan with generic asset classes identified in the model even when different investment funds within a mutual fund family charge

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<sup>160</sup>29 C.F.R. §2509.96-1(e).

<sup>161</sup>ERISA §405(a), 29 U.S.C. §1105(a).

<sup>162</sup>29 C.F.R. §2550.404c-1(d)(2).

<sup>163</sup>29 C.F.R. §2509.96-1(e).

<sup>164</sup>29 C.F.R. §2509.96-1(b) n.2.

different advisory fees. IB 96-1 provides guidance to persons offering participant investment education even with respect to plans that do not satisfy Section 404(c).

While the guidance in IB 96-1 is helpful to plan sponsors and many service providers, the IB did not address several other key issues:

- The IB offered no examples of information that may be provided to beneficiaries of individual retirement accounts without constituting investment advice.
- The IB did not address the implications of providing information that *does* constitute investment advice when dealing with plans that qualify as 404(c) Plans.
- The IB failed to address the application of existing prohibited transaction class exemptions to service providers who provide investment advice, and are considered fiduciaries for participant-directed plans and/or IRAs.
- The IB was silent on whether its guidance applies equally to the definition of “investment advice” for purposes of the prohibited transaction rules of Code section 4975.

Subsequently, in Advisory Opinion 2001-09A,<sup>165</sup> the DOL did provide guidance that a mutual fund advisor could offer interactive asset allocation systems (and automatic rebalancing following such systems) without giving rise to prohibited transactions if the allocations are “the product of a computer program applying a methodology developed, maintained and overseen by a financial expert who is independent” of the mutual fund advisor. Although the allocations would affect the advisor’s fees, since different investment options carried different advisory fees, the DOL concluded that the arrangement would not violate the fiduciary prohibited transactions under Section 406(b)(1) or (3).<sup>166</sup> Since the DOL has interpretive authority over prohibited transaction rules under both ERISA and the Code, this interpretation applies to parallel provisions of Code Section 4975.

## F. Prohibited Transaction Exemptions for Investment Advice

The PPA added two new prohibited transaction exemptions to permit fiduciary advisers to provide investment advice to participants.<sup>167</sup> Both the legislative history and the DOL have indicated that these new exemptions do not affect prior guidance issued by the DOL on investment education.<sup>168</sup> To qualify for these exemptions, the adviser must be registered as an investment adviser, bank, insurance company, broker, or dealer and must be a fiduciary.<sup>169</sup> Many financial institutions prefer not to become fiduciaries and may therefore continue to provide investment education rather than investment advice under the exemptions.

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<sup>165</sup>DOL Adv. Op. 2001-09A, Dec. 14, 2001.

<sup>166</sup>29 U.S.C. §1106(b)(1), (3).

<sup>167</sup>ERISA §408(b)(14), (g), 29 U.S.C. §1108(b)(14), (g), *added by* PPA §601(a)(1).

<sup>168</sup>152 Cong. Rec. S8, 752 (daily ed. Aug. 3, 2006) (statement of Sen. Enzi, Chairman of the Senate Health, Education, Labor and Pensions Committee); DOL Field Assistance Bulletin 2007-01, Q&A 1 (Feb. 2, 2007).

<sup>169</sup>ERISA §408(g)(11)(A), 29 U.S.C. §1108(g)(1)(A).

The first exemption permits investment advice under a fee-leveling arrangement.<sup>170</sup> The DOL has indicated that only the individual fiduciary adviser who provides the investment advice is obligated to have fees that do not vary depending on the underlying investments.<sup>171</sup>

The second investment advice exemption permits a fiduciary adviser to develop his or her own computerized investment advice model, which must be based on generally accepted investment theories taking into account “the historical returns of different asset classes over defined periods of time” as well as relevant information about the participant, such as “age, life expectancy, retirement age, risk-tolerance, other assets or sources of income, and preferences as to certain types of investment.”<sup>172</sup> The model must be objective and cannot favor the fiduciary adviser who created the computer model or any party with whom the advisor has a material affiliation or contractual arrangement.<sup>173</sup> The model must take into account all the investment options in the plan without assigning any option inappropriate weight.<sup>174</sup> However, the DOL has proposed regulations under which the model has to take into account only “designated investment options” and need not consider “brokerage windows,” “self-directed brokerage accounts,” or similar plan arrangements.<sup>175</sup> The model must be certified by an “eligible investment expert.” Both types of investment advice arrangement must be audited annually.<sup>176</sup> The arrangements must be expressly authorized by a fiduciary independent of the financial advisor, normally the plan administrator or other plan fiduciary.<sup>177</sup> The fiduciary adviser must provide notice to the participants and beneficiaries,<sup>178</sup> for which DOL has proposed a model.<sup>179</sup> The fiduciary adviser must also provide required securities disclosures.<sup>180</sup> The transaction with respect to which the fiduciary provided investment advice has to be effected by the participant or beneficiary.<sup>181</sup> Compensation received by the fiduciary adviser under either arrangement must be reasonable and the terms of the transaction must be at least as favorable as an arm’s-length transaction.<sup>182</sup>

## XII. SARBANES-OXLEY BLACKOUT NOTICES AND RESTRICTIONS

The Sarbanes-Oxley Act was enacted on July 30, 2002, in response to Enron and other corporate scandals. One aspect of the Enron debacle that enraged the public was the allegation that participants in Enron’s 401(k) plan were prevented, by an administrative blackout, from selling their Enron stock while executives were free to sell Enron stock they held outside the plan. As a result, Sarbanes-Oxley required that participants and beneficiaries be notified at least 30 days in

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<sup>170</sup>ERISA §408(g)(2), 29 U.S.C. §1108(g)(2).

<sup>171</sup>DOL Field Assistance Bulletin 2007-01 Q&A 3 (Feb. 2, 2007).

<sup>172</sup>ERISA §408(g)(3)(B)(i)–(ii), 29 U.S.C. §1108(g)(3)(B)(i)–(ii).

<sup>173</sup>ERISA §408(g)(3)(B)(iii), 29 U.S.C. §1108(g)(3)(B)(iii)–(iv).

<sup>174</sup>ERISA §408(g)(3)(B)(iv)–(v), 29 U.S.C. §1108(g)(3)(B)(iv)–(v).

<sup>175</sup>Prop. 29 C.F.R. §2550.408g-1(j)(1), 73 Fed. Reg. 49,896, 49,932 (Aug. 22, 2008).

<sup>176</sup>ERISA §408(g)(3)(C), (5), 29 U.S.C. §1108(g)(5).

<sup>177</sup>ERISA §408(g)(4), 29 U.S.C. §1108(g)(4).

<sup>178</sup>ERISA §408(g)(8), 29 U.S.C. §1108(g)(8).

<sup>179</sup>Prop. Appendix to 29 C.F.R. §2550.408g-1, 73 Fed. Reg. 49,896, 49,932 (Aug. 22, 2008).

<sup>180</sup>ERISA §408(g)(7)(A), 29 U.S.C. §1108(g)(7)(A).

<sup>181</sup>ERISA §408(g)(7)(B), 29 U.S.C. §1108(g)(7)(B).

<sup>182</sup>ERISA §408(g)(7)(C)–(D), 29 U.S.C. §1108(g)(7)(C)–(D).

advance of any blackout<sup>183</sup> and placed restrictions on executives purchasing or selling company stock during a blackout.<sup>184</sup>

Both of these requirements became effective January 26, 2003 (180 days after enactment). In January 2003, the DOL issued regulations implementing the notices that plan administrators must give in advance of a blackout,<sup>185</sup> and the SEC issued final regulations on the trading restrictions during blackout periods.<sup>186</sup>

Although these rules are often described as applying to 401(k) plan blackouts involving company stock, the DOL rules in fact apply to all defined contribution plans subject to ERISA. The SEC rules also apply to defined contribution plans, but is limited to those belonging to publicly-traded companies that hold employer stock. The SEC rule applies to both domestic issuers and foreign issuers whose stock is traded in the U.S.

## A. Blackout Defined

While both agencies' regulations define a "blackout period" as a period of three consecutive *business* days in which participants in a defined contribution plan are subject to restrictions on making investment changes, the DOL rules also apply to periods during which the participants' ability to obtain loans or distributions from the plan are "temporarily suspended, limited, or restricted."<sup>187</sup> However, the SEC rules apply only to a blackout period in which 50 percent or more of the participants and beneficiaries are temporarily unable to trade employer stock.<sup>188</sup> Note that the DOL rules apply whether or not the plan invests in any employer securities. Thus, even a multiemployer money purchase plan that held no employer stock could be subject to the DOL notice rules but would not be subject to the SEC rules.

A foreign private issuer's executives and directors will not be subject to the blackout trading restrictions, even if the 50 percent test is satisfied, if the number of defined contribution plan participants located in the United States affected by the temporary trading suspension:

- is less than 50,000, and
- does not exceed 15 percent of the foreign private issuer's employees worldwide.<sup>189</sup>

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<sup>183</sup>ERISA §101(i), 29 U.S.C. §102(i).

<sup>184</sup>Section 306(a) of the Sarbanes-Oxley Act of 2002.

<sup>185</sup>The DOL regulation defining the blackout notice requirements was published at 68 Fed. Reg. 3,716–729 (Jan. 24, 2003). A companion regulation, 29 CFR Parts 2560.502 and 2570, which establishes the process for assessing and appealing penalties for failure to provide notice, was published at 68 Fed. Reg. 3,729–3,741 (Jan. 24, 2003).

<sup>186</sup>SEC Regulation BTR (Blackout Trading Restriction), 15 CFR Part 245, was issued in SEC Release 34-47225 published at 68 Fed. Reg. 4,388 (Jan. 28, 2003).

<sup>187</sup>29 C.F.R. §2520.101-3(d)(1)(i); 15 C.F.R. §245.100(b).

<sup>188</sup>15 C.F.R. §245.100(b)(1).

<sup>189</sup>15 C.F.R. §245.100(b)(2).

Plans maintained outside the U.S. primarily for the benefit of nonresident aliens are excluded for both U.S. and foreign issuers. The controlled group rules used for plan qualification purposes are applied in determining the entities to be considered in assessing these thresholds.

Certain circumstances are not considered “blackouts” under the DOL rules. For instance, no notice is required merely because the participants’ activities are inhibited due to:

- normal plan operations which have been disclosed to participants and beneficiaries;
- securities law requirements;
- requirements for qualified domestic relations orders, including restrictions imposed pending determination of whether an order is qualified; or
- restrictions precipitated by a participant’s action or the action of a third party with respect to an individual participant’s account (such as a tax levy, a dispute over a deceased participant’s account, or failure to obtain a PIN number).<sup>190</sup>

Similar exceptions apply under the SEC rule.<sup>191</sup> Both rules, however, require that participants be informed of these restrictions in advance through plan documents such as summary plan descriptions, summaries of material modifications or explanations given to participants in connection with their investment elections. The SEC rule requires that the restrictions be disclosed within 30 days of formal enrollment or the adoption of an amendment affecting those restrictions.<sup>192</sup>

Note that the blackout notice requirements only apply to temporary suspensions or limitations. Thus, no notice is required for a permanent restriction on new contributions to an investment option, replacement of one investment option with another, a plan termination and similar permanent restrictions.

While the blackout in Enron occurred as a part of an administrative change from one trustee and record-keeper to another, future blackouts are also likely to occur as a result of threatened bankruptcy or some other unusual financial event, such as accounting fraud or misstatement requiring restatement of financials. Fiduciaries are likely to respond to this uncertainty by halting new purchases of employer stock but permitting participants to continue to sell the stock they hold in the plan.

## **B. Notice Requirements**

Under the DOL rules, plan administrators must provide written notices to participants and beneficiaries affected by a blackout and, if the plan holds employer securities, to the issuers of those securities.<sup>193</sup> The written notice must be furnished at least 30, but not more than 60, *calendar* days in advance of the last date on which affected participants and beneficiaries may exercise their

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<sup>190</sup>29 C.F.R. §2520.101-3(d)(1)(ii).

<sup>191</sup>15 C.F.R. §245.102.

<sup>192</sup>15 C.F.R. §245.102(a)(2).

<sup>193</sup>29 C.F.R. §2520.101-3(a).

affected rights before the commencement of any blackout period.<sup>194</sup> The issuer of employer securities in the plan must then give notice to the executives. The DOL rules permit distribution of the written notice by first class mail, certified mail, express mail, private delivery service, or electronic transmission.

The administrator is not required to give the 30-day advance notice under the DOL rule if:

- deferral of the blackout period would result in a violation of the exclusive purpose or prudence requirements (e.g., if the plan administrator determines that it would not be prudent to continue to permit participants to direct investments into company stock after a company announces it is filing for bankruptcy);
- commencement of the blackout period is due to events that were unforeseeable or circumstances that were beyond the control of the plan administrator, such as a major power failure that incapacitates the plan's record keeping system; or
- the blackout only applies to participants and beneficiaries who enter or leave the plan in connection with a merger, acquisition or divestiture involving the plan or plan sponsor.<sup>195</sup>

In all three circumstances, the administrator must provide written notice to participants as soon as reasonably possible unless notice in advance of the end of the blackout period is impracticable (e.g., where the need for a blackout period is determined only a few days before the beginning of the blackout period and the period is only a few days in duration).<sup>196</sup> In the first two cases (i.e., prudence or unforeseen circumstances), the plan administrator must make signed and dated determinations as to the reason for non-compliance.<sup>197</sup> If notice can be reasonably provided to a group of participants and beneficiaries (e.g., electronic distribution is available for active participants but mail delivery to former employees would not be effective), then the plan administrator has the obligation to provide notice to that group.<sup>198</sup>

The plan administrator is required to provide all affected participants and beneficiaries with an updated notice explaining the reasons for the change in the date(s) and identifying all material changes in the information contained in the prior notice.<sup>199</sup> The updated notice must be provided as soon as reasonably possible, unless such notice in advance of the termination of the blackout period is impracticable. The issuer is also required to update its notice to executives and directors.<sup>200</sup>

Under the SEC regulations, the issuer must give notice to the directors, executive officers and the SEC no later than:

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<sup>194</sup>29 C.F.R. §2520.101-3(b)(2)(i).

<sup>195</sup>29 C.F.R. §2520.101-3(b)(2)(ii).

<sup>196</sup>29 C.F.R. §2520.101-3(b)(2)(iii).

<sup>197</sup>29 C.F.R. §2520.101-3(b)(2)(iv).

<sup>198</sup>68 Fed. Reg. 3,716, 3,719 (Jan. 24, 2003).

<sup>199</sup>29 C.F.R. §2,520.101-3(b)(4).

<sup>200</sup>15 C.F.R. §245.104(b)(2)(ii).

- five business days *after* the company receives the blackout notice from the plan administrator, or
- fifteen calendar days *before* the actual or expected beginning date of the blackout period if the company does not receive a blackout notice.<sup>201</sup>

According to the SEC, the five-day rule will ensure that a company typically will not be required to provide its blackout notice to its directors and executive officers until it has received the plan administrator's blackout notice. However, this will require coordination within the company to ensure that the processes are in place for the plan administrator to give the notice to the appropriate individual who can then issue the notice to directors and executive officers and make sure that those individuals are aware of the restrictions.

U.S. companies must file the notice with a Form 8-K no later than the fourth business day after receiving the plan administrator's blackout notice or, if no notice is received from the plan administrator, on the same day directors and executive officers are notified.<sup>202</sup> Note that this is one day earlier than the notice is required to be provided to the executives. If there is a change in the blackout period, a new Form 8-K must be filed on the date that notice is given to the executives and directors containing the updated beginning or ending dates of the blackout period, explaining the reasons for the change in the date or dates, and identifying all material changes in the information contained in the prior report.<sup>203</sup> The Form 8-K is filed electronically through the EDGAR system and is a public document typically available through the company's website as well as the EDGAR database. Since this is the same form used to file financial press releases and other company announcements required under the securities laws, locating blackout notices can be time consuming.

Foreign private issuers subject to the blackout trading restriction must file a copy of each notice provided to directors and executive officers during the most recently completed fiscal year as an exhibit to the annual report (Form 20-F or 40-F), unless the notice previously was provided to the SEC on Form 6-K.<sup>204</sup>

### C. Content of Notices

Under the DOL regulation, the participant notice must be written so it can be easily understood by the average participant. The notice must include:

- the reasons for the blackout period;
- a description of the rights otherwise available under the plan that will be temporarily suspended, limited or restricted during the blackout period;
- a list of the investments subject to the blackout;
- the length of the blackout period by reference to—

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<sup>201</sup> 15 C.F.R. §245.104(b)(2)(i).

<sup>202</sup> Item 5.04 Form 8-K (available on the SEC website at <http://www.sec.gov/about/forms/form8-k.pdf>).

<sup>203</sup> 17 C.F.R. §245.104(b)(2)(iii) and instructions to Item 5.04 Form 8-K.

<sup>204</sup> 17 C.F.R. §245.104(b)(3)(ii).

- the expected beginning and ending dates of the blackout period, or
- the calendar week (beginning on Sunday) during which the blackout period is expected to begin and end, provided that during such weeks information as to whether the blackout period has begun or ended is readily available, without charge, to affected participants and beneficiaries, such as via a toll-free number or access to a specific web site, which is described in the notice;
- a statement advising participants and beneficiaries to review their current investments in light of their inability to direct or diversify their assets during the blackout period; and
- the name, address, and telephone number of the plan administrator or other contact responsible for answering questions regarding the blackout period.<sup>205</sup>

If 30-day notice is required and cannot be provided, the notice must include a statement that Federal law generally requires notice to be furnished at least 30 days in advance of the last date that participants and beneficiaries could exercise affected rights immediately before commencement of the blackout period and an explanation as to why the plan was unable to furnish at least 30 days advance notice.<sup>206</sup>

Under the SEC regulation, the notice of blackout period to the SEC and affected directors and executive officers must include the following information:

- the reason or reasons for the blackout period;
- a description of the plan transactions to be suspended during, or otherwise affected by, the blackout period;
- the description of the class of equity securities subject to the blackout period;
- the length of the blackout period, using the same type of description as required in the DOL notice to officers and directors and, in the 8-K, a description of how, during the blackout period and during the two years after the blackout period ends, a security holder or other interested party may obtain, without charge, the actual beginning and ending dates of the blackout period; and
- the name, address and telephone number of the person designated by the issuer to respond to inquiries about the blackout period, or, in the absence of such a designation, the issuer's human resources director or person performing equivalent functions.<sup>207</sup>

The DOL regulation includes a model notice.<sup>208</sup> While plan administrators are not required to use the model notice, most administrators will do so, adapting the notice to their particular circumstances. The SEC regulation does not include a model notice.

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<sup>205</sup>29 C.F.R. §2520.101-3(b)(1).

<sup>206</sup>29 C.F.R. §2520.101-3(b)(1)(v).

<sup>207</sup>17 C.F.R. §245.104(b)(1).

<sup>208</sup>29 C.F.R. §2520.101-3(e).

## D. Insiders and Trading Restrictions

Sarbanes-Oxley bars directors and executive officers from selling or transferring their public company stock acquired through their service to the company if the blackout restrictions apply.<sup>209</sup> The SEC has defined executive officer to have the same meaning as officer under the traditional insider trading rules. Thus, an executive officer includes a company's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), and any other officer who performs a policy-making function for the company.

Logically, the restrictions on executives should be parallel to those that apply to participants in the plan(s) affected by the blackout. For example, if plan participants are prevented from purchasing company stock but are permitted to freely sell their stock, executives should similarly be free to sell but prohibited from purchasing company stock. However, the SEC regulations do not appear to differentiate between complete and partial pension fund blackouts.

The final SEC rules exempt the following trades by insiders from the blackout trading restriction:

- increases or decreases in equity securities holdings resulting from a stock split, stock dividend or pro rata rights distribution;
- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities that satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c); and
- transactions that occur automatically or are made pursuant to an advance election or are otherwise outside the control of the director or executive officer, such as:
  - compensatory grants and awards of equity securities (including options and stock appreciation rights),
  - acquisitions or dispositions of equity securities in connection with a merger, acquisition, or similar transaction occurring by operation of law,
  - acquisitions or dispositions of equity securities pursuant to a domestic relations order, and
  - purchases or sales of equity securities pursuant to certain "tax-conditioned" employee benefit plans, other than discretionary transactions.<sup>210</sup>

A discretionary plan transaction within a "tax-conditioned" plan would include an intra-plan transfer of assets into or out of equity securities of the company, or a cash-out from a fund invested in equity securities of the company. The final rules clarify that transactions made in connection

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<sup>209</sup>Sarbanes-Oxley Act §306(a)(1), 15 U.S.C. §7244(a)(1).

<sup>210</sup>15 C.F.R. §245.101(c).

with death, disability, retirement, or termination of employment, or transactions involving a diversification or distribution required by the Code are not considered discretionary.

The final SEC rules also expanded the exemption for “tax-conditioned” plans to cover an employee benefit plan of a foreign private issuer that either has been approved by the taxing authority of a foreign jurisdiction, or is eligible for preferential treatment under the tax laws of a foreign jurisdiction because the plan provides for broad-based employee participation.

Many companies already prevent directors and executives from trading except during a window after quarterly and annual financial results come out. These restrictions, designed to avoid violations of insider trading rules, effectively create significant executive blackout periods (typically more than two months in each quarter). Rather than further restricting directors and executives from trading company stock, such companies are likely to schedule plan blackouts to occur during existing executive blackouts. Alternatively, some plan sponsors are making arrangements to permit trading in employer stock during a blackout to eliminate the restrictions on executives.

## **E. Blackout Penalties**

The Sarbanes-Oxley Act sets civil penalties of up to \$100 per day per affected participant from the date of the failure of a plan administrator to furnish written notice of a blackout period required by the DOL rules.<sup>211</sup> The penalty does not apply to the failure to provide notice to an issuer. The DOL may waive all or a part of a penalty to be assessed due to mitigating circumstances for noncompliance.<sup>212</sup> For purposes of calculating the penalty amount, the amount assessed for each violation under the regulation is computed from the date of the administrator’s failure to provide a notice of the blackout period (i.e., 30 days before the beginning of the blackout period) to the final day of the blackout period. A notice that is provided late does not end the time period for assessing the penalty but is a factor that will be taken into account in determining the degree or willfulness of a violation.<sup>213</sup>

A violation of the SEC blackout trading restrictions by a director or executive officer is subject to SEC enforcement actions. In addition, when a director or executive officer realizes a profit from a prohibited transaction during a blackout period, the company (or a security holder of the company on its behalf) can bring an action to recover that profit. For publicly-traded securities, the SEC says the profit is the difference between (a) the amount paid or received for the equity security on the date of the transaction during the blackout period, and (b) the average market price of the equity security over the first three trading days after the blackout period.<sup>214</sup>

## **XIII. AUTOMATIC ENROLLMENT**

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<sup>211</sup>ERISA §502(a)(7), 29 U.S.C. §1132(7).

<sup>212</sup>29 C.F.R. §2560.502c-2(d).

<sup>213</sup>68 Fed. Reg. 3,730 (Jan. 24, 2003).

<sup>214</sup>15 C.F.R. §245.103(c).

## A. PPA Automatic Enrollment Provisions [New Topic]

Studies have shown that automatic enrollment increases participation and retirement savings.<sup>215</sup> The PPA added several provisions to ERISA that are designed to encourage automatic enrollment of participants in 401(k) plans. The new provisions include:

- A new 401(k) nondiscrimination safe harbor for a “qualified automatic contribution arrangement” (QACA);<sup>216</sup>
- Permitted in-service distributions without tax penalties if participants opt out shortly after being automatically enrolled under an “eligible automatic contribution arrangement” (EACA);<sup>217</sup> and
- Preemption of state antigarnishment laws for withholding of employees’ contributions under automatic enrollment arrangements.<sup>218</sup>

These provisions generally operate independently, allowing an employer to choose which features to include in its 401(k) plan. For example, a plan that uses the 401(k) automatic enrollment safe harbor may use a default investment other than a QDIA and need not permit employees to withdraw their contributions once they have been automatically enrolled.

## B. 401(k) Automatic Enrollment Safe Harbor [New Topic]

New Code Section 401(k)(13) provides a safe harbor under which a plan will automatically satisfy the nondiscrimination rules for employee deferrals and company matches if it satisfies the requirements for a QACA.<sup>219</sup>

- The plan must provide a specific schedule of automatic contributions for each non–highly compensated employee, beginning at 3 percent of compensation and increasing by one percentage point in each subsequent year until the employee’s contribution reaches 6 percent of compensation.<sup>220</sup>
- The employer must provide one of the following contribution formulas:
  - !/? A match of 100 percent of the first 1 percent of compensation that each nonhighly compensated employee defers, plus 50 percent of additional deferrals up to 6 percent. Thus, if a participant defers 6 percent of compensation, the employer match would be 3.5

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<sup>215</sup>See Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116(4) Q.J. ECON. 1149–87 (2001); James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Savings for Retirement on the Path of Least Resistance*, BEHAV. PUB. FIN. 304–351 (Russell Sage Foundation 2006); Olivia S. Mitchell & Annamaria Lusardi, *Financial Literacy and Planning: Implication for Retirement Wellbeing*, Working Paper 2006-01 (Wharton Pension Research Council 2007); Shlomo Benartzi & Richard H. Thaler, *Heuristics and Biases in Retirement Savings Behavior*, 21(3) J. ECON. PERSP. 81–104 (2007).

<sup>216</sup>I.R.C. §401(k)(13).

<sup>217</sup>I.R.C. §414(w).

<sup>218</sup>ERISA §514(e).

<sup>219</sup>I.R.C. §401(k)(13)(A).

<sup>220</sup>I.R.C. §401(k)(13)(C)(i)–(iii).

percent of compensation (1 percent plus 2.5 percent),<sup>221</sup> or

!?! A nonelective contribution of 3 percent for each nonhighly compensated employee.

The plan must be amended to provide for the automatic contributions before the beginning of the plan year and the automatic contribution arrangement must be in effect for at least 12 months.<sup>222</sup>

The participant must have the option not to have contributions made or to elect a different level of contribution.<sup>223</sup> The participant must be provided with notice sufficiently early so that he or she has a reasonable period to opt out.<sup>224</sup> The notice must explain the level of elective deferrals that will be made if the participant does not make an affirmative election, the participant's right to opt out or elect a different level of contribution, as well as how automatic contributions will be invested in the absence of an investment election by the participant.<sup>225</sup> There is no requirement that automatic contributions be invested in a QDIA (discussed in Section VII.C, above), but some default investment alternative must be designated. The IRS has provided a model that may be used to satisfy this notice requirement.<sup>226</sup>

### C. Permitted In-Service Withdrawals [New Topic]

The distribution rules for qualified automatic enrollment arrangements are generally the same as those for other 401(k) plan deferrals. However, while in-service distributions for those younger than age 59½ are generally prohibited, as they are for other 401(k) plans, Code Section 414(w) provides a special rule that permits a plan to allow participants to withdraw amounts contributed through automatic enrollment within 90 days of the first automatic deferral. The distribution must be equal to the amount deferred, adjusted for earnings. This special withdrawal rule applies to any automatic enrollment arrangement, not just the automatic enrollment 401(k) safe harbor. However, the automatic deferrals must be invested in a qualified default investment under the DOL QDIA regulation.<sup>227</sup>

The notice requirement is generally the same as for the 401(k) automatic enrollment safe harbor, with the addition of the participant's right to make a permissible withdrawal and the procedure for electing the withdrawal.<sup>228</sup> The IRS model automatic enrollment notice includes the necessary information.<sup>229</sup> A notice will be deemed to satisfy the timing requirement if the notice is given at least 30 days and no more than 90 days before the beginning of each plan year. Newly eligible employees may be notified on the date of eligibility or within the 90-day period before becoming eligible.<sup>230</sup> This will allow employers to begin automatic enrollment with the first pay period for new employees, so long as those employees receive the notice before the first deferral is

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<sup>221</sup>I.R.C. §401(k)(13)(D)(i)(I).

<sup>222</sup>Treas. Reg. §1.401(k)-3(a), (3)(e).

<sup>223</sup>I.R.C. §401(k)(13)(C)(ii).

<sup>224</sup>I.R.C. §401(k)(13)(E)(ii)(III); Prop. Treas. Reg. §1.401(k)-3(k)(4)(iii).

<sup>225</sup>I.R.C. §401(k)(13)(E)(ii)(I)-(II); Prop. Treas. Reg. §1.401(k)-3(k)(4)(i)-(ii).

<sup>226</sup>Available on the IRS Web site at [http://www.irs.gov/pub/irs-tege/sample\\_notice.pdf](http://www.irs.gov/pub/irs-tege/sample_notice.pdf).

<sup>227</sup>I.R.C. §414(w)(3)(C); Prop. Treas. Reg. §1.414(w)-1(b)(4).

<sup>228</sup>I.R.C. §414(w)(4); Prop. Treas. Reg. §1.414(w)-1(b)(3).

<sup>229</sup>Available on the IRS Web site at [http://www.irs.gov/pub/irs-tege/sample\\_notice.pdf](http://www.irs.gov/pub/irs-tege/sample_notice.pdf).

<sup>230</sup>Prop. Treas. Reg. §1.414(w)-1(b)(3)(iii)(B).

withheld from their paycheck.

#### **D. ERISA Preemption of State Antigarnishment Laws [New Topic]**

ERISA does not preempt state criminal statutes of general applicability.<sup>231</sup> As a result, prior to the PPA, state criminal statutes prohibiting garnishment of employees' wages impeded automatic 401(k) enrollment. The PPA extended ERISA preemption to state antigarnishment laws that otherwise would prohibit any automatic contribution arrangement, so long as the participant has the option to make elective deferrals or receive cash compensation and the plan provides for a uniform percentage of compensation to be contributed if the participant makes no election.<sup>232</sup> The contributions do not have to be invested in a QDIA.<sup>233</sup> There is also no requirement that the plan allow permissible withdrawals.

### **XIV. CONCLUSION**

The requirements of Section 404(c) and the implementing regulations are detailed and exacting. When a plan meets those requirements, however, its fiduciaries will be spared the responsibility of making such decisions for the participants and may therefore avoid many of the problems discussed in Chapters 5, 10, and 12.

Previously, participants have been given the opportunity to construct and pursue their own investment strategy by choosing among the core alternatives and additional investment alternatives. Nonetheless, experience has shown that many participants do not want to construct their own portfolios. For those participants, the new QDIAs will provide a diversified portfolio.

For participant-directed plans to provide retirement security, plan participants need to understand sound investment principles. Although ERISA does not require plans to provide investment advice, most plan sponsors and plan fiduciaries recognize the importance of educating participants about investment fundamentals to aid them in their investments. The DOL has facilitated such education by identifying how participants may be educated without turning the provider into a plan fiduciary. In addition, the new prohibited transaction exemptions for investment advice will make investment advice more available to participants.

In the wake of Enron, WorldCom, and other highly publicized business failures that impacted participant-directed plans invested in company stock, the DOL and the courts are reexamining fiduciary responsibilities in participant-directed plans. Although the relevant judicial decisions have largely involved employer stock, the principles established in those cases will inform fiduciary behavior in all aspects of participant-directed plans.

The blackout requirements enacted by Congress in Sarbanes-Oxley add to the complexity of administering participant-directed accounts. Although the Sarbanes-Oxley blackout notice rules

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<sup>231</sup>See ERISA §514(b)(4), 29 U.S.C. §1144(b)(4).

<sup>232</sup>ERISA §514(e)(1)–(2), 29 U.S.C. §1144(e)(1)–(2), *added by* PPA §902.

<sup>233</sup>29 C.F.R. §2550.404c-5(f)(4); preamble to the QDIA Regulation, 72 Fed. Reg. at 60,466.

would have had little impact on events at Enron, as Enron apparently gave 30 days' notice before its blackout, the rules have created additional paperwork and imposed time limits for giving notice whenever a blackout occurs. The rules also require greater coordination between the plan administrator and the executive suite before implementing any blackout.

The new rules designed to encourage automatic enrollment in 401(k) plans enacted by the PPA are the most significant changes for participant-directed plans. Plans can now include automatic enrollment arrangements without concern about state antigarnishment laws. Employers have a new 401(k) safe harbor for automatic enrollment and fiduciaries have new safe harbors for QDIAs as well as mapping. Participants who do not want to defer money into their 401(k) plans not only have the opportunity to opt out but, if they fail to do so, can reverse their automatic enrollment. Both academic studies and the experience of early adopters suggest that automatic enrollment will increase participation, thereby enhancing employees' retirement security.

**DOL Model Blackout Notice**  
**Important Notice Concerning Your Rights Under the**  
**[Enter Name of Individual Account Plan]**

[Enter date of notice]

1. This notice is to inform you that the [enter name of plan] will be [enter reasons for blackout period, as appropriate: changing investment options, changing record keepers, etc.].

2. As a result of these changes, you temporarily will be unable to [enter as appropriate: direct or diversify investments in your individual accounts (if only specific investments are subject to the blackout, those investments should be specifically identified), obtain a loan from the plan, or obtain a distribution from the plan]. This period, during which you will be unable to exercise these rights otherwise available under the plan, is called a “blackout period.” Whether or not you are planning retirement in the near future, we encourage you to carefully consider how this blackout period may affect your retirement planning, as well as your overall financial plan.

3. The blackout period for the plan will begin on [enter date] and end [enter date].

4. [In the case of investments affected by the blackout period, enter the following: During the blackout period you will be unable to direct or diversify the assets held in your plan account. For this reason, it is very important that you review and consider the appropriateness of your current investments in light of your inability to direct or diversify those investments during the blackout period. For your long-term retirement security, you should give careful consideration to the importance of a well-balanced and diversified investment portfolio, taking into account all your assets, income and investments. You should be aware that there is a risk to holding substantial portions of your assets in the securities of any one company, as individual securities tend to have wider price swings, up and down, in short periods of time, than investments in diversified funds. Stocks that have wide price swings might have a large loss during the blackout period, and you would not be able to direct the sale of such stocks from your account during the blackout period.]

5. [If timely notice cannot be provided (see paragraph (b)(1)(v) of this section) enter: (A) Federal law generally requires that you be furnished notice of a blackout period at least 30 days in advance of the last date on which you could exercise your affected rights immediately before the commencement of any blackout period in order to provide you with sufficient time to consider the effect of the blackout period on your retirement and financial plans. (B) [Enter explanation of reasons for inability to furnish 30 days advance notice.]]

6. If you have any questions concerning this notice, you should contact [enter name, address and telephone number of the plan administrator or other person responsible for answering questions about the blackout period].