Using ERISA's new default-investment rule to avoid liability for participants' failures to choose investments

by

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A new rule [1] provides an ERISA-governed retirement plan's fiduciary some relief from responsibility for deciding exactly how to invest a plan account of a participant, beneficiary, or alternate payee who hasn't directed investment. If a plan provides for investment under a *qualified default investment alternative* and meets several conditions, a plan fiduciary isn't liable for what results because of investing an individual's account in a QDIA. The rule's relief is available not only for a default investment made under an implied-election or "automatic-contribution" arrangement but also for other default investments.

This isn't a complete explanation of the 112-page rule; instead, this overview focuses on a few themes, and leaves the details for when a client gets advice [2] – which should be NOW.

Effective date
The new rule's protection against liability becomes available for QDIA investments made on [3] or after December 24, 2007. [4] To get that protection, you must rewrite an individual-account plan's default-investment notice NOW.

For an employer working with a calendar-year plan or enrollment, a realistic goal could be to improve procedures and notices to get protection for default investments after January 1, 2008. Because the required notice usually [5] must be delivered at least 30 days before the first QDIA investment (or the first day of a plan year), plan fiduciaries might want to implement improved procedures in **November 2007**.

Target-year funds
The rule allows the use of a fund customarily described as "life-cycle" or "targeted-retirement-date".

Balanced funds
A default fund may be one "with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual[.]" The rule refers to a "balanced fund" as an example of a fund that *could* meet the quoted description.

Even better, a managed account
The rule allows as a default investment an account managed by a registered investment adviser, bank, trust company, insurance company, or plan sponsor that confirms in writing that it is a plan fiduciary.

Even as a default investment, a managed account could give participants an asset allocation that's more finely tuned than the mix of a typical target-year fund, which groups participants into five-year bands. If a participant's retirement age is in 2032, why not solve the math exactly for 2032, instead of 2030 or 2035? What's more, a managed account manager's communications can help a participant "see" the relationships of how modern portfolio theory relates to investing for retirement. [6]

Whether a default is funds or using a manager, a default could ignore all of the participant's preferences and personal circumstances other than his or her age. For example, an asset allocation that's "optimized" under modern portfolio theory knowing only the participant's age and presuming that he or she intends to retire at Social Security normal retirement age could be a qualified default.

Investment mix

Even if a fund or account is based on "generally accepted investment theories", to qualify as a QDIA it also must "provide … a mix of equity and fixed[-]income exposures[.]" For example, even if applying a modern-portfolio-theory model would cause a manager of a 21-year-old's account to invest 100% in stocks, a QDIA must have some investment in bonds or other fixed-income investments.

Money-market fund allowed for up to 120 days

The rule allows a principal-preservation fund as a QDIA for a participant's first 120 days. After the 120-day period, a fiduciary can continue to get QDIA relief only if it redirects the individual's account to another qualified default investment.

This ERISA rule recognizes that a plan fiduciary might prefer a short-term default that could help reduce the likelihood of a possible loss during a participant's "beginner" participation. The rule recognizes the tax law for a plan's "automatic-contribution" arrangement, which allows a plan to permit an employee to choose an "undo" distribution no later than 90 days after the first elective deferral. But the opportunity to use a principal-preservation fund for up to 120 days isn't conditioned on whether a plan has such an "undo" or "automatic-contribution" provision.

Stable-value fund NOT allowed

Despite intense lobbying, the Labor department rejected requests that a "stable-value" fund or stated-interest contract be included among the qualified default options. However, the rule provides some transition relief on and after December 24, 2007 concerning amounts invested in a "benefit-sensitive" default investment before December 24, 2007 if all other conditions are met.

Even if all other conditions are met, this transition relief can be available only concerning "an investment product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment[-]grade bonds, while providing liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives", and only if "[t]here are no fees or surrender charges imposed in connection with withdrawals initiated by a participant or beneficiary[.]"

What you don't get excused from

Although a plan fiduciary is relieved from liability for a loss that is the "direct and necessary result" from investing in any *qualified default investment alternative* that met all conditions, a plan fiduciary must select (and regularly monitor) a default fund or manager using expert prudence, care, and diligence. For example, once a fiduciary decides that the *category* of target-year funds is a fitting default for a plan, within that category a fiduciary must select which target-year funds are prudent for the plan's and its non-directing individuals' needs. Further, the designating plan fiduciary must satisfy itself that there is no prohibited transaction that would result from using a fund or manager.

About the default-investment notice

The rule includes several detailed requirements for what information a default-investment notice must explain in plain language so that an "average participant" can understand it. The Labor department chose not to provide a model notice. So the deciding plan fiduciary will need to check carefully that its notice not only "covers all the bases" but also does a good job in using plain-language writing methods and explaining information to a class of participants who one must presume are inattentive.

Furnishing investment information

To get QDIA relief concerning a default-invested participant, beneficiary, or alternate payee, a fiduciary must deliver to the individual the QDIA notice and at least the information required by the ERISA § 404(c) regulations – even if the fiduciary doesn't follow other aspects of the ERISA § 404(c) regulations or doesn't follow the ERISA § 404(c) regulations concerning other individuals.

What to do now

This is only a quick overview. Please call me or another lawyer for advice about how the rule relates to your plan or your investment-advice business.

Fiduciary Guidance Counsel is available to render a written opinion that a particular plan's use of a specified investment option is a *qualified* default investment that gets an employer or other fiduciary the new rule's relief from liability.

If you're interested, ask me to send you free written information about my qualifications and experience.

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[1] *Default Investment Alternatives Under Participant Directed Individual Account Plans*, Federal Register, volume 72, number 205 (October 24, 2007) at pages 60452-60480; to be codified as 29 C.F.R. § 2550.404c-5 ("Fiduciary relief for investments in qualified default investment alternatives").

[2] This overview isn't a substitute for getting your own advice. It's incomplete, and doesn't consider circumstances that might be relevant to your situation. Each of the author and the person that furnished this overview to you doesn't warrant the accuracy or completeness of any information. This information describes the author's understanding of relevant law as of the date shown in the footer. Relevant law could change at any time. The author's permission for a business to furnish this overview isn't an endorsement of that business. The author doesn't endorse any investment or service other than the services of his law firm.

[3] Many retirement-services providers follow the New York Stock Exchange's trading days and times. On December 24, 2007, the NYSE's Trading Floor closes at 1:00 p.m. New York time. (For example, this is 10 a.m. in Pacific Time, which is used in California and Washington and in much of Idaho, Nevada, and Oregon.)

[4] The *Pension Protection Act of 2006* applies ERISA § 404(c)(5) "to plan years beginning after December 31, 2006." But ERISA § 404(c)(5) provides its relief only to amounts "invested by the plan in accordance with regulations prescribed by the Secretary." Concerning amounts invested before December 24, 2007 – or at least before October 24, 2007 – it might be difficult to argue that amounts were invested "in accordance with" a rule that didn't exist.

[5] To get QDIA relief for a default investment under an automatic-contribution arrangement, the 30-days rule is relaxed if the participant has the right to choose an "undo" distribution during the 90 days after the date of the first elective deferral. With that provision, the notice must be delivered no later than the participant's "date of plan eligibility".

[6] Pension consultant Steve Lansing and I have suggested that a plan fiduciary selecting a default option consider using a professionally-managed account, and explained why doing so can be better than using target-year funds. *See* Stephen J. Lansing with Peter Gulia, THE FINAL FRONTIER: INVESTMENT ADVICE AND PROFESSIONALLY MANAGED ACCOUNTS (April 30, 2007), available at http://benefitslink.com/articles/guests/20070430_final_frontier.pdf.