The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 16, No. 8 © 2008 The Metropolitan Corporate Counsel, Inc. August 2008

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

Dana Scott Fried

Loeb & Loeb LLP

Part I of this article (in our July issue), in which the author discusses the timing of contributions of 401(k) plan elective deferrals, ERISA Section 404(c) compliance and the new default investments rules, can be found on our website at www.metrocorpcounsel.com.

4. Monitoring Of Plan Investment Options

The prudence of plan investments is a hallmark requirement of ERISA. In the context of a defined contribution plan, this amounts to providing an array of diversified investment options having good recent and longer-term performance, and which are managed by professionals with proven track records.

Often, the investment consultant or other service provider will assist the plan sponsor in the selection of the plan's investment options as part of the initial plan installation; however, the ERISA prudence requirement applies not only to the selection of the initial investment options, but to their ongoing performance as well. This is not to say that each investment option must provide a particular level of earnings or gains, but rather, that the options in the aggregate must offer a diversified range and that within each particular investment class (e.g., an S&P 500 index fund) the performance of the plan investment option must be reasonable in comparison to the performance of appropriate comparator indices (e.g., the return of an investment in the actual S&P 500) and those of competitors' similar funds.

__Dana Scott Fried__ is a Partner in the New York office of Loeb & Loeb LLP. He concentrates his practice in all aspects of ERISA, employee benefits and executive compensation, including qualified and nonqualified retirement plans and employment, change of control, retention, equity compensation and incentive agreements and arrangements.

Dana Scott Fried

Most defined contribution plan platforms permit investment in funds of a number of different fund families; consequently, plan fiduciaries, preferably with the assistance of a qualified investment professional, will have the choice of similar funds offered by different providers. The recent and longer-term past performance as well as the expense ratios of these competing funds should be carefully evaluated in determining which funds to use under the plan (e.g., if there are three available money market funds, two of which are currently providing an identical return and one which has in the past and continues currently to provide a greater return than the others, and where the expense ratios of the three funds are identical, the decision to utilize the better-performing fund would be obvious.) This comparison to peer funds and appropriate comparator indices must be undertaken by the plan fiduciaries on an ongoing basis. In regard to this ongoing monitoring obligation, it is the process of monitoring and taking appropriate action when and if necessary, and not the actual investment results, which must pass muster under ERISA.

The typical approach to address this monitoring requirement is to establish an appropriate in-house committee (investment know-how and education being significant plusses for membership, e.g., the CFO is typically a member) which would meet on a quarterly basis to review the performance of the plan's investments for the immediately preceding calendar quarter. With minimal arm-twisting, the fund family or consultant receiving fees in connection with the plan's investments can often be recruited to assist in the monitoring process. (Not only would its expertise be helpful in determining the appropriate comparators, but guidance therefrom can also be expected in regard to the typical expense ratios for different types of funds. It may also have valuable institutional or industry knowledge, such as that a particular fund's manager, whose track record has been excellent over the short and long-term, is to retire or otherwise be replaced, obviously an issue for consideration by the plan's fiduciaries with respect

Please email the author at dfried@loeb.com with questions about this article.

to the affected fund.)

An excellent approach is to arrange for the investment consultant/professional to prepare a brief written report, typically in chart form, to show the performance of each fund for the previous quarter, three-month, six-month, one-year, five-year and even sometimes 10-year period, against the appropriate comparators for the same periods. Disappointing results by a fund for the past quarter might earn it a place on an investment "watch list" established and maintained for the plan by the plan committee, for continued scrutiny of its performance, ultimately resulting in its replacement under the plan or removal from the watch list, based on its ongoing results. Poorly performing funds (as compared to the appropriate indices – a down market is a down market for all), over a period of more than two or three quarters, should be replaced with better-performing alternative funds charging similar or lesser expenses. The accumulation of these quarterly reports and the minutes of the related committee meetings serves to establish and document a record of active fiduciary service – the maintenance of these files will thereby provide additional protection to the plan's fiduciaries.

5. New Survivor Annuity Requirement

Tax-qualified retirement plans that are subject to the "qualified joint and survivor annuity" ("QJSA") requirements, generally limited to defined benefit and money purchase (i.e., providing for a fixed employer contribution) defined contribution plans, although from time-to-time also affecting certain 401(k) and other types of profit-sharing plans (see item 6 below), are generally required to provide a married participant with a retirement benefit payable in the form of a "qualified joint and survivor annuity" (i.e., a pension for the participant's life with a survivor pension for the life of the participant's spouse, the payment of which is triggered by the participant's death, and the amount of which survivor pension is not less than 50 percent and not greater than 100 percent of the amount of the pension payable during the joint lives of the participant and the spouse, and which is the actuarial equivalent of a single life annuity pension for the participant's life only) unless the participant elects to receive a different form of benefit (during a specified period and following the participant's receipt of a required explanation of the optional forms of available benefits under the plan) with the written consent of the participant's spouse. Effective for plan years beginning on or after January 1, 2008, a plan subject to the QJSA requirements must now also offer married participants a "qualified optional survivor annuity" ("QOSA") optional form of benefit, which is a joint and survivor annuity form of pension with a survivor annuity percentage for the spouse equal to 75 percent where the QJSA under the plan provides for a survivor percentage of less than 75 percent, or equal to 50 percent where the QJSA under the plan provides for a survivor percentage of 75 percent or greater. In either case, it is the actuarial equivalent of the single life annuity form of pension for the participant's life only, payable at the same time. A plan that provides an optional form of joint and survivor annuity pension with a survivor percentage which satisfies the QOSA requirement will be compliant without the need for change.

Consequently, under a plan subject to the new QOSA requirements, the election form and required written description of the plan's optional forms of benefit must be expanded to include the QOSA, and either the summary plan description for the plan must be revised to include the QOSA and be distributed to the plan participants, or a "summary of material modifications" (a specific type of notice that advises participants of a change to the summary plan description) must be prepared and distributed to the plan participants regarding the addition of the QOSA. A plan amendment will also be required; the deadline for amending a plan for the QOSA rules is the last day of the first plan year beginning on or after January 1, 2009.

6. Applicability Of Qualified Joint And Survivor Annuity Requirements To 401(k) Plan

The QJSA requirements (there is also a parallel requirement to provide a special pre-retirement death benefit called a "qualified preretirement survivor annuity") are applicable to all tax-qualified retirement plans other than defined contribution profit-sharing plans, including 401(k) plans, which require a married participant's spouse to be his or her beneficiary for the receipt of a death benefit under the plan (i.e., the participant's account balance under the plan at the time of the participant's death) unless the participant's spouse consents in writing to the participant's designation of another individual/trust (or individuals/ trusts) as the participant's beneficiary under the plan (the "QJSA Exception").

Sponsors of 401(k) plans that are aware of the QJSA Exception almost universally avail themselves of it to exempt their plans from the complexity of addressing the QJSA requirements (and now including the QOSA requirement as well [see item 5 above]), which require special election forms and procedures and written descriptions of the plan's optional forms of benefit. Further, where a defined contribution plan does provide for the QJSA/QOSA forms of benefit, to pay the benefit in such form, the purchase of an annuity contract from an insurance company will typically be required, leading to additional expense which generally reduces the value of the aggregate benefit payable. However, certain prototype versions of 401(k) plans, most typically provided by insurance companies, do not provide for the QJSA Exception, or require a special election to be made by the plan sponsor in completing the adoption agreement for the prototype plan document, which can be missed. Consequently, the sponsor of a 401(k) plan may unintentionally or unknowingly, and in either case, unnecessarily, be the sponsor of a 401(k) plan which is subject to the QJSA/ QOSA (and qualified preretirement survivor annuity) requirements. Where such is the case and the plan sponsor is simply unaware, the validity of distributions made to participants in a different form (i.e., the typical lump sum) as well as the plan's tax-qualified status, may be called into question.

If a company maintains a 401(k) plan which is subject to the QJSA/QOSA requirements, which requirements have not been taken into account in the plan's operation, self-correction may be possible. Further, in all events, the plan can be amended to eliminate those requirements by way of the QJSA Exception. The key is to determine whether or not the plan has been drafted properly to utilize the available QJSA Exception, where desired.

Conclusion

The rules applicable to tax-qualified retirement plans can be daunting for in-house counsel. However, the plethora of penalties and other sanctions for failures to comply, no matter how innocent, leads to the need for proactive review of plan documents, procedures and applicable law and regulations, with the assistance of outside counsel as needed.