

Will You Be Forced to "Make Good" on Employee Investment Losses?

by Michael D. Koppel, CPA & Mark Nowak, Esq.

Many closely held businesses have 401(k) plans in which their employees may participate. This is a very popular employee benefit. But it is one that could unexpectedly cost you or your business a significant amount of money - perhaps enough to cover any and all losses incurred by employees participating in the investment plan.

Generally speaking, 401(k) plans and their counterparts are governed by the provisions of the Employee Retirement Security Act ("ERISA"). That law sets out numerous rules which qualified retirement plans are required to follow.

One of the requirements of a 401(k) plan is that it offer participants a wide range of investment alternatives. What those alternatives consist of is left to the discretion of the trustees (the "fiduciaries"), who are most often the officers and shareholders of the closely held business. In many cases allowing the plan to offer a variety of mutual and money market funds fulfills this requirement.

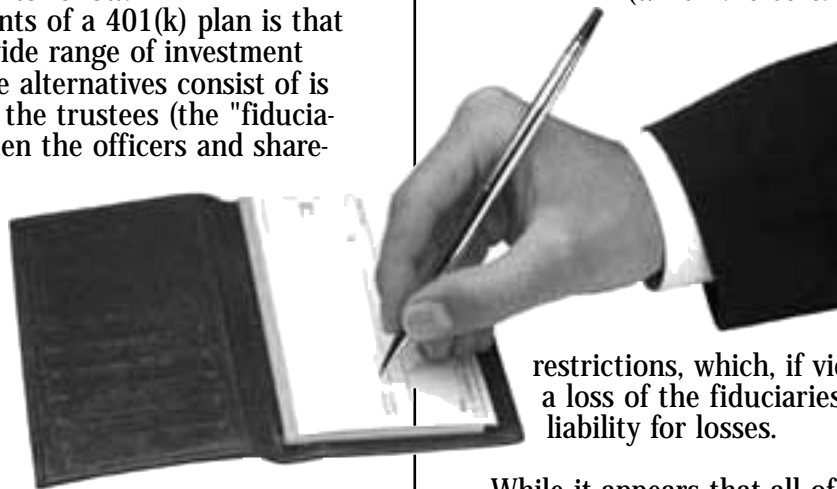
Many fiduciaries of 401(k) plans believe that they are not responsible for any investment losses incurred by the plan's participants or their beneficiaries (collectively, the "participant"). This belief is based on ERISA Section 404(c), which states that if a plan provides for individual accounts and allows a participant to exercise investment control - and the participant does in fact participate in the investment decisions - the fiduciaries will not be liable for investment losses.

In order to offer the level of investment control contemplated by Section 404(c) the plan participant must be provided with a reasonable opportunity to give investment instructions to the plan fiduciaries, or the fiduciaries' designee. The participant must also be provided with sufficient investment information with which to make informed invest-

ment decisions.

Under ERISA, a plan is not deemed to fail to provide a participant with control over investments merely because the plan:

- Imposes reasonable charges for expenses, provided that the participant is periodically informed of the charges;
- Permits the fiduciaries to decline to perform certain investment instructions, including instructions which would result in prohibited transactions (which are certain legally proscribed activities) or which would result in taxable income for the plan;
- Imposes reasonable restrictions on the frequency with which a participant may submit investment instructions; or
- Contains other restrictions, which, if violated, would result in a loss of the fiduciaries' protection against liability for losses.



While it appears that all of these requirements may be easily fulfilled easily by the fiduciaries of a 401(k) plan, it is important to understand what is required of those fiduciaries to meet the standard that a participant have sufficient information to make informed investment choices. For example, in order to receive the protection offered by Section 404(c), plan fiduciaries must provide the following information, even without being asked for it:

- An explanation that the plan is intended to comply with the various ERISA rules by having a participant's account separately maintained and having the participant exercise control over the account, also stating that the fiduciaries may be relieved of any responsibility for any losses incurred in the participant's account.

Will You Pay for Employee 401(k) Losses?

- A description of all investment alternatives available to each participant, together with a general description of the investment objectives and "risk and return characteristic" of each alternative. This description should include the type and diversification of the assets comprising each alternative.
- Identification of designated managers.
- An explanation of how and when investments maybe modified. This should include information regarding any voting or other restriction on investment alternatives.
- A description of fees or other transaction expenses related to purchases, sales or other account activity.
 - The name and address of the plan fiduciaries (or fiduciaries' designee) who, upon request, will provide information if the plan offers investment in the employers' securities as an alternative.
 - A description of the procedures established to provide confidentiality of information relating to the purchase of employer securities, as well as information regarding voting and other rights of the securities (including the name, address and phone number of the plan fiduciaries responsible for monitoring compliance).
 - In accordance with the provisions of the Securities Act of 1933, a prospectus must be provided to the participant prior to or immediately following the participant's initial investment in an asset; and
 - Subsequent to a participant's making an investment in any alternative, any materials provided to the plan relating to voting rights or similar information must be delivered to the participant.

Further, a participant may be considered to have insufficient investment information unless the participant is provided, either directly or upon request, with the following additional information (which must be based on the most recent information available to the plan):

- A description of the aggregate annual expenses of each investment alternative which reduces the rate of return for the investment, with the aggregate

amount expressed as a percentage of the average net asset value of the investment alternative.

- Copies of any prospectuses, financial statements and reports and any other information made available to the plan.
- A list of the assets comprising the portfolio of each investment alternative and the value of each such asset. With respect to any asset with a fixed rate of return issued by a financial institution, a participant must receive information regarding the insurer of the contract and its term and rate.
- The value of shares or units of investment alternatives available to participants, as well as current and past investment performance, determined net of expenses, on a reasonable and consistent basis; and
- Information concerning the value of all shares or units in investment alternatives held in the participant's account.

Maintaining the protection offered by Section 404(c) is further complicated because the regulations do not indicate precisely how often the fiduciary must update a plan participant regarding the effects of changing investment options.

Sound confusing? It is. However, failure to follow these rules may cause the fiduciaries of a plan to lose their immunity and be liable for losses incurred by each plan participant. With the volatility that the stock market has shown recently, no fiduciary should want to be in a position that effectively makes the fiduciaries guarantors of any investment.

What can you do to protect yourself and your company? Have a qualified professional to review your procedures and records to determine if you are in compliance. It is well worth the time and effort to make sure you cover all your bases. Being forced to cover investment losses is not the kind of employee benefit you planned to offer when you decided to offer a 401(k) plan.

This article was prepared with the help of Mark Nowak of the law firm Sherin and Lodgen LLP, Boston, Mass.



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