



## Don't Lose Sleep over Automatic Investments

### *Federal Law Offers Fiduciary Relief to Automatic 401(k) Plan Sponsors*

All investors face the risk of losing money. It's enough to keep some people up at night. The risk is especially troubling to 401(k) plan sponsors, some of whom may be concerned that participants might sue them if their investments lose money. Sponsors can rest easier by following regulatory guidelines to reduce their exposure. But, until passage of the Pension Protection Act of 2006 (PPA), this "fiduciary liability" relief did not apply to sponsors of automatic 401(k) plans.

Pension law offers a measure of fiduciary relief from potential liability for investment losses if participants "have control" over their own investments. This relief is limited; plan sponsors and other fiduciaries still have a duty to prudently select and monitor each investment option. But some plan sponsors have been concerned that their fiduciary liability exposure may be greater if they established default investments. It hasn't been clear whether participants exercise "control" over their investments in automatic 401(k) plans if they remain in the plan's default investment.

The PPA removes this ambiguity. As long as the sponsor follows certain conditions, participants will be deemed to have exercised control over certain default investments. Sponsors that automatically enroll employees will qualify for the same kind of fiduciary relief they get when participants exercise control over their investments by making affirmative choices.

Now, under certain conditions, plan sponsors have the green light to include diversified equities in default investment funds (though plan fiduciaries still have a legal duty to prudently select and monitor default investments). A trend moving away from conservative default investments started before the PPA. It has accelerated, now that sponsors have greater confidence to select default funds that contain diversified equities. This is important, since automatically enrolled plan participants tend to stay in the default investment.

Consider how remaining in a principal-preservation fund over the long term could affect a saver's outcomes.\* Assume a 30-year-old employee with no retirement savings is automatically enrolled in a low-risk investment that earns three percent a year on average. If he contributes \$2,000 a year (adjusted for inflation), he will have an estimated \$200,256 when he turns 65. But if the same 30-year-old contributes \$2,000 a year to a fund that earns an average of seven percent a year, his total savings by age 65 would be \$426,107.\*\*

*\*This estimate is based on historical average returns and is not a predictor of future returns.*

*\*\*This example is based on retirement income estimates using a calculator at [www.ipers.org](http://www.ipers.org).*



## The Specifics

Fiduciary relief is available to automatic 401(k) plan sponsors as long as they meet specific conditions defined by the Department of Labor (DOL) regulations. *(Note: This document does not attempt to describe all of the specific conditions; for a full listing, visit [www.dol.gov](http://www.dol.gov).)* Sponsors need to offer participants the chance to direct their own investments. If participants fail to do so, and are defaulted into a “Qualified Default Investment Alternative” (QDIA), sponsors can qualify for fiduciary relief similar to the relief that applies when participants affirmatively elect their investments.

### Qualified Default Investment Alternatives

QDIAs can be made up of funds or assets handled by an investment manager, a plan sponsor acting as a fiduciary or a plan trustee.<sup>11</sup> Generally, the funds cannot include the employer’s securities (with limited exceptions), and they need to be diversified to minimize the risk of large losses.

Under the DOL regulations (effective December 24, 2007), three main types of investments qualify as QDIAs—lifecycle funds, balanced funds and managed accounts.

A **lifecycle fund** or model portfolio, also known as a target retirement date fund, is an investment mix that seeks both long-term appreciation (through diversified equity investments, such as stocks) and principal preservation (through fixed-income investments, such as bonds or stable value funds). A participant’s age, expected retirement date or life expectancy determine the investment mix. The mix becomes more conservative as the participant gets closer to retirement, usually by shifting assets from stocks to fixed-income investments.

If participants are defaulted into a QDIA, plan sponsors can get fiduciary relief similar to the relief they get when participants affirmatively choose investments.

A **balanced fund** or model portfolio is a similar mix of diversified equity and fixed-income investments. A target level of risk for plan participants as a whole determines the investment mix. The mix doesn’t vary with the age or other individual circumstances or preferences of particular participants.

With a **managed account**, an investment manager provides an investment management service under which it allocates the assets of a participant’s individual account. The goal is to achieve a diversified mix of equity and fixed-income investments that seeks both long-term appreciation and principal preservation. The manager uses investment alternatives available in the plan and adjusts the mix based on an individual’s age, target retirement date or life expectancy. The mix becomes more conservative with increasing age.

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<sup>11</sup> ERISA section 3(38) defines “investment manager.”



The DOL regulations also treat capital preservation (such as certain stable value) funds as QDIAs for up to 120 days after the participant's first contribution or to the extent the plan invested in certain capital preservation funds before December 24, 2007 (a "grandfather" provision that is subject to certain conditions). The regulations also make clear that a lifecycle or balanced fund can still be a QDIA even if offered through a variable annuity or similar contract, through common or collective trust funds or pooled investment funds or with investment or death benefit guarantees.

Regulations accommodate diversified default investment alternatives that seek both long-term appreciation and capital preservation.

The DOL notes that not every default investment fund that satisfies the definition of QDIA will be deemed acceptable. But it also acknowledges that investment options other than those defined as QDIAs (such as ongoing investments in stable value funds) may be deemed to be acceptable. Regardless, fiduciaries still have a legal duty to prudently select and monitor QDIA funds, and could be liable for losses that result from a failure to do so.

### Additional Requirements

Beyond selecting qualified default investments, plans must give participants written notice before the default investment kicks in and annually thereafter. The notice needs to be written in a manner that can be understood by the average plan participant.

The regulations require that sponsors give participants investment materials the plan receives regarding QDIAs. Participants invested in QDIAs need to have the same opportunities to direct their investments (including how often) that the plan gives to other participants. During the first 90 days after an employee's first contribution, a transfer out of a QDIA or a withdrawal of all contributions by a participant opting out of the plan cannot be penalized through restrictions or expenses such as surrender charges or redemption fees. Also, the plan must offer a broad range of investment alternatives.

Under the regulations, plan sponsors have to notify participants before contributions go into the default investment, and again before the start of each plan year.

### Implications

A goal of the PPA is to increase retirement savings by encouraging more sponsors to add automatic features to their 401(k) plans. Before the law's enactment, automatic 401(k) sponsors were at a potential disadvantage with respect to fiduciary liability because they provided default investments. Now that relief is available, policymakers and benefits analysts expect an opening of

Plan sponsors still have fiduciary responsibility for prudently selecting and monitoring QDIAs and other investment options, including consideration of the associated fees and expenses.



the floodgates to automatic plan adoption. The result will be more employees than ever building their capacity to support a comfortable standard of living in retirement.

When choosing a QDIA or any other investment alternative, plan sponsors are still responsible for prudently selecting and monitoring the specific investment fund, portfolio or service, including careful consideration of the associated fees and expenses. But you don't need to lose sleep over putting participants into funds that are appropriate for long-term investing.

Like many plan sponsors, you may find little reason not to adopt automatic 401(k) plan features. Talk with your plan service provider about your options. If your provider does not offer automatic 401(k) plan support, you might want to look for one that does.

The PPA and the DOL regulations have encouraged more plan sponsors to include diversified equity investments in their default funds.<sup>12</sup> This may give participants a better shot at financial security in retirement, while giving plan sponsors protection from additional fiduciary liability. This should help us all rest easier.

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<sup>12</sup> See preamble to the QDIA regulations: <http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf>.