THE INDIVIDUAL RESPONSIBILITY MODEL OF RETIREMENT PLANS TODAY: CONFORMING ERISA POLICY TO REALITY

Colleen E. Medill
University of Nebraska-Lincoln, cmedill2@unl.edu

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Colleen E. Medill*

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* Associate Professor of Law, The University of Tennessee College of Law. I thank my colleagues at the College of Law, Dwight L. Aarons, Judith M. Cornett, Thomas Y. Davies, Amy Morris Hess, Don A. Leatherman, Robert M. Lloyd, Thomas E. Plank, and Glenn Harlan Reynolds for their helpful comments and suggestions. Earlier versions of this Article were presented at a faculty forum at the College of Law and at the Young Scholars Workshop at the annual meeting of the Southeastern Conference of American Law Schools during the summer of 1998.
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INTRODUCTION

America faces a ticking demographic time bomb that requires increased retirement savings.¹

Federal retirement policy today presents a regulatory paradox.² Numerous studies have shown that participants in retirement savings plans³ need retirement planning education and investment advice. Yet they receive materials that are either too basic for participants who are financially sophisticated or too sophisticated for participants who are financially illiterate.

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³ References throughout this Article to retirement plans refer to employee pension benefit plans subject to all of the requirements of Title I of ERISA. See 29 U.S.C. §§ 1002 (2)(A), 1003(a)-(b) (1994).
Most participants do not receive professional investment advice before they direct the investment of their retirements savings. Why? This situation is the result of regulations and rulings issued by the Department of Labor, the federal agency that interprets and enforces the Employee Retirement Income Security Act of 1974 ("ERISA").

This paradox is significant. Congress enacted ERISA to correct well-publicized flaws in the traditional employer-controlled defined benefit plan. Since the early 1980s, employers have moved away from the defined benefit retirement plan and toward the 401(k) plan, under which each employee is responsible for funding and directing the investment of his own retirement savings (the "individual responsibility model"). The pension industry estimates that by the year 2001, 401(k) plan assets will grow to almost $1.5 trillion. The number of 401(k) plan participants will reach 28 million. For many individuals, the only source of retirement income to supplement Social Security will be their 401(k) plan savings. One of the most important tasks faced by the Department of Labor today is to interpret and apply ERISA's statutory provisions, originally designed to regulate the employer-controlled defined benefit plan, to the employee-directed 401(k) plan.

The Department of Labor's current administrative policy toward 401(k) plans today is flawed. It assumes a sophisticated level of financial and investment knowledge that is beyond the competence of many 401(k) plan participants. Recent Department of Labor initiatives designed to encourage

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5 See infra note 17 and accompanying text. In a defined benefit plan, the plan promises to pay the participant a fixed periodic payment upon commencement of retirement. See Hughes Aircraft Co. v. Jacobson, 525 U.S. 432 (1999). The employer is responsible for funding the plan and investing its assets. See infra notes 42-48 and accompanying text.

6 See infra Part I.B. This trend has been well-publicized in the popular press. As the cover of the June 28, 1999 issue of U.S. News and World Report aptly describes, we have become a "401(k) Nation." U.S. News & WORLD REP., June 28, 1999, at cover.

7 See 401(k) Assets Climb, EMPLOYEE BENEFIT PLAN REV., July 1996, at 60.

8 See id.

9 See infra note 34 and accompanying text.

10 See infra Part IV.A.
retirement savings education for participants do not solve this problem.\textsuperscript{11} Instead, the Department of Labor has created additional uncertainty in an area of ERISA that already was ambiguous.\textsuperscript{12} These recent initiatives both undermine ERISA’s fiduciary protections for plan participants and impose an undue burden on sponsoring employers—the opposite result of what Congress intended when it enacted the statute.\textsuperscript{13}

This Article assumes that Congress is unwilling, or politically unable, to modernize ERISA by making fundamental changes to the statute itself.\textsuperscript{14} I argue that statutory amendments are not necessary. The Department of Labor can and should “modernize” ERISA through its administrative authority to interpret the statute.\textsuperscript{15} I propose that the Department of Labor revisit and amend its own administrative policies to reflect the reality of today’s individual responsibility model.\textsuperscript{16} Administrative modernization will solve the regulatory paradox. The result will be a federal retirement policy that remains true to ERISA’s original goal—to ensure retirement income security for millions of Americans.

I. THE SIGNIFICANCE OF THE INDIVIDUAL RESPONSIBILITY MODEL FOR FEDERAL RETIREMENT POLICY

Congress developed ERISA’s statutory scheme in the 1970s as a political response to well-publicized fiduciary abuses, funding failures, and vesting inequities common among defined benefit retirement plans in the 1950s and 1960s.\textsuperscript{17} Beginning in the early 1980s, first social scientists and policy makers,\textsuperscript{18} and later legal scholars,\textsuperscript{19} began to notice a trend. Participation in

\begin{itemize}
  \item See infra Part III.B.
  \item See infra Part IV.B.
  \item See infra Parts IV.B & C.
  \item See infra note 419 and accompanying text.
  \item See generally WILLIAM N. ESKRIDGE, JR., DYNAMIC STATUTORY INTERPRETATION (1994).
  \item See infra Part V.
  \item See, e.g., ROBERT L. CLARK & ANN A. MCDERMED, THE CHOICE OF PENSION PLANS IN A CHANGING REGULATORY ENVIRONMENT (1990); EMPLOYEE BENEFIT RESEARCH INST., WHEN WORKERS CALL THE SHOTS; CAN THEY ACHIEVE RETIREMENT SECURITY? (Dallas L. Salisbury ed., 1995); PENSION RESEARCH COUNCIL, LIVING WITH DEFINED CONTRIBUTION PLANS (Olivia S. Mitchell & Sylvester J. Schieber eds., 1998); POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY (Michael S. Gordon et al. eds., 1997); THE FUTURE OF PENSIONS IN THE UNITED STATES 102-25 (Ray Schmitt ed., 1993); U.S. GEN. ACCOUNTING OFFICE,
traditional defined benefit retirement plans was declining. Participation in individual account retirement plans (also known as defined contribution retirement plans) was steadily increasing. Participation in 401(k) plans, a type of individual account plan, was skyrocketing. Part I of this Article explores the policy ramifications of these trends.


21 In an individual account or defined contribution plan, the amount of the participant's retirement benefit is the non-forfeitable amount available in the participant's plan account when benefit payments commence. See 29 U.S.C. § 1002(34) (1994); Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 439 (1999).

22 See PENSION & WELFARE BENEFITS ADMIN., supra note 20, at 80 tbl.F8; see also GAO PRIVATE PENSIONS REPORT, supra note 18, at 3-9.

23 Individual account plans come in various types. See EMPLOYEE BENEFITS RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 69-79 (5th ed. 1997); see also AMERICAN BAR ASS'N, supra note 17, at 71-241; DAN M. MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 247-96 (7th ed. 1996). The 401(k) plan, also known as the cash or deferred arrangement (CODA), is a particular type of individual account plan. See I.R.C. § 401(k) (1994 & Supp. III 1997); Treas. Reg. § 1.401(k)-1 (as amended in 1995); MCGILL ET AL., supra, at 285-86. The 401(k) plan is unique among the various types of individual account plans in that contributions to the plan are funded by the employee-participants themselves, not the employer. See I.R.C. § 401(k); Treas. Reg. § 1.401(k)-1. See generally EMPLOYEE BENEFITS RESEARCH INST., supra, at 93; AMERICAN BAR ASS'N, supra note 17, at 208-09.

24 See sources cited infra notes 27-36 and accompanying text. Various theories exist for why participation in defined benefit plans has declined while participation in individual account plans has increased. See, e.g., PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, TRENDS IN PENSIONS 1992, at 59, 68 (1992); Steven Sass, Crisis In Pensions, REGIONAL REV. (Fed. Reserve Bank of Boston), Spring 1993, at 14, reprinted in LANGBEIN & WOLK, supra note 17, at 53. One theory attributes the trend to structural changes in the economy and corresponding shifts in the labor force. See, e.g., Gustman & Steinmeier, supra note 18; Kruse, supra note 18. Another theory attributes the trend to the high costs of plan administration and regulatory compliance for defined benefit plans relative to defined contribution plans. See PENSION & WELFARE BENEFITS ADMIN., supra note 20, at 2; CLARK & MCDERMED, supra note 18; U.S. GEN. ACCOUNTING OFFICE, 401(k) Plans, supra note 18, at 13; MCGILL ET AL., supra note 23, at 39-42; Edwin C. Hustead, Trends In Retirement Income Plan Administrative Expenses, in LIVING WITH DEFINED CONTRIBUTION PLANS, supra note 18, at 166, 166-77; Ippolito, supra note 18, at 13-18; Sylvester Schieber &
A. The Rapid Growth of 401(k) Plans

When Congress enacted ERISA in 1974, the participant-directed 401(k) plan did not exist. Today's 401(k) plan is the product of amendments to the Internal Revenue Code, made pursuant to the Revenue Act of 1978, which did not become effective until 1980. Graph 1 below, taken from the Private Pension Plan Bulletin, illustrates the rapid growth of 401(k) plans.

GRAPH 1
NUMBER OF 401(k) PLANS
1984-1993


26 Id. § 135(c)(1). Congress enacted section 401(k) to resolve uncertainty concerning the qualified status of certain profit sharing plans under section 401(a). See H.R. CONF. REP. NO. 1800, at 206-07 (1978), reprinted in 1978 U.S.C.C.A.N. 7198, 7212-13. See generally Theodore E. Rhodes & Harry J. Conaway, Cash or Deferred Arrangements, in 40 INST. ON FED. TAX'N, Conf. on EMPLOYEE BENEFITS § 10:02 (1982); Paul Schultz, Cash or Deferred Arrangements, in 43 INST. ON FED. TAX'N, CONFERENCE ON EMPLOYEE BENEFITS § 10:01 (1985). It is clear that Congress did not foresee the implications of section 401(k) when this section was added to the Code. See R. Theodore Bena, Reflections on the Birth and Growth of 401(k) Plans, 22 TAX MGMT. COMP. PLAN. J. 353, 358 (1994) (article by the generally recognized inventor of the 401(k) plan).

Table 1 below, compiled from the *Private Pension Plan Bulletin* data, documents the growth of 401(k) plans from 1984 to 1993 using the measures of number of active participants, number of plans, and plan assets.

### TABLE 1
**"MEASURES" OF 401(k) PLANS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Active Participants (in thousands)</th>
<th>Number of 401(k) Plans</th>
<th>401(k) Plan Assets (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>7,540</td>
<td>17,303</td>
<td>91,754</td>
</tr>
<tr>
<td>1993</td>
<td>23,138</td>
<td>154,527</td>
<td>616,316</td>
</tr>
</tbody>
</table>

By all these measures, the growth of 401(k) plans has been dramatic. In a separate 1996 study commissioned by Congress to ascertain the significance of 401(k) plans, the GAO reported that:

One in four workers who have pension coverage participates in a 401(k) pension plan.... Much of the growth in defined contribution pension plans has been due to the increase in the number of 401(k) plans.

---

28 *See Pension & Welfare Benefits Admin., supra* note 20, at 95 tbl.F.23. An "active participant" is defined to include: (1) any worker currently in employment who is covered by a plan and who is earning retained service credit under a plan, and (2) any nonvested former employee who has not yet incurred a break in service. *See id.* at 19, n.1, tbl.B.7. I have focused on the category of "active" participants to illuminate current and future trends.

29 *See id.* at 95 tbl.F23.

30 *See id.*

pension plans. In 1992, 401(k) plans accounted for 20 percent of all pension plans and 35 percent of all pension plan participants.  

401(k) plans are particularly popular among smaller employers. Significantly, smaller employers oftentimes offer 401(k) plans as the only retirement plan for their employees. Moreover, the rapid growth of 401(k) plans is expected to continue in the future. Pension industry estimates hypothesize that by the year 2001, the number of 401(k) plan participants will reach 28 million and 401(k) plan assets will increase to almost $1.5 trillion. These industry projections, published in 1996, are likely understated given subsequent changes in the law that make 401(k) plans more widely available. At the time these projections were published, tax-exempt organizations could not establish new 401(k) plans for their employees. Congress has since amended the law to allow tax exempt employers to establish new 401(k) plans for their employees. In addition, Congress has simplified the rules for administering 401(k) plans to encourage small employers (those with 100 or fewer employees) to adopt 401(k) plans for their employees. These changes in the law are likely to increase participation in 401(k) plans; only the potential magnitude of the increase is unknown.

B. Implications for Federal Retirement Policy

The employer-controlled defined benefit plan and the participant-directed 401(k) plan represent two distinct policy models for retirement. The defined benefit plan is a "paternalistic" model in that the employer, rather than the employee, bears the responsibility for ensuring that the plan's promised level

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32 U.S. GEN. ACCOUNTING OFFICE, 401(k) PLANS, supra note 18, at 2-3.
33 See PENSION & WELFARE BENEFITS ADMIN., supra note 20, at 49 tbl.D.4 (showing number of 401(k) type plans by participants size and primary or supplemental status, 1993). The Private Pension Plan Bulletin data for 1993 indicate that of the 154,527 401(k) plans reported, 129,156 had 99 or fewer participants. See id.
34 See id. Of the 154,527 401(k) plans reported for 1993, 131,988 were the only plan sponsored by the employer. Of this number, 115,845 plans had 99 or fewer participants. See id.
35 See supra note 8 and accompanying text.
36 See supra note 7 and accompanying text.
of retirement benefits is provided to the retired participant. In contrast, the participant-directed 401(k) plan shifts the risks and responsibilities for retirement income security to the individual.

In the traditional defined benefit plan, the plan promises to pay the participant a specified level of benefits upon retirement in accordance with the formula described in the plan. The employer sponsoring the plan is solely responsible and legally liable for funding the benefits promised by the plan. This funding obligation is independent of the profitability or financial status of the employer. The plan's assets are held in one trust fund; there is no separate account for each plan participant. The employer (or the employer's designated fiduciary) is solely responsible for investing the plan's assets. The employer bears the market risk with respect to the plan's investments. If the plan's investments perform well, investment gains may offset the amount the employer must contribute to the plan. If the plan suffers investment losses, however, the employer must make up for those losses through additional contributions. In the event the plan cannot pay the participant's promised retirement benefits, the Pension Benefit Guaranty Corporation (PBGC) insurance program will pay at least some portion of the promised retirement benefits to the participants.

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42 See sources cited supra note 41. The normal form of payment of this retirement benefit will be an annuity for the life of the participant or, if the participant is married, an annuity for the joint lives of the participant and spouse. The defined benefit plan may offer the participant (and, if married, the participant's spouse) the choice of a different form of payment, such as a lump sum payment. See I.R.C. § 401(a)(11) (1994 & Supp. III 1997); AMERICAN BAR ASS'N, supra note 17, at 161-68; McGILL ET AL., supra note 23, at 220-24.

43 For a discussion of the minimum funding requirements for defined benefit plans, see AMERICAN BAR ASS'N, supra note 17, at 135-143; McGILL ET AL., supra note 23, at 595-604.

44 Waivers of the minimum funding requirements are obtainable under certain conditions for employers in financial distress. See AMERICAN BAR ASS'N, supra note 17, at 137-39; McGILL ET AL., supra note 23, at 603.


46 ERISA permits the sponsoring employer to appoint a fiduciary investment manager for the plan's assets. See id. § 1103(a).

47 See id. § 1104(a)(1)(C).

48 The PBGC is a self-financed public corporation similar to the Federal Deposit Insurance Corporation or the Securities Investor Protection Corporation. For a discussion of the PBGC and its defined benefit plan insurance program for single-employer plans, see AMERICAN BAR ASS'N, supra note 17, at 362-89; McGILL ET AL., supra note 23, at 743-56.
In the participant-directed 401(k) plan, each individual is responsible for determining the amount of his own retirement benefit. The individual must decide how much of his compensation to contribute to his retirement account in the 401(k) plan. This decision ideally would require the participant to have a retirement income goal in mind. The participant also must decide how to invest the funds contributed to his 401(k) retirement account. This investment decision is important to achieving the participant's retirement income goal because accumulated investment earnings over time will form a significant portion of the participant's retirement savings. These contribution and investment decisions are critical ones because the participant's retirement benefit will amount to the balance in his 401(k) plan account.

The participant-directed 401(k) plan presents a challenge to policy makers. At the individual level, the “success” of each participant plan in achieving

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49 The participant's salary deferral contributions to the 401(k) plan could, of course, be supplemented by the employer through a matching or profit sharing contribution. For purposes of illustration and discussion, I have omitted these possibilities.

50 Each employee who participates in the plan elects to reduce his or her current compensation by up to the lesser of the section 402(k)(11) amount ($6,000 in 1999) or 15% of the employee's compensation. See I.R.C. § 404(a)(3)(A) (1994 & Supp. III 1997); I.R.S. Notice 98-53, 1998-46 I.R.B. 24; EMPLOYEE BENEFITS RESEARCH INST., supra note 23, at 100. This amount is then contributed by the employer to the employee's individual account under the 401(k) plan. See I.R.C. § 401(k)(2)(A) (1994 & Supp. III 1997). Highly compensated employees may not be able to defer the maximum amount due to the section 401(k) nondiscrimination rules. See EMPLOYEE BENEFITS RESEARCH INST., supra note 23, at 96-97.

Until very recently, the conventional approach to 401(k) plan design held that a participant had to decide affirmatively to contribute to a 401(k) plan. Inaction by the employee meant no contributions were made. In a 1998 private letter ruling, however, the Internal Revenue Service ruled that employers could enroll their employees in the employer's 401(k) plan and deduct a portion of each employee's compensation, thus shifting the burden to the employee to “opt out” of participation in the plan. Priv. Ltr. Rul. 98-400-48 (Jul. 7, 1998); see also infra note 219.


52 For an illustration of the effect of tax-deferred accumulated earnings, see LANGBEIN & WOLK, supra note 17, at 156.

53 See EMPLOYEE BENEFITS RESEARCH INST., supra note 23, at 70. This retirement benefit is likely to be paid in the form of a lump sum. See BUREAU OF LABOR STATISTICS, supra note 51, at 142 tbl. 170 (showing that 92% of 401(k) plans permit lump sum distribution payments). Many 401(k) plans also permit the participant to access his 401(k) plan retirement benefits prior to retirement in the form of plan loans or hardship withdrawals. See id. at 141-42 tbls. 168 & 169; U.S. GEN. ACCOUNTING OFFICE, 401(k) PENSION LOANS: LOAN PROVISIONS ENHANCE PARTICIPATION BUT MAY AFFECT INCOME SECURITY FOR SOME (1997).
retirement security is highly dependent on the contribution and investment decisions made by that individual. These decisions require a certain level of information and knowledge, along with the ability to apply that knowledge to one's own financial circumstances. The aggregate successes and failures of participants in 401(k) plans have direct and significant political and policy implications on a nationwide scale. Numerous prophets have foretold of the coming demographic sea change as the baby boomers approach retirement age. Many studies have examined the traditional "three-legged stool" of federal retirement policy and conclude that two of the three financial "legs" that are to support future retirees—personal savings and Social Security—are failing. Personal savings rates are at their lowest levels since 1939. The

54 "Success" in achieving retirement security is in itself an amorphous concept with many possible measures. See, e.g., Emily S. Andrews, Gaps In Retirement Income Adequacy, in The Future of Pensions, supra note 18, at 1.


57 See Keville, supra note 19, at 545; Associated Press, Americans' Savings Lowest Ever; Rate is Contrary to Economy's Growth, Newsday, Aug. 14, 1998, at A35; Christina Duff, Consumer Outlays Exceed Income, Driving Savings to a Record Low Level, Wall St. J., Aug. 4, 1998, at A2; see also U.S. Private Savings Crisis—Long Term Economic Implications and Options for Reform, Hearing Before the Subcomm. on Deficits, Debt Management, and Long-Term Economic Growth of the Senate Comm. on Finance, 103d Cong. 2 (1994); Kotlikoff & Auerbach, supra note 55, at 94-95; JCT Staff Description of Tax Incentives for Savings, 29 Daily Tax Rep., Feb. 12, 1998, at L-27, L-33 ("The personal savings rate of 3.8 percent of disposable personal income is the lowest computed by the Commerce Department since 1939."). Although some may contend that households are merely substituting retirement plan savings for personal savings, at least one study indicates that this is not the case, particularly for lower income households. See J. Sabelhaus, How Does Pension Coverage Affect Household Savings?, in U.S. Dep't of Labor, Pensions, Savings, and Capital Markets 47, 55-57 (1996). But see Gordon, supra note 19, at 1548.
projected fiscal “collapse” of the Social Security system, unless significant but controversial changes are made, is now a given in the minds of both politicians and the public. Thus, the need for a strong “third leg” of employer-sponsored retirement plans is greater than ever.

In the world of the individual responsibility model, retirement income security will be determined by the decisions of the plan participants themselves. It is crucial to know whether participants are making retirement planning decisions that are likely to result in the accumulation of adequate retirement income. Subpart C examines the empirical evidence and research concerning participant decision-making under the individual responsibility model.


C. Evidence of Participant Decision-Making Under the Individual Responsibility Model

Sex education and 401(k) education have a lot in common: No one can agree on how much students should be told.62

A number of studies have attempted to examine the retirement savings knowledge and decision-making behavior of plan participants. The results of these studies consistently indicate that, although some plan participants are highly knowledgeable and make retirement savings decisions that are likely to lead to the accumulation of adequate retirement savings, many participants suffer from financial "illiteracy." As a result, they make decisions that place them at risk of failing to accumulate adequate savings for retirement.

1. Participant Retirement Savings and Financial Knowledge

Many Americans have a false sense of confidence as it concerns their own retirement. A 1993 study (the "Bernheim Study") found that among the least financially secure segment of the population, nearly two-thirds believed that their standard of living during retirement would be as high or higher than it was today, despite the fact that most of these individuals acknowledged that they saved significantly less than they should, and expressed little or no confidence in Social Security.63 The 1997 Retirement Confidence Survey ("RCS")64 found that although only six percent of Americans "believe that, in general, people in the United States save enough money to live comfortably throughout their retirement years," sixty-eight percent were "very confident" or

62 Ellen E. Schultz, Employees Looking for Advice on 401(k)s Often Face Obstacles, WALL ST. J., Feb. 6, 1998, at Cl.
63 This study was conducted by B. Douglas Bernheim, the Lewis and Virginia Eaton Professor of Economics at Stanford University. The study was conducted through an analysis of annual household survey data collected by Merrill Lynch, Inc. in 1993. See B. Douglas Bernheim, Financial Illiteracy, Education, and Retirement Saving, in LIVING WITH DEFINED CONTRIBUTION PENSIONS, supra note 18, at 38.
64 The 1997 Retirement Confidence Survey, the seventh in a series of annual surveys, was co-organized by the Employee Benefits Research Institute ("EBRI"), the American Savings Education Council ("ASEC"), and Mathew Greenwald & Associates, Inc. EBRI is a private, nonprofit and nonpartisan public policy research organization. ASEC, which is part of the EBRI Education and Research Fund, is a nonpartisan partnership of more than 200 private and public sector institutions whose mission is to raise public awareness of what is needed to ensure long-term financial security in retirement. Mathew Greenwald & Associates, Inc. is a market research firm based in Washington, D.C.

The 1997 RCS was conducted in July 1997 through telephone interviews with 1,001 randomly selected individuals ages 25 and older. Of these 1,001 individuals surveyed, 772 were current workers and 229 were retirees. EMPLOYEE BENEFITS RESEARCH INST., THE 1997 RETIREMENT CONFIDENCE SURVEY (RCS) SUMMARY OF FINDINGS 1 (1997).
"somewhat confident" that they personally would have enough money to live comfortably throughout their retirement years. Among those who identified themselves as "very confident" concerning their personal retirement prospects, only slightly more than half had actually attempted to calculate their retirement savings needs. The 1997 RCS found that overall only 36% of current workers had attempted to determine the amount they needed for retirement. Out of the 36% who had attempted a calculation, however, 24% could not give a figure when asked. Thus, the RCS concluded that in reality approximately 75% of all current workers have no idea of the amount they need to save for retirement. This survey result is ominous because a target or goal for retirement savings is a prerequisite for informed decision-making by participants in 401(k) plans.

Studies also have concluded that a significant portion of the public lacks fundamental knowledge of the financial concepts necessary for decision-making under the individual responsibility model. The Bernheim Study reported that "existing literature demonstrates that most Americans know little about managing personal finances and their choices reflect this ignorance." The Bernheim Study also reported that many study respondents do not understand common financial instruments, noting that "[r]oughly 42 percent could not identify the proper explanation for the difference in average returns between mutual funds and federally insured CDs." An analysis of the results of the 1996 RCS reached a similar conclusion, finding that "the majority of working Americans appear to have a limited amount of financial knowledge regarding issues important in planning and saving for retirement."

The 1996 RCS assessed the public's general knowledge regarding retirement planning and savings issues. Based on the answers to the survey questions, 33% of workers were judged to have a high level of retirement financial knowledge, 55% of workers were judged to have only a moderate

65 Id. at 3.
66 Id. at 4.
67 Id. at 3. The 1998 Retirement Confidence Survey found that this 36% figure had increased to 45%. See EMPLOYEE BENEFITS RESEARCH INST., ISSUE BRIEF NO. 200, WHAT IS YOUR SAVINGS PERSONALITY? THE 1998 RETIREMENT CONFIDENCE SURVEY 3 (1998).
68 See EMPLOYEE BENEFITS RESEARCH INST., supra note 64, at 4.
69 See id.
70 Bernheim, supra note 63, at 43.
71 Id. at 44.
level of retirement financial knowledge, and 11% had little relevant knowledge of financial issues.\textsuperscript{73} Not surprisingly, on average the higher the workers' educational level and household income, the greater level of retirement financial knowledge they possessed.\textsuperscript{74}

Given the emphasis placed by the individual responsibility model on participants' direction and control over the investment of their retirement plan assets, it is particularly important for plan participants to be informed of the relative historical returns among basic investment options offered in participant-directed plans. The results of the 1996 RCS indicate that many individuals do not have a working knowledge of the historical returns for common categories of investment options. For example, only 61% of workers knew that over the last twenty years, the U.S. stock market provided a greater rate of return than U.S. government bonds.\textsuperscript{75} Only 53% of workers knew that employer stock is typically a more volatile investment than a diversified portfolio of stocks.\textsuperscript{76}

In addition to lacking a retirement savings goal and basic investment knowledge, many workers appear to underestimate the amount of time they will spend in retirement.\textsuperscript{77} When asked about the life expectancy of a male who retires at age sixty-five, less than half knew that the average life expectancy was 80 years.\textsuperscript{78} Significantly, a majority either underestimated the average life expectancy or did not know the average life expectancy.\textsuperscript{79}

In summary, research studies indicate that there is a lack of knowledge among the public concerning retirement savings goals, basic investment information, and a realistic assessment of the amount of time likely to be spent in retirement. This lack of knowledge would not be a cause for concern if plan participants sought advice from financial and retirement professionals. In reality, however, the Bernheim Study found that individuals rarely seek professional guidance. Instead, most people rely primarily on their own judgment or the advice of parents, relatives, and friends.\textsuperscript{80}

\textsuperscript{73} See id.
\textsuperscript{74} See id.
\textsuperscript{75} See id. at 9-10.
\textsuperscript{76} See id. at 10.
\textsuperscript{78} See EMPLOYEE BENEFITS RESEARCH INST., ISSUE BRIEF No. 169, PARTICIPANT EDUCATION: ACTIONS AND OUTCOMES 6 (1996).
\textsuperscript{79} See id.
\textsuperscript{80} See Bernheim, supra note 63, at 55-56. The 1998 RCS found that even among the 17% of the
The lack of knowledge among plan participants, coupled with their reluctance to seek professional advice, is problematic because such knowledge forms the foundation for decision-making under the individual responsibility model. Workers who do not calculate the amount they need for retirement, who invest poorly, and who underestimate the amount of time they will spend in retirement, are unlikely to attain their desired standard of living during retirement. The research evidence presented below indicates that many plan participants are likely to become disappointed retirees.

2. Decisions Concerning Plan Participation and Contribution Amounts

On an aggregate level, the 1997 RCS found that 76% of employees who were offered a 401(k) or similar plan by their employer chose to participate in the plan by making contributions. Among these plan participants, only 65% were aware of the maximum amount that could be contributed, and less than 50% of these plan participants actually contributed the maximum amount. The three top reasons given by participants choosing not to contribute to the plan were: (1) cannot afford to save; (2) saving for other goals; and (3) difficulty in withdrawing funds.

A 1993 study found that the average contribution rate was 7% of annual wages. Not surprisingly, higher income workers tend to contribute more to their 401(k) plan than lower income workers, and older workers contribute more than younger workers. A 1996 study found, for example, that on average, workers earning $75,000 or more contribute over 8% of salary, while workers earning less than $25,000 contribute less than 5% of salary.

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population characterized as "retirement savers," the most common source of information for making investment decisions was input from a spouse (80%). See EBRI ISSUE BRIEF No. 200, supra note 67, at 3, 10; Arleen Jacobius, Looking to Plan Sponsors: One-Third of Participants Get Most 401(k) Investment Information from Newsletters and Education Programs, PENSIONS & INVESTMENTS, Nov. 30, 1998 at 14.

81 See EMPLOYEE BENEFITS RESEARCH INST., supra note 64, at 6. Similar retirement savings plans would be a 403(b) plan, a salary reduction simplified employee pension plan, or a plan for state and local government employees established under Section 457 of the Internal Revenue Code, I.R.C. § 457 (1994 & Supp. III 1997). See EBRI ISSUE BRIEF No. 181, supra note 72, at 8.

82 See EMPLOYEE BENEFITS RESEARCH INST., supra note 64, at 8.

83 See id.

84 EMPLOYEE BENEFITS RESEARCH INST., ISSUE BRIEF No. 174, CONTRIBUTION RATES AND PLAN FEATURES: AN ANALYSIS OF LARGE 401(k) PLAN DATA 3 (1996).


86 See U.S. GEN. ACCOUNTING OFFICE, 401(k) PLANS, supra note 18, at 6.
Researchers have attempted to identify the factors that influence an employee’s decision whether to participate in and how much to contribute to a 401(k) plan. Numerous studies have concluded that a major factor influencing employee participation and contribution rates is participant retirement savings education provided by the employer. For example, the 1998 RCS found that among workers who received educational materials or attended seminars about retirement savings through their employer, 41% were influenced by this educational information to begin participating in a retirement savings plan, and 43% were influenced to change the amount they contributed to their retirement savings plan. Other studies similarly conclude that retirement savings education and materials provided by the employer increase participation rates and contribution amounts.

3. Decisions Concerning Investment Allocation of Retirement Plan Assets

When employees call the shots, they invariably shoot themselves in the foot. If we've heard it once, we've heard it a thousand times. Employees don't know how to invest. They invariably buy in at the top of the market and sell at the bottom. You could probably make money watching what they do and doing just the opposite.

Like the decisions of whether to participate in a 401(k) plan and how much to contribute, the participant’s investment decisions play a crucial role in

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87 See, e.g., EBRI ISSUE BRIEF NO. 181, supra note 72, at 8; EBRI ISSUE BRIEF NO. 174, supra note 84, at 4; EBRI ISSUE BRIEF NO. 169, supra note 78, at 7-8; Bernheim, supra note 63, at 56-64; Clark & Schieber, supra note 85, at 71-81; Andrea L. Kusko et al., Employee Decisions with Respect to 401(k) Plans, in LIVING WITH DEFINED CONTRIBUTION PLANS, supra note 18, at 98; Papke, supra note 18, at 313-24.

88 See EBRI ISSUE BRIEF NO. 200, supra note 67, at 12-13; EBRI ISSUE BRIEF NO. 169, supra note 78, at 7-8, 18-19; EMPLOYEE BENEFITS RESEARCH INST., supra note 64, at 6; Bernheim, supra note 63, at 56-64; Clark & Schieber, supra note 85, at 82-95; see also Employers Will Not Increase Benefits to Cover Social Security Costs, Survey Finds, DAILY TAX REP., Aug. 8, 1998, at G-2, G-3. The other major factors that influence participants are the availability of an employer matching contribution, the constraints on the maximum employee contribution amount, and the availability of plan loans. See EBRI ISSUE BRIEF NO. 181, supra note 72, at 8-9; EBRI ISSUE BRIEF NO. 174, supra note 84, at 11-13; GAO 401(K) LOANS REPORT, supra note 53, at 5-6; Clark & Schieber, supra, at 82-95; Kusko et al., supra note 87, at 104-06; Papke, supra note 18, at 318-24.

89 See EBRI ISSUE BRIEF NO. 200, supra note 67, at 12-13.

90 See, e.g., EMPLOYEE BENEFITS RESEARCH INST., supra note 64, at 6; EBRI ISSUE BRIEF NO. 169, supra note 78, at 7; Bernheim, supra note 63, at 56-64; Clark & Schieber, supra note 85, at 82-95; Paul Yakoboski, Participant-Directed Retirement Plans Today and Critical Issues for Tomorrow, in WHEN WORKERS CALL THE SHOTS, supra note 18, at 9.

91 Dave Veeneman & Elizabeth McWhirter, Implementing Effective Asset Allocation, in WHEN WORKERS CALL THE SHOTS, supra note 18, at 51, 51.
determining his retirement income. Inappropriate investment allocations place the participant at risk of accumulating insufficient retirement assets.\(^9\)

Surveys of plan participants indicate that, although a majority of participants who make contributions to retirement plans prefer to make their own investment decisions, a substantial minority do not. A 1994 survey found that 62% of survey respondents who contributed to a plan wanted to make their own investment decisions, but 34% would prefer to have their employer make their investment decisions for them.\(^9\) Another 1994 study obtained similar results—33% of participants wanted someone else to manage their retirement savings for them.\(^9\) Significantly, this same study found that only 26% of plan participants, and only 8% of plan sponsors, believed the participants were well-qualified to make their own investment decisions.\(^9\)

When examining the investment allocation behavior of participants under the individual responsibility model, aggregate or average figures can be misleading from a policy perspective because they mask key distinctions among individual participants.\(^9\) Several case studies using individual level data, each of which is described below, indicate that a significant number of participants make investment decisions that are contrary to the basic principles of prudent retirement investing.

a. EBRI case study

The Employee Benefits Research Institute ("EBRI")\(^9\) conducted a case study of participant investment allocation decisions for participants in 401(k) plans sponsored by three very large employers: AT&T, IBM Corporation, and New York Life Insurance Company.\(^9\) Each 401(k) plan had an average of

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\(^9\) See *id*


\(^9\) EBRI is a private, nonprofit and non partisan public policy research organization that conducts research on employee benefit programs in the private sector, including retirement plans. *See supra* note 64.

\(^9\) See *EBRI Issue Brief No. 176, supra* note 96, at 3.
60,000 participants.\textsuperscript{99} Two of the plans offered employer securities as an investment option.\textsuperscript{100} All three 401(k) plans had well-developed educational programs to assist workers in making appropriate investment decisions.\textsuperscript{101}

The EBRI case study found that the percentage of plan participants who had none of their 401(k) plan assets invested in equity funds (excluding company stock) was 21\%, 25\% and 37\%, respectively, for the three plans.\textsuperscript{102} One of the basic principles of retirement investing is that younger workers should invest more heavily in a diversified portfolio of equities because although they have greater short term volatility, over the long run equities have a higher rate of investment return.\textsuperscript{103} Surprisingly, the EBRI case study found that, despite the investment education programs offered by the employer, the percent of younger participants (aged twenty to twenty-nine and thirty to thirty-nine) with zero equity investments ranged from 17\% to 34\%.\textsuperscript{104} The EBRI study concluded that a large percentage of participants, particularly younger plan participants, were potentially at risk of accumulating insufficient retirement assets.\textsuperscript{105}

With respect to non-equity investments, the EBRI study found that the average percentage of participants who had over 80\% of their 401(k) plan account balance invested in non-equities was 29\%, 32\%, and 11\%.\textsuperscript{106} When analyzed by age group, the study found that for each plan this percentage increased with participant age.\textsuperscript{107} This behavior is encouraging because it is consistent with the basic retirement investing principle that as individuals approach retirement age they should adjust their portfolio to a more conservative (i.e., less volatile) mix of holdings.\textsuperscript{108}

The study contained mixed results for the two plans that offered company stock as an investment option. Generally, retirement planning professionals do not recommend high concentrations of investment in company stock because such investments magnify the risk that the participant will suffer both reduced lifetime and retirement income if the employer becomes financially in-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{99} See id. at 4.
\item \textsuperscript{100} See id.
\item \textsuperscript{101} See id.
\item \textsuperscript{102} Id. at 7, 10, 12.
\item \textsuperscript{103} See id. at 7.
\item \textsuperscript{104} Id. at 13-14 & chart 1.
\item \textsuperscript{105} Id. at 7, 10, 13-14.
\item \textsuperscript{106} Id. at 8, 10, 13 tbl.8.
\item \textsuperscript{107} See id.
\item \textsuperscript{108} See id. at 8, 9, 14.
\end{itemize}
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secure. In one plan, the average account balance was 42% invested in company stock. For this plan, approximately 20% of participants had nothing invested in company stock, and approximately 20% had over 80% invested in company stock. In contrast, the average account balance investment in company stock for the other plan was only 6%, with over 77% of participants having nothing invested in company stock and only approximately 2% of participants being over 80% invested in company stock. The EBRI study concluded that one of the primary reasons for the smaller percentage of participants of the first plan who were highly concentrated (over 80% invested) in non-equities was the plan’s much larger concentration of investments in company stock.

b. Goodfellow and Schieber case study

Goodfellow and Schieber conducted a case study using administrative records on slightly more than 36,000 participants drawn from 24 defined contribution plans holding nearly $1.4 billion in assets. The results of the Goodfellow and Schieber case study were consistent with those of the EBRI case study. The Goodfellow and Schieber study found that, in accordance with conventional retirement planning wisdom, as participants aged they tended to move away from the riskier (equity) investment options. The Goodfellow and Schieber study also found, however, that there were significant numbers of plan participants who were highly concentrated in either non-equity investments or company stock. Significantly, the study found that workers at the lowest wage levels were three to five times as likely to have 80% or more of their plan assets invested in company stock than workers at higher wage levels.

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109 See Vickie L. Bajtelsmit & Jack L. VanDerhei, Risk Aversion and Pension Investment Choices, in POSITIONING PENSIONS, supra note 18, at 45, 55; Goodfellow & Schieber, supra note 96, at 80; Stabile, supra note 19, at 81-82. A 1997 GAO report using 1993 data on the extent of 401(k) plan investment in employer stock found that although less than 2% of 401(k) plans were invested in employer stock, such investments constituted over 10% of 401(k) plan assets and affected over 25% of 401(k) plan participants. This result occurs because it is the largest employer plans that tend to offer employer stock as an investment option. U.S. GEN. ACCOUNTING OFFICE, 401(K) PENSION PLANS: EXTENT OF PLANS’ INVESTMENTS IN EMPLOYER SECURITIES AND REAL PROPERTY (1997).

110 See EBRI ISSUE BRIEF No. 176, supra note 96, at 11.

111 See id. at 13 & tbl.8.

112 See id. at 8 & tbl.3.

113 See id. at 15. Professor Stabile reports other studies finding similarly high concentrations of investments in employer stock in 401(k) plans. Stabile, supra note 19, at 82 nn.106-09.

114 Goodfellow & Schieber, supra note 96, at 75.

115 Id. at 77 & tbl.4.

116 Id. at 77-80 & tbls.6-7.
levels. As the authors of the study noted, it is “ironic that the workers who generally have the least potential to control the operations of the employers for which they work are the most willing to fully commit their long-term retirement security to the successful performance of these organizations.”

c. Bajtelsmit and VanDerhei case study

Bajtelsmit and VanDerhei conducted a case study of the retirement plan investment decisions of 20,000 management employees of a large United States employer. The results of this case study were consistent with the findings of the EBRI and the Goodfellow and Schieber studies, indicating that a significant number of plan participants overly concentrate investment of their retirement assets in both non-equity funds and employer stock.

The study grouped the plan’s investment options into three main categories: fixed income (non-equity) funds, diversified equity funds, and employer stock. The study reported participant investment allocations by gender, and controlled for age, job tenure, and income levels. It found that for male participants, 41% of their account balance was invested in employer stock, almost 45% was invested in fixed income funds, and only 14% was invested in diversified equity funds. For female participants, the percentages were similar. On average, 42% of the account balances for female participants were invested in employer stock, 45% were invested in fixed income funds, and approximately 13% were invested in diversified equities. Bajtelsmit and VanDerhei found that women in the sample were more likely than male participants to invest in the conservative fixed income funds and less likely to invest in diversified equities. The study also found that, consistent

117 See id. at 86.
118 Id. Not only is it ironic, it can have devastating consequences, as the unfortunate employees of Color Tile, Inc. learned when the company was declared bankrupt. See Stabile, supra note 19, at 64 & n.12; Vanessa O'Connell & Pui-Wing Tam, Employer Stock May Be Risky for Nest Eggs, WALL ST. J., Feb. 11, 1998, at C1. The Color Tile incident prompted Congress to amend ERISA to limit employer-directed investment of participant 401(k) plan accounts in employer stock to 10% of the account balance. This 10% limitation does not apply to participant-directed investments in employer stock. See discussion infra at notes 380-82.
119 Bajtelsmit & VanDerhei, supra note 109, at 56.
120 See id. at 57. Allocations to a social responsibility equity fund were excluded because of the nonfinancial objectives that may influence the participant’s choice of such a fund. See id.
121 See id. at 57 tbl. 3.
122 See id.
123 Id. at 60. Bajtelsmit and VanDerhei were unwilling to find that their results were conclusive evidence of gender differences in risk aversion, or that their results necessarily implied that elderly women would be worse off in retirement. Id. at 60, 62. Other studies have concluded that gender influences investment decisions. See U.S. GEN. ACCOUNTING OFFICE, 401(k) PLANS, supra note 18, at 24; Richard P. Hinz et al.,
with the findings of the EBRI and Goodfellow and Schieber studies, as participants aged they increased their allocations to fixed income investments.\textsuperscript{124}

d. DALBAR study

With the exception of company stock, the investment options offered under participant-directed 401(k) plans tend to be mutual funds.\textsuperscript{125} Therefore, another aspect of participant decision-making with respect to investment of their plan assets is the rate of returns plan participants are likely to achieve on mutual fund investments.\textsuperscript{126}

DALBAR, Inc.\textsuperscript{127} ("DALBAR") conducted a study of mutual fund investor behavior over a fourteen-year period, from 1984 through 1997.\textsuperscript{128} The purpose of the DALBAR study was to determine the "real" investment returns for mutual fund investors, as compared with the theoretical market investment returns frequently quoted in the media.\textsuperscript{129} The original 1994 DALBAR study analyzed money flows in and out of mutual funds from the beginning of 1984 through September 30, 1993.\textsuperscript{130} The original study was then updated through

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\textsuperscript{124} See Bajtelsmit & VanDerhei, supra note 109, at 61.
\textsuperscript{125} See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Part 2.4.1; William A. Schmidt, The Marketing of Retirement: Section 401(k) Plans and the Mutual Fund Industry, 1994 INVESTMENT LAW. 1, 17. In 1996 mutual funds became the largest segment of assets held in 401(k) plans, comprising just over 40% of asset value. See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Part 2.4.1; see also Ronald D. Hurt, The Changing Paradigm of 401(k) Plan Servicing, in LIVING WITH DEFINED CONTRIBUTION PLANS, supra note 18, at 199; John D. Rea & Richard G. Marcis, Responses of Mutual Fund Investors to Adverse Market Disruptions, in LIVING WITH DEFINED CONTRIBUTION PLANS, supra note 18, at 136. Employers sponsoring participant-directed 401(k) plans use mutual funds as investment options to meet the diversification requirements of ERISA Section 404(c) for participant-directed plans. See infra Part II.C.1. Mutual funds are popular among 401(k) plan participants because they can obtain daily valuations of their plan accounts and can freely change their investments from one mutual fund to another. See Schmidt, supra, at 17.

\textsuperscript{126} A "mutual fund" is a registered, open-end investment company established pursuant to the Investment Company Act of 1940, 15 U.S.C. § 80a-1 to 80b-21 (1994 & Supp. III 1997), that continuously offers to the public securities (shares in the fund) that can be redeemed by the shareholder on demand. See 1 THOMAS P. LEMPEKE ET AL., REGULATION OF INVESTMENT COMPANIES, § 1.01, at 1-2 (1999).

\textsuperscript{127} DALBAR, Inc. is a private company located in Boston, Massachusetts, that conducts research for and provides services to the financial services industry.

\textsuperscript{128} DALBAR, INC., QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR STUDY 1-31 (1994); DALBAR INC., QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR STUDY, 1997 UPDATE (1998).

\textsuperscript{129} DALBAR STUDY, supra note 128, at 9.

\textsuperscript{130} Id.
Three types of mutual funds were measured in the study: equity funds, fixed income funds, and money market funds. Using sales, redemption, and retention rates, the study calculated the cumulative real returns for investors in the three types of funds, and then compared these returns for the "benchmark" returns typically used in the three fund classes.

The DALBAR study found that, as a result of their investment behavior, mutual fund investors earn far less than the widely quoted benchmark returns. The DALBAR study found that for equity funds, although the S&P 500 Index reported an average annual return of 17% per year for 1984 to 1997, the average equity fund investor during this period earned real returns of only 6.71% per year. The average fixed income fund investor actually fared better, earning annual returns of 7.24%, but still underperformed all of the fixed income fund benchmarks. The DALBAR study concluded that the gaps between real and theoretical (benchmark) returns for the average equity and fixed income fund investor were the result of attempts by investors to time the market. Instead, they end up "buying high and selling low," the opposite of a well-known investment axiom.

4. The Impact of Participant Investment Education and Investment Advice on Investment Allocation Decisions

An employer who sponsors a participant-directed 401(k) plan is not required to provide educational materials on retirement savings and investing to the plan participants. Nevertheless, many employers choose to provide...
educational materials to their employees.\textsuperscript{140} Two of the three topics most frequently addressed in educational materials are those related to participant investment allocation decisions—asset allocation and the attributes of various plan investment options.\textsuperscript{141} Generally, employees are confident in the educational information provided by their employers\textsuperscript{142} and rely on employer-provided information as one of the primary sources of investment information.\textsuperscript{143} Importantly, those who rely more heavily on employer-provided investment information tend to be the same types of participants who face the highest risk of accumulating insufficient retirement assets. These participants include those who have less money in their plan accounts, have lower incomes, are younger, have less education, and contribute a small percentage of their income to the plan.\textsuperscript{144} Even more importantly, a significant percentage of employees consistently indicate that they respond to investment allocation educational materials by changing their plan investment allocation mix.\textsuperscript{145} Numerous surveys have found that, of those employees who received and read the investment allocation education materials, 40-50\% changed their plan investment allocation mix as a result.\textsuperscript{146}

The mere fact that employees may change their investment allocations in response to education does not necessarily indicate they make the types of changes that are more likely to result in the accumulation of sufficient plan assets for retirement.\textsuperscript{147} This point is illustrated by the results of the EBRI case study of participant investment allocation decision-making at AT&T, IBM Corporation, and New York Life Insurance Company.\textsuperscript{148} All of the EBRI

\textsuperscript{140} According to the 1997 Retirement Confidence Survey, two-thirds of the respondents reported that their employer had provided retirement plan educational materials to them within the last six months. Of these respondents, 86\% reported that they had read the materials. \textit{See Employee Benefits Research Inst., supra note 64, at 6.} Other surveys report similarly high numbers. \textit{See} EBRI Issue Brief No. 181, \textit{supra} note 72, at 8; EBRI Issue Brief No. 169, \textit{supra} note 78, at 6; Yakoboski, \textit{supra} note 90, at 20-21.

\textsuperscript{141} \textit{See} EBRI Issue Brief No. 169, \textit{supra} note 78, at 11. The third most frequently covered topic is estimating the amount of income needed for retirement. \textit{See id.}

\textsuperscript{142} \textit{See id.} at 7 (stating that over 75\% of all survey respondents said they were confident in the information provided by their employer).

\textsuperscript{143} \textit{See} Yakoboski, \textit{supra} note 90, at 22.

\textsuperscript{144} \textit{See id.}

\textsuperscript{145} \textit{See} Lorraine M. McCarthy, \textit{Investments: Most Workers Ill-Equipped to Handle Retirement Savings, Investment Study Says, Pens. \& Bens. Daily (BNA), at d4 (May 4, 1998); Plan Administration: Investment Education Programs Can Affect Behavior, Buck Survey Says, Pens. \& Bens. Daily (BNA), at d10 (Nov. 12, 1997).}

\textsuperscript{146} \textit{See} EBRI Issue Brief No. 200, \textit{supra} note 67, at 13; \textit{Employee Benefits Research Inst., supra note 64, at 6; EBRI Issue Brief No. 169, supra note 78, at 7; Yakoboski, supra note 90, at 21.}

\textsuperscript{147} \textit{See} McCarthy, \textit{supra} note 145, at d10.

\textsuperscript{148} \textit{See supra} notes 98-113 and accompanying text.
study 401(k) plan participants had the benefit of a well-developed participant education program. Nevertheless, a significant percentage of plan participants made unconventional investment allocation decisions that would appear to place them at risk of accumulating insufficient assets for retirement.

Such a result is not surprising. First, modern portfolio theory is highly complex, with even experts in the field disagreeing about its proper application. Second, for reasons related to legal constraints and liability issues created by ERISA, participant education materials concerning investment allocation tend to be general in nature. The plan participant receiving general educational materials must absorb the relatively complex investment theory principles and concepts contained in the materials, and then apply this knowledge to the participant’s individual financial and lifestyle circumstances. Given the lack of basic financial knowledge of many plan participants, this can be a daunting task.

D. Conclusion

The research indicates that plan participants under the individual responsibility model are not a monolithic group. Participants range in their level of knowledge concerning retirement savings and general financial concepts from the illiterate to the sophisticated. The research also indicates that plan participants vary widely in the types of decisions they make under the individual responsibility model. Some participants make 401(k) plan contribution and investment allocation decisions that are likely to result in adequate retirement savings; others do not.

This diversity among plan participants calls for a Department of Labor administrative approach that is designed to achieve adequate retirement savings for all plan participants, not just the knowledgeable and capable ones. Most participants already receive some type of educational materials from their employers. What they really need, yet do not receive, is investment advice. Part II explains why.

149 See supra note 101 and accompanying text.
150 See supra note 105 and accompanying text.
151 See, e.g., Bajtelsmit & VanDerhei, supra note 109, at 51-52; Veeneman & McWhirter, supra note 91, at 51-57; Weiss & Sgaraglino, supra note 19, at 1186-90.
152 See infra Part III.
II. ERISA'S FRAMEWORK GOVERNING PARTICIPANT EDUCATION AND INVESTMENT ADVICE

ERISA’s statutory scheme is built around the concept of a "fiduciary."153 A party having fiduciary status is subject to ERISA’s statutorily defined legal duties, transactional prohibitions, and liabilities.154 In contrast, a "non-fiduciary" who provides services to a plan effectively is exempt from civil liability to plan participants under ERISA.155 Furthermore, the "non-fiduciary" is generally immune from liability under state law by virtue of ERISA’s preemption provisions,156 and is subject to fewer transactional prohibitions than a fiduciary.157 Therefore, ERISA’s “line” between fiduciaries and non-fiduciaries is a critical distinction with far-reaching legal consequences.

Department of Labor interpretations of ERISA’s fiduciary provisions have created a complex and tangled regulatory web. As a result, few employers and plan service providers today are willing to provide investment advice to plan

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153 See 29 U.S.C. § 1002(21)(A) (1994); Mertens v. Hewitt Assoc’s., 508 U.S. 248, 251-54 (1993). ERISA requires that the plan document must identify at least one named fiduciary (typically the employer or its agent(s)) who has the authority to control the operation and administration of the plan. See 29 U.S.C. § 1102(a) (1994). Other persons are fiduciaries with respect to the plan to the extent they exercise discretionary authority or control with respect to the management or administration of the plan, render investment advice for a fee, or exercise authority or control over the management or disposition of the plan’s assets. See id. § 1002(21)(A).

154 See infra Parts II.A., II.B., II.D.


156 ERISA section 514 preempts all state statutory, regulatory, and common law, subject to certain limited exceptions. See 29 U.S.C. § 1144 (1994). Although the Supreme Court has recently indicated a willingness to limit the breadth of its prior jurisprudence regarding the scope of ERISA preemption, these cases do not appear to indicate any willingness on the part of the Court to exclude conduct involving the rendering of administrative-type services to a retirement plan or its participants. See Unum Life Ins. Co. of America v. Ward, 119 S. Ct., 1380, 1391-92 (1999); De Buono v. NYSIA-ILA Med. & Clinical Servs. Fund, 520 U.S. 806, 810-11 (1997); California Div. of Labor Stds. Enforcement v. Dillingham Constr. N.A. Inc., 519 U.S. 316 (1997); New York State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 658 (1995) (state laws that affect plan administration still preempted).

157 See infra Part II.D.
participants for fear of becoming an ERISA fiduciary. These interpretations involve the very heart of ERISA’s statutory protections for plan participants—(1) the definition of fiduciary; (2) fiduciary and co-fiduciary duties; (3) the Department of Labor’s regulations governing participant-directed plans; and (4) the prohibited transaction rules and exemptions. Each of these areas, and the obstacles they present to investment advice, are explained below.

A. The “Investment Advisor” as ERISA Fiduciary

ERISA’s statutory definition of a fiduciary includes investment advisors. Under the statutory definition, a person is a fiduciary investment advisor with respect to an ERISA plan to the extent that a person “renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so.”

The obvious ambiguities in the statutory definition led the Department of Labor to issue a regulation attempting to define the first element of the statutory definition, the rendering of “investment advice,” almost immediately after the enactment of ERISA. Under the Department of Labor’s interpretation, a person who provides advice, or makes recommendations concerning plan investments on a regular basis, is deemed to have rendered “investment advice” so long as two criteria are satisfied. First, the person providing the advice or making the recommendations must be aware, either by a mutual agreement, arrangement, or understanding, that the recipient of this information (either the plan or its fiduciary) is relying on the information as a primary basis for making investment decisions with respect to plan assets. Second, the advice or recommendations must be individualized to the plan and based on the particular needs of the plan, such as the plan’s investment

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158 See infra Part II.E.
159 29 U.S.C. § 1002(21)(A)(ii) (1994). Several points are noteworthy concerning this statutory definition. First, under the definition the person to whom the advice is being rendered is irrelevant. See id. Thus, the definition applies equally to investment advice rendered to a plan administrator responsible for investing the assets of a $100 million defined benefit plan as it does to investment advice rendered to a 401(k) plan participant responsible for directing the investment of his $10,000 salary deferral account. Second, the definition has two elements that must both be satisfied for fiduciary status to attach. The person must render (1) “investment advice” and (2) receive a “direct or indirect” “fee or other compensation.” Id; see also 29 C.F.R. § 2509.96-1(b) & n.3 (1999).
160 See 40 Fed. Reg. 50,843 (1975) (codified at 29 C.F.R. § 2510.3-21(e) (1999)).
161 A “person” includes affiliated entities. See 29 C.F.R. § 2510.3-21(e)(1)(ii), (e) (1999).
162 See id. § 2510.3-21(e)(1)(ii)(B).
policies or strategy, overall portfolio composition, or diversification of plan assets.\textsuperscript{163}

This interpretation originally was targeted at brokers and dealers in the securities industry who executed securities transactions on behalf of defined benefit plans.\textsuperscript{164} The securities industry needed to know whether a broker-dealer who routinely counseled the plan’s sponsoring employer concerning investments for the plan as part of its customer services, and who received sales commissions on the resulting plan transactions, was a fiduciary under ERISA.\textsuperscript{165} The industry urged the Department of Labor to interpret the statute to mean that if the plan’s sponsoring employer paid the sales commissions directly (instead of deducting commissions from plan assets), the “fee or other compensation” element necessary for fiduciary status would be missing.\textsuperscript{166} The Department of Labor rejected this statutory interpretation.\textsuperscript{167} According to the Department of Labor’s interpretation, the “fee or other compensation” requirement of section 3(21)(A)(ii) is not limited to payments that come directly from the plan, but rather includes “all fees or other compensation incident to the transaction in which the investment advice has been or will be rendered.”\textsuperscript{168}

This 1975 Department of Labor interpretation of a fiduciary investment advisor is the starting point for understanding why 401(k) plan participants currently do not receive investment advice. To illustrate, assume that the Company sponsors a 401(k) plan and wants to hire an investment advisor for the plan participants. If the Company pays the investment advisor for these services using plan assets, under ERISA’s statutory definition the investment professional clearly will be a fiduciary of the plan. But suppose instead that the Company is willing to pay the investment advisor using Company assets, not plan assets. Under the Department of Labor’s 1975 interpretation of a fiduciary investment advisor, the investment advisor would still be a fiduciary of the plan. As a result, the investment advisor becomes subject to all of the legal constraints, discussed in subparts B and D below, imposed upon ERISA plan fiduciaries.

\textsuperscript{163} See id.

\textsuperscript{164} See id. § 2510.3-21(d).

\textsuperscript{165} See id. § 2510.3-21(d)(2); 40 Fed. Reg. 50,842 (1975).

\textsuperscript{166} See 40 Fed. Reg. at 50,842.

\textsuperscript{167} See id.

The Department of Labor's interpretation of a fiduciary investment advisor also is the starting point for understanding why educational materials on retirement planning and plan investments provided to plan participants tend to be very general in nature. Today, plan service providers, like securities brokers in 1975, oftentimes receive fees generated by the plan's mutual fund investments. Thus, as a practical matter, the "fee or other compensation" element required to be a fiduciary investment advisor is always satisfied. If the plan service provider is a fiduciary, receipt of these fees is prohibited under ERISA. To avoid becoming a fiduciary, the service provider must scrupulously avoid satisfying the other element necessary to become an investment advisor: the rendering of "investment advice." As a result, service providers carefully avoid investment advisor status by providing only general educational information rather than materials and other assistance responsive to the needs and circumstances of the individual participant.

B. Fiduciary and Co-Fiduciary Responsibilities

ERISA section 404(a)(1) establishes four broadly-defined fundamental duties governing the conduct of all ERISA fiduciaries. For purposes of participant retirement savings education and investment advice under ERISA, the most significant section 404(a)(1) duties include the duty of care, the duty of loyalty (also known as the exclusive benefit rule), and the duty of prudent diversification. ERISA's duty of care requires that the employer who is the named fiduciary of a retirement plan manage the plan with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent

169 See infra Part II.D.
170 See infra Part II.D.
173 See LANGBEIN & WOLK, supra note 17, at 649.
174 An ERISA fiduciary is personally liable for breach of its fiduciary duties. See 29 U.S.C. § 1109(a) (1994). Under ERISA section 410(a) any attempt to relieve an ERISA fiduciary from its statutorily prescribed duties and liability through an exculpatory clause in the plan document is void as against public policy. See id. § 1110(a); AMERICAN BAR ASS'N, supra note 17, at 344-45. A person who is (or is subsequently determined by a court to be) a fiduciary under the statutory definition with respect to a retirement plan cannot avoid the fiduciary responsibilities and liability imposed by ERISA by simply declaring to the plan participants that it is not a fiduciary. See AMERICAN BAR ASS'N, supra note 17, at 345-46.
man acting in a like capacity and familiar with such matters would use in the
conduct of an enterprise of like character and with like aims." The
employer's duty of care includes the duty prudently to select and monitor the
activities of both co-fiduciaries to the plan, including any investment advisors,
and non-fiduciary service providers. ERISA's duty of loyalty requires that
the fiduciary investment advisor discharge its duties "solely in the interest" of
the plan participants and "for the exclusive purpose of providing benefits to
participants." 177

ERISA's duty of prudent diversification requires the employer to diversify
the investment of plan assets in order to minimize the risk of large losses. 178 If
an employer sponsors a plan where each participant directs the investment of
his or her own account, but the plan fails to meet the Department of Labor's
regulations governing participant-directed plans, 179 the sponsoring employer
remains subject to the fiduciary duty of prudent diversification. 180

In addition to the general fiduciary duties of section 404(a)(1), ERISA
section 405(a) 181 creates co-fiduciary responsibilities. If the employer sponsor-

175 29 U.S.C. § 1104(a)(1)(B); see also Herdrich v. Pegram, 154 F.3d 362, 371 (7th Cir. 1998); Donovan
v. Mazzola, 716 F.2d 1226, 1231 (9th Cir. 1983); Cunningham, 716 F.2d at 1464.
176 See 29 C.F.R. §§ 2509.75-8, FR-14, 2509.96-1(e) (1999); ADVISORY COUNCIL ON EMPLOYEE
WELFARE AND PENSION BENEFIT PLANS, U.S. DEP'T OF LABOR, REPORT OF THE WORKING GROUP ON
GUIDANCE IN SELECTING AND MONITORING SERVICE PROVIDERS 2-6 (1996); PWBA Op. Ltr. 97-16A, Pens.
Plan Guide (CCH) § 199860 (May 22, 1997).
177 29 U.S.C. § 1104(a)(1)(A). ERISA's duty of loyalty is derived from the principle under the common
law of trusts that the fiduciary must avoid conflicts of interest in carrying out its fiduciary duties. See Eaves v.
Penn, 587 F.2d 453, 457 (10th Cir. 1978); RESTATEMENT (SECOND) OF TRUSTS § 206 (1959); GEORGE
rev'd 1978); 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, SCOTT ON TRUSTS § 170, at
178 See 29 U.S.C. § 1104(a)(1)(C). The House Conference Report on ERISA describes this duty of
prudent diversification as follows:

The degree of investment concentration that would violate this requirement to diversify cannot be
stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances
of each case. The factors to be considered include (1) the purposes of the plan; (2) the amount of
the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether
mortgages, bonds, or shares of stock or otherwise; (5) distribution as to geographic location; (6)
distribution as to industries; (7) the dates of maturity.

179 See infra Part II.C.
180 This creates obvious and serious potential fiduciary liabilities for the employer for plan investment
losses because the participants have selected the investments, and their selections may not have been prudent
or diversified. See supra Part I.C.
ing a 401(k) plan has engaged a fiduciary investment advisor to counsel plan participants, the employer is subject to these section 405(a) co-fiduciary duties vis-à-vis the fiduciary investment advisor.\(^\text{182}\) The employer will be liable for breach of its co-fiduciary duties under section 405(a) if the employer (1) knowingly participates in or attempts to conceal a fiduciary breach by the fiduciary investment advisor;\(^\text{183}\) (2) breaches one of the employer’s own fiduciary duties, and thereby enables the fiduciary investment advisor to breach one of its section 404(a)(1) fiduciary duties;\(^\text{184}\) or (3) has knowledge of a fiduciary breach by the investment advisor and fails to make reasonable efforts to remedy the breach.\(^\text{185}\)

For the employer sponsoring the 401(k) plan, potential co-fiduciary liability under the second alternative, section 405(a)(2), is the most worrisome. Section 405(a)(2) does not require the employer to have actual knowledge of the investment advisor’s fiduciary breach in order to trigger the employer’s co-fiduciary liability.\(^\text{186}\) This means that the employer’s co-fiduciary liability could be triggered unknowingly as a result of a breach of the duty of care by the advisor, such as a failure to monitor the activities of the co-fiduciary investment advisor.\(^\text{187}\)

\(^{182}\) See id. Section 405(c)(1) of ERISA allows the employer as the named plan fiduciary to incorporate a procedure in the governing plan document to designate another person, such as a fiduciary investment advisor, to carry out fiduciary responsibilities under the plan. \textit{Id.} § 1105(c)(1). Such a designation by the named fiduciary does not, however, relieve the employer of its potential co-fiduciary liability under section 405(a). See id. § 1105(c)(2)(B); 29 C.F.R. § 2509.75-8, FR-14 (1999). The employer also remains subject to the duty of care in selecting and retaining the delegated fiduciary. See 29 U.S.C. § 1105(c)(2)(A)(i), (iii).


\(^{184}\) Id. § 1105(a)(2).

\(^{185}\) Id. § 1105(a)(3).

\(^{186}\) See sources cited supra note 176. A fiduciary who breaches any of the duties contained in sections 404(a)(1) is personally liable under ERISA section 409(a) to make good any losses to the plan resulting from the breach and to restore to the plan any profits that have been made through the use of plan assets by the fiduciary. 29 U.S.C. § 1109(a) (1994). A statutory interpretation question arises under ERISA section 502(a) where an investment advisor breaches its fiduciary duties concerning the investment advice rendered to a participant. Has the fiduciary breach injured "the plan" or the individual participant? See \textit{Massachusetts Mut. Life Ins. Co. v. Russell}, 473 U.S. 134, 140 (1985) (section 502(a)(2) claim for fiduciary liability under section 409(a) limited to "plan-wide" relief). This distinction is critical because if the injury is deemed to be only to the individual participant and not to "the plan" under section 409(a), the injured participant must bring an ERISA civil enforcement action under ERISA section 502(a)(3), 29 U.S.C. § 1132(a)(3) (1994). See \textit{Varity Corp. v. Howe}, 516 U.S. 489, 509-10 (1996). Relief for any claim under this section is limited to "traditional equitable relief," and, unlike a claim for relief under section 502(a)(2) for liability under section 409(a), cannot include monetary damages. See \textit{Mertens v. Hewitt Assocs.}, 508 U.S. 248, 257-59 (1993). In this situation the better statutory interpretation is that liability exists under section 409(a) because the conduct involved the investment of plan assets. In the case of co-fiduciary liability under section 405, both fiduciaries usually are
C. Participant-Directed Plans and the 404(c) Regulations

Section 404(c)(1) of ERISA\textsuperscript{188} authorizes participant-directed plans by creating an exception to the employer’s fiduciary duties of care and prudent diversification.\textsuperscript{189} Under this exception, if the participant fails to diversify his account and invests all the account assets in a single stock, the employer will not be liable for any resulting investment losses.\textsuperscript{190} This exception is limited to liability for plan asset investment losses that occur as a direct result of the participant’s exercise of control over the assets held in the participant’s plan account.\textsuperscript{191}

1. Overview of the 404(c) Regulations

The key concept underlying section 404(c) is the exercise of independent control over investment decisions by each plan participant.\textsuperscript{192} Rather than defining this concept of independent control, both the language of section 404(c) and its legislative history left this task to the Department of Labor to resolve through the issuance of regulations ("404(c) Regulations").\textsuperscript{193}

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\textsuperscript{188} 29 U.S.C. § 1104(c)(1) (1994 & Supp. III 1997). ERISA section 404(c)(1) states:

In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

(A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

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

\textsuperscript{189} See supra Part II.B for a discussion of these duties.


\textsuperscript{192} See 29 C.F.R. § 2550.404c-1(a), (c); 57 Fed. Reg. at 46,924-25.

The 404(c) Regulations provide a strong legal incentive for employers to allow participants to direct the investment of their retirement savings accounts. Technically, compliance with the 404(c) Regulations is optional. An employer who sponsors a participant-directed 401(k) plan that fails to comply with the 404(c) Regulations has not, merely because of such noncompliance, breached its fiduciary duties under ERISA. Noncompliance with the 404(c) Regulations means that the employer continues to be responsible, and thus potentially liable, for the prudent investment and diversification of the participant accounts under the plan, despite the fact that the participants have made the investment decisions themselves. Given the unconventional investment decisions made by many plan participants, application of this regulation may lead to significant potential employer liability, particularly in times of market volatility or decline.

For the employer, compliance with the 404(c) Regulations has two significant legal consequences. First, the employer is relieved of liability for any investment losses resulting from the participant’s investment decisions. Second, the participant who manages the investment of his plan account is not a fiduciary. Therefore, the employer is not subject to potential co-fiduciary liability for the participant’s imprudent investment decisions.

The 404(c) Regulations describe the conditions that must be satisfied for a participant to be deemed to have exercised independent control over the assets in his account. First, the participant must have the opportunity to choose from a broad range of investment alternatives, which may include employer securities. Second, the participant must be able to give investment

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195 See id. at 46,907.
196 See 29 U.S.C. § 1104(c)(1); 29 C.F.R. § 2550.404c-1(d)(2)(i).
197 See 29 U.S.C. § 1104(c)(1); 29 C.F.R. § 2550.404c-1(d)(1).
198 See 57 Fed. Reg. at 46,924.
199 See 29 C.F.R. § 2550.404c-1(b)(1)(ii), (b)(3). Under the 404(c) Regulations, a plan provides the requisite broad range of investment alternatives only if the investment options under the plan offer participants the opportunity materially to affect the potential return on the assets in the participant’s plan account. The plan must offer at least three investment alternatives, each of which is diversified and has materially different risk and return characteristics. In addition, the participant must have the opportunity to diversify investments so as to minimize the risk of large losses. See id. § 2550.404c-1(b)(3). Mutual funds are particularly well-suited to satisfy these diversification requirements because, unlike investments in individual stocks, they can provide diversification for small investment amounts. See Victoria E. Schonfeld & Thomas M.J. Kerwin, Organization of a Mutual Fund, 49 Bus. Law. 107 (1993).
instructions with a frequency that is appropriate in light of the market volatility of the plan's investment alternatives. Third, the participant must be able to diversify investments within and among investment alternatives so as to minimize the risks of large losses. Finally, the participant must obtain "sufficient information" to make informed investment decisions. Assuming these criteria are satisfied, the employer will not be liable for investment losses incurred by plan participants who direct the investment of their plan accounts.

2. Assumptions Concerning Participant Decision-Making Competence

The 404(c) Regulations divide the universe of "sufficient information" that must be furnished to the plan participants into two categories: information that must be supplied to all plan participants (mandatory information), and information that must be provided only if requested by a plan participant.

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201 See 29 C.F.R. § 2550.404c-1(b)(1)(ii), (b)(2)(ii)(C). The plan may place restrictions on the frequency with which participants may give investment instructions so long as the restrictions are reasonable. See id. § 2550.404c-1(b)(2)(ii)(C). At least three of the investment alternatives must allow participants to give investment instructions no less frequently than once within any three month period. Participants also must be given the opportunity to move from a more volatile investment alternative to a less volatile investment alternative within the broad range of investment options offered by the plan. Special rules apply to investments in employer securities. See id. § 2550.404c-1(b)(2)(ii)(C)(3).

202 See id. § 2550.404c-1(b)(1)(ii), (b)(3)(i)(C).

203 See id. § 2550.404c-1(b)(2)(i)(B).

204 The 401(c) Regulations provide for three narrow exceptions to this rule. The employer will not be relieved from potential fiduciary liability for investment losses only if: (1) the participant was subject to "improper influence" by a plan fiduciary or the plan sponsor with respect to the transaction; (2) the plan fiduciary has concealed material, non-public, but lawfully disclosable facts regarding the investment from the participant; or (3) the participant is legally incompetent and the responsible fiduciary accepting the participant's investment direction actually knows that the participant is legally incompetent. Id. § 2550.404c-1(c)(2).

205 Id. § 2550.404c-1(b)(2)(i)(B)(1). The mandatory information category includes the following materials: (1) an explanation that the plan is intended to constitute an ERISA section 404(c) plan and that plan fiduciaries may be relieved of liability for losses which are the result of participants' investment instructions; (2) a description of the investment alternatives available under the plan, including a general description of the investment objectives and risk and return characteristics of each alternative; (3) an explanation of how to give investment instructions, any limits or restrictions on giving instructions, and any restrictions on the exercise of voting, tender or similar rights; (4) a description of any transaction fees or expenses that are charged to the participant's account; and (5) a description of the additional information that is available on request and the identity of the person(s) responsible for providing that information. See id. If the participant makes an investment in an investment alternative that is subject to federal securities laws, the participant must be given a copy of the most recent prospectus (unless the prospectus was furnished immediately before the participant's investment). See id. If the investment involves the exercise of voting, tender or similar rights, and these rights are passed through to participants, the participant also must receive any materials related to the exercise of these rights. See id.
Significantly, the 404(c) Regulations expressly state that the employer is not required to provide investment advice to the plan participants. Equally significant is that the list of mandatory and upon request information required under the 404(c) Regulations does not include the types of basic retirement savings educational materials that many plan participants might want or need as a prerequisite to making informed investment decisions. Instead, the information to be provided to plan participants pursuant to the 404(c) Regulations, although voluminous, is directed at the level of a financially sophisticated investor. For example, plan participants receive a prospectus that meets the requirements of federal securities laws, proxy materials for exercise of voting and tender rights, financial statements, and a description of investment management fees, administrative fees, and transaction fees and costs.

The informational disclosure requirements of the 404(c) Regulations assume that all plan participants are knowledgeable and financially sophisticated investors capable of making their own investment decisions. Such a monolithic view of the universe of plan participants is contradicted by evidence from studies of participant retirement savings knowledge and investment behavior.

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206 See id. § 2550.404c-1(b)(2)(i)(B)(2). The "upon request" information category includes the following materials: (1) a description of the annual operating expenses of the plan’s investment alternatives, including any investment management fees; (2) copies of any prospectuses, financial statements and reports and other information furnished to the plan relating to an investment alternative; (3) a listing of assets comprising the portfolio of each investment alternative that holds plan assets; (4) information concerning the value of shares or units in investment alternatives available under the plan along with information concerning the past and current investment performance of each alternative; and (5) information concerning the value of shares or units in investment alternatives held in the account of the participant. Id.

207 Id. § 2550.404c-1(c)(4); 57 Fed. Reg. 46,906, 46,913, 46,922 (1992) (plan sponsors are not required to bring plan participants up to the level of financial expertise of the fiduciaries of the plan).

208 See supra notes 206-07.


213 Under the 404(c) Regulations, a participant’s investment direction is not an exercise of independent control only if the participant is legally incompetent and the fiduciary responsible for implementing the investment direction has actual knowledge that the participant is legally incompetent. See 29 C.F.R. § 2550.404c-1(o)(2)(iii). There is no affirmative duty on the part of the fiduciary responsible for carrying out the participant’s investment direction to ascertain the competence, legal or otherwise, of the directing participant. See 57 Fed. Reg. 46,906, 46,922 n.24 (1992).

214 See supra Part I.C.
3. **Employer Fiduciary Responsibilities**

Approximately one-third of plan participants under the individual responsibility model would prefer to leave the task of investing their retirement savings up to their employer.\(^{215}\) Under the 404(c) Regulations, the employer is not required expressly to give participants the choice of "opting out" of the responsibility for investment decisions.\(^{216}\) The 404(c) Regulations do require that the participant must first make an *affirmative investment direction* to trigger the employer's exemption from fiduciary liability for investment losses.\(^{217}\) Until the participant gives an affirmative investment direction, the employer retains fiduciary responsibility for the prudent diversification of the participant's account.\(^{218}\) The employer is not required, however, to disclose this fact expressly to the plan participants.\(^{219}\) Therefore, as a practical matter, plan participants are (mis)led to believe that, like it or not, they must select among the plan's investment options.\(^{220}\)

\(^{215}\) See supra note 93 and accompanying text.
\(^{216}\) See 29 C.F.R. § 2550.404c-1.
\(^{218}\) See id. This fiduciary investment responsibility may become significant to the extent employers take advantage of a recent revenue ruling by the Internal Revenue Service. See Rev. Rul. 98-30, 1998-25 I.R.B. 8. Prior to Revenue Ruling 98-30, ERISA tax lawyers believed that Internal Revenue Code section 401(k) and its implementing regulations required that the employee affirmatively elect to contribute part of his compensation to the plan in lieu of receiving cash. If the employee failed to make such an election, the employer had to pay the employee's compensation in cash to the employee. Revenue Ruling 98-30 reverses the conventional understanding of ERISA tax lawyers concerning section 401(k). Employers who desire to increase the participation levels of their employees in 401(k) plans may structure the plan so that an employee's compensation is *automatically reduced* by a fixed percentage and contributed on the employee's behalf to the 401(k) plan. The employee must affirmatively elect *not* to participate in the 401(k) plan and receive the full amount of his compensation in cash. See id. The underlying purpose of this type of plan design is to cause higher participation rates among employees due to the fact that a certain number of employees simply never will bother to request and complete the paperwork necessary to elect affirmatively out of the deferral arrangement. The potential ERISA trap for employers is that some participants who never affirmatively decided to participate in the 401(k) plan may be more likely not to make an affirmative direction regarding the investment of their plan assets, thus leaving the employer with a fiduciary duty under ERISA section 404(a)(1) to invest the undirected portion of these participant accounts. See 57 Fed. Reg. at 46,923.

\(^{219}\) Disclosure of the employer's fiduciary duty to invest plan assets prudently until the participant makes an affirmative investment direction is not contained in the list of mandatory or upon request information that must be provided to plan participants under the 404(c) Regulations. See supra notes 205-06.

\(^{220}\) For ease of administration, section 404(c) plans typically are designed so that part of the paperwork necessary for the participant to enroll in the plan includes a form directing the plan trustee how to invest participant contributions to the plan. Therefore, the plan participant is left with the impression that *all* paperwork, including the investment direction form, must be completed in order for the participant to enroll in the plan. Once this investment direction form has been completed, the investment direction will continue to apply to each new contribution to the plan (via automatic payroll deduction of salary deferrals), unless the direction is affirmatively revoked by the plan participant.
The other significant fiduciary duties retained by an employer who sponsors a participant-directed plan involve specific applications of the employer's duty of care. The employer's duty of care includes the duty prudently to select, retain, and monitor the activities of service providers to the plan. The employer must prudently select and monitor the ongoing appropriateness of the plan's menu of investment options, and monitor the reasonableness of the fees paid to service providers from plan assets.

D. The Prohibited Transaction Rules and Exemptions

The financial services entities—banks, trust companies, insurance companies, securities brokerage firms, and mutual fund companies—that provide the employer with both administrative plan services and access to the plan's investment options also are capable of providing investment advice to participants. In today's financial world, these entities often have complex fee arrangements in place, directly or indirectly, between the respective entity and the mutual funds offered as investment options under the plan. These fee arrangements between the plan's mutual fund investment options and the plan's service provider oftentimes create a potential conflict of interest that,

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221 The remaining section 404(a)(1) fiduciary duties retained by an employer who sponsors a section 404(c) plan are technical in nature and do not present potential legal obstacles to participant retirement education and investment advice. See generally 29 C.F.R. § 2550.404c-1(d)(2).

222 See sources cited supra note 176.


225 See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Parts 2.6-2.7.

226 For a general overview of the types of business arrangements and fees in the financial services sector, see the Department of Labor's 1998 report, PENSION & WELFARE BENEFITS ADMIN., supra note 31, Parts 2.7, 3.3-3.4. For specific "real life" examples, the reader is referred to the factual descriptions underlying requests to the Department of Labor by Shearson Lehman (now Smith Barney), Prudential, Paine Webber, Wells Fargo Bank, and the Trust Company of the West for individual administrative relief from ERISA's prohibited transaction rules. These real life examples are contained in the sources cited infra in notes 345-46 and 352-54. Other examples of strategic business alliances between plan service providers and mutual funds ("bundled" services) are described in PWBA Op. Ltr. 97-16A, Pens. Plan Guide (CCH) ¶ 19,9860; 1 LEMPKE ET AL., supra note 126, § 25.02, at 25-4, § 25.03, at 25-19 to -20; Leonard P. Larrabee, III, Update On Strategic Alliances in the 401(K) Market, in PENSION PLAN INVESTMENTS 11 (PLI Tax L & Prac. Course Handbook Series No. J-397, 1997); Schmidt, supra note 125, at 17; Mary Romano, For One-Step Money Managing, Clients Are Turning to "Bundled" 401(K) Plans, WALL ST. J., Aug. 12, 1994, at A5. Payment of fees out of mutual fund assets is restricted under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 (1994). See generally 1 LEMPKE ET AL., supra note 126, § 7.03, at 7-13 to 7-17, § 7.05, at 7-18 to 7-33. The federal Securities and Exchange Commission interprets and enforces the provisions of the Investment Company Act. See generally id. Chs. 1-1 to 1-5, 2-1 to 2-16.
under ERISA’s fiduciary prohibited transaction rules, prevents the plan’s service provider from providing investment advice to the plan participants.\footnote{See Tina Ruyter, Advice for Sale, PLAN SPONSOR, Dec., Jan. 1998, at 55. In 1997, the Department of Labor issued two advisory opinion letters clarifying the conditions under which the receipt by a service provider of certain types of fees under bundled services arrangements would not be considered a prohibited transaction. See PWBA Op. Ltr. 97-16A, Pens. Plan Guide (CCH) ¶ 19,9860; PWBA Op. Ltr. 97-15A, 1997 ERISA LEXIS 18; Advisory Opinions: Labor Department Says Service Providers Must Disclose Payments from Mutual Funds, Pens. & Ben. Daily (BNA), at d2 (June 2, 1997). In both situations, however, the service provider was not also rendering investment advice to plan participants. See id.}  

The ERISA prohibited transaction rules applicable to individual account plans are set forth in section 406.\footnote{29 U.S.C. § 1106 (1994).} Section 406 creates two sets of prohibited transaction rules. Section 406(a) describes transactions prohibited for all “parties in interest,”\footnote{See id. § 1002(14)(B).} which include both non-fiduciary plan service providers\footnote{See id. § 1002(14)(A).} and fiduciaries of the plan.\footnote{See id. § 1106(b).} Section 406(b) describes additional transactions prohibited only to fiduciaries of the plan.\footnote{See 29 C.F.R. § 2550.408b-2(e)(1) (1999); Klevan, supra note 228, at 561-62.} The section 406(b) fiduciary prohibited transactions are derived from the common law trust principle that a fiduciary must have an undivided duty of loyalty to the trust for which it acts.\footnote{See 29 U.S.C. § 1002(14).} Section 406(b)(1) prohibits a fiduciary from engaging in self-dealing with respect to plan assets.\footnote{See 29 U.S.C. § 1106(b)(1). See generally AMERICAN BAR ASS’N, supra note 17, at 312-15.} Section 406(b)(2) prohibits a fiduciary from engaging in transactions using plan assets where the fiduciary has a
conflict of interest. Finally, section 406(b)(3) prohibits a fiduciary from receiving a "kickback" from other parties who are connected with a transaction involving plan assets.

ERISA section 408 contains a number of statutory exemptions to the section 406 prohibited transaction rules. The Department of Labor has administrative authority to interpret ERISA's prohibited transaction rules and statutory exemptions and to issue administrative exemptions from the prohibited transaction rules, including administrative exemptions from the section 406(b) fiduciary prohibited transactions. Administrative relief from

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238 As originally enacted, ERISA gave the Department of Labor and the Treasury Department dual jurisdiction over the prohibited transaction rules. Thus, the Department of Labor had interpretive and exemptive authority over ERISA's prohibited transaction rules and the Treasury Department had interpretive and exemptive authority over the prohibited transaction rules under the Internal Revenue Code applicable to qualified plans. When this dual jurisdiction scheme proved administratively difficult, President Carter proposed, and Congress approved, Reorganization Plan No. 4. See Reorg. Plan No. 4 of 1978 § 102(a), 43 Fed. Reg. 47,713 (1978). Under Reorganization Plan No. 4, the Treasury Department transferred almost all of its interpretive and exemptive authority over the Internal Revenue Code's prohibited transaction rules to the Department of Labor. See id.; see also AMERICAN BAR ASS'N, supra note 17, at 7, 37-38. At the time, one of the limited areas over which the Treasury Department retained jurisdiction was the application of the Internal Revenue Code's prohibited transaction rules to participant-directed transactions involving plan assets that were exempted by ERISA section 404(c) from ERISA's general fiduciary duty rules. See Reorg. Plan No. 4 of 1978, § 102(a); see also 57 Fed. Reg. 46,906, 46,928 (1992) ("[T]he authority to grant administrative exemptions for section 404(c) transactions remains with the Treasury Department pursuant to the Reorganization Plan No. 4 of 1978."). But see Wade & Loebl, supra note 228, at 193-94 ("Labor has the last word on the extent of Treasury's authority."). Although not articulated, the likely rationale for giving the Treasury Department sole jurisdiction over prohibited transactions arising in the context of participant-directed 404(c) plans was that the participant's directing the investment of his or her account was functionally analogous to ownership of an individual retirement account ("IRA"). IRAs generally are not subject to Title I of ERISA, see 29 U.S.C.§ 1004(a) (1994 & Supp. III 1997); 29 C.F.R. § 2510.3-2(d) (1999), but are subject to the prohibited transaction rules of the Internal Revenue Code, see I.R.C. § 408(e)(2)(A) (1994 & Supp. III 1997). The interpretation of prohibited transactions involving 404(c) plan assets engaged in by nonparticipant fiduciaries to the plan, however, is still under the sole jurisdiction of the Department of Labor. See Wade & Loebl, supra note 228, at 193-94 & nn. 22-24.

239 29 U.S.C. § 1108(a). To issue an administrative exemption, the Department of Labor must find that the proposed transaction satisfies three criteria: (1) the exemption must be administratively feasible; (2) it must be in the interests of the plan, its participants and its beneficiaries; and (3) it must be protective of the rights of plan participants and beneficiaries. See id. § 1108(a)(1)-(3). Congress's rationale in permitting administrative exemptions to the prohibited transaction rules was twofold. First, Congress reasoned that some otherwise prohibited transactions "nevertheless should be allowed in order not to disrupt the established business practices of financial institutions which often perform fiduciary functions in connection with these plans consistent with adequate safeguards to protect employee benefit plans." H.R. CONF. REP. No. 93-1280, at 309 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5089-90. Second, Congress believed that certain prohibited transactions should be permitted because they have the potential for "benefit to the community as a whole" if
ERISA’s section 406(b) fiduciary prohibited transaction rules does not relieve the plan fiduciary from its other fiduciary responsibilities under sections 404(a) and 405.\footnote{240}

The most important statutory exemptions under section 408 for today’s individual responsibility model are those in section 408(b)(2). This exemption allows any non-fiduciary who provides services to the plan to be paid out of plan assets no more than reasonable compensation for its services.\footnote{241} The section 408(b)(2) statutory exemption is not applicable, however, to a section 406(b) prohibited transaction between the plan and a plan fiduciary.\footnote{242} In such a situation, the plan fiduciary’s only alternative is to qualify for an administrative exemption for relief from the section 406(b) fiduciary prohibited transaction rules.

The following series of simple hypothetical examples illustrate how ERISA’s fiduciary prohibited transaction rules operate to deter plan service providers from providing fiduciary investment advice to plan participants.

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\footnote{240} See 62 Fed. Reg. 59,744, 59,747 (1997) (Prohibited Transaction Exemption 97-60); 57 Fed. Reg. 11,514, 11,522 (1992) (proposed Prohibited Transaction Exemption 92-77); 49 Fed. Reg. 13,208, 13,211 (1984) (proposed Prohibited Transaction Exemption 84-24); 42 Fed. Reg. 18,732 (1977) (Prohibited Transaction Exemption 77-4). \footnote{241} See 29 U.S.C. § 1108(b); 29 C.F.R. § 2550.408b-2 (1999). \footnote{242} The statutory language at the beginning of section 408(b) could have been interpreted by the Department of Labor as exempting both non-fiduciary service providers from the prohibited transaction rules of section 406(a) and fiduciaries who rendered investment advisory services for compensation from the prohibited transaction rules of section 406(b). See 29 U.S.C. § 1108(b). The Department of Labor did not adopt this statutory interpretation. Rather, the Department’s position is that the section 408(b)(2) statutory exemption allowing payment of not more than reasonable compensation out of plan assets applies only to payments to non-fiduciary service providers that otherwise would be prohibited by section 406(a). See 29 C.F.R. § 408b-2(a), (e).
Assume the Company sponsors a participant-directed 401(k) plan for its employees. The Company uses a local brokerage firm ("Service Provider") to execute the participants' investment directives. First, begin with the assumption that the Service Provider does not render investment advice to the plan's participants. If a participant directs the Service Provider to sell 100 shares of ABC Company stock in his plan account, and to buy XYZ Company stock instead, the Service Provider receives a sales commission on the transaction. If the amount of the commission is paid out of plan assets, i.e., deducted from the participant's plan account, as long as the commission is disclosed and is reasonable in amount, the payment of the commission out of plan assets qualifies for the section 408(b)(2) prohibited transaction exemption.\(^{243}\)

This example provides a starting point for purposes of illustration, but it is not reflective of most participant-directed plans. Currently, few section 404(c) plans allow the plan participants to choose among the world of potential individual stock or other investments because of the difficulty inherent in valuing and reporting the variety of investments held in each participant's account.\(^{244}\) Participant-directed plans typically offer mutual funds as investment options\(^{245}\) to satisfy the 404(c) Regulations, which require that the plan offer a diversified range of at least three investment options.\(^{246}\) Taking the illustration above, assume that instead of directing the Service Provider to buy and sell individual stocks, the participant directs the Service Provider to sell his shares of Mutual Fund A and buy shares of Mutual Fund B. Mutual Fund B might charge a sales commission to the participant—in mutual fund parlance, a "load" charge to invest in the fund.\(^{247}\) The more likely scenario today, however, is that Mutual Fund B is a "no load" fund, i.e., it does not charge an up front load sales commission in the traditional sense.\(^{248}\) In a no-load mutual fund, various fees are deducted each year from mutual fund assets,
based on a percentage of the assets held in Fund B.\(^{249}\) Pursuant to its business arrangement with the Service Provider, the mutual fund company shares part of the fees deducted from the assets of Mutual Fund B with the Service Provider.\(^{250}\) Alternatively, if the Service Provider is also the mutual fund company itself (or an affiliate), the mutual fund company retains all of the fees generated by the mutual funds.\(^{251}\) Unlike the direct deduction of a sales commission from a participant’s plan account assets, these fees,\(^{252}\) because they are deducted at the mutual fund level out of mutual fund assets, escape the prohibited transaction rules of Section 406(a) for nonfiduciaries altogether, even though plan assets are invested in the mutual fund.\(^{253}\)

Compare this scenario with the situation in which the Service Provider agrees to render fiduciary investment advice to the plan’s participants. Because the Service Provider is now a fiduciary with respect to the plan, it becomes subject to the more stringent fiduciary prohibited transaction rules of section 406(b). When the mutual fund company shares a portion of the fees

\(^{249}\) See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Part 3.3.5. These fees are a combination of fees authorized under section 12(b) of the Investment Company Act of 1940 ("Rule 12b-1 fees") and deferred contingent sales charges. See id. Rule 12b-1 fees are used by a no-load mutual fund to compensate members of the fund’s marketing and distribution network in lieu of the traditional sales commission. See id. Rule 12b-1 fees also may be used to pay for outsourced mutual fund shareholder services. See 1 LEMPKE ET AL., supra note 126, § 7.05, at 7-25 to -26, 7-31 to -33.

\(^{250}\) For example, the Mutual Fund may be operating under a third-party payment plan, whereby a portion of the fund’s 12b-1 fees are paid to the Service Provider based on the percentage of the fund’s assets that are attributable to the Service Provider’s customers—the plan’s participants. This and other possible business arrangements between the Mutual Fund and the Service Provider are described in LEMPKE ET AL., supra note 126, § 7.05, at 7-25 to -33.

\(^{251}\) Examples of such arrangements are described infra Part III.C.

\(^{252}\) Under federal securities laws, these fees must be disclosed in the mutual fund’s prospectus as expense ratios. The three categories of expense ratios reflect the various types of fees that can be deducted from mutual fund assets. "Management fees" compensate the fund’s investment advisor(s). "Marketing and distribution fees" ("Rule 12b-1 fees") are used to provide sales commissions to persons in the fund’s distribution network or to compensate third parties who provide recordkeeping services to the fund’s shareholders. "Administrative expenses" are used to pay for other fund shareholder services. See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Part 3.4.3. Mutual fund shareholder services include such things as answering customer inquiries, maintaining shareholder accounts and records, processing transactions, and providing periodic account balance statements to shareholders. See 1 LEMPKE ET AL., supra note 126, § 7.05, at 7-31. See generally Matt Murray, Bank Offers Fund Investors Just the Ticket, WALL ST. J., Aug. 7, 1996, at C1.

\(^{253}\) Under ERISA section 401(b)(1), 29 U.S.C. § 1101(b)(1) (1994), the assets contained in the mutual fund itself are not "plan assets"—only the mutual fund shares are plan assets. See 1 LEMPKE ET AL., supra note 126, § 25.02, at 25-6. By virtue of ERISA section 3(21)(B), 29 U.S.C. § 1002(21)(B) (1994), the mutual fund, the mutual fund company, and the investment advisors who manage the fund’s investment portfolio are not considered to be ERISA fiduciaries solely because ERISA plan assets (the 401(k) plan monies) have been invested in the mutual fund. See id.
deducted from the assets of Mutual Fund B with the Service Provider, this payment is now a prohibited “kickback” transaction under section 406(b)(3)\textsuperscript{254} even if the fee payment is fully disclosed to and approved by the plan’s sponsoring employer.\textsuperscript{255} When it renders investment advice to plan participants, the Service Provider’s potential for transgressing the section 406(b) fiduciary prohibited transaction rules can arise in more subtle ways. Suppose the plan’s Service Provider is the mutual fund company itself (or its affiliate). The plan offers three of the Service Provider’s own no load mutual funds—a money market fund, a bond fund, and an equity fund—as investment options to the plan participants. The fees generated by the equity fund and deducted out of mutual fund assets are more than the fees generated by the money market fund.\textsuperscript{256} Assume the Service Provider advises the plan participant to invest in the equity fund. Even if this investment advice is in the best interest of the plan participant, and is consistent with the Service Provider’s fiduciary duties under section 404(a),\textsuperscript{257} the mere potential for a higher fee causes the Service Provider to engage in a “self-dealing” fiduciary prohibited transaction under section 406(b)(1).\textsuperscript{258}

When ERISA’s fiduciary prohibited transaction rules were first adopted in 1974, they caused similar problems for the service providers who provided investment advice to defined benefit plans. As a result, securities brokerage firms, followed by mutual fund companies, and then finally by third party investment advisors, requested and received administrative relief from the Department of Labor in the form of class exemptions from ERISA’s fiduciary prohibited transaction rules.\textsuperscript{259} It is uncertain whether these class exemptions

\textsuperscript{254} See supra note 236 and accompanying text.
\textsuperscript{255} See 29 C.F.R. §2550.408b-2(e)(1), (f) Ex. (2) (1999).
\textsuperscript{256} This is typically the case, because it takes more effort to manage a portfolio of equities than to manage a portfolio of short-term U.S. Treasury bonds. For specific examples, the reader is referred to the facts described in the individual prohibited transaction exemptions for investment advice programs. See infra Part III.C.
\textsuperscript{257} See supra Part II.B.
\textsuperscript{258} See Kievan, supra note 228, at 563-64.
\textsuperscript{259} Prior to the enactment of ERISA, broker-dealers routinely rendered investment advice to employers who sponsored defined benefit plans, and received sales commissions on the plan’s securities transactions. See 40 Fed. Reg. 5,201 (1975) (Interim Exemption). After the enactment of ERISA, this business practice became a prohibited fiduciary self-dealing transaction under Section 406(b), 29 U.S.C. § 1106(b) (1994). Almost immediately after ERISA became effective, the Department of Labor granted administrative relief to the securities industry from the fiduciary prohibited transaction rules pursuant to Prohibited Transaction Exemption 75-1 ("PTE 75-1"). See 40 Fed. Reg. at 5,201-02 (1975) (Interim Exemption); 40 Fed. Reg. 50,845-50 (1975) (Prohibited Transaction Exemption 75-1); DONALD J. MEYERS & MICHAEL B. RICHMAN, ERISA CLASS EXEMPTIONS 1-2 (2d ed. 1996). PTE 75-1 gave only temporary relief to broker-dealers who also acted as fiduciary investment advisors to plans. See id. at 1. The Department of Labor eventually granted
are available to fiduciaries who render investment advice to plan participants under the individual responsibility model, for primarily two reasons. First, a common condition for relief under the administrative exemptions is that the investment transactions and all fees paid to the plan's fiduciary investment advisor must be disclosed to and approved by an "independent fiduciary" for the plan. 260 When the Department of Labor developed the terms and conditions of these administrative exemptions, this independent fiduciary was assumed to be the employer who sponsored the defined benefit plan. 261 It is unclear whether the plan participants can each act as their own independent fiduciaries for purposes of satisfying this condition, particularly when the 404(c) Regulations specifically provide that the plan participants are not fiduciaries. 262 Second, the class exemption may, as a condition for exemptive relief, prohibit the fiduciary from receiving "sales commissions" resulting from plan investments. 263 The Department of Labor's position is that so-called Rule 12b-1 fees 264 paid by no-load mutual funds are "sales commissions," and


Shortly after the issuance of PTE 75-1, representatives of principal underwriters for mutual fund companies, along with pension consultants and the insurance industry, requested and received Prohibited Transaction Exemption 77-9 ("PTE 77-9"), which eventually became Prohibited Transaction Exemption 84-24 ("PTE 84-24"). See 49 Fed. Reg. 13,208-13 (1984); 42 Fed. Reg. 32,395-401 (1977); 41 Fed. Reg. 56,760-62 (1976). The mutual fund industry requested this administrative exemption because ERISA's fiduciary prohibited transaction rules prevented the underwriters from receiving sales commissions or "loads" on the sale of mutual fund shares. See 41 Fed. Reg. at 56,761-62; MEYERS & RICHMAN, supra, at 140-41. In addition, the Department of Labor issued Prohibited Transaction Exemption 77-4 ("PTE 77-4"), which allows service providers to act in the dual role of investment advisor to both the plan's sponsoring employer and the mutual funds in which the plan's assets are invested. See 42 Fed. Reg. 18,732 (1977); MEYERS & RICHMAN, supra, at 92-100.

260 See Prohibited Transaction Exemption 84-24, Section V(C), 49 Fed. Reg. at 13,212 (1984); Prohibited Transaction Exemption 77-4, Section II(d)-(e), 42 Fed. Reg. at 18,733 (1977); MEYERS & RICHMAN, supra note 259, at 92-93, 140-41, 701-02.

261 See sources cited supra notes 259-60.

262 The Department of Labor had indicated in a 1980 advisory opinion letter that, for purposes of interpreting the independent fiduciary approval requirement under PTE 77-9 (now PTE 84-24), plan participants could be substituted for the necessary "independent fiduciary." See PWBA Op. Ltr. 80-30A, 1980 WL 8932 (May 21, 1980). The 404(c) Regulations take the position that plan participants in 404(c) plans are not fiduciaries. See 29 C.F.R. §2550.404c-1(d)(1) (1999). Adding to the confusion, the Department of Labor has indicated in a series of advisory opinion letters issued in 1994 and 1995 that, if the plan is properly designed, the plan participant can be substituted for the employer as the plan's "named fiduciary" for purposes of directing a trustee under section 403(a)(1) of ERISA. See Colleen E. Medill, The Law of Directed Trustees Under ERISA: A Proposed Blueprint for the Federal Courts, 61 Mo. L. Rev. 825, 830-31 (1996).

263 See Prohibited Transaction Exemption 77-4, Section II(e), 42 Fed. Reg. at 18,733.

264 See supra note 252.
therefore the receipt of these fees violates the terms and conditions for administrative relief from the fiduciary prohibited transaction rules.265

To date, the Department of Labor has not issued a class exemption from the fiduciary prohibited transaction rules designed to allow service providers to provide investment advice to plan participants who direct the investment of their retirement plan assets. The Department of Labor has, however, granted several individual exemptions that allow individual service providers to offer investment advice to plan participants.266 These individual exemptions, discussed in Part III.C., form the framework for a much-needed class exemption designed specifically for today's individual responsibility model.

E. Lack of Participant Education and Investment Advice as a Product of Department of Labor Policy

Prior to the issuance of the 404(c) Regulations, employers were reluctant to allow plan participants to direct the investment of their 401(k) plan accounts because of the employer's potential fiduciary liability for investment losses. The 404(c) Regulations eliminated this investment liability concern, thereby encouraging employers to allow participants to direct the investment of their retirement savings. The 404(c) Regulations do not, however, require the employer to provide plan participants with retirement savings educational materials or investment advice.267

The Department of Labor's broad definition of a "fiduciary investment advisor"268 provides a legal incentive, for both employers and plan service providers, strictly to limit the information and assistance provided to participants to the types of information and disclosures required by the 404(c) Regulations. These required disclosures and information are directed at the level of a financially sophisticated investor. If additional materials or personal

265 See PWBA Op. Ltr. 93-13A, n.4, 1993 WL 188472 (Apr. 27, 1993) (Rule 12b-1 fees considered sales commissions); PWBA Op. Ltr. 93-12A, n.4, 1993 WL 188471 (Apr. 27, 1993) (same). Further legal uncertainty arises because PTE 77-4 does permit the plan's fiduciary investment advisor to receive administrative fees from the mutual fund (excluding Rule 12b-1 fees) for shareholder services other than investment advisory services to the fund ("secondary services"), provided that these fees for secondary services are disclosed to the plan's independent fiduciary. See PWBA Op. Ltr. 93-12A, text accompanying nn.3 & 4, 1993 WL 188471. The determination of whether a fee paid at the mutual fund level is for investment advisory services to the fund or for secondary services to mutual fund shareholders involves an inherently uncertain case by case analysis. See PWBA Op. Ltr. 93-13A, n.3, 1993 WL 188472.

266 See infra Part III.C.
267 See supra Part II.C.
268 See supra Part II.A.
assistance is provided to plan participants, both the employer and the plan service provider have strong legal and financial incentives to keep the materials or personal assistance at a level that is general rather than personalized to the participant's individual needs and circumstances. Why? Because general materials and assistance minimize the risk that the materials or assistance will be interpreted to be the fiduciary rendering of individualized "investment advice" to plan participants.\textsuperscript{269} By avoiding fiduciary investment advisor status, the service provider supplying the materials or assistance to plan participants avoids potential fiduciary liability, and the employer avoids potential co-fiduciary liability.\textsuperscript{270}

The service provider also may achieve a second, financially more significant, benefit by avoiding fiduciary status as an investment advisor. By avoiding fiduciary status, the service provider is subject only to the prohibited transaction rules of section 406(a), not to the more stringent fiduciary prohibited transaction rules of section 406(b).\textsuperscript{271} Therefore, the service provider can continue to receive a reasonable fee or commission, paid out of plan assets through a deduction from the participant's account, for non-fiduciary services provided to the plan. More importantly, the service provider can continue to receive fees, paid at the mutual fund level, pursuant to various business arrangements with the plan's mutual fund investment options.\textsuperscript{272}

In contrast, compare the situation of a non-fiduciary service provider with that of a service provider who renders fiduciary investment advice to plan participants. The fiduciary service provider is subject to potential liability under ERISA for any breach of its fiduciary duties under section 404(a).\textsuperscript{273} More importantly, the fiduciary service provider becomes subject to the fiduciary prohibited transaction rules of section 406(b).\textsuperscript{274} Because there are no clearly applicable class exemptions, these fiduciary prohibited transaction rules prohibit the service providers from receiving fees deducted at the mutual fund level out of mutual fund assets.\textsuperscript{275} Consequently, from the service

\textsuperscript{269} See supra Part II.A.
\textsuperscript{270} See supra Part II.B.
\textsuperscript{271} See supra Part II.D.
\textsuperscript{272} See supra note 241 and accompanying text.
\textsuperscript{273} See supra note 253 and accompanying text.
\textsuperscript{274} See supra Part II.B. This is not necessarily a significant deterrent. See infra notes 433-37 and accompanying text.
\textsuperscript{275} See supra Part II.D.
\textsuperscript{276} See supra Part II.D.
provider's perspective, there is substantially less liability and substantially more in the way of potential revenue to be gained by not providing investment advice to plan participants, and thereby remaining a non-fiduciary.

From the employer's perspective, having a service provider render investment advice to plan participants subjects the employer to potential co-fiduciary liability.\(^{277}\) To minimize such liability and to fulfill its own fiduciary duty of care, the employer must prudently monitor the conduct of the fiduciary investment advisor.\(^{278}\) Such supervisory responsibility is contrary to the appeal of the individual responsibility model for many employers, who desire fewer administrative tasks.\(^{279}\) Few employers have the expertise to evaluate whether a professional investment advisor is acting prudently in advising the plan participants. Although the employer who sponsors a participant-directed plan still retains a fiduciary duty to monitor the plan's non-fiduciary service providers, this fiduciary duty is much more narrow in scope, and presents a less onerous and less costly administrative task, when compared with engaging and monitoring the services of a fiduciary investment advisor for plan participants.

If, despite these potential liability concerns, the employer desires to offer investment advice to plan participants, the employer could hire a professional who is independent of the plan's mutual fund investment options to provide investment advice to plan participants. The fee paid to this professional investment advisor cannot be paid out of plan assets due to the prohibition on fiduciary self-dealing.\(^{280}\) This option is unattractive to many employers who have adopted the individual responsibility model. Employers would prefer to have plan administrative and servicing fees paid out of plan assets through deductions from each participant's individual account, thereby reducing the employer's cost of administering the plan.\(^{281}\)

In conclusion, the lack of meaningful decision-making assistance in the form of educational assistance and individualized investment advice to plan participants is the direct product of Department of Labor administrative policy. Despite the emergence of the participant-directed 401(k) plan and evidence of questionable decision-making behavior by many plan participants, the Depart-

\(^{277}\) See supra Part II.B.

\(^{278}\) See sources cited supra note 176.

\(^{279}\) See sources cited supra note 24.

\(^{280}\) See supra Part II.D.

\(^{281}\) See sources cited supra note 24. The recent trend is for employers to shift plan administrative expenses to plan participants. See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Part 3.6.
ment has continued to adhere to interpretations of ERISA's fiduciary prohibited transaction provisions that were formulated for defined benefit plans. As a result, both employers and plan service providers are deterred from doing anything more than the bare minimum required by the 404(c) Regulations. Meanwhile, the plan participants, whom ERISA was designed to protect, are left with the responsibility of individually accumulating adequate savings for retirement, without the benefit of professional investment advice.

Recognizing the perils of the individual responsibility model for plan participants, Congress and the Department of Labor have taken measures to encourage employers and plan service providers to provide more retirement savings investment education to plan participants. These recent initiatives are discussed in Part III, and critiqued in Part IV.

III. RECENT INITIATIVES TO ENCOURAGE PARTICIPANT INVESTMENT EDUCATION

A. The Savings Are Vital to Everyone's Retirement Act of 1997

In November of 1997, Congress enacted the Savings Are Vital to Everyone’s Retirement Act of 1997 (the “SAVER Act”). Congress found that the impending retirement of the baby boom generation “will severely strain our already overburdened entitlement system, necessitating increased reliance on pension and other personal savings,” and that “far too many Americans—particularly the young—are either unaware of, or without the knowledge and resources necessary to take advantage of, the extensive benefits offered by our retirement savings system.” The purpose of the SAVER Act is to promote public education and awareness of the need for personal retirement savings.

The SAVER Act amends ERISA by adding two new sections. First, new ERISA section 516 requires the Department of Labor to establish and maintain an ongoing program of public outreach designed to promote retirement savings by the public. Second, new ERISA section 517 requires the President to


\[283\] See id. \$ 2.


\[285\] See 111 Stat. 2139 (amending 29 U.S.C. \$ 1146(a)). The SAVER Act requires the Department of Labor to include specific types of retirement savings-related information as part of its outreach program, and
convene three National Summits on Retirement Savings in 1998, 2001, and 2005. The purpose of these National Summits is to increase public awareness and knowledge of the value of personal savings for retirement, to identify barriers to increased retirement savings, and to develop legislative and policy recommendations to promote retirement savings.

Although the SAVER Act sets forth ambitious goals for increasing retirement savings through public information, its potential effectiveness is questionable. As discussed in Part I, studies of the general public’s knowledge of saving and investing for retirement indicate that the groups most at risk for inadequate retirement savings are low-wage, lower educated workers. This group is also less likely to access or benefit from the Department of Labor’s Internet site. Moreover, merely providing individuals with general information concerning retirement savings issues has not proven effective in the past in influencing the choices of plan participants. In short, the SAVER Act, at best, represents a symbolic gesture that is unlikely to effect meaningful change in the retirement savings habits of many Americans.

also requires the Department of Labor to establish a permanent retirement savings information site on the Internet. See id. (to be codified at 29 U.S.C. § 1146(c)-(d)).


See supra note 74 and accompanying text.

For example, since the taxation rules governing direct rollovers were changed by the Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290 (codified at scattered sections of 26 U.S.C.), effective in 1993, plan administrators have been required by law to provide the plan participant with a detailed explanation of the participant’s options and an explanation of the adverse tax consequences of failing to elect the direct rollover option. See I.R.C. § 402(f) (1994 & Supp. III 1997); Treas. Reg. § 1.402(f)-1, Q&A-1 (as amended in 2000). The Treasury Department has issued a “safe harbor explanation” that plan administrators may use to satisfy the direct rollover explanation requirement. See I.R.S. Notice 92-48, 1992-2 C.B. 377. Yet the legislative history to the SAVER Act itself notes that “79% of those who did participate [in 401(k) plans] failed to roll over all of their account into either a new plan or an Individual Retirement Account (IRA) when they changed jobs (thus not only depleting their retirement savings but also incurring a significant tax penalty).” H.R. REP. No. 105-104, at 7, reprinted in 1997 U.S.C.C.A.N. at 2770.

B. Interpretive Bulletin 96-1 Concerning Participant Investment Education

In 1996 the Department of Labor issued Interpretive Bulletin 96-1 because of a growing concern that many participants lacked sufficient knowledge to make informed investment decisions. Interpretive Bulletin 96-1 encourages employers to establish retirement savings investment education programs for plan participants by clarifying the legal distinction between non-fiduciary participant investment education efforts and the fiduciary rendering of investment advice. Interpretive Bulletin 96-1 is structured as a series of four graduated "safe harbors." Information or materials provided to plan participants that fall within a safe harbor category are "educational" and not the fiduciary rendering of investment advice. If the information or materials do not fall within a safe harbor category, whether the information or materials constitute the fiduciary rendering of investment advice is determined by a facts and circumstances analysis based on the Department of Labor's interpretation of a fiduciary investment advisor.

1. Safe Harbors 1 and 2: Plan Information and General Financial and Investment Information

The first and most basic of the four safe harbors, plan information, overlaps to a great extent with the information the employer is required to provide the participant under ERISA’s summary plan description requirements. Under this safe harbor, the employer or service provider may provide participants with general information concerning the plan. For example, the information may explain the benefits of participating in the plan and increasing contributions; the disadvantages of withdrawing money prior to retirement or failing to elect a direct rollover; the terms and operation of the plan; and the investment options available under the plan. The Department of Labor’s

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292 See id.; see also 29 C.F.R. § 2509.96-1(b)-(c). The Department of Labor developed Interpretive Bulletin 96-1 after an extensive review of the educational materials currently being provided by employers and service providers to plan participants. See 61 Fed. Reg. at 29,586.
293 See 29 C.F.R. § 2509.96-1(d).
294 See id.
295 See id. § 2509.96-1(d); see also supra Part II.A.
297 See 29 C.F.R. § 2509.96-1(d)(1)(i).
298 See id.
300 See 29 C.F.R. § 2509.96-1(d)(1)(i).
301 See id. § 2509.96-1(d)(1)(ii).
rationale for treating this information as "educational" is that such items are generic and do not indicate that a particular investment option is appropriate for certain individuals.\footnote{See id. § 2509.96-1(d)(1)(ii).} Therefore, these items do not constitute investment "advice" or "recommendations" to individual plan participants.\footnote{See id.}

The second of the four safe harbors, general financial and investment information, introduces the participant to the concepts used in retirement planning. This safe harbor allows the participant to receive the equivalent of a crash course in investment theory. The participant may receive information explaining the investment concepts of risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment.\footnote{See id. § 2509.96-1(d)(2).} The materials may describe the historic differences in rates of return between different categories of investments (e.g., equities, bonds, or cash).\footnote{See id.} In addition, the educational materials may explain in general the effects of inflation, estimating future retirement income needs; determining investment time horizons; and assessing risk tolerance.\footnote{See id.} Again, the Department of Labor's rationale for treating this information as "educational" is that this theoretical information has no direct link to the plan’s specific investment options or to the financial circumstances of individual participants.\footnote{See id.}

2. Safe Harbors 3 and 4: Asset Allocation Models and Interactive Investment Materials

The third safe harbor category allows a participant to receive "asset allocation models."\footnote{Id.} The Interpretive Bulletin describes asset allocation models as pie charts, graphs, or case studies that provide sample asset allocation portfolios for hypothetical individuals with different time horizons and risk profiles.\footnote{See id. § 2509.96-1(d)(3).} For example, a set of sample portfolios might be labeled as the "Young Professional Portfolio," "Growing Family Portfolio," "College

\footnote{See id. For a description with examples of the evolution of asset allocation models in today's market place, see Veenan & McWherter, supra note 91, at 51-53. For a discussion of some of the underlying design issues involved in creating asset allocation models, see Brian Temoe & A. Foster Higgins, Appropriate Asset Allocation: What Is It? Investment Option Issues at Retirement, in WHEN WORKERS CALL THE SHOTS, supra note 18, at 43; Veenan & McWherter, supra note 91, at 53-56.}
Bound Portfolio,” and the “Ready to Retire Portfolio.”\textsuperscript{310} In theory, asset allocation models are designed to fit an individual participant “profile” captured by the label assigned to the sample portfolio.\textsuperscript{311} One of the criticisms of asset allocation models is that in reality, these profile labels do not always fit the unique circumstances of each plan participant.\textsuperscript{312}

The fourth safe harbor category, interactive investment materials, consists of the various types of investment tools a participant may use to estimate his future retirement income and the effect of different investment allocations on that income.\textsuperscript{313} The materials can be in the form of questionnaires, worksheets, software, or other similar interactive materials.\textsuperscript{314}

The Interpretive Bulletin imposes a number of restrictions and requirements for asset allocation models and interactive investment materials. The models and materials must be based on generally accepted investment theories that take into account the historic returns of various asset categories.\textsuperscript{315} For interactive materials, there must be an objective correlation between the investment allocations generated by the materials and the information and data supplied by the participant.\textsuperscript{316}

All material facts and assumptions on which an asset allocation model is based must accompany the model.\textsuperscript{317} A statement must caution participants that in applying particular models to their individual situations, they should also consider their other assets, income, and investments.\textsuperscript{318} Interactive investment materials must disclose all material facts and assumptions that may affect the participant’s assessment of the different investment allocations generated by the materials.\textsuperscript{319} The interactive materials must either take into account the participant’s other assets, income, and investments, or state that the participant should take these items into account.\textsuperscript{320}

\textsuperscript{310} See Veenan & McWherter, supra note 91, at 51.
\textsuperscript{311} See id.
\textsuperscript{312} See id. Although more sophisticated asset allocation models today have eliminated these labels in favor of “neutral” labels, such a change in form does not resolve this application problem. See id. at 51-52.
\textsuperscript{313} See 29 C.F.R. § 2509.96-1(d)(4).
\textsuperscript{314} See id.
\textsuperscript{315} See id. § 2509.96-1(d)(3)(i); (d)(4)(i).
\textsuperscript{316} See id. § 2509.96-1(d)(4)(i)-(ii).
\textsuperscript{317} See id. § 2509.96-1(d)(3)(ii).
\textsuperscript{318} See id. § 2509.96-1(d)(3)(iv).
\textsuperscript{319} See id. § 2509.96-1(d)(4)(iii).
\textsuperscript{320} See id. § 2509.96-1(d)(4)(v).
If the asset allocation model or the interactive investment materials identify specific investment options available under the plan, an additional disclosure statement is required. Models or materials must state that other investment alternatives having similar risk and return characteristics may be available under the plan, and identify where such information may be obtained. However, the model or materials do not have to identify these other investment alternatives.

The Department of Labor's rationale for treating asset allocation models and interactive investment materials as "educational" is that the disclosures accompanying the models and materials enable participants to assess independently the relevance and application of particular investment allocations to their own personal situation. Therefore, the Department of Labor concluded that these models and materials do not constitute a "recommendation" of investments to the participant, and thus are not the fiduciary rendering of "investment advice" under section 3(21)(A)(ii) of ERISA. In other words, the participant is deemed to be exercising independent judgment and is not relying on the investment allocation suggested by the model or materials. This policy applies even if the plan offers only one mutual fund for each investment category suggested by the models or materials.

3. Applying the Safe Harbors: The Participant's Perspective and the "Steering Problem"

Although the point is not explicitly discussed in the text of Interpretive Bulletin 96-1 itself, the Department of Labor commentary accompanying publication of the final Bulletin indicates that employers and service providers can "mix and match" the information described in the four safe harbors and the means of presentation of this information to the plan participants. It is easy

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321 See id. § 2509.96-1(d)(3)(iii); (d)(4)(iv).
322 See id. § 2509.96-1(d)(3); (d)(4). As originally proposed, Interpretive Bulletin 96-1 would have required the service provider to identify all investment alternatives under the plan that would satisfy the investment allocations indicated by the models or materials. The purpose underlying this requirement was to prevent potential "steering" of plan participants into specific investment options. See 61 Fed. Reg. 29,586, 29,586-57 (1996). In response to comments by service providers, the Department of Labor reduced this requirement to a disclosure statement. See id. The "steering problem" is explained and discussed infra Part III.B.3.
323 See 29 C.F.R. § 2509.96-1(d)(3), (d)(4).
324 See id.
325 See id.
to envision a scenario using the safe harbors that, *from the participant's perspective*, results in the rendering of "personalized" investment advice. To illustrate, assume the following hypothetical example. A participant receives general information on estimating his retirement needs and a retirement planning software program. The participant enters personal data into the software program, including data on the participant's non-retirement assets, income, and other investments. A representative of the service provider assists the participant in using the software program and completing the required data input. Based on the information entered by the participant, the software program generates an investment allocation plan for the participant. Each identified investment category is paired with one specific mutual fund available under the plan. Such a printout might look like this:

**YOUR PERSONALIZED INVESTMENT PORTFOLIO**

- 60% Domestic Equities (Service Provider Large Cap Fund)
- 20% Long-Term Bonds (Service Provider High Grade Bond Fund)
- 20% International Equities (Service Provider Global Fund).

From the plan participant's perspective, this printout is indistinguishable from the situation where the participant's insurance agent or stock broker provides investment advice for the participant's non-ERISA assets. Nevertheless, under Interpretive Bulletin 96-1 the participant has received investment "education," not investment advice.

The example also illustrates the potential for service providers to use safe harbor asset allocation models or interactive investment materials to "steer" plan participants into certain funds offered as investment options under the plan (the "steering problem"). A financial incentive exists for the service provider to steer a participant into a particular fund when the fees paid to the service provider by one mutual fund are greater than the fees paid by other funds. To avoid this steering problem, Interpretive Bulletin 96-1, as originally proposed, would have required the service provider to identify all of the specific funds offered under the plan that fell within an investment category. Using my previous example as an illustration, under this requirement the printout could not identify just one mutual fund for each of the

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327 The Department of Labor allows such personal assistance. See id.
328 It also is indistinguishable from programs, approved by the Department of Labor, that provide fiduciary investment advice to plan participants. See infra Part III.C.
330 See id.
331 See supra note 322.
three investment categories. Instead, the printout would have to identify all mutual funds available under the plan that could be used to satisfy the recommended investment of, for example, “60% Domestic Equities.” This requirement was eliminated in the final Bulletin due to objections by plan service providers. As a result, in my example the investment printout need state only that “other investment alternatives having similar risk and return characteristics may be available under the plan,” and must identify “where information on those investment alternatives may be obtained.”

The steering problem exists as a result of ERISA’s failure to regulate non-fiduciary conduct. Under Interpretive Bulletin 96-1, the service provider who stays within the safe harbors is not a fiduciary with respect to the plan. Therefore, the service provider is not subject to the fiduciary duty of loyalty and its fees (paid out of mutual fund assets) are not subject to ERISA’s prohibited transaction rules. Consequently, when designing its “safe harbor” investment models and materials the non-fiduciary service provider may act with its own best interests in mind (identifying the highest fee-generating mutual fund) rather than solely in the interest of the plan participant (identifying the lowest fee-generating mutual fund). The only legal constraint imposed by ERISA on such self-serving conduct by the non-fiduciary service provider is the employer’s fiduciary duty to “monitor” the service provider.

The ultimate effect on the participant’s retirement savings can be substantial. The Department of Labor’s own study on the issue presents the following example:

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332 See supra note 322.
334 See supra notes 154-57 and accompanying text.
335 See supra Part III.B.1, 2.
336 See supra notes 173, 177 and accompanying text.
337 See supra note 253 and accompanying text.
338 The design of the service provider’s models and materials must still satisfy the criteria for safe harbor treatment under Interpretive Bulletin 96-1. See supra Part III.B.1, 2. Within these parameters, however, the service provider is free to steer participants to particular mutual funds.
339 See sources cited supra note 176. If the mutual fund fees paid to the service provider are not so outrageous that they attract the attention of the plan participants or the Department of Labor, the typical employer is unlikely to notice a steering problem. See DOL Issues Section 401(k) Fee Guide, Continues To Consider Further Requirements, 25 Pens. & Ben. Rep. (BNA) 1545 (Jul. 6, 1998) (stating that employers are generally unknowledgeable about fees). The amount of fees paid out of mutual fund assets are, of course, subject to regulation by the Securities and Exchange Commission pursuant to the Investment Company Act of 1940. See supra note 226.
Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and [mutual fund level] fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If [mutual fund level] fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

The steering problem is invidious because employers and plan participants generally are ignorant of the impact of mutual fund fees on retirement savings. It also raises serious policy concerns, particularly when Interpretive Bulletin 96-1 is contrasted with other recent Department of Labor rulings on individual service provider programs that provide investment advice to plan participants.

C. Individual Prohibited Transaction Exemptions for Investment Advice Programs

The Department of Labor has granted a series of fiduciary prohibited transaction exemptions to individual service providers. An individual exemption allows the service provider to provide fiduciary investment advice to plan participants without a violation of ERISA’s prohibited transaction rules. This series began with the ground-breaking Shearson-Lehman Brothers, Inc. (“Shearson Lehman”) exemption in 1992. More recently, the Department of Labor granted an individual exemption to a group of related entities affiliated with the Trust Company of the West. These rulings on investment advice programs for plan participants are important barometers of

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342 See infra Part III.C.
343 The criteria for granting individual prohibited transaction exemptions are discussed supra note 239.
344 See supra Part II.D.
Department of Labor policy, and thus worthy of attention for two reasons. First, ERISA's statutory criteria for individual prohibited transaction exemptions are the same as those for class prohibited transaction exemptions. Therefore, a series of exemptions granted to individual service providers may be used to form the basis for a class prohibited transaction exemption available to the entire industry. Second, a fiduciary prohibited transaction exemption provides relief only from ERISA's prohibited transaction rules. The investment advice program in operation still must comply with ERISA's fiduciary duty requirements. As a result, when the Department of Labor exempts a program providing investment advice from the prohibited transaction rules, that program still must be consistent with ERISA's fiduciary provisions. A close examination of the Trust Company of the West exemption, however, reveals how the "educational" models and materials permitted under Interpretive Bulletin 96-1 can be inconsistent with ERISA's fiduciary provisions.

1. The Shearson Lehman Exemption and Its Progeny

To understand the significance of the recent Trust Company of the West exemption, one must begin with the 1992 Shearson Lehman exemption and its progeny. In 1991, Shearson Lehman formed a mutual fund company offering twelve different mutual funds. A wholly-owned subsidiary of Shearson Lehman served as investment manager for these mutual funds and received investment advisory fees from the mutual funds based on a percentage of the assets invested in each mutual fund. The fees paid by each mutual fund to the investment advisor varied; the equity funds paid the highest fee, while no fee was paid by the money market fund.

Shearson Lehman proposed to offer investment advice to participants in plans that used its mutual funds as investment options. The same Shearson subsidiary that provided the investment advice also served as investment advisor to the mutual funds. Thus, a fiduciary self-dealing prohibited transaction issue arose because the Shearson subsidiary could receive a higher

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347 See supra note 239.
348 See supra note 239.
349 See sources cited supra note 240.
350 See sources cited supra note 240.
fee by "steering" plan participants into the higher-fee-paying equity fund. Shearson Lehman proposed to eliminate this potential conflict of interest, and thus eliminate the prohibited transaction, by directly charging the plan participants a fixed fee (the "participant fee") for investment advice. This participant fee was reduced by the fees paid by the mutual funds to the Shearson subsidiary in its capacity as the funds' investment advisor (the "mutual fund fee"). Under Shearson's proposal, the maximum total amount the Shearson subsidiary could receive was limited to the amount of the participant fee. This limitation removed any financial incentive and thus "solved" the steering problem.

The Department of Labor's approval of the Shearson-Lehman exemption was a well-publicized event in the ERISA world. Other major players among plan service providers—Prudential, Paine Webber, and Wells Fargo Bank—quickly followed suit by seeking and receiving their own individual exemptions for similar investment advice programs. All of these "progeny" exemptions were patterned after the Shearson Lehman model of a fixed participant fee for investment advice, offset by the mutual fund fees paid by the mutual funds.

2. Breaking New Ground: The Trust Company of the West Exemption

From the service provider's perspective, the potential economic disadvantage of the Shearson Lehman model is its limitation on fees. The Trust Company of the West proposed a creative solution that removed this limitation. To solve the steering problem, Trust Company of the West turned to the "neutral" computer. It proposed to hire an independent expert in the field of modern portfolio theory to construct asset allocation models using

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355 See sources cited supra notes 352-54.
the various mutual funds offered by Trust Company of the West. A second independent expert in the field of participant investment behavior was hired to develop, together with the outside financial expert, worksheet materials for the participants. Trust Company of the West proposed that the information elicited by the worksheet for each participant be entered into a computer program. This computer program was designed by independent programmers, using parameters provided by independent financial and behavioral experts. The computer program would then generate an investment portfolio for the participant using the Trust Company of the West mutual funds.

Trust Company of the West proposed to charge no participant fee at all for its investment advice. The sole compensation for the investment advice to participants would be the fees paid to Trust Company of the West from its mutual funds. These fees again varied, with the money market fund paying the lowest fees and the equity funds paying the highest fees. Thus, the Trust Company of the West retained the full amount of the mutual fund fees without any limitation.

The Department of Labor approved this computerized solution to the steering problem and granted the exemption. Approval of the Trust Company of the West exemption was again well-publicized in the ERISA world. It immediately raised questions in the minds of many plan service providers, who publicly wondered how this fiduciary investment advice program differed from the “educational” programs made possible under Interpretive Bulletin 96-1. The Department of Labor initially responded by downplaying the significance of the exemption as just another of the Shearson

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357 See Fred Williams, Ibbotson to Build TCW Advisory Program, PENSIONS & INVESTMENTS, Apr. 20, 1998, at 28; sources cited supra note 356.
358 See sources cited supra note 356.
359 Under Trust Company of the West’s proposal, the “neutrality” of the financial and behavioral experts responsible for designing this system was assured because their compensation would be paid directly by Trust Company of the West and would be unrelated to the investment decisions made by the plan participants. See Prohibited Transaction Exemption 97-60, 62 Fed. Reg. at 59,748-49.
360 As a marketing strategy, the Trust Company of the West proposal was brilliant. The participants never see a separate charge for investment advice—to them, the advice looks “free.” In reality, of course, the participants still pay. See supra note 340 and accompanying text (DOL study example).
Later, the Department apparently realized what the service providers had seen immediately—it was possible to use the safe harbors of Interpretive Bulletin 96-1 to construct a "nonfiduciary" program of investment "education" that was functionally indistinguishable from the fiduciary investment advice program pioneered by the Trust Company of the West. To counteract this possibility, the Department of Labor cautioned employers that their service providers should first obtain a fiduciary prohibited transaction exemption from the Department of Labor before offering a program of investment "education" patterned after the Trust Company of the West model. The implication, of course, was that an investment "education" program designed to take advantage of the safe harbors of Interpretive Bulletin 96-1 could constitute fiduciary investment advice. As a result, rather than clarifying the legal definition of a fiduciary investment advisor, the Department of Labor appears only to have added to the confusion.

There are only two differences between the Trust Company of the West program and an investment "education" program using asset allocation models and interactive investment materials under safe harbors 3 and 4 of the Bulletin. The first difference is that the fiduciary investment advice given under the Trust Company of the West program is generated by a computer program designed by outside independent experts. In contrast, the "educational" materials of safe harbors 3 and 4 are designed by the service provider. This distinction is invisible to the plan participant. It also allows in-house experts to design investment materials and programs that will "steer" participants into high fee-generating investments. The second difference is that under Interpretive Bulletin 96-1, if the education materials "identify" a specific mutual fund, the participant must receive a disclosure/disclaimer that "other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those alternatives may be obtained." Such boilerplate is unlikely to put the average plan participant on notice that he has received investment "education,"

See Trust Company May Collect Fees, supra note 362.
See Fred Williams, Fidelity Isn't Offering Advice, But . . . Participants to Get "Personalized" Ideas, PENSIONS & INVESTMENTS, Dec. 8, 1997, at 3.
See Williamson, supra note 363. Fidelity's proposed investment education software program provides an example of an "educational" program that is similar, if not identical, to the Trust Company of the West's fiduciary investment advice program. See Williams, supra note 365.
not investment advice, and should independently evaluate the suggested investments.

In light of this functional equivalence, one must wonder why Trust Company of the West continued to pursue to completion its prohibited transaction exemption request after the Department of Labor issued Interpretive Bulletin 96-1. Trust Company of the West was concerned that the Department of Labor would consider its program to be investment advice.\(^{369}\) The Department of Labor’s apparent acquiescence is well worth pondering. By going forward with its exemption request after Interpretive Bulletin 96-1 was issued, Trust Company of the West conceded that its program provided investment advice to plan participants. Conceding fiduciary status creates obvious disadvantages for Trust Company of the West that would not exist if its program qualified as investment education under Interpretive Bulletin 96-1. Trust Company of the West opened itself up to potential liability for breach of its fiduciary duties under ERISA. It also incurred the additional expenses associated with maintaining its expert-generated computerized investment advice program.

Compare this situation with the position of Trust Company of the West if its program were merely investment education under Interpretive Bulletin 96-1. As a non-fiduciary education provider, Trust Company of the West would have no potential fiduciary liability under ERISA. Any claims of potential liability under state law would be preempted by ERISA. Effectively, Trust Company of the West would be immune from liability for its investment educational services. And it could develop its own educational materials “in-house” without the paid assistance of outside experts.

Given the disadvantages of conceding fiduciary status, one must speculate that either Trust Company of the West acted out of an abundance of caution, or the Department of Labor refused to provide sufficient assurance to Trust Company of the West that its program fell within the safe harbor parameters of Interpretive Bulletin 96-1. The Department of Labor’s subsequent public comments made after the Trust Company of the West exemption was approved indicate that it was the latter concern that led Trust Company of the West to go forward with its exemption request.\(^{370}\) As a result, the legal line between investment education and investment advice remains a murky one.


\(^{370}\) See Williamson, supra note 363.
IV. CRITIQUE OF THE CURRENT POLICY APPROACH TO THE INDIVIDUAL RESPONSIBILITY MODEL

A fundamental policy tension lies at the heart of ERISA's statutory scheme. ERISA involves a delicate balancing of two core legislative objectives. On the one hand, Congress wanted to design a system of federal law that would be protective of plan participants and ensure the security of their retirement benefits. On the other hand, Congress retained the existing system of voluntarily sponsored retirement plans by private parties, and thus recognized that the system as a whole could not be made "so complex that administrative costs, or litigation expenses, unduly discourage employers from offering [employee] benefit plans in the first place." I argue in this Part that the Department of Labor's current policy approach to the individual responsibility model is contrary to both of these legislative objectives.

A. Should Federal Policy Assume That All Participants Are Informed Decision-Makers?

The most striking feature of the 404(c) Regulations is their treatment of plan participants as a monolithic group of knowledgeable and informed decision-makers. The empirical evidence indicates that participants vary in their level of financial and investment knowledge. They also vary in their ability to apply the sophisticated investment concepts required for investment decision-making under the individual responsibility model.

A monolithic approach could be justified if it assumed that all plan participants needed substantial assistance, starting with the most basic educational information relating to retirement planning and investment decisions. The 404(c) Regulations do not require that basic educational information be provided to plan participants. Rather, the 404(c) Regulations' informational requirements begin at the level of a financially sophisticated plan participant who, for example, can analyze a securities prospectus. The

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373 Varity Corp., 516 U.S. at 497; see also H.R. REP. No. 93-533, at 1, reprinted in 1974 U.S.C.C.A.N. at 4639 (stating that "the committee has been constrained to recognize the voluntary nature of . . . retirement plans").
374 See supra Part IIC. At least one former commissioner of the federal Securities and Exchange Commission has stated publicly that plan participants in section 404(c) plans are not well-served by full
404(c) Regulations compound the decision-making burden placed on financially illiterate participants by providing that the employer has no obligation to provide investment advice. All plan participants are presumed capable of making prudent investment decisions once they are given the required disclosure information. A blizzard of information, much of it incomprehensible to the plan participant, relieves the employer of its fiduciary duty to ensure that plan assets are prudently diversified.

This assumption of participant investment competence becomes even more transparent when the plan offers employer securities as an investment option. Investing retirement assets in the financial future of the employer is a high risk strategy that places the employee in a position of "double jeopardy," at risk of losing both his job and his retirement savings. Yet the 404(c) Regulations allow the plan to offer employer securities as an investment option. Significantly, the 404(c) Regulations do not impose any limitation on the percentage of the participant's plan assets that may be invested in employer securities, despite empirical evidence indicating that some plan participants choose to concentrate the investment of their retirement savings in employer securities.

In the Taxpayer Relief Act of 1997, Congress recognized and partially responded to the risks posed by concentrating the investment of retirement plan assets in employer securities. The Act amends ERISA so that employers are prohibited from investing more than 10% of participant 401(k) plan salary deferrals in employer securities. In contrast, the 404(c) Regulations allow

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375 See WHEN WORKERS CALL THE SHOTS, supra note 18, at 98-99 (statement of former Commissioner Richard Roberts).

376 Compare U.S. GEN. ACCOUNTING OFFICE, 401(K) PENSION PLANS: EXTENT OF PLANS' INVESTMENTS IN EMPLOYER SECURITIES AND REAL PROPERTY (1997) (reporting that based on 1993 Form 5500 data, only 2,449 of approximately 160,000 401(k) plans owned employer securities or real property), with Stabile, supra note 19, at 64 n.10, 67 n.22.

377 See Stabile, supra note 19, at 78-85; Daniel Kadlec, Spread Your Bets, TIME, Feb. 1, 1999, at 72; supra note 109 and accompanying text.

378 See sources cited supra note 200 and accompanying text.

379 See supra notes 110-11, 117, 121-22 and accompanying text.


381 See id. This amendment was prompted by the Color Tile incident. See supra note 118.
the plan participant to invest all of his retirement savings in employer securities \(^{382}\)—the retirement equivalent of "caveat retiree."

Interpretive Bulletin 96-1 continues the Department of Labor's "one size fits all" policy approach to the individual responsibility model. Safe harbors 1 and 2 encourage employers to provide basic educational information to participants. ERISA's summary plan description requirements already required the employer to provide much of this "safe harbor" information to plan participants. \(^{383}\) For information not already required, such as the generic investment information of safe harbor category 2, the Department of Labor's own 1975 regulation defining investment advice left little doubt that such general investment information was not fiduciary investment advice. \(^{384}\) Thus, safe harbors 1 and 2 appear merely to codify, as a symbolic effort, pre-existing Department of Labor policy.

The area of true legal ambiguity addressed by Interpretive Bulletin 96-1 concerns the asset allocation models and the interactive investment materials of safe harbors 3 and 4. The Department of Labor's justification for deeming these items "educational" is that if the requisite disclosure requirements are satisfied, all participants will be able to assess the relevance of the models and materials for their individual circumstances and apply them accordingly. Thus, the Department of Labor rationalizes, participants will not "rely" on the models and materials when making investment decisions. This rationale presumes that every participant has the knowledge and ability to evaluate the facts and assumptions that underlie the models and materials. This rationale is inconsistent with the empirical evidence. It is simply wrong to think that participants are not relying on the investment allocations and specific mutual funds suggested by these models and materials. Participants must rely on these materials; they are not investment experts. They lack the requisite independent expertise to evaluate the key assumptions imbedded in the models and materials, such as "retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and investment rates of return." \(^{385}\) This incongruity between policy and reality is highlighted by the

\(^{382}\) See sources cited supra note 199-200. Professor Stabile has proposed that the 10% limitation on investment in employer securities should be applied without regard to whether it is the employer or the participant who makes the investment decision. Stabile, supra note 19, at 88.


\(^{384}\) See supra Part II.A.

absence of a requirement that the basic information of safe harbors 1 and 2 be provided to participants if the participants are receiving the asset allocation models of safe harbor 3 or the interactive investment materials of safe harbor 4. Ironically, providing this basic information might enable more participants to perform the sophisticated independent evaluation presumed by the Department of Labor.

B. Interpretive Bulletin 96-1: Encouragement or Burden to the Employer?

The Department of Labor issued Interpretive Bulletin 96-1 to encourage investment education for plan participants.386 When Interpretive Bulletin 96-1 is evaluated in the context of the employer’s fiduciary responsibilities and the 404(c) Regulations, it becomes apparent that the burden imposed on the employer is a heavy one. The result is that participants are likely to receive less assistance in making investment decisions.

Interpretive Bulletin 96-1 imposes on the employer a duty prudently to select and monitor the activities of any education provider or investment advisor.387 This monitoring duty becomes increasingly difficult for the employer as the education provider advances up the Interpretive Bulletin’s safe harbor levels. At the safe harbor level 1 (plan information) the employer easily can ascertain that the educational materials are accurate in their description of the employer’s own plan and its basic features, benefits, and investment options. Safe harbor level 2, educational information on general financial and investment concepts, is more difficult for the typical employer to monitor for accuracy. At safe harbor levels 3 and 4, asset allocation models and interactive investment materials, the employer is called to monitor whether the models and materials are based on “generally accepted investment theories” and disclose all underlying “material facts and assumptions.” Ascertaining that these conditions have been satisfied is beyond the expertise of many, if not most, employers.388

387 See 29 C.F.R. § 2509.96-1(e). This duty is part of the employer’s fiduciary duty of care. See sources cited supra note 176.
388 See ADVISORY COUNCIL, supra note 176, at 4.

Many of the problems with respect to service providers arise because the responsible plan fiduciary either does not understand his role and responsibility in the selection and monitoring of service providers or exercises poor judgment because he does not have experience or an appropriate source of information concerning legal requirements and industry practices.
If the educational provider has failed to satisfy the criteria for safe harbor protection under Interpretive Bulletin 96-1, the employer faces significant potential liability under ERISA. Two scenarios are possible. The education provider may, under the Department of Labor's 1975 regulation defining "investment advice," remain a non-fiduciary. Alternatively, under this regulation the "education" provider may, in fact, be a fiduciary investment advisor. This determination of non-fiduciary or fiduciary status will turn on a facts and circumstances analysis. The adverse consequences for the employer under each possibility are analyzed below.

First, assume that the education provider has not acted as a fiduciary, but has provided inaccurate or misleading information to the participants. The employer becomes potentially liable for a breach of its duty to monitor the education provider. It is at this point that Interpretive Bulletin 96-1 intersects with the 404(c) Regulations and the employer enters a legal quagmire. Does an education provider's failure to comply with the conditions for safe harbor status under Interpretive Bulletin 96-1 eliminate the employer's protection from fiduciary liability for participant-directed investment transaction losses under ERISA section 404(c)? The answer to this issue is uncertain. The rationale underlying the employer's section 404(c) exemption from fiduciary liability for participant-directed investment losses is that the directing participant has exercised informed independent control. What if the participant's investment decision has been "tainted" by misleading educational information? Interpretive Bulletin 96-1 states that:

In the context of an ERISA Section 404(c) plan, neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants ... would, in itself, give rise to fiduciary liability for loss ... that is the direct and necessary result of a participant's ... exercise of independent control.

In a footnote to Interpretive Bulletin 96-1, however, the Department of Labor has indicated that providing information to plan participants "may affect a participant's ... ability to exercise independent control over the assets in his

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*Id.; see also sources cited supra note 151 (maintaining that modern portfolio theory is notoriously difficult to comprehend, even among experts in the field).*

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*See supra Part II.A.*

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*See supra note 159 and accompanying text.*

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*See sources cited supra note 176 and accompanying text.*

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*29 C.F.R. § 2509.96-1(e) (emphasis added).*
or her account for purposes of relief from fiduciary liability under ERISA Section 404(c)” but stated that such circumstances were “beyond the scope of this interpretive bulletin” and that “no inferences should be drawn regarding such issues.”

Translated into plain English, Department of Labor policy on this issue is to evaluate the employer’s liability for investment losses on a case by case basis. In times of a progressively rising stock market, the inherent uncertainty of a case by case analysis is no more than a point of theoretical debate for academics. Since the final 404(c) Regulations were issued in 1992, the stock market generally has experienced a steady upward climb. Consequently, participant-directed investments have tended to perform well, leaving little financial incentive for participants in section 404(c) plans to challenge an employer’s degree of compliance with the 404(c) Regulations in the courts.

In times of stock market volatility or even decline, however, the prospect of significant participant investment losses in participant-directed plans becomes a very real concern for employers. A volatile or declining stock market heightens the potential financial consequences of an employer’s breach of its duty to monitor the investment education materials provided to plan participants. When these economic circumstances occur, suits against employers for participant-directed investment losses are more likely to arise. Ironically, the truly culpable party—the education provider responsible for providing the misleading investment information—will not be liable under either ERISA or state law for its negligent conduct.

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393 Id. at n.2.
395 One noteworthy exception is the ongoing litigation by participants in the Unysis Corporation plan who had the misfortune of selecting Executive Life Insurance Company (“Executive Life”) guaranteed investment contracts as their investment option. When Executive Life was declared insolvent, these plan participants filed suit against the employer, Unysis, for breach of its fiduciary duties under section 404(a)(1) and sought to recover their investment losses. Unysis’s defense was that it was exempt from such liability pursuant to section 404(c). The Department of Labor’s final 404(c) Regulations were not at issue in the case because the employer’s disclosures and Executive Life’s insolvency predated the Regulations’ adoption. Nevertheless, the court’s ultimate disposition of the case may have significant implications for enforcement of the 404(c) Regulations. See generally In re Unysis Sav. Plan Litig., 74 F.3d 420 (3d Cir. 1996).
396 The participants’ claim would be that the employer breached its fiduciary duties of care and prudent diversification. See supra Part II.B. The federal courts have exclusive jurisdiction over breach of fiduciary duty claims. See 29 U.S.C. § 1132(e)(1) (1994).
397 This result occurs because the education provider is not a fiduciary. See supra notes 153-57 and
Now assume the other possibility—that the employer's "education" provider actually has rendered fiduciary investment advice. Interpretive Bulletin 96-1 provides that the employer is subject to co-fiduciary liability for the acts of its fiduciary investment advisor.\textsuperscript{398} The Interpretive Bulletin appears to contemplate a situation where the employer has consciously engaged the services of a fiduciary investment advisor.\textsuperscript{399} Under my scenario, the employer (mistakenly) thought it was hiring an "education" provider to give participants asset allocation models and interactive investment materials. In this situation the employer has \textit{unknowingly} hired a co-fiduciary and assumed co-fiduciary responsibilities and potential liability.\textsuperscript{400} How can the employer ascertain whether its service provider is a non-fiduciary (providing investment education) or a fiduciary (providing investment advice)? The employer is supposed to be guided and thus reassured by the safe harbor criteria of Interpretive Bulletin 96-1. Ascertaining whether the service provider's asset allocation models or interactive investment materials satisfy these criteria is beyond the expertise of most employers. They, like the plan participants, simply will rely on the representations of the service provider that the safe harbor criteria for non-fiduciary status have been satisfied.

Such reliance is at the employer's peril. Mere representations are not determinative of the service provider's fiduciary status with respect to the plan or of its co-fiduciary status with respect to the employer.\textsuperscript{401}

There is a straightforward way for the employer to avoid this potential legal quagmire. The employer can strictly limit the information provided to plan participants to the minimum disclosure requirements of the 404(c) Regulations—exactly the opposite result of what Interpretive Bulletin 96-1 was intended to accomplish.

\textsuperscript{398} 29 C.F.R. § 2509.96-1(e) (1999).
\textsuperscript{399} \textit{Id.}
\textsuperscript{400} See supra Parts II.A, B.
\textsuperscript{401} See sources cited supra notes 153, 174, 181. In a co-fiduciary situation, it is unclear whether an employer's reliance on service provider representations is a valid defense to a claim of co-fiduciary liability. It is clear that the fiduciary may rely upon information, data, statistics or analysis furnished by persons performing non-fiduciary ministerial functions for the plan, assuming the fiduciary has exercised prudence in the selection of such persons. \textit{See} 29 C.F.R. § 2509.75-8, FR-11 (1999).
C. Erosion of ERISA's Statutory Protections for Plan Participants

Is current Department of Labor policy consistent with and supportive of ERISA's statutory protections for plan participants? I argue in this subpart that, to the contrary, the Department of Labor's approach erodes ERISA's statutory disclosure requirements and its fiduciary-based structure protecting plan participants.

Under the individual responsibility model, the contribution and investment decisions of the plan participant determine the "security" of his retirement benefit. Although the Department of Labor issued Interpretive Bulletin 96-1 to encourage more investment education for plan participants, the 404(c) Regulations undermine the Bulletin's beneficial impact. The only decision-making assistance to plan participants required under the 404(c) Regulations is financial information that many plan participants cannot understand or use.402 The financial disclosures required under the 404(c) Regulations are inconsistent with one of ERISA's fundamental mechanisms for protecting plan participants—the participant disclosure requirements.403 One of the important, but often overlooked, functions of the disclosure requirements is to promote "economic efficiency by providing participants ... with the information they need to accommodate their personal financial affairs to the employer's program, as for example, determining their need for additional savings."404 Another important function of the participant disclosure requirements is to promote employer compliance with ERISA's fiduciary duty requirements and prohibited transaction rules by "arming" plan participants with information sufficient to allow them to detect fiduciary misconduct and bring appropriate civil enforcement actions under ERISA.405 In enacting ERISA, Congress recognized that for the disclosure requirements to serve these functions effectively, the information must "be written in a manner calculated to be understood by the average plan participant."406

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402 See supra notes 205-06 and accompanying text.

403 See 29 U.S.C. § 1001(b) (1994) ("It is hereby declared to be the policy of this chapter to protect ... the interests of participants in employee benefits plans ... by requiring the disclosure and reporting to participants ... of financial and other information with respect thereto ... "); id. § 1022 (summary plan description requirements); id. § 1023 (annual report requirements); id. § 1024 (requirements for filing and furnishing information to plan participants).


Both of these functions remain vital under today's individual responsibility model. Adequate information is critical to participant decisions concerning 401(k) plan contributions and investments. Adequate information also enables plan participants to monitor and thus deter abuse of plan assets, such as excessive fees deducted from the accounts of 401(k) plan participants. The disclosure system of the 404(c) Regulations is inconsistent with these functions because the average plan participant is unlikely to be able to understand or use the information he receives.

The 404(c) Regulations also are inconsistent with ERISA's participant disclosure requirements and the fiduciary duty protections for plan participants. In theory, a participant may choose to have the employer invest the assets held in his account by refusing to make an affirmative investment direction. However, the 404(c) Regulations do not require the employer to reveal and explain this "option" to the participant. Thus, the employer is free to omit this key piece of information when providing the participant with materials concerning the plan's investment options. The plan participant is left with the impression that he must choose investments for his plan account, and unknowingly "waives" the employer's fiduciary responsibilities by making an affirmative investment direction. This result is inconsistent both with the essential concept of informed independent participant control justifying the employer's section 404(c) fiduciary liability exemption and with ERISA's premise that the employer's fiduciary responsibilities under section 404(a) cannot be waived by the plan participants.

Interpretive Bulletin 96-1 further erodes ERISA's fiduciary-based statutory protections for plan participants. An "education" provider is free to steer plan participants into higher fee-paying mutual funds using "educational" materials. The education provider's conduct escapes regulation under ERISA because Interpretive Bulletin 96-1 labels the provider a "nonfiduciary." In lieu of

408 See supra notes 217-18 and accompanying text.
409 See supra note 219 and accompanying text.
410 See supra note 220 and accompanying text.
411 See supra note 220. Under the 404(c) Regulations, once the participant makes an initial investment direction, the employer's section 404(c) fiduciary liability exemption is triggered, and the employer thereafter is no longer responsible for investing those assets. See supra note 217 and accompanying text.
412 See supra Part II.C.
413 See sources cited supra note 174.
ERISA's statutory protections regulating fiduciary conduct, Interpretive Bulletin 96-1 substitutes a disclaimer.\textsuperscript{414} Envision this disclaimer, in capital letters and bold print:

\begin{center}
OTHER INVESTMENT ALTERNATIVES HAVING SIMILAR RISK AND RETURN CHARACTERISTICS MAY BE AVAILABLE UNDER THE PLAN. INFORMATION ON THESE INVESTMENT ALTERNATIVES MAY BE OBTAINED FROM ________________.
\end{center}

Who fills in the “blank” under these circumstances, and more importantly, their status under ERISA, is not addressed by Interpretive Bulletin 96-1. Interpretive Bulletin 96-1 justifies the non-fiduciary status of the education provider based on the fiction that the participant is not relying on the information, but rather is performing an independent assessment. If the participant attempts to perform an independent assessment, what information is he likely to receive concerning these “other investment alternatives”? The likely response will be securities prospectuses in accordance with the 404(c) Regulations. What happens if, having been provided with this information concerning other investment alternatives, the inquiring participant requests assistance in evaluating these “outside” alternatives? Interpretive Bulletin 96-1 does not address this scenario, but the education provider likely will be reluctant to go beyond providing securities prospectuses for fear of rendering fiduciary investment advice. Thus, the plan participant likely will be left with the choice of either ignoring the specific plan investment option identified by the educational materials, selecting it, or evaluating the additional securities prospectuses concerning other investment alternatives and reaching an independent conclusion. Most plan participants likely will rely on the educational materials and select the identified mutual fund.\textsuperscript{415}

\begin{footnotesize}
\begin{itemize}
\item[414] See supra note 322 and accompanying text.
\item[415] An alternative solution to this problem would be to prohibit asset allocation models and interactive investment materials from identifying specific mutual funds available under the plan. This alternative suffers from the twin flaws of being both unhelpful to participants and easily circumvented by the education provider. Educational materials that limit their conclusions to generic asset categories would frustrate the plan participant who, having worked through the educational materials, arrives at a conclusion that his perfect investment allocation is “60% bond funds/40% equity funds.” What the participant really wants to know, of course, is what specific funds available under his plan satisfy this generic asset allocation? Alternatively, the specific mutual funds available under the plan could be labeled so as to make a “generic” asset allocation model in reality a “specific” recommendation of particular investment options. If the conclusion reached by the participant by using the educational materials is that his account should be invested “60% bond funds/40% equity funds,” and the participant’s 404(c) plan offers the minimum 404(c) required number of three
\end{itemize}
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Interpretive Bulletin 96-1’s characterization of the education provider as a non-fiduciary is inconsistent with the perceptions of plan participants, who are likely to rely on the materials as investment advice. From the perspective of the participant there is no distinction between a fiduciary investment advisor operating under a program similar to the Trust Company of the West program and a non-fiduciary educational provider operating at the outer margins of Interpretive Bulletin safe harbor categories 3 and 4. This characterization of the educational provider as a non-fiduciary is inconsistent with the Supreme Court’s analysis of fiduciary status in Varity Corp. v. Howe. In Varity Corp. the court indicated that the perceptions of the average plan participant should be taken into consideration when making a legal determination of fiduciary status under ERISA.

The Department of Labor could have drawn the “education” versus “investment advice” line between safe harbors 1 and 2 and safe harbors 3 and 4. Why did it choose not to do so? Under current policy, such an approach would discourage providing more investment education for plan participants. Making asset allocation models and interactive investment materials fiduciary investment advice would trigger more frequent application of the fiduciary prohibited transaction rules. Rather than directly addressing the real legal obstacle—the fiduciary prohibited transaction rules—the Department of Labor gerrymandered around the issues by declaring the service provider’s conduct as “nonfiduciary.” The consequence of this short-sighted approach is a significant erosion of ERISA’s statutory protections for plan participants.

V. CONFORMING FEDERAL RETIREMENT POLICY TO THE REALITY OF TODAY’S INDIVIDUAL RESPONSIBILITY MODEL

Today’s individual responsibility model presents an administrative challenge to the Department of Labor. ERISA’s statutory scheme, enacted

investment options, the Money Market Fund, the Bond Fund, and the Equity Fund, it becomes obvious that the materials’ “generic” conclusions are actually recommendations of specific plan investment options.

416 See supra notes 387-68 and accompanying text.


418 Varity Corp., 516 U.S. at 498-505. In Varity Corp., the employer formed two subsidiaries. One subsidiary was insolvent from the day of its creation, and this insolvency was known to company officers. See id. at 492-93. Company officers held a series of meetings to induce employees of the newly formed subsidiary voluntarily to switch their health plan coverage to the plan sponsored by the new subsidiary. At these meetings company officers made false statements concerning the future viability of the new subsidiary. See id at 493-94. The Supreme Court held that the company officers were fiduciaries when making these statements, relying in part on the perceptions of the employees in the context of the meetings. See id. at 503.
twenty-five years ago, had as its foundation the employer-controlled defined benefit plan. As participant-directed 401(k) plans have become more prominent, the Department of Labor has responded in an ad hoc fashion, piling new regulations and interpretation upon this old foundation. A coordinated and integrated regulatory response, designed specifically for today's participant-directed 401(k) plan, is needed.

In an ideal world, Congress would modernize ERISA through statutory amendments. As shown in Part II, such amendments would need to sweep broadly, reforming the very core of the statute—the definition of a fiduciary, the duties of a fiduciary, and the transactions prohibited to a fiduciary. To date Congress has proven unwilling (or simply politically unable) to enact broad ERISA reforms.\textsuperscript{419} I propose that statutory reforms, although certainly desirable, are not necessary. The Department of Labor can remove the legal obstacles to retirement education and investment advice by modernizing its own administrative policies interpreting ERISA's statutory provisions.

This Part sets forth a series of coordinated proposals designed to revise Department of Labor administrative policies in a comprehensive fashion. The cumulative effect of these proposals is to promote the rendering of professional, fiduciary retirement planning and investment advice to plan participants while mitigating the burdens placed on sponsoring employers. Each of the proposals set forth below is capable of being implemented at the administrative level without amendment to ERISA's statutory scheme.

A. Proposal: Revise the 404(c) Regulations

Four significant changes are proposed for the 404(c) Regulations. First, the 404(c) Regulations should require participant education at safe harbor levels 1 and 2 for all participant-directed plans. Under Interpretive Bulletin 96-1, safe harbors levels 1 and 2 allow the employer or service provider to provide information concerning the plan and general financial and investment

\textsuperscript{419} Political consensus on ERISA statutory reform appears possible only for narrowly tailored, uncontroversial amendments that leave undisturbed the underlying core of the statute. See Colleen E. Medill, HIPAA and its Related Legislation: A New Role for ERISA in the Regulation of Private Health Care Plans? 65 TENN. L. REV. 485, 507-08 (1998). Congress's legislative actions in 1997 concerning retirement plans illustrate the point. The SAVER Act, discussed supra Part I.A., is purely a symbolic amendment. The amendment to ERISA made by the Taxpayer Relief Act of 1997, discussed supra notes 380-81 and accompanying text, targets a specific issue—employer-directed investment of 401(k) plan monies in employer stock—that is a relatively rare phenomenon. See supra note 51 (83% of 401(k) plans allow participants to direct their investments).
information. Requiring that all participants in 404(c) plans receive this educational information is more consistent with the disparity in knowledge and financial sophistication among plan participants. It also is more consistent with Section 404(c)'s underlying concept of independent participant control. This requirements ensures that all participants will have access to and may draw upon a uniform knowledge base to make informed investment decisions.

The proposal would impose few additional administrative burdens on employers. ERISA already requires employers to provide much of the plan information covered under safe harbor 1. The Department of Labor can minimize the administrative impact of the requirement by developing a list of required information similar to the list of information required in summary plan descriptions. As in summary plan descriptions, the educational information should be presented in a manner that is comprehensible to the average plan participant.

Second, the 404(c) Regulations should limit to 10% the amount of elective salary deferral contributions that can be invested by plan participants in employer stock or real property. A significant percentage of plan participants overly concentrate their retirement savings in employer stock. Such concentration of retirement assets in any one investment poses substantial risks to the participant's retirement income security.

Congress has already recognized the risk that concentrated investments in employer stock pose to retirement savings. In the Taxpayer Relief Act of 1997, Congress amended ERISA to limit employer-directed investments of 401(k) plan monies in employer stock to 10% of the value of the participant's 401(k) plan account. As Professor Stabile has noted, however, this change is simply not enough. Under Proposal A, the 10% limitation would be extended to participant-directed investments of 401(k) plan assets. Unlike this recently enacted limitation on employer-directed investments, my proposal does not require a statutory amendment. It can be implemented as part of the 404(c) Regulations.

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420 See supra note 383 and accompanying text.
423 See supra notes 380-81.
424 See Stabile, supra note 19, at 88.
Third, the 404(c) Regulations should require employers either to inform participants expressly of their ability to “opt out” of Section 404(c) by refusing to make an investment direction; or, in the alternative, to provide fiduciary investment advice to plan participants. Under this proposal, the 404(c) Regulations would require the employer to do one of two things. The employer may disclose to the participant that he has the right to refuse to make an investment direction, thereby continuing the employer’s fiduciary duty to invest prudently and to diversify the assets held in the participant’s 401(k) plan account. Alternatively, the employer may offer fiduciary investment advice to the plan participant.

Requiring the employer to disclose this already existing legal right to the plan participant is more consistent with the spirit of full participant disclosure that underlies ERISA. Requiring employers to disclose this “opt out” option to plan participants will impose a burden on the employer if a significant number of participants choose to let the employer invest their retirement savings. Employers who sponsor another retirement plan where the employer, or its designated agent, already maintain responsibility for the investment of plan assets are less likely to find this disclosure requirement burdensome. They are already making plan asset investment decisions. Employers who are unprepared or unwilling to assume fiduciary responsibility for making investment decisions may still take advantage of the second option, providing fiduciary investment advice to plan participants.

The second option provides employers with a strong incentive to provide professional investment advice to plan participants. Under current Department of Labor policy, ERISA’s fiduciary prohibited transaction rules present significant legal obstacles to such investment advice. As a result, invest-

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425 See supra Part IV.C. This disclosure option will become even more important to the extent that employers adopt “automatic enrollment” 401(k) plans. See supra note 218.

426 See sources cited supra note 24.

427 This proposal raises a question—can the employer combine all of the undirected 401(k) plan monies and invest them as a pool using one investment strategy for all? Or must the employer take into account each participant’s circumstances and invest the participant’s account using an investment strategy tailored to the individual participant? This issue exists under current law, but the Department of Labor has not addressed it. My response would be to minimize the burden on the employer by allowing it to invest undirected 401(k) plan monies as a unit rather than on a participant-by-participant basis.

428 See supra Part II.D.
ment advice for plan participants is difficult for employers to obtain. Proposal B below proposes that the Department of Labor address the obstacles of the prohibited transaction rules directly by developing exemptions designed for today's individual responsibility models. These administrative exemptions will make investment advice for plan participants less costly and more readily available.

Fourth, the 404(c) Regulations should be revised to address explicitly the circumstances under which an employer who offers fiduciary investment advice to plan participants will qualify for the section 404(c) fiduciary liability exemption for participant-directed investment losses. The 404(c) Regulations are ambiguous on this point. This ambiguity must be clarified so that employers are not deterred from making investment advice available to plan participants. From the perspective of the sponsoring employer, using a third party to provide professional investment advice to participants raises another concern—potential co-fiduciary liability. Proposal D below mitigates the employer's co-fiduciary responsibilities and potential liability concerning the actions of the investment advisor.

B. Proposal: Develop Class Prohibited Transaction Exemptions to Encourage Investment Advice

Service providers under today's individual responsibility model are unlikely to be deterred from rendering fiduciary investment advice due to concerns over fiduciary liability under ERISA. Typical plan service providers such as banks, securities brokers, insurance companies and mutual fund companies routinely render investment advice concerning non-ERISA assets held in IRAs and private express trusts. In these non-ERISA contexts, providing such investment advice creates a fiduciary relationship under the common law. From a liability standpoint the risks are much higher for

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429 See supra Part II.E.
430 See infra Part V.B.
431 For example, the 404(c) Regulations could designate a safe harbor for the employer preserving its section 404(c) protection against investment losses based on the employer's duty of care in selecting and retaining the investment advisor. See sources cited supra note 176.
432 See infra Part V.D.
434 See BOGERT & BOGERT, supra note 177, § 701, at 201-08; see also SCOTT & FRATCHER, supra note 177, § 16A, at 215.
investment advice regarding the investment of non-ERISA assets because, unlike assets subject to ERISA, the breach of a common law fiduciary duty exposes the fiduciary to potential *punitive* damages. Nevertheless, this greater liability exposure does not deter the rendering of investment advice in the non-ERISA context. Rather, the real obstacle preventing service providers from rendering fiduciary investment advice to plan participants is ERISA's fiduciary prohibited transaction rules.

The administrative exemptions to the prohibited transaction rules available to fiduciary investment advisors today are designed for employer-controlled defined benefit plans, not participant-directed 401(k) plans. Proposal B suggests two revisions to Department of Labor policy. First, the Department of Labor should create a series of new class exemptions patterned after the terms and conditions of the individual exemptions granted to Shearson Lehman and Trust Company of the West. Second, the Department of Labor should modernize existing class exemptions to reflect the participant-directed plan and its use of the no-load mutual fund as an investment option. Each of these revisions is discussed below.

These suggested revisions are consistent with ERISA's statutory criteria for the issuance of administrative exemptions to the prohibited transaction rules governing fiduciary conduct. The Department of Labor should interpret and construe the statutory criteria that the exemption must be "in the interests of the plan and of its participants" and must be "protective of the rights of participants" broadly and take into account the empirical research indicating the need for investment advice. Plan participants and plan assets will be protected from potential abuse by ERISA's section 404(a) fiduciary duties of loyalty and prudence. These fiduciary responsibilities of the investment

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436 See *Rigney*, supra note 433, at 63.

437 See supra Parts II.D., E.

438 See supra notes 259-61 and accompanying text.

439 See supra note 239 and accompanying text.


442 See discussion of the "steering problem" supra Part III.B.3.

443 The federal courts have construed the section 404(a)(1) duty of loyalty as permitting a fiduciary to receive an "incidental benefit." See *Trenton v. Scott Paper Co.*, 832 F.2d 806, 809 (3d Cir. 1987); *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982). I view allowing the investment advisor to receive reasonable mutual fund fees from the plan's investment options as consistent with the incidental benefit doctrine and
advisor, which are not waived when the Department of Labor grants an exemption from ERISA's fiduciary prohibited transaction rules, provide adequate safeguards for plan participants.

The first proposed action, the creation of class exemptions patterned after the Shearson Lehman and Trust Company of the West individual exemptions, eliminates the legal obstacle of ERISA's fiduciary prohibited transaction rules. The fixed limitation on participant fees of the Shearson Lehman exemption and the "neutral" design of the Trust Company of the West computerized investment advice program protect participants against intentional "steering" into higher-fee-generating investment options. The plan participants are protected against excessive fee-taking by the fiduciary investment advisor at the mutual fund level through another set of federal laws—the federal securities laws governing mutual fund companies.

The second proposed policy change is the modernization of the terms and conditions of existing class exemptions. The two most significant class prohibited transaction exemptions applicable to mutual fund investments were issued in 1977 and 1984, prior to the emergence of participant-directed plans and no-load mutual funds. These exemptions should be explicitly updated to allow the participants, rather than the employer, to receive disclosure of and approve the investment advisor's business ties to the plan's mutual fund investment options. The disclosure standard for participants should again parallel ERISA's disclosure standards for summary plan descriptions. The disclosures should be written in a manner that is comprehensible to a plan participant without special expertise in investment or financial matters, and should take into account the average level of participant

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444 See sources cited supra note 240.
446 See supra note 226.
447 See supra note 259 (discussing Prohibited Transaction Exemption 77-4).
448 See supra note 259 (discussing Prohibited Transaction Exemption 84-24).
449 Prohibited Transaction Exemptions 77-4 and 84-24 both contemplate that the employer will act as the "independent fiduciary" who must receive disclosure of and approve the fiduciary investment advisor's financial arrangements with the plan's mutual fund investment options. See supra notes 259-60 and accompanying text. It is unclear under current Department of Labor policy whether a plan can be designed so that the plan participants themselves will qualify as the approving independent fiduciaries necessary to satisfy the terms of these class exemptions. See supra note 262 and accompanying text.
450 See supra note 406 and accompanying text.
knowledge of financial investment matters as reflected by the empirical research.

In addition, the terms and conditions of the Department of Labor's 1977 class exemption, prohibiting the investment advisor from receiving any "sales commission" from the participant's mutual fund investment, should be revisited in light of the growing popularity of the no-load mutual fund as a plan investment option. The various fee arrangements that exist today between no-load mutual funds and plan service providers were not possible under the federal securities laws in 1977, and thus were not contemplated by or covered under the terms of the original exemption. In updating this 1977 exemption, the Department of Labor should give strong deference to the comprehensive regulation of these no-load mutual fund fees by another federal agency, the Securities and Exchange Commission.

C. Proposal: Revise Interpretive Bulletin 96-1 So That Real Investment Advisors (Safe Harbor Levels 3 and 4) Are Real ERISA Fiduciaries

Interpretive Bulletin 96-1 is flawed. It erodes ERISA's statutory protections for plan participants by making service providers who provide asset allocation models and materials non-fiduciaries. At the same time, it imposes undue burdens on employers. These burdens lie in the employer's duty to monitor the "educational" materials supplied to plan participants for compliance with the Bulletin's requirements.

Proposal C reforms Interpretive Bulletin 96-1 so that it is more consistent with ERISA's two core legislative objectives. The stated objective of Interpretive Bulletin 96-1—to encourage employers and service providers to offer investment education to plan participants—is unaffected by Proposal C. Such investment education is provided at safe harbor levels 1 and 2.

The flaw in Interpretive Bulletin 96-1 lies in its characterization of service provider conduct at safe harbor levels 3 and 4—asset allocation models and interactive investment materials. The presentation of these models and materials to plan participants varies along a continuum. At one end, the

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451 See sources cited supra notes 263-65 and accompanying text.
452 See Prohibited Transaction Exemption 77-4, 42 Fed. Reg. 18,732-34 (1977); see also MEYERS & RICHTMAN, supra note 259, at 92-100.
453 See supra note 226.
454 See supra Part IV.C.
455 See supra Part IV.B.
models and materials are likely to be little more than a small step beyond the educational materials of safe harbors 1 and 2. At the other end of the continuum, however, the models and materials (and particularly the service provider’s presentation of them) become indistinguishable from the fiduciary rendering of investment advice. Drawing a line somewhere in the middle of this continuum is impracticable. Interpretive Bulletin 96-1 takes the approach that is least protective of plan participants, characterizing the entire range of service provider conduct as non-fiduciary, thereby leaving plan participants at the far end of the spectrum, unprotected in the event of service provider misconduct.

Proposal C advocates the opposite approach to this difficult characterization issue. If service provider conduct at safe harbor levels 3 and 4 is characterized as fiduciary conduct, the plan participants are better protected because service provider conduct at all points along the continuum remains subject to ERISA’s fiduciary-based protections for plan participants. Although this approach may be criticized as overly inclusive of fiduciary conduct toward the educational end of the continuum, such an approach is more consistent with ERISA’s core legislative purpose of protecting plan participants.

Proposal B, described above, removes the legal obstacles and financial disincentives to fiduciary investment advice under ERISA’s prohibited transaction rules. The other legal deterrent to fiduciary investment advice for plan participants—the employer’s potential co-fiduciary liability—is addressed in Proposal D.

D. Proposal: Provide Guidance to Employers Concerning the Duty to Monitor and Co-Fiduciary Liability for Investment Advisor Conduct

The employer’s fiduciary duty under ERISA section 404(a) to monitor the activities of a co-fiduciary investment advisor imposes a significant administrative burden. The parameters of this employer responsibility are un-

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456 See supra Part III.B.2.
457 See supra note 415.
458 See supra Part IV.C.
459 See supra Part III.B. The criteria for compliance with safe harbors 3 and 4 are potentially useful in that they can be viewed as forming the framework outlining the fiduciary responsibilities of an investment advisor to plan participants.
460 See supra Part IV.C.
461 See supra Part IV.B.
Clarification in the form of regulatory guidance is needed to address and resolve these monitoring issues, with an eye toward mitigating the burden placed on the employer.

The Department of Labor should allow employers to assert as a defense to a co-fiduciary liability claim good faith reliance on representations made by a co-fiduciary investment advisor. The employer’s duty to monitor the activities of a fiduciary investment advisor arises under section 404(a) as part of its duty of care, and also under section 405 in the form of co-fiduciary liability for the wrongful conduct of the investment advisor. The parameters of the employer’s duty to monitor and co-fiduciary liability have not been the subject of regulatory guidance. Under Proposals A and C, the role of service providers with respect to the individual responsibility model will change so that more service providers will be engaged in fiduciary conduct as investment advisors to plan participants. Consequently, the scope of the employer’s duty to monitor and co-fiduciary liability will become more significant, and the need for regulatory guidance to resolve ambiguities in the statute will become more critical.

Under Proposal D, the employer can rely in good faith upon the representations of the investment advisor that its advice is consistent with its duties as an ERISA fiduciary. This proposal mitigates the potentially onerous monitoring burden placed on employers by clarifying that, absent actual knowledge of wrongdoing, the employer is not required as part of its duty of monitoring to inquire beyond the representations of the investment advisor. Thus, the employer is not required to discern whether, for example, the investment advisor’s recommendations to individual plan participants are in accordance with modern portfolio theory. Providing such regulatory guidance provides assurance to employers and thereby encourages them to provide fiduciary investment advice to plan participants.

A countervailing policy consideration is that restricting the scope of the employer’s duty of monitoring restricts the protections available to plan participants. Under Proposal D, if the fiduciary investment advisor breaches its fiduciary duties in the course of advising plan participants, the employer is less likely to incur co-fiduciary liability, and thus the participants’ legal recourse under ERISA may be limited to bringing suit against the fiduciary investment advisor. Consequently, it becomes much more important for the

\(^{462}\) See supra Part IV.B.
investment advisor to be financially solvent and thus able to restore to the
participant any investment losses or ill-gotten profits resulting from the
advisor’s breach of fiduciary duty. Proposal E below addresses this concern.

E. Proposal: Establish Financial Solvency Requirements for Fiduciary
Investment Advisors

Proposals A, B, and C above all serve to encourage service providers to
assume the role of fiduciary investment advisors to plan participants under the
individual responsibility model. At the same time, Proposal D limits the scope
of the employer’s co-fiduciary monitoring duties and potential liability with
respect to fiduciary investment advisors. Consequently, to ensure adequate
protection to plan participants, the Department of Labor should impose
financial solvency requirements on fiduciary investment advisors so that plan
participants will be able to recoup any investment losses or ill-gotten profits
resulting from an advisor’s breach of fiduciary duty.

Service providers generally fall into two categories; those who already
operate in highly regulated industries, such as banks, securities brokerage
firms, insurance companies, or mutual fund companies, and those that do not.
This distinction should be incorporated into Department of Labor policy.
Those service providers who operate in highly regulated industries where
another administrative body sets and monitors solvency requirements should
be made exempt from any additional regulatory solvency requirements under
Department of Labor policy. “Non-regulated” service providers should be
made subject to a bonding requirement based on the amount of plan assets
subject to the investment advice. In the context of a non-regulated fiduciary
investment advisor, a bonding requirement is desirable because it is easily
verifiable.

This solvency requirement should be implemented in two areas. First, it
should be incorporated into the terms and conditions of the class prohibited
transaction exemptions available to fiduciary investment advisors. Second, it
should be incorporated into regulatory guidance on the employer’s duty to

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464 This proposed bonding requirement would parallel the bonding requirement for plan fiduciaries under
section 412 of ERISA for fraudulent or dishonest acts. 29 U.S.C. § 1363(a) (1994). The bonding requirement
under Proposal E would expand the protections of the section 412 bonding requirement by expanding its scope
to cover negligent conduct and by increasing the amount of the bond, without a maximum limitation, based on
the value of the plan assets subject to the fiduciary’s investment advice. Id.
monitor the co-fiduciary investment advisor.\textsuperscript{465} Under this regulatory guidance, the employer would be responsible, as part of its duty of monitoring, for independently verifying that a non-regulated fiduciary investment advisor had satisfied the bonding requirement. Alternatively, the employer would not be responsible as part of its duty of monitoring for independently verifying the financial stability of a fiduciary investment advisor in the regulated industry category.

F. Response to Potential Criticisms of the Proposals

Under the proposals set forth above, the employer must either obtain professional investment advice for plan participants or invest the 401(k) assets of participants who choose not to do so themselves. A potential criticism of these proposals is that the additional costs to the employer could ultimately reduce retirement plan coverage, particularly among the cost-sensitive smaller employers who tend to favor participant-directed 401(k) plans.\textsuperscript{466} Several factors mitigate against the likelihood that the proposals will increase plan administrative costs to the point that retirement plan coverage is significantly reduced as a result.\textsuperscript{467} First, the competition among financial services entities for retirement plan dollars is fierce.\textsuperscript{468} This competition, if encouraged by the Department of Labor, is likely to act as a natural constraint on increased administrative costs.\textsuperscript{469} Second, under the individual responsibility model the

\textsuperscript{465} See sources cited \textit{supra} note 176 and accompanying text.

\textsuperscript{466} See supra notes 33-34 and accompanying text.

\textsuperscript{467} In an ideal policy world, policy makers would know the exact correlation between increasing plan costs and the willingness of employers to continue to sponsor retirement plans. Despite the abundance of research among social scientists in this area, no one has yet been able to put forth a comprehensive theory explaining how plan costs, along with other factors, influence the employer’s voluntary decision to sponsor a retirement plan. Thus policy makers in this area must operate to a certain extent in an informational vacuum.


\textsuperscript{469} The Department of Labor’s 1998 study of 401(k) plan fees concluded that the wide variance in fees being charged by 401(k) plan service providers indicates that the market for 401(k) plan services is inefficient due to a lack of easily accessible and comparable fee disclosure information for employers. See \textit{PENSION & WELFARE BENEFITS ADMIN.}, \textit{supra} note 31, § IV. The study indicates that enhanced disclosure of fees and improved access to information concerning the fees charged by various 401(k) plan service providers would reduce the administrative costs of 401(k) plan sponsorship to employers, particularly smaller employers, by allowing them to more easily comparison shop for plan services. See \textit{id.} Part 2.7.4 & § V. The Department of
employer can pass through most, if not all, of the increased administrative costs to the plan participants in the form of administrative fees deducted from participant accounts. Thus, any resulting increased plan costs are likely to be borne by the parties—the plan participants—who are benefitting from the enhanced services.

Third, many plan service providers already have investment advice programs in place and routinely offer these services to non-ERISA clients, such as individuals who are directing the investment of their individual retirement accounts, or trustees who are responsible for investing the assets of private express trusts. These programs and services are easily transferrable to the ERISA context, where the service provider will be subject to less, not more, potential fiduciary liability.

Finally, the requirements of these reform proposals can be phased in over time, beginning first with large employers, and gradually becoming applicable to smaller employers. By phasing these requirements in over time, the likelihood is increased that once the new the requirements apply to the cost-sensitive smaller employers, the competition among plan service providers for 401(k) plan dollars will have reduced any additional administrative cost increases to a minimum.

Labor is considering what, if any, additional measures it will take to improve fee disclosures. See DOL Issues Fee Guide, supra note 339; Labor Department Seeks to Gauge Fees' Role In Section 401(K) Choices, 25 Pen.

& Ben. Rep. (BNA) 2599 (Nov. 9, 1998). The Department of Labor could further encourage price competition by developing uniform standards for disclosure of service provider fees. It also could maintain as a public service a database, available online, containing information on fees voluntarily supplied by service providers.

Deductions from participant accounts can significantly reduce the amount of money available upon retirement. See Stephen J. Butler, Beware of “Packaged” Retirement Plans, WALL ST. J., Sept. 18, 1995, at A18. This danger is mitigated by the employer's fiduciary duty to monitor and avoid the deduction of "excessive" fees from participant accounts. See sources cited supra note 176.

See PENSION & WELFARE BENEFITS ADMIN., supra note 31, Parts 2.6-2.7; Rigney, supra note 433, at 63; Williams, supra note 365.

See supra notes 433-36 and accompanying text.
CONCLUSION

The ultimate goal of ERISA is to promote and protect retirement income security for plan participants. Under today's individual responsibility model of retirement plans, this purpose can best be achieved by providing plan participants with professional assistance, by accountable fiduciaries, in making retirement planning and investment decisions. The Department of Labor's current interpretation of ERISA, originally developed in the context of the employer-controlled defined benefit plan, is ill-suited to today's participant-directed 401(k) plan. This Article invites the Department of Labor to interpret ERISA in a more flexible manner and modernize administrative policy to conform to the reality of participant decision-making under the individual responsibility model.