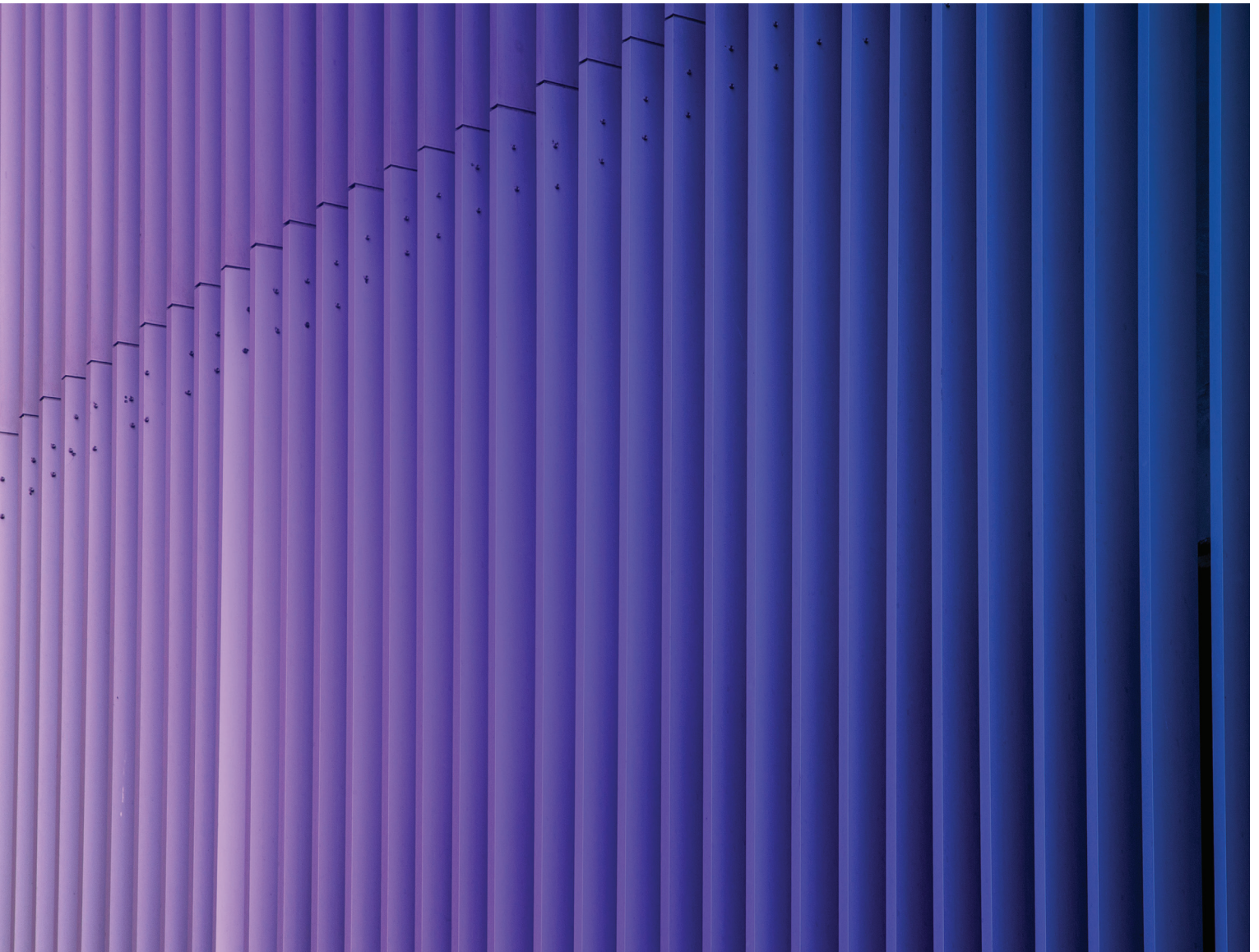




Company Stock in 401(k) Plans:

Best Practices to Consider When Managing Fiduciary Responsibilities

For many companies, including company stock in their 401(k) plans can be a compelling way to attract, retain and motivate employees while optimizing the plan sponsor's cash flow position. However, this practice often creates additional fiduciary responsibilities and legal risks for plan sponsors, resulting in fewer companies offering this benefit.

Plan sponsors that offer company stock in their 401(k) plans can take several steps to help manage risk and strengthen their overall retirement plans, including working with an independent fiduciary.



Despite decline, company stock is still prevalent among large plans

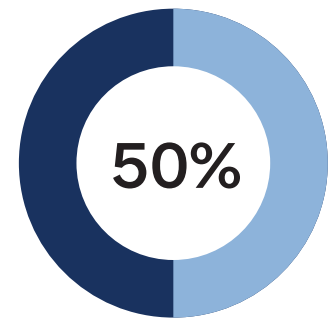
The percentage of companies that offer company stock in their 401(k) plans has decreased from 11% in 2005 to 8% in 2024.¹ Contributing significantly to that decline was the 2014 U.S. Supreme Court case that eliminated the “presumption of prudence” defense and held fiduciaries of company stock plans to the same duty of prudence standards as other Employee Retirement Income Security Act of 1974 (ERISA) fiduciaries. This led to greater legal scrutiny of fiduciary responsibilities at plan sponsors and, unsurprisingly, a decline in those offering company stock to participants.

Despite that, about 50% of large companies still offer company stock as part of their 401(k) programs,² which can benefit both participants and plan sponsors.

Percentage of companies that offer company stock in their 401(k):



Percentage of **large** companies that offer company stock in their 401(k):



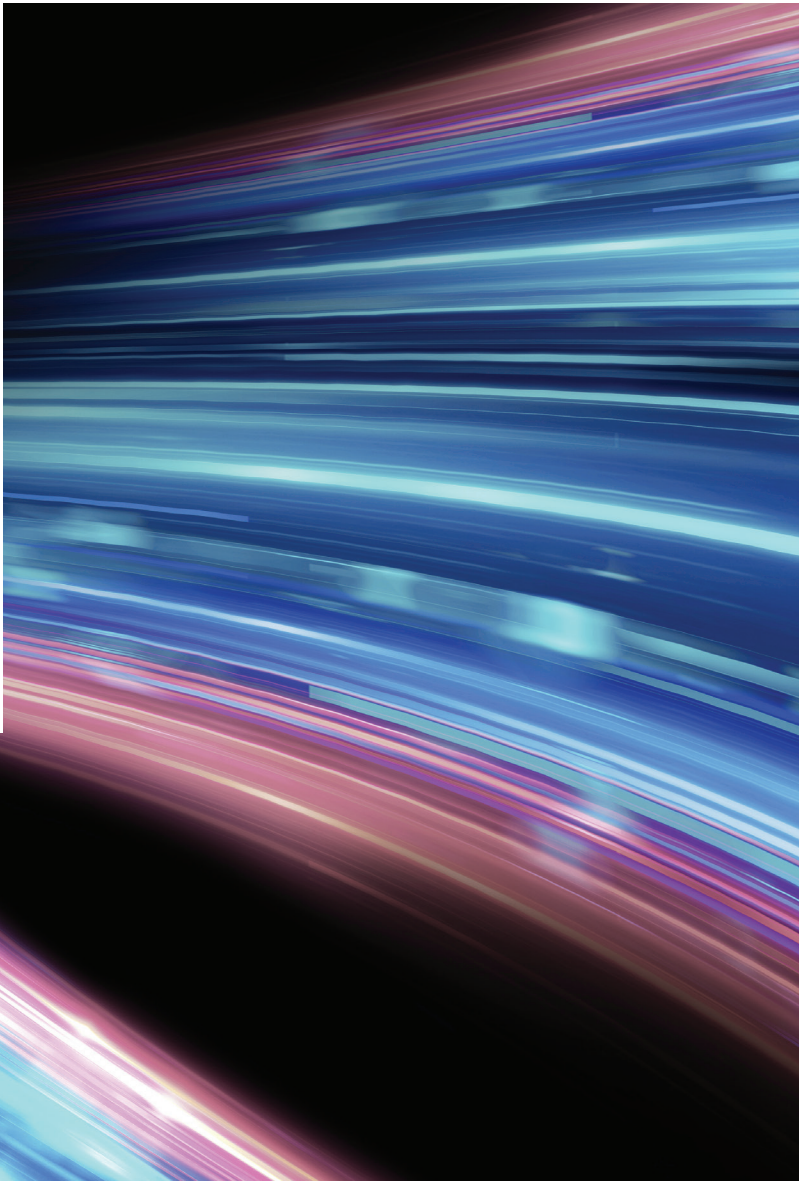
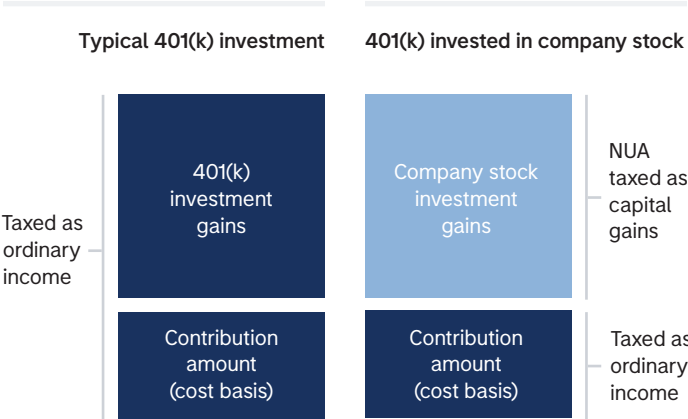


A tool for talent

Offering company stock through a 401(k) plan allows companies to expand access to equity-based compensation beyond senior executives and other high-level employees. Giving employees at all levels of the company a way to participate in its growth creates a sense of ownership, aligns incentives and can serve as effective motivation. As a result, company stock can be a tool for attracting and retaining talent.

Investing in company stock through a 401(k) plan can also provide tax benefits for participants, thanks to the net unrealized appreciation (NUA) rule. In addition to the benefits of any 401(k) contribution (i.e., contributions and investment growth aren't taxed until withdrawal), the growth of contributions made to company stock may be taxed as long-term capital gains (typically 15% or 20%) instead of ordinary income (as much as 37%) upon distribution.

Employer contributions made via company stock instead of cash may strengthen the company's cash flow and free up capital for other investments in the business. However, this practice creates additional fiduciary concerns, which is why only 12% of companies that include company stock as an investment option in their 401(k) plans use company stock to make employer-matching contributions.²





How plan sponsors can manage fiduciary risks

While the increased legal risk has caused some plan sponsors to stop offering company stock in their 401(k) plans, eliminating the program can have adverse tax consequences for participants. Doing so instantly eliminates the potential NUA benefits, which can dramatically decrease the amount of after-tax funds available to participants for retirement.

Best practices for managing risks associated with including company stock in their 401(k) plans



Encourage diversification



Provide balanced, targeted communications



Work with an independent fiduciary



Don't view the plan in a vacuum

Please consult with your legal and tax advisors.

Rather than eliminating the program, plan sponsors can take a few steps to continue offering company stock in their 401(k) plans and effectively manage their legal risk.

ENCOURAGE DIVERSIFICATION

One of the biggest risks to any investment portfolio is over-concentration. Thus, plan sponsors should include plan-design elements that encourage diversification and reduce the risk that participants may have an unduly large portion of their retirement savings allocated to their company's stock.

A potentially more effective way to do this is by limiting the percentage of participant deferrals that can go to company stock; sponsors typically place a cap at 20% or 25%. This can be a better option than limiting the amount of the participant's total assets that can be allocated to company stock and could result in forced rebalancing at inopportune times. Doing so could harm participants and potentially create additional legal exposure for plan sponsors.

WORK WITH AN INDEPENDENT FIDUCIARY

Hiring an investment consultant allows the plan sponsor to transfer fiduciary responsibility to a third party charged with complying with ERISA standards. Whether a non-discretionary 3(21) consultant, a 3(38) consultant with full investment discretion, or a fully outsourced chief investment officer (OCIO), a qualified consultant can provide ongoing analysis through a disciplined, documented process to determine whether the company's stock is a prudent investment option for 401(k) plan participants.

In addition, this relationship alleviates the potential for (or perception of) conflicts of interest among members of the investment committee and other corporate decision-makers, many of whom may be deemed "insiders" by regulators.

Some consultants may exclude company stock oversight from the scope of their engagement, so it is important to find a partner who is willing and qualified to assume this responsibility.

PROVIDE BALANCED, TARGETED COMMUNICATIONS

Plan sponsors should provide participants with accurate information about the availability of company stock as an investment option. Just as importantly, plan sponsors should avoid communications that could be perceived as encouraging participants to invest in company stock over other investment options.

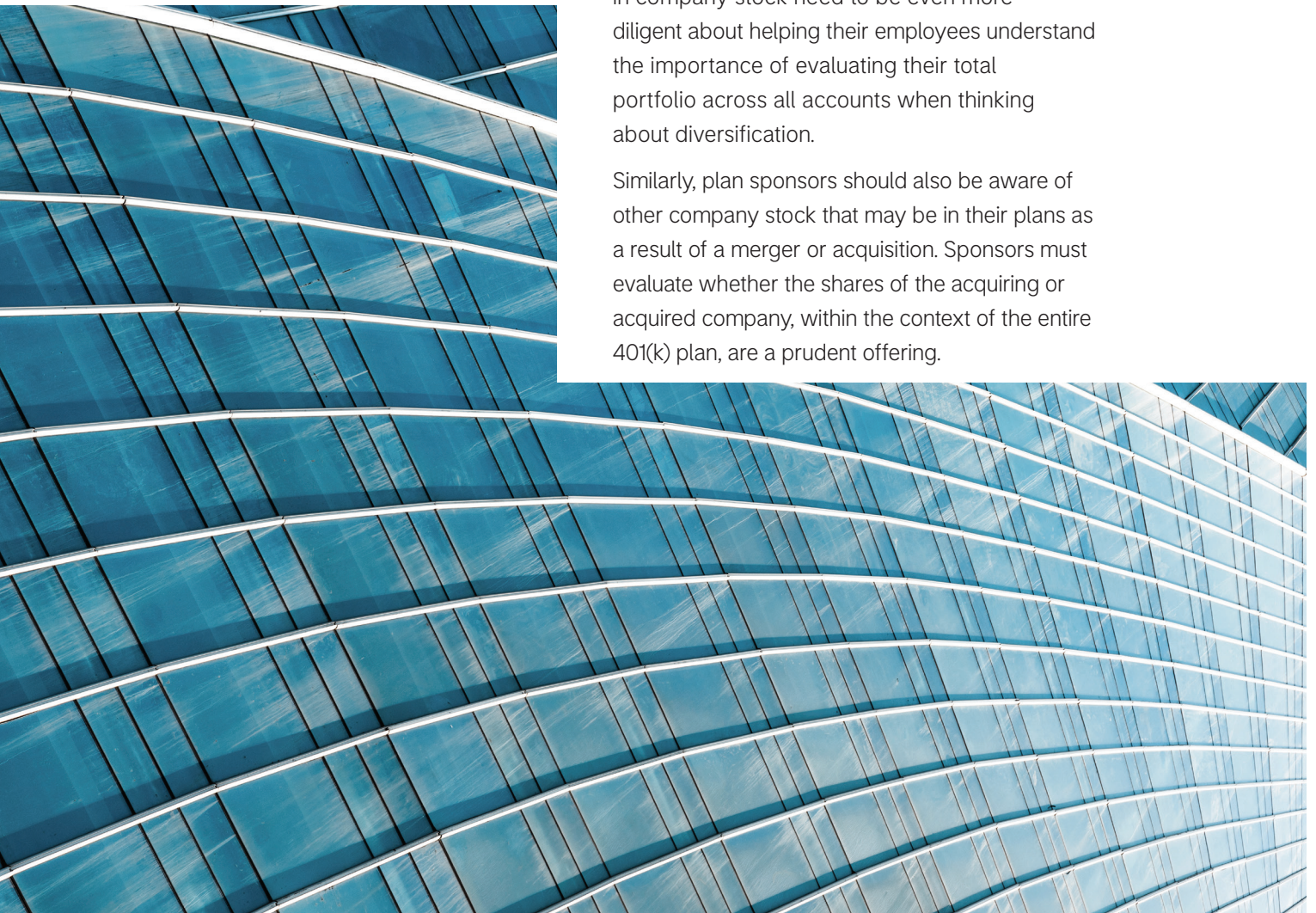
This is particularly true when it comes to communications regarding NUA. Any communication about NUA rules should advise participants to consider their long-term investment objectives rather than letting tax considerations disproportionately guide their investment decisions.

DON'T VIEW THE PLAN IN A VACUUM

In addition to providing access to company stock through 401(k) plans, many plan sponsors also give employees the opportunity to invest in company stock through an Employee Stock Purchase Plan (ESPP) or as part of a broader equity compensation plan. When deciding on company stock in their 401(k) plans, sponsors need to consider the total benefits plan and the potential implications for employees across the company. For example, if a company already offers employees tax-advantaged ways to invest in company stock through an ESPP, the incremental incentive-alignment benefits of adding company stock to the 401(k) plan may be minimal.

Concentration risk is another consideration. Companies that offer multiple ways to invest in company stock need to be even more diligent about helping their employees understand the importance of evaluating their total portfolio across all accounts when thinking about diversification.

Similarly, plan sponsors should also be aware of other company stock that may be in their plans as a result of a merger or acquisition. Sponsors must evaluate whether the shares of the acquiring or acquired company, within the context of the entire 401(k) plan, are a prudent offering.





The importance of working with a third-party fiduciary

The legal risks related to offering company stock in a 401(k) plan may be significant yet manageable. Working with an independent fiduciary that has experience overseeing these plans can be an effective way to help manage the risks while maintaining the benefits for participants and plan sponsors.

With more than 50 years of experience advising institutional clients, Morgan Stanley brings deep expertise across the entire employee benefits and equity compensation landscape for both public and private companies. The firm is uniquely equipped to guide a 401(k) plan through the complex, interrelated decisions involved in building an effective retirement plan that addresses the needs of the organization and its workforce.



For more information on best practices for managing company stock in your retirement plan, contact your Morgan Stanley representative.

Sources:

¹ Vanguard, "How America Saves," June 2025.

² Fidelity, "The Evolving Role of Company Stock within 401(k) Plans," October 2024; large companies defined as those with over 25,000 employees.

Disclosures:

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