



## The Principle of Participant Control over Assets in 404(c): Do Proxies Matter?

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### Overview

When it comes to general principles, we are as attracted to the “exceptions” as hummingbirds are attracted to the color red. Attend any tax planning seminar, for example, and casually state that in regards to paying a particular tax “there is this *one* exception...” A crowd will gather, and will generate buzz that is likely to extend well beyond the immediate circle.

Of course, beyond the buzz we usually find that the exception is not a true exception at all. The tax “loophole” is not intended to open the door for tax avoidance, but is designed to apply some general tax principle to a particular type of situation or problem.

Section 404(c) of ERISA has generated all the buzz and controversy of an exception to the general principle of named fiduciary responsibility. The traditional buzz about 404(c) is that it allows plan sponsors to limit some of their fiduciary responsibility. But it is important to recognize that the buzz is half of the story, and that 404(c) is no blanket exception that allows plan sponsors to duck fiduciary responsibility. Instead, 404(c) simply allows *fiduciary responsibility* to “move” in concert with *control over assets*. Participants in a 404(c) plan are making their own investment (allocation) decisions, and it follows that the responsibility for these decisions should rest with these participants. If 404(c) did *not* exist, plan sponsors might find themselves responsible as fiduciaries for investment decisions (i.e., selections and monitoring) over which they could exercise no control.

### The Principles of Fiduciary Responsibility and Control over Assets

Two principles form the core of 404(c). The first of these principles—fiduciary responsibility—is not unique to the section. The general principle of fiduciary responsibility is the foundation upon which ERISA is constructed. But in any consideration of 404(c), it is important to recognize that the section is surrounded by a comprehensive framework of duties and criteria for exercising fiduciary responsibility. In other words, the limitations of fiduciary responsibility that 404(c) grants are couched in terms of the broader responsibilities required of all pension plan fiduciaries.

The second principle at the core of 404(c) is the principle of *control of assets*:

*“Section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) provides that if a pension plan that provides for individual accounts permits a participant or beneficiary to exercise control over assets in his account and that **participant or beneficiary in fact exercises control over assets in his account**, then the participant or beneficiary shall not be deemed to be a fiduciary by reason of his exercise of control **and no person who is otherwise a fiduciary shall be liable for any loss, or by reason of any breach, which results from such exercise of control.**” (ERISA, §2550.404c-1(a); emphasis added)*

Within the general framework of fiduciary responsibility, 404(c) fiduciaries may limit their liability consistent with the degree of control over assets that is available and exercised by plan participants. This is not a sweeping limitation. Beyond the list of qualifications that must be met to qualify for 404(c), a fiduciary’s liability is limited only to the degree that participants exercise control over the assets in their account.



To summarize, 404(c) fiduciaries are responsible for the typical duties of building a well-diversified platform of investment choices, monitoring the risk and return performance of these selections, and providing plan participants with timely and accurate information. Within this context, the 404(c) fiduciary shifts control to the plan participant. Investment allocation decisions should be made at the participant level, and the plan fiduciary should carefully document that participants are provided the information necessary to effectively exercise control. But fiduciaries must also consider the degree of control, and any limitations on participant control. The limitation of liability afforded by 404(c) is directly linked to the degree of control available to, and exercised by, plan participants.

## Control and Proxy Voting

The voting of proxies is directly linked to control of assets, since these votes are a feature of ownership of financial assets. The role of proxies in determining the degree of “control” can vary in form, but in general proxies must be considered as an element of ownership.

The criteria for 404(c) qualification first splits along two lines: a) plans that hold employer stock; and b) plans that do not hold employer stock. For those plans that hold employer stock, one test of participant control is the “pass through” of proxy votes to the participant. Participants in these plans must vote the proxies on the employer’s stock, and must do so without “improper influence by a plan fiduciary or plan sponsor.” Thus, procedures for timely and clean “pass through” voting of the employer stock are vital to maintaining 404(c) status. Some recent court cases have highlighted the importance of the particular duties associated with employer stock (for example, *Global Crossing, LTD. ERISA Litigation*, US District Court, Southern District of New York, 02 Civ.7453).

For investments other than employer stock, pension plans may choose to follow either a pass-through proxy approach, or to vote the proxies at the plan level. In many cases, the administrative burden of pass through voting will outweigh the benefits of greater participant control. In some cases, simply determining the individual who should vote the proxy at a point in time is a complex record keeping task.

404(c) does not require plans to use the pass-through voting approach in order to satisfy the broad principle of participant control over assets. Plan sponsors are required to provide participants with instructions on how to give investment instructions, and to explain any limitations (including instructions regarding the “...exercise of voting, tendering, and similar rights to a participant’s or beneficiary’s investment...” (b)(2)(A)(iv). Due to the administrative hassles of pass through voting, proxies are typically voted at the plan level. But 404(c) plan sponsors should be aware of two issues associated with voting proxies at the plan level:

1. Voting proxies at the plan level is a step removed from the control afforded by pass-through voting. Although the practice may be defended in light of administrative and cost arguments, it is not a “pure” form of voting control. In its purest sense, the principle of control would require plan sponsors to create a pass-through system for participants to receive all proxy materials and vote all proxies.
2. 404(c) status does not diminish general fiduciary responsibility for the plan, including such decisions as the voting of proxies.

Ultimately, the test of control in 404(c) is case by case, transaction by transaction:

*“Whether a participant or beneficiary has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case.” (3)(c)(ii).*

## Reviewing 404(c) Policies

1. Regular 404(c) Compliance Review: Plans that declare 404(c) status should regularly evaluate their policies and procedures. Plan sponsors should recognize that the 404(c) limitation on liability is not a “once for all” condition, nor is it a blanket that covers all



transactions. Each investment procedure should be gauged for its compliance with 404(c) provisions.

2. Proxy Policy and Procedures: We find that proxy policy and procedures are commonly overlooked in 404(c) reviews. This oversight may result from a tendency to see the proxy as an “extra,” merely procedural item. In fact, proxy voting cannot be separated in any meaningful way from the ownership of a financial asset. Plan sponsors should ensure that third parties who handle proxy materials recognize this ownership perspective, and that procedures for timely delivery and voting are strictly followed.
3. View Plan-Level Voting as a Fiduciary Responsibility: Unless pass-through voting is used, plan sponsors should view their proxy policies and procedures as a vital element of fiduciary responsibility. 404(c) status does not diminish this responsibility. In fact, 404(c) plan sponsors may need a more comprehensive proxy policy so that participants understand how to exercise control (input to voting), as well as any necessary limitations on individual participant control.

The 404(c) section of ERISA is a complex exception, and as such it has created its share of buzz and debate. Our purpose in this paper is to highlight two important aspects of 404(c). First, the central test for limitation of liability is participant control over assets (including the proxy vote). Thus, the handling of proxies must be considered in the design of all policies related to “control of assets.” Second, although pass-through voting is a more pure form of control, many 404(c) plans will find such a system unworkable or too costly. Given the advantages of voting these proxies at the plan-level, plan sponsors should recognize that they again “pick up” full fiduciary responsibility. Policy and procedures for handling these proxies should be developed and monitored carefully by 404(c) sponsors.

