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"I Thought Our Plan Was In Compliance!" – Part I

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Tax-qualified retirement plans are subject to a myriad of complex federal tax and labor law requirements. Compliance with applicable law and regulations can be an overwhelming responsibility for the in-house counsel of a small or mid-sized company, especially one lacking an HR Department. "I thought our plan was in compliance" will not suffice in the context of an Internal Revenue Service or Department of Labor audit, nor will it placate senior management should penalties be imposed against the company. Also noteworthy is that many operational compliance failures are eligible for "self-correction" without governmental notice, intervention or sanctions; however, once discovered as part of a regulatory audit, the self-correction opportunity is lost. It is imperative that in-house counsel be aware of the latest applicable law developments affecting the company's tax-qualified retirement plan or plans, as well as the steps needed for compliance. This article will describe a number of current compliance pitfalls to consider and address as needed.

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1. Timing Of Contributions Of 401(k) Plan Elective Deferrals

Applicable law imposes a time limitation on the contribution to a 401(k) plan of employee elective deferrals (i.e., salary reduction amounts to be contributed to the plan on a pre-tax basis rather than paid currently to the employee as taxable compensation). This requirement is the earlier of (i) the earliest date on which the contributions can reasonably be segregated from the employer's general assets, and (ii) the 15th business day of the month next following the month in which the amounts of the elective deferrals would otherwise have been payable to the deferring employee in cash as part of his or her wages.

Often missed by employers, the key element is the "earlier of" requirement. Historically, many companies failed to take this requirement into account, erroneously believing "15 business days" to be a safe harbor, and consequently waiting as many as 45 days to contribute the elective deferrals to the plan ("I thought we had until the 15th business day of April to contribute the elective deferrals from the March 1 payroll!"). In reaction to the many failures of this type discovered as part of its 401(k) plan audits (penalties apply to late contributions), the U.S. Department of Labor (the "DOL") revised the Series 5500 Annual Report Form to specifically address this concern. As the Form 5500 is often prepared by the company's auditors, as part of their annual plan audit, accounting firms have been requiring their clients to document compliance with this requirement. A small or mid-sized company that argues that it needs more than a few business days to contribute elective deferrals to its plan faces an uphill battle with both its auditors and the government. Recently, the DOL issued a proposed regulation that, if finalized, will carve out a limited exception for "small plans" (fewer than 100 participants at the beginning of the plan year), by establishing a safe harbor period of 7 business days for the contribution of elective deferrals to the plan.

2. ERISA Section 404(c) Compliance

Most defined contribution plans and virtually all 401(k) plans permit participants to self-direct the investments of their individual plan accounts among a menu of mutual fund options made available under the plan. However, unless the requirements of Section 404(c) of ERISA ("Section 404(c)") are met, the fiduciaries of the plan (if no specific delegation has taken place, this may well be the com-

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pany's board of directors) could have liability for participants' investment decisions which lead to losses in their plan accounts. Conversely, provided that the selection of the investment options is prudent, diversified and sufficiently broad (i.e., as to relative diversification, risk and rate of return characteristics), and that the plan fiduciaries continue to appropriately monitor the investment options (see item 4 of Part II, in the August issue), compliance with Section 404(c) will insulate the plan fiduciaries from losses incurred by participants' plan accounts in connection with self-directed investment decisions effected by the participants. Often, a company utilizing a prototype plan document, typically obtained from a consultant, fund company, insurance company or bank, will incorrectly believe that its plan is covered by Section 404(c) on the basis of language to that effect in the Summary Plan Description ("SPD") booklet for the plan, which was provided as part of the initial prototype plan documents package. Although such a provision in the SPD is helpful, more is required for compliance with Section 404(c) and its available protections.

The often-neglected fundamental Section 404(c) compliance requirement is the participant notice. To be compliant, a Section 404(c) notice must, among other requirements, (i) explain that the plan is intended to comply with Section 404(c) for the purpose of relieving the plan's fiduciaries of liability for losses resulting from a participant's investment directions under the plan, (ii) describe the plan's investment alternatives, including a general description of the investment objectives and relative risk and return characteristics of each, (iii) identify any designated investment managers, (iv) describe any applicable transaction fees and expenses that affect participants' accounts in connection with the investments, and (v) identify the name, address and telephone number of the persons responsible for providing information and documents to plan participants upon their request, as well as a description thereof, which includes the most recent mutual fund prospectus, information regarding passed-through voting, tender and similar rights, and descriptions of fund annual operating expenses. Consequently, not only is a compliant participant notice required, but an arrangement must also be established to receive and respond to participants' requests for covered information and documents.

In general, compliance with the requirements of Section 404(c) need not be difficult, especially where a consultant, broker or investment specialist earning a fee in connection with the plan's investments, as a commercial matter, will agree to prepare the notice and to respond to participants' requests for information and documents. (However, such service providers may not necessarily volunteer their services in this regard, often necessitating pressure from in-house counsel to obtain the additional services.) The worst-case scenario should be that the plan sponsor itself addresses the requirements with the assistance of the applicable service provider(s), rather than failing to comply and losing the available protection. Perhaps most critical, the Section 404(c) notice must be provided to new plan participants and, if and when there are changes affecting the investment options, a revised notice must be prepared and provided to all participants; the mere existence of a compliant notice in the company's forms file will not suffice.

3. New Default Investments Rules

In the past, when a participant in a defined contribution plan that provided for participant-directed investments failed to provide investment directions for his or her plan account (or a portion thereof), fearing responsibility for the risk of investment loss/loss of principal, plan fiduciaries would "default" the participant's account (or applicable portion) into a money market or other stable value fund. On the theory that such investments, while protective of principal, would not provide adequate returns, as part of the Pension Protection Act of 2006, Congress amended Section 404(c) (see item 2, above) to add a voluntary safe harbor for "qualified default investment alternatives" ("QDIAs"), which provide for "a mix of asset classes consistent with capital preservation or long-term capital appreciation or a blend of both," and, effective December 24, 2007, the DOL promulgated a final regulation providing the requirements for QDIAs. A QDIA must be (i) a registered investment company, (ii) managed by an "investment manager" as defined under ERISA (generally, an asset manager registered under the Investment Advisers Act of 1940), or (iii) managed by a plan sponsor acting in its capacity as the plan's "named fiduciary" under ERISA.

For the QDIA safe harbor to be available, the plan participant must have been afforded the opportunity to provide his or her investment directions with respect to the funds in question, but failed to do so. A participant notice is required to explain and describe the QDIA and participants' rights with respect thereto. Investment materials (e.g., prospectuses) for the QDIA must be provided to participants. In addition, participants defaulted into a QDIA must be afforded the opportunity to direct investments out of the QDIA as often as those participants who made an affirmative decision to invest in the QDIA (but no less frequently than once in any three-month period), and no transfer fees or restrictions can be imposed on a participant who opts out of the QDIA within 90 days of his or her initial investment therein.

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There are generally two types of QDIAs – long-term QDIAs and a short-term QDIA for new participants. There are three types of qualifying long-term QDIAs – (i) age-based funds (i.e., "lifecycle" funds) or asset allocation models (i.e., "target date" funds), (ii) "balanced funds," and (iii) individually managed accounts. Each long-term QDIA generally must include both fixed income and equity components (although certain lifestyle and target-based funds may not). The particular QDIAs selected for a plan are subject to the same ERISA fiduciary prudence and monitoring obligations (see item 4 of Part II, in the August issue) as the plan's other investment fund options.

Part II of this article will appear in the August issue of The Metropolitan Corporate Counsel. *In it the author will discuss monitoring plan investment options, the new survivor annuity requirement and the applicability of the qualified joint and survivor annuity requirements to 401(k) plans.*