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U.S. DEPARTMENT OF LABOR
ERISA ADVISORY COUNCIL
QUALIFIED DEFAULT INVESTMENT ALTERNATIV
LOOKING BACK AND THINKING AHEAD

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Looking Back – Key Stakeholders

- Looking back **from a legal perspective** to the evolution of ERISA-covered DC plans, participant directed investments and QDIAs, we see a long history of key stakeholders working together to set policy and create new and innovative DC plan investments with the goal of providing better retirement outcomes and financial wellness for working Americans.
- These key stakeholders have included:
  - Congress
  - Regulators, including the DOL, the Department of Treasury/IRS, the SEC and federal and state banking and insurance regulators
  - Academia
  - Plan Sponsors and other Plan Fiduciaries
  - Other industry stakeholders, including trade associations, consulting firms, asset managers, insurers, recordkeepers and law firms.

When thinking ahead, it is critical to recognize that policy and innovations require key stakeholders to work together. Like the old example of the 3 legged stool, effective policy developments and product innovations require support from key stakeholders.

Looking Back – The 404(c) Statutory Safe Harbor

- ERISA Section 404(c) included a fiduciary safe harbor for participant-directed investments in individual account plans for when participants exercise control over the assets in their account.
- In 1987, DOL issued its proposed 404(c) regulations. The regulations were finalized in 1992.
- **Prior to the finalization of the DOL's 404(c) regulations** – in my experience:
  - ➢ DC plans largely were not subject to participant directed investments.
  - ➢ DC plan fiduciaries were tasked with prudently investing a single pool of assets for all participants and beneficiaries.
  - ➢ DC plans were often referred to as "supplemental" or "thrift" plans as corporate defined benefit plans had accumulated substantially more assets than DC plans and offered retirement income to participants

Looking Back - The Impact of the DOL's 404(c) Regulations

After the 404(c) regulations were finalized:

- Over time, participant-directed investments became the norm.
- Offering a "broad range" of investments became the norm.
  - ➢ The term "broad range" is taken directly from the DOL's 404(c) regulations.
- Daily valuation and daily investment election transfers newly became the norm.
  - ➢ The 404(c) regulations require at a minimum 3 investment options that permit participants to give instructions at least once within any 3 month period.
  - ➢ **But** the regulations included a general requirement that each investment vehicle would permit participants to give instructions "with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject."

These examples reflect the power of a fiduciary safe harbor, the impact of perceived risk or uncertainty on the implementation of the safe harbor working together with new technologies.

Looking Back – ERISA Safe Harbors for Changes in Investment Options and DIAs

404(c) of ERISA was amended to include fiduciary safe harbors for qualified changes in investment options (404(c)(4)) and for DIAs by the PPA in 2006.

- Both safe harbors address the example of where participants could be treated as not exercising control over their account but instead provide 404(c) fiduciary safe harbor protections for when a plan fiduciary changes the plan's investment line up or defaults participant investments to a DIA.
- For a change in investment options, 404(c)(4) requires that "the stated characteristics of the remaining or new investment options…., including characteristics relating to risk and rate of return, are, as of immediately after the change, **reasonably similar** to those of the existing investment options as of immediately before the change"
- For DIAs, 404(c)(5) directed DOL to "provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both"

Looking back – The Intent of the DOL's QDIA Regulations

DOL adopted its QDIA Regulations in 2007.

- **"The intent [was] to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker's long-term retirement savings needs."** (DOL Fact Sheet (April, 2008))
- Prior to this time, stable value was one of the more popular investment options in DC plans as was company stock.
  - The regulation provided limited "grandfather" relief for stable value by providing relief only for contributions invested in stable value products prior to the effective date of the final rule. The transition relief did not provide relief for future contributions to stable value products. (DOL Fact Sheet (April, 2008))
  - **"The proposed rule, by providing relief from fiduciary liability, is both intended and expected to tilt plan sponsors' default investment preferences away from [money market mutual funds, certain bank deposits, and stable value insurance products] and toward the three types [of QDIAs the rule] embraces."** (Preamble to the proposed regulation (October, 2007)
  - The regulation also strictly limited investments in employer securities as a part of a QDIA - **"the Department does not believe it is appropriate for a qualified default investment alternative to encourage investments in employer securities…".** (Preamble to the final regulation (October, 2007))

By 2005, DC plans and IRAs had more assets than government and private sector DB plans combined. (ICI, June, 2024)

Defining a QDIA under DOL's Regulations

- an investment fund product or model portfolio **such as a life-cycle or target date fund** that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (*i.e.*, decreasing risk of losses) with increasing age.

- an investment fund product or model portfolio **such as a balanced fund** that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this alternative, asset allocation decisions are not required to take into account the age of an individual participant, but rather focus on the demographics of the participant population as a whole and requires a fiduciary to take into account the demographics of the plan's participants, similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction.

- an investment management service **such as managed accounts** with respect to which an investment manager allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age.

Asset allocation decisions for eligible products and portfolios is not required to take into account risk tolerances, investments or other preferences of an individual participant.

The Impact of the DOL’s QDIA Regulations

As intended by DOL, QDIAs now represent significant accumulations of assets and are often the single investment for many participants in their DC plans. Frequently, QDIAs also often make up a substantial percentage of a DC plan’s assets.

- This reflects the power of defaults and auto-features, when coupled with a fiduciary safe harbor.
- Another reason is because when plan fiduciaries make changes in the plan’s investment line-up, the QDIA fiduciary safe harbor is often preferred over the “change in investment options” fiduciary safe harbor which requires that the stated characteristics of the new investment options be “reasonably similar” to those of the terminating investment options.

This also reflects the effectiveness of creating a fiduciary safe harbor with input from key stakeholders (Congress, DOL, Academia, the industry, etc.) and the impact of perceived risk and uncertainty on the use of a safe harbor.

As of Q1 2024, DC plans are reported to have substantially more assets than corporate DB plans (and nearly as much as corporate & government DB plans combined); DC plans & IRAs are reported to have 2x+ the assets of corporate & government DB plans. (ICI, June, 2024)

Looking Forward: What Should DOL Do?

DOL should, working together with key stakeholders, continue to issue regulatory or sub-regulatory guidance to support the creation of new and innovative DC plan investments with the goal of providing better retirement outcomes and financial wellness for working Americans, including to support plan fiduciaries adopting QDIAs to address retirement income and decumulation strategies and other new innovations and developments.

When the QDIA regulations were adopted:

- The only references to “retirement income” were in reference to the estimated impact of the rules on average annual pension income and on how in creating the estimates account balances at retirement were converted into lifetime annuities.
- There was little reference made to how QDIAs might someday be designed to themselves offer lifetime income and/or guaranteed income. For example:
  - ✓ A reference in the preamble to the final rules on how a QDIA could have an annuity feature and an acknowledgement of how participants could lose the right to elect an annuity by transferring out of the QDIA.
  - ✓ A discussion of how QDIAs could be offered through variable annuity contracts which might include annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts would not themselves affect the status of a variable annuity contract as a QDIA.
- Fixed income and equities were referenced throughout but the regulations did not address other asset classes or investment types other than as noted above (and for stable value and company stock) by way of limitation and exclusion.

Custom Target Date Funds as an Example

- In its proposed QDIA regulations, DOL proposed that except for QDIAs established as registered investment companies, QDIAs needed to be managed by a 3(38) investment manager.
- In response to industry comments, DOL made clear in the final 2007 regulations that a QDIA could be established by a named fiduciary, such as by an employer serving as named fiduciary and managing their investments and creating their QDIA in-house.
- DOL further explained and amplified this point in its Field Assistance Bulletin No. 2008-03 (Q1 and 17) and in its April 2008 technical corrections to the QDIA regulations by making it clear that a plan sponsor or a committee comprised primarily of plan sponsor employees could establish a QDIA.
- In February 2013, the DOL also issued its "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries," which included the heading: *Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan*.

This series of regulatory and sub-regulatory guidance reflects the value of continued guidance and action taken by DOL to both create policy and also support innovation for plan fiduciaries that seek to improve participant outcomes.

The Annuity Safe Harbor as Another Example

In 2008, the DOL issued a fiduciary safe harbor regulation (§ 2550.404a-4) for the selection of an annuity provider or contract for benefit distributions in a DC/individual account plan.

The regulation included the following requirements for the plan fiduciary:

(1) Engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

(2) Appropriately consider information sufficient to assess the ability of the annuity provider to make **all future payments** under the annuity contract;

(3) Appropriately consider the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;

(4) Appropriately conclude that, at the time of the selection, **the annuity provider is financially able to make all future payments** under the annuity contract and **the cost of the annuity contract is reasonable** in relation to the benefits and services to be provided under the contract; and

(5) If necessary, consult with an appropriate expert or experts for purposes of compliance with the safe harbor requirements.

Some argued that "the safe harbor has the effect of establishing a heightened standard of review for the selection and monitoring of annuities that is unduly stringent and has limited relevance to many annuity investment and distribution options." (Preamble to final rule.)

The Annuity Safe Harbor: Take 2

- In July 13, 2015, the DOL issued FAB 2015-02 and acknowledged a recurring comment on the fiduciary safe harbor "is that employers remain unclear about the scope of their fiduciary obligations with respect to annuity selection under [DC plans]. … Confusion or lack of clarity regarding the nature and scope of fiduciary responsibilities to act prudently in making, monitoring and reviewing annuity selections under a [DC plan] could lead plan sponsors or their advisors in some instances to overestimate or otherwise misunderstand the duration or extent of those fiduciary responsibilities. **This, in turn, could create or reinforce disincentives for plan sponsors to offer their employees an annuity as a lifetime income distribution."**

- The FAB was limited to providing examples for an immediate annuity providing fixed monthly payments for life and a deferred fixed annuity longevity annuity purchased at retirement but providing payments at an advanced age, such as 80 or 85 and provided that a fiduciary's selection and monitoring of an annuity provider is judged based on the information available at the time of the selection, and at each periodic review, and not in light of subsequent events. The periodic review requirement in the Safe Harbor Rule does not mean that a fiduciary must review the prudence of retaining an annuity provider each time a participant or beneficiary elects an annuity from the provider as a distribution option. **The frequency of periodic reviews to comply with the Safe Harbor Rule depends on the facts and circumstances. For example, if a "red flag" about the provider or contract comes to the fiduciary's attention between reviews (e.g., a major insurance rating service downgrades the financial health rating of the provider or several annuitants submit complaints about a pattern of untimely payments under the contract), the fiduciary would need to examine the information to determine whether an immediate review is necessary, or, depending on the facts and circumstances, the fiduciary may need to conduct an immediate review.**

- DOL also added an explanation of the applicable statute of limitations, focusing the guidance on **ERISA litigation**. "Thus, for example, if the plaintiff bases his or her claim on the imprudent selection of an annuity contract to distribute benefits to a specific participant, the claim would have to be brought within six years of the date on which plan assets were expended to purchase the contract."

The Annuity Safe Harbor – Take 3

The SECURE Act adopted the 404(e) annuity safe harbor which expanded the use of the annuity safe harbor to guaranteed retirement income contracts. Specifically:

> an annuity contract for a fixed term or a contract (or provision or feature thereof) which provides guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan.

The safe harbor included the following requirements for the plan fiduciary:

(A) engage in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase such contracts;

(B) with respect to each insurer identified under (A)—(i)consider the financial capability of the insurer to satisfy its obligations under the contract; and (ii) consider the cost (including fees and commissions) of the contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under the contract; and

(C) on that basis, concludes that—(i)at the time of the selection, the insurer is financially capable of satisfying its obligations under the contract; and (ii) the relative cost of the selected contract is reasonable.

Notably, the statutory safe harbor is not limited to a contract for benefit distributions and allows for reliance on specified written representations from the insurer to satisfy the financial capability requirements.

What Can DOL Do to Support the Annuity Safe Harbor?

- Issue sub-regulatory guidance similar to the "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries" such as on the topic of "Selection of Annuities: Tips for ERISA Plan Fiduciaries" to further support the adoption of annuities to offer lifetime income.
- Issue additional regulatory or sub-regulatory guidance to expand the safe harbor to other types of in-plan annuities and out-of-plan options.
- Issue updated sub-regulatory guidance to clarify the use of the safe harbor for TDF and other QDIA or pooled fund fiduciaries purchasing annuities as a part of the QDIA/pooled fund and for purchases outside of the QDIA/pooled fund.
  - The DOL's 2014 Information Letter to J. Mark Iwry addressed the DOL regulation (*not the statutory safe harbor*), addressed unallocated deferred group annuity contracts (*not other annuities*) and annuity contracts which provided for immediate or deferred annuity payments that were distributed only after the TDF dissolved at its target date (*and not the range of other options we see today*).

More Tips on Target Date Funds, Decumulation and Lifetime Income

- In its Field Assistance Bulletin No. 2008-03 (Q16) the DOL asked and answered the following question:

  Can a plan sponsor use two different QDIAs, for example, one for its automatic contribution arrangement, but another for rollover contributions?

  Yes. Nothing in the QDIA regulation limits the ability of a plan sponsor to use more than one QDIA, so long as all requirements of the regulation are satisfied with respect to each QDIA.

  Providing additional sub-regulatory guidance could support the further use of multiple QDIAs for various different reasons. In 2024, for example, we might ask the question with different examples, such as different QDIAs for different employee populations based on age or other factors. Coordination of this guidance with the Department of Treasury/IRS would also be important.

- **Update DOL's 2010 "Investor Bulletin: Target Date Retirement Funds" and DOL's 2013 "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries" to address the various different types of lifetime income structures target date funds offer today and that fiduciaries should inquire about**.
- **Further supplement the DOL's 2021 Supplement Statement on Private Equity in DC Plan DIAs (which was focused on "plan-level fiduciaries") to support including private equity and other non-traditional investments in professionally managed institutional TDFs and QDIAs/pooled funds.**
- **Create DOL Investor Bulletins or Tips on Decumulation and Lifetime Income options.**

End Notes

DOL guidance is often most effective in supporting innovation and good actions by plan fiduciaries seeking to improve retirement outcomes of working Americans when the process includes input from multiple key stakeholders.

Importantly, any guidance should not lead plan fiduciaries or their advisors to overestimate or misunderstand the extent of their fiduciary responsibilities, create or reinforce disincentives or inflate the perceived risk for DC plans to offer decumulation and lifetime income options in their DC plans.

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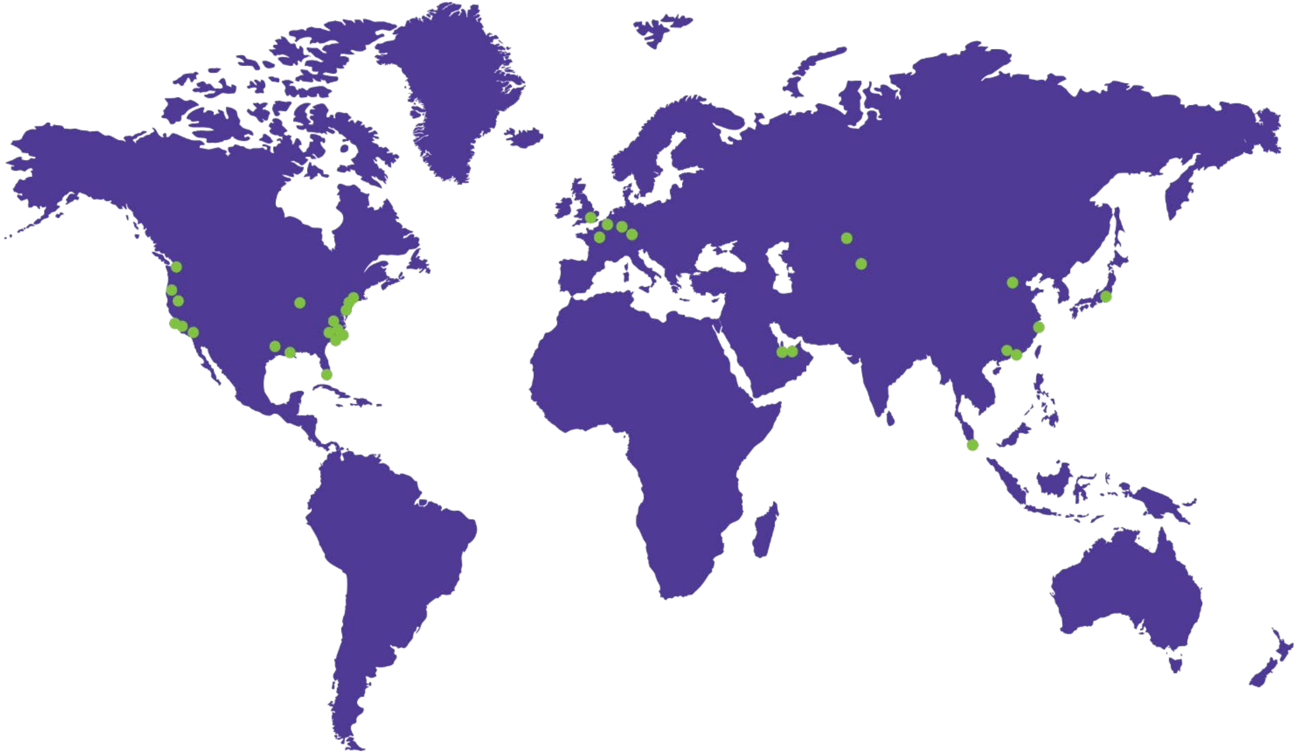

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