

**HELPING RETIREMENT PLAN PARTICIPANTS REACH THEIR GOALS  
NEW ENGLAND EMPLOYEE BENEFITS COUNSEL (NEEBC)**

**Recent Developments for 401(k) Plans and Plan Participants:  
Target Date Funds, DC Plan Annuitization and Financial Literacy**

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## RECENT DEVELOPMENTS FOR 401(K) PLANS AND PLAN PARTICIPANTS: TARGET DATE FUNDS, DC PLAN ANNUITIZATION AND FINANCIAL LITERACY

### I. Target Date Funds

#### A. Background.

1. *Product Description.* Target date funds, also known as life cycle funds, are popular investment vehicles for individuals saving for retirement. As a legal matter, these investment products are typically established as mutual funds (i.e., open-end investment companies registered under the Investment Company Act of 1940), although these products can also be created in the form of bank collective funds and other pooled investment vehicles. Target date funds are a type of balanced fund, with investments in a mix of asset classes.

Target date funds are designed to provide a convenient investment solution for individual investors who do not want to be burdened with the responsibility of finding the right mix of assets for their retirement investments. The defining characteristic of a target date fund is its “glide path,” which determines the overall asset mix of the fund over time. The fund’s asset allocation automatically becomes more conservative (i.e., higher allocation to fixed income investments and lower allocation to equity investments) as the fund gets closer to its target date. Many target date funds are designed so that they will not reach the end of the glide path, or the fund’s most conservative mix of assets, until a number of years after the target retirement date have elapsed (e.g., 20 years after the target date). The asset mix for these funds changes during the post-target date phase of the glide path, on the theory that investors can tolerate a higher level of equity exposure in the early years of their retirement given their expected longevity.

Although retail investors can invest in target date funds directly or through their individual retirement accounts, these products have become especially popular with 401(k) plans. Because of the convenience offered by target date funds, which rebalance their underlying investments automatically, plan sponsors often use them as the default investment for auto-enrolled participants. If a 401(k) plan sponsor decides to add target date funds to its investment menu, it will typically add eight to twelve target date funds from the same fund family. It is customary to include a “retirement income” target date fund for those already in retirement along with other funds that have projected target dates in 5-year increments (e.g., 2010, 2015, 2020, etc.).

2. *Performance Issues.* Congress and regulators have voiced deep concerns regarding the design of target date funds, especially funds with near-term target dates. The average investment loss for funds with a target date of 2010 was roughly -25% due to the market turmoil in 2008, with individual fund losses running as high as -41%, according to an analysis by the U.S. Securities and Exchange Commission (“SEC”).<sup>1</sup>

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<sup>1</sup> Based on SEC staff analysis of data as of October 14, 2009, as presented in the testimony of Mr. Andrew J. Donohue, Director, SEC Division of Investment Management, before the United States Senate Special Committee

## B. QDIA Rules.

1. Pension Protection Act. From a policy perspective, the Pension Protection Act of 2006 (the “PPA”) encourages employers to adopt automatic enrollment features for their participant-directed defined contribution plans (“DC plans”) by providing a new type of fiduciary liability relief for default investments. Under longstanding provisions under Section 404(c) of the Employee Retirement Income Security Act of 1974 (“ERISA”), plan fiduciaries are generally relieved from investment responsibility for a participant’s exercise of control over his or her own plan account, as long as the plan provides a broad range of investment alternatives and satisfies certain other related requirements. Under the more recent PPA guidance, a participant is deemed to have exercised control over the assets in his or her account if, in the absence of investment directions from the participant, the plan fiduciary invests such assets in a qualified default investment alternatives (“QDIA”).

As required by the PPA, the U. S. Department of Labor (the “DOL”) issued proposed regulations in 2006 describing the types of investments that constitute QDIAs and finalized them in 2007. In both its proposed and final regulations, the DOL specifically designated target date funds (as well as certain other types of investments) as QDIAs. Following the enactment of the PPA and the issuance of the DOL’s final regulations on QDIAs, many 401(k) plan sponsors changed their default investment funds for their automatically-enrolled participants to QDIAs.<sup>2</sup>

2. Requirements for Fiduciary Relief. In order to qualify for relief from fiduciary liability for investment losses resulting from a participant’s default investment in a QDIA, the following conditions must be satisfied:

- The default investment must be a QDIA;
- Participants must have the opportunity to invest in fund choices other than the QDIA (and invest in the QDIA only because they failed to do so);
- Advance notice of the plan’s default investment provisions must be provided to participants annually;
- Investment materials, including prospectuses, for the QDIA must be provided to participants;
- Participants must be able to transfer assets to other investment choices at least quarterly without penalty; and
- A broad range of ERISA Section 404(c) investment alternatives must be offered by the plan.

The fiduciary relief provided under the QDIA regulations is the same type of relief provided under ERISA Section 404(c). However, it is not necessary for a plan to be a “Section 404(c) plan” to qualify for the fiduciary relief for QDIAs.

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on Aging on October 28, 2009.

<sup>2</sup> See e.g., The Vanguard Group, Inc., *How America Saves 2008: A Report on Vanguard 2007 Defined Contribution Plan Data* (2008).

3. QDIA Requirements. To qualify as a QDIA within the meaning of the DOL's final regulations, a target date fund must be an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and 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 or life expectancy. It must also change its asset allocations and associated risk levels over time with the object of becoming more conservative with increasing age.

However, asset allocation decisions for the fund are not required to take into account risk tolerances, investments or other preferences of an individual participant. Give the broad and flexible nature of this definition, other than requiring a "mix" of equity and fixed income exposure, the QDIA regulations do not impose any substantive requirements regarding the composition of target date funds or impose any type of minimum asset allocation to conservative investments.

4. Fiduciary Duty to Evaluate QDIA. A participant who is defaulted into a QDIA is responsible for his or her passive decision, or "negative" election, to invest in this specific investment option. However, the preamble to the DOL's final regulations on QDIAs states that the plan fiduciary continues to have the obligation to prudently evaluate, select and monitor any investment option that will be made available to the plan's participants, including any option that is used as a default investment for a plan with an automatic enrollment feature. In other words, the plan sponsor remains responsible for ensuring that the QDIA, just like any other option in the plan's investment menu, is a prudent investment choice.

### C. Conflicts of Interest in Target Date Funds.

1. The Investment Company Act of 1940. Most target date funds as a legal matter are in the form of an open-end investment company registered under the Investment Company Act of 1940 (the "Company Act"), commonly referred to as a mutual fund. This type of fund is a separate legal entity, typically a corporation or business trust. It has its own board of directors or trustees charged with protecting the interests of the fund's shareholders, including retirement plans and their participants. In accordance with the Company Act, at least 75% of the board's members must be independent. This requirement, along with many other conditions under the Company Act, are designed to prevent a fund manager's interests from taking precedence over the interests of participants and other fund shareholders. Despite these requirements, there are a number of embedded conflicts of interest that persist within many target date mutual funds.

2. Conflicts of Interest in Fund-of-Funds Structure. Target date funds typically have a "fund of funds" tiered investment structure. Instead of investing in portfolio securities directly, the target date fund actually invests in other mutual funds, which in turn invest in portfolio securities. A conflict of interest arises in this fund-of-funds structure because many target date funds invest in affiliated mutual funds.

From a product development perspective, when a fund family creates a target date fund, it naturally has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers. Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. In the report prepared by the Senate Special Committee on Aging, it was reported that target date funds have higher expense ratios than the rest of the core portfolio in 401(k) plans.<sup>3</sup> Furthermore, although many target date funds invest in affiliated underlying funds exclusively, the reality is that many fund families do not have “best in class” funds for each and every applicable asset class.

A related conflict arises with respect to the mix of funds that underlie the target date fund. Because equity funds typically pay higher fees than other funds, the fund family has an incentive to design the target date fund so that it has a higher exposure to equity, increasing its aggregate fees at the expense of plan participants and also increasing the product’s expected volatility. This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments. Thus, even in funds with a target date of 2010, underlying equity funds constituted up to 68% of assets, which in turn contributed to recent volatility and investment losses.

Although an investment manager for a target date fund is permitted to invest in affiliated underlying funds under the Company Act, it would not be permitted to manage the target date fund’s investment in this conflicted manner if it were actually subject to the fiduciary standards under ERISA.

D. DOL Advisory Opinion 2009-04A (Requested On Behalf of Avatar Associates).

1. *Fiduciary Status of Asset Managers.* Generally, when a person or firm manages the assets of an ERISA plan, the person or firm becomes a fiduciary with respect to the plan and is subject to the standard of care mandated under ERISA. However, there is a general exception that applies when a plan invests in shares of a mutual fund.

- Under Section 401(b)(1) of ERISA, when a plan invests in a security issued by a registered investment company, “the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company.” Thus, when a plan invests in shares of a mutual fund, the underlying assets of the mutual fund are not deemed to be plan assets.

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<sup>3</sup> *Target Date Retirement Funds: Lack of Clarity Among Structures and Fees Raises Concerns*, Summary of Committee Research, United States Senate Special Committee on Aging (October 2009).

- Under ERISA Section 3(21)(B), a plan’s investment in a registered investment company “shall not by itself cause such investment company or such investment company’s investment adviser” to be deemed to be a fiduciary. Accordingly, the mutual fund’s investment adviser is generally not deemed to be a fiduciary of the plan investing in such mutual fund.

The combined effect of these rules is to create a carve-out from ERISA’s fiduciary rules for mutual fund investment managers. To illustrate its significance, let’s assume that a plan sponsor has appointed a professional asset manager to invest a segment of the plan’s portfolio in U.S. large cap securities. The appointed asset manager would clearly be a fiduciary subject to ERISA’s fiduciary requirements. Similarly, if the plan sponsor decided to invest this segment of the plan’s portfolio in a bank collective fund investing in U.S. large cap securities, the bank managing this collective fund would automatically be deemed a plan fiduciary. However, if the plan sponsor were to invest this segment of the plan’s portfolio in a U.S. large cap mutual fund, the fund’s manager would not be subject to any of ERISA’s fiduciary requirements.

2. *Are Mutual Fund Managers Ever Subject to ERISA?* The Wagner Law Group believes that the managers of target date funds can as a matter of law be held responsible for their conduct as ERISA plan fiduciaries in certain instances. Section 3(21)(B) of ERISA provides that a plan’s investment in a mutual fund “shall not by itself cause such [fund] or such [fund’s] investment adviser or principal underwriter to be deemed to be a fiduciary (emphasis added).” This wording demonstrates that the exception whereby target date fund advisers escape fiduciary status does not apply in all instances and is not absolute. In the firm’s recent request to the DOL on behalf of Avatar Associates, it requested clarification on the scope of this exception as applied to target date funds investing in other affiliated mutual funds. In its response letter, Advisory Opinion 2009-04A, the DOL declined to rule that the investment advisers to such funds should be viewed as fiduciaries to investing plans.

3. *Plan Sponsors Are Alone in Fiduciary Responsibility.* The implications of the DOL ruling are clear and may be surprising to many plan sponsors. Phyllis Borzi, Assistant Secretary for the DOL’s Employee Benefits Security Administration, in her testimony regarding QDIAs before the Senate Special Committee on Aging stated that “[the plan sponsor] continues to have the obligation to prudently evaluate, select, and monitor any investment option that will be made available to the plan’s participants and beneficiaries.” Thus, in its selection of target date funds as default investment options, plan sponsors alone are responsible for monitoring target date funds and the construction, management and oversight of their portfolios of underlying funds. Unfortunately many plan sponsors incorrectly believe that they do not need to evaluate the target date fund’s underlying investments, and they wrongly assume that fund managers have accepted this responsibility as ERISA fiduciaries on their behalf.

E. Best Practices for Plan Sponsors.

Given the fact that plan sponsors are alone in their fiduciary responsibility with respect to target date funds, they should pay careful attention to the underlying investments of their target date funds. Plan fiduciaries should ensure that these funds are prudently selected and monitor them on an ongoing basis. Some of the important factors that they should be mindful of include:

- The annual operating expense of the target date fund, including fees and costs of the underlying fund. Plan sponsors should also monitor the extent to which revenue sharing payments from target date funds, or any other funds, are being used to pay for administrative services provided to the plan.
- The target date fund's glide path, including the concentration in equity investments and the expected volatility. As discussed above, many target date funds do not reach their most conservative mix of assets until several years or more after the target retirement date. Plan fiduciaries should specifically evaluate both the pre- and post-target date phases of the glide path and determine whether it is appropriate for their participants.
- The quality and expenses of each of the underlying funds that comprise the investments of the target date fund.
- The extent to which the manager of the target date fund can use its discretion to shift the fund's asset allocations, or allow it to drift, away from the target allocation determined under the glide path. Many target date funds give the fund manager the authority to change the fund's asset allocation at any time, provided the fund's percentage allocation to each specific underlying fund remains within a specified "band" or percentage range based on the fund's glide path. After assessing the glide path itself, plan fiduciaries should consider how the fund manager is using any such discretion.
- Alternative investment solutions, including other target date funds and other target date investment vehicles operating in other legal forms, such as a bank collective fund.

Based on its review, if a plan sponsor concludes that a target date fund is no longer a prudent investment choice, it should substitute or eliminate the fund from the plan's investment menu in accordance with its fiduciary duties under ERISA.

F. Political and Regulatory Scrutiny of Target Date Funds.

On December 16, 2009, U.S. Senator Herb Kohl (D-WI), chairman of the Senate Special Committee on Aging, announced his intent to introduce legislation that would require target date fund managers to take on ERISA fiduciary responsibility in order for such funds to be eligible for designation as the plan's QDIA. At a hearing before the Senate Special Committee on Aging, senior representatives of both the U.S. Securities and Exchange Commission and the DOL acknowledged that additional rules are necessary to protect plan participants, and both agencies appear to favor enhanced disclosure with respect to target date funds.

**II. DC Plan Annuitization**

Although defined benefit plans are required under federal tax law to provide annuity distribution options, 401(k) plans and most other types of DC plans are not subject to this requirement. As a result, many participants in DC plans are unable to take distributions from their individual accounts in the form of lifetime income payments.

There are critics who say that annuities and tax-qualified accounts don't mix. One criticism that is frequently made against the use of annuities within DC plans is that the tax-deferred benefits of an annuity are worthless inside of a tax-exempt account, since any investment in a tax-qualified account accumulate on a tax-deferred basis automatically. However, given the fact that few investment vehicles are able to replicate the stream of lifetime income payments that can be provided by annuities, they may be a desirable investment option for economic reasons unrelated to their tax benefits. Furthermore, in the case of a 401(k) plan participant who wants to convert his or her account balance into an annuity, it would be extremely inefficient from a tax perspective for the participant to take a lump sum distribution, pay ordinary income taxes on the lump sum, and then use the after-tax proceeds to purchase an annuity.

To address this economic need, annuity providers have launched and created various products tailored to the DC plan market. Although there are numerous types of annuity arrangements for DC plans, they can be categorized into three basic approaches as described in sections A, B and C below.

A. Annuitization Outside of Plan.

1. Rollovers Through IRA Annuity Portal. Just as retired participants can roll over their DC plan accounts to individual retirement accounts, they can also roll them over to individual retirement annuities ("IRA annuities"). Of course, participants can shop for annuities by contacting annuity providers individually. However, rollover processing platforms have developed internet portals ("IRA annuity portals") which are designed to give participants access to wholesale or institutionally priced immediate annuities. With the use of these portals, participants seeking to roll over their plan accounts to IRA annuities may request annuity quotes from multiple insurance carriers.

These portals are not available to individuals and must be implemented by the plan sponsor.

2. *No Endorsement from Employer.* These IRA annuity portals are typically provided as a convenience by the employer to its employees, and not as an employer-provided benefit. Under DOL Reg. Section 2510.3-21, an IRA annuity will not be treated as an ERISA plan sponsored by the employer so long as:

- (a) the employer does not make any contributions to the IRA annuity,
- (b) participation is completely voluntary for employees,
- (c) the sole involvement of the employer is to permit the annuity provider to publicize the program to employees without any endorsement, and
- (d) the employer receives no compensation from the annuity provider.

(By satisfying these same conditions with respect to any individual retirement accounts used by participants for rollover purposes, employers also avoid being treated as the sponsor of these accounts for ERISA purposes.)

3. *No Fiduciary Requirements for Non-Endorsed IRA Annuities.* So long as the IRA annuity is not an ERISA plan sponsored by the employer, the employer has no fiduciary duty to evaluate the quality or cost of the IRA annuities offered to participants through the IRA annuity portal. For ERISA purposes, the selection of the rollover IRA annuity is the exclusive responsibility of the individual participant. Although employers are not responsible as ERISA fiduciaries, they should be aware that the financial institution that is making the IRA annuity portal available (or its affiliate) may be an insurance broker, receiving fees or commissions with respect to the annuities sold to plan participants. In many instances, the portal provider does not require any compensation from the employer.

4. *Plan Documentation.* When a participant takes a distribution from the plan and rolls it over to an IRA annuity (in the form of a direct or indirect rollover from the plan to the IRA annuity), the purchase of the IRA annuity occurs outside of the plan. Accordingly, just as a plan document does not need to contain any special provisions concerning the terms and conditions of the rollover individual retirement accounts, the plan document does not need to include the terms and conditions of rollover IRA annuities.

#### B. Annuity Distribution Option Inside of Plan.

1. *Distributions of Individual Annuity Contracts.* A 401(k) plan can provide annuity distribution options to participants in the same manner that money purchase plans customarily provide them. Money purchase plans are a type of DC plan, but employers must make mandatory contributions on behalf of plan participants and they are also

required to offer annuity payment options in accordance with federal tax law. Typically, if a participant elects to receive a distribution in the form of an annuity under a money purchase plan, the sponsor will purchase an individual annuity contract on behalf of the participant and then distribute the contract to the electing participant. Similarly, a 401(k) plan or any other type of DC plan could be amended (a) to offer annuity payment options to participants, and (b) to provide for the purchase and distribution of individual annuity contracts to those participants electing an annuity payment option. The individual contracts would provide fixed annuities, making fixed dollar payments over the life of the individual (or joint lives of the individual and his or her spouse).

2. *Fiduciary Requirements.* In 1995, the Department issued Interpretive Bulletin 95-1, providing guidance concerning the fiduciary standards under ERISA applicable to the selection of annuity providers for purposes of distributions from a defined benefit plan. This guidance states that the selection of an annuity provider in connection with benefit distributions is a fiduciary act governed by the fiduciary standards of ERISA Section 404(a)(1), which includes the duty to act prudently and solely in the interest of the plan's participants. In addition, the plan sponsor must take steps calculated to obtain the “safest annuity” available, unless under the circumstances it would be in the interest of the participants to do otherwise.

In Advisory Opinion 2002-14A, the DOL stated that this “safest annuity” standard was equally applicable to defined contribution plans. However, Section 625 of the Pension Protection Act of 2006 overturned this interpretive ruling. As a result, in addition to limiting the scope of Interpretive Bulletin 95-1 to defined benefit plans only, the DOL issued new rules governing the selection of annuity providers for the purposes of benefit distributions from DC plans.

These rules, issued under DOL Reg. Section 2550.404a-4 and finalized in 2008, provide a non-exclusive safe harbor for the selection of annuity providers for DC plans. This safe harbor is satisfied if the plan fiduciary:

- (a) engages in an objective and thorough search of annuity providers;
- (b) considers the ability of the annuity provider to make future payments;
- (c) considers the cost (including fees and commissions) of the annuity contract relative to its benefits and services;
- (d) concludes that the annuity provider is financially able to make all future payments and that the cost of the annuity contract is reasonable; and
- (e) if necessary, consults with experts to comply with these standards.

3. *Qualified Plan Requirements – QJSA Rules.* Other than money purchase plans, DC plans are not required to offer annuity payment options to participants. However, if any such DC plan is amended to offer an annuity option, it must provide married participants a qualified joint and 50% survivor annuity (a “QJSA”) in the absence of a payment election to the contrary with spousal consent. A tax-qualified DC plan must satisfy a number of other related notice and waiver requirements under the applicable QJSA rules.

4. *Gender Equality in Annuity Pricing.* Title VII of the Civil Rights Act of 1964 generally prohibits employers, with at least 15 employees, from discriminating against employees on the basis of their gender, subject to certain narrow exceptions. In *City of Los Angeles Dept. of Water & Power v. Manhart*, 452 U.S. 161 (1981), the Supreme Court held that Title VII was violated in the case of a pension plan requiring a higher rate of contribution from female employees to fund their benefits as determined under gender-distinct mortality tables. In a related ruling, *Arizona Governing Committee v. Norris*, 463 U.S. 1073 (1983), the Supreme Court held that a pension plan that required equal contributions from male and female employees, but provided smaller annuity benefits to female employees because of gender-distinct mortality tables, also resulted in a violation of Title VII. (As a result of these Supreme Court decisions, the IRS now mandates the use of unisex mortality tables with respect to calculating certain lump sum payments under defined benefit plans.)

In order to avoid a violation of Title VII, an employer sponsoring a DC plan with annuity distribution options should be aware of the gender equality requirement with respect to annuity pricing. When purchasing an individual annuity contract for a DC plan participant electing payment in the form of an annuity, a covered employer should find an annuity provider that does not price annuities based on gender. This requirement would be in addition to the employer's fiduciary duties to find a prudent annuity provider in accordance with ERISA Section 404(a)(1). (This gender equality requirement does not apply to the pricing of rollover IRA annuities that are not endorsed by the employer.)

### C. Gradual Purchase of Deferred Annuities Inside of Plan.

1. *Variable Group Deferred Annuity Contracts.* A DC plan could use a variable group deferred annuity contract to make an annuity option available to participants for both investment and distribution purposes. Unlike an individual annuity contract issued in the name of the participant, a group contract is issued in the name of the plan trust or the plan sponsor. And instead of being purchased with a one-time premium payment, the individual plan participant invests in the variable annuity investment gradually over time (the "accumulation phase"). During this accumulation phase, the participant directs the investment of his or her premium contributions into the variable annuity's underlying mutual funds and/or a fixed account providing a stated rate of return. After the participant retires, the value of the participant's underlying investments (based on the performance of the underlying mutual funds and fixed account) is converted into an annuity and the "payout phase" begins. Under the terms of many contracts, before the payout phase begins, the participant can determine whether the payments will be fixed amounts, or variable amounts fluctuating with the value of the underlying mutual fund investments.

2. *Death Benefits and Living Benefits.* Many group variable annuity contracts provide additional protection to the participant in the form of "death benefits" and/or "living benefits." For example, if a participant were to die during the accumulation phase, a contract with a death benefit feature would pay a death benefit

equal to the total premiums paid (or another stated amount) to the participant's account, which in turn would be paid out to the participant's beneficiary.

Living benefits, such as a guaranteed minimum withdrawal benefit ("GMWB"), protect against a sudden decline in the underlying investments of the variable annuity. For example, if the value of a participant's variable annuity investments abruptly declined by 35%, a contract with a GMWB feature would allow the participant to withdraw a stated percentage of the total premiums paid (e.g., 6%) annually until the full principal amount was recovered. This withdrawal would have to commence before the end of the accumulation phase, and the withdrawals would be in lieu of any lifetime payments during the payout phase.

2. Cost to Participants. Variable annuity investments generally have higher fees and expenses than mutual funds. Such ongoing costs include (a) mortality and expense risk charges compensating the annuity provider for its insurance risks, (b) administrative expenses to cover recordkeeping and other services, and (c) the expenses associated with the underlying mutual funds. If the variable annuity includes any death benefits or living benefits, the contract will also include an ongoing charge for these features as well. Depending on the nature of the commission arrangement between the annuity provider and the broker or advisor selling the contract to the plan sponsor, many variable annuity contracts will impose a "surrender charge," which is a back-end sales charge that is imposed if the investor prematurely terminates, or withdraws money from, the contract during a stated period after the purchase of the annuity (the "surrender period").

3. Lack of Portability. Generally, if an eligible employee participating in a DC plan with a variable group annuity contract switches jobs, the participant generally can not make an in-kind transfer of his or her interest under the annuity contract to the new employer's plan. If the participant wishes to transfer his or her interest in the predecessor employer's plan to the new plan, the participant has little recourse but to liquidate the annuity and roll over the cash proceeds (after payment of any surrender charges) to the new plan. Alternatively, the participant can simply leave his or her annuity interest behind in the predecessor employer's plan.

4. Fiduciary Requirements. As discussed above, the selection of an annuity provider in connection with providing a variable annuity option to participants for investment and distribution purposes is a fiduciary act governed by the standards of ERISA Section 404(a)(1). Thus, the plan sponsor must make its annuity provider selection in accordance with its duty to act prudently and solely in the interest of the plan's participants and beneficiaries. It would be prudent for plan sponsors to adhere to the recent guidance provided under Section 2550.404a-4 of DOL regulations with respect to the non-exclusive safe harbor and, if necessary, consult with experts to comply with these standards.

5. Tax Requirements. The IRS addressed various tax-qualification requirements for DC plans with variable group annuity investment options for

participants in PLR 200951039. This private letter ruling was helpful to the benefits community since it illustrated how these plans were viewed with respect to the age 70 ½ minimum distribution requirements and for purposes of the QJSA rules. In sum, DC plans with annuity investment options were not subject to any “surprise” interpretations with respect to these rules.

#### D. Recent Developments.

1. *Legislative Proposals.* A number of bills have been introduced in Congress, which are designed to provide tax incentives to save for retirement through annuities (e.g., Lifetime Pension Annuity for You Act, Retirement Security for Life Act). These bills typically encourage annuitization by exempting a percentage of annuity income up to a stated threshold (e.g., \$5,000 for individuals or \$10,000 for couples). Although they typically do not extend this exemption to annuity payments from defined benefit plans, they do exempt annuity payments made from DC plans.

2. *The Retirement Security Project.* The Retirement Security Project, a joint venture of the Brookings Institution and the Urban Institute, has released two white papers regarding DC plan annuitization. These papers were co-authored by Mark Iwry, who was recently appointed by the Treasury Secretary to serve as the Deputy Assistant Secretary for Retirement and Health Policy. The white papers include proposals to encourage DC plan annuitization by using deferred annuities as the default investment for participants for certain purposes.

3. *DOL and IRS Request for Information.* The DOL, Internal Revenue Service and the Treasury Department issued a joint release on February 2, 2010, requesting information regarding lifetime income options for participant in retirement plans. In this release, these agencies announced that they were currently reviewing the rules under ERISA and the related rules under the Internal Revenue Code, to determine whether and how they could enhance the retirement security of participants by facilitating access to lifetime income arrangements. The requests for information addressed a range of topics, including participant education, required disclosures, 401(k) plan and other tax-qualification rules, selection of annuity providers, ERISA Section 404(c) and QDIAs.

### III. Practices Relating to Financial Literacy of Participants

Through its formal and informal releases over the past decade or so, the DOL has acknowledged the importance of closing a so-called information gap by providing DC plan participants with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations.

#### A. Regulatory Overview.

1. *DOL Interpretive Bulletin 96-1.* To allay plan sponsor fears that their efforts to provide educational guidance to participants might be interpreted as giving investment advice for which they could be held liable, the DOL issued Interpretive

Bulletin 96-1. This 1996 release describes four safe harbors representing examples of the type of information, materials and educational services that can be furnished to participants without constituting investment advice. The DOL noted that there could be many more such examples of investment education that did not reach the level of fiduciary investment advice.

2. *SunAmerica Ruling.* In 2001, the DOL issued the so-called SunAmerica ruling, DOL Advisory Opinion 2001-09A, which allowed investment providers of DC plans to simultaneously give asset allocation advice to DC plan participants. One of the key conditions of this ruling requires the investment provider to deliver its asset allocation advice to participants in accordance with a computer model overseen by an independent financial expert. If all the applicable conditions are satisfied, the investment provider's aggregate fees are allowed to vary based on the investment options selected by the participants.

3. *Pension Protection Act.* In 2006, Congress attempted to increase the availability of participant-level investment education and advice by enacting a new prohibited transaction exemption as part of the PPA. To qualify for this exemptive relief, a fiduciary adviser (e.g., investment adviser, broker-dealer) is required to ensure that the fees for its investment advice are level (i.e., fees will not vary based on any recommended investment options that are selected by a participant) (the "Fee-Leveling Safe Harbor"). Alternatively, the investment advice can be provided through the utilization of an objective computer model that is independently certified not to favor investment options that would result in greater fees for the adviser (the "Computer Model Safe Harbor").

The DOL finalized its regulations implementing the PPA statutory exemption on January 21, 2009. Along with this interpretive guidance for the PPA statutory exemption, these regulations also included a separate but related administrative exemption which had the effect of liberalizing certain restrictions under the PPA statutory exemption. For example, the Fee-Leveling Safe Harbor under the new administrative exemption imposed the fee-leveling requirement on the individual representative of the fiduciary adviser only (unlike the PPA statutory exemption which imposed fee-leveling on both the individual representative and the fiduciary adviser itself).

However, due to concerns over the fact that the DOL's new administrative exemption did not adequately mitigate a fiduciary adviser's potential conflicts of interest, these "final" regulations were withdrawn in their entirety on November 19, 2009 before ever taking effect. The DOL proposed a second iteration of its investment advice regulations on February 26, 2010, which are substantially similar to the interpretive portion of the withdrawn regulations relating to the PPA statutory exemption. The newly proposed regulations do not attempt to re-introduce any kind of administrative exemption to supplement the PPA statutory exemption. These new regulations, as proposed, impose the fee-leveling requirement on both the individual representative of the fiduciary adviser and the fiduciary adviser itself, but not on its affiliates. (This interpretive position is generally consistent with the PPA statutory exemption and the DOL's original

interpretation of the PPA's fee-leveling requirement as announced in Field Assistance Bulletin 2007-1.)

B. Investment Needs of Participants.

1. ERISA Advisory Council's 2007 Working Group. In 2007, the ERISA Advisory Council formed a Working Group on Financial Literacy of Plan Participants and the Role of the Employer, which has made a series of recommendations for consideration by the Secretary of Labor relating to participant education and advice.<sup>4</sup> As part of its findings, the Working Group noted that participants needed to have:

- A familiarity with investment basics, such as the time value of money, asset allocation, risk management and taxation;
- Knowledge of each of the plan's investment options;
- A working knowledge of the plan design features, such as the ramifications of the plan's various distribution options, the calculation of minimum withdrawals, and the rules relating to rollovers; and
- An understanding of the benefits of plan participation and contributing to the plan, as well as the effect of pre-retirement withdrawals on retirement income.

2. 2007 Working Group's Other Findings. The Working Group discovered that participants and non-participants alike generally had no idea how much money would be required to provide an income stream at retirement that would support the participant's current standard of living. Furthermore, participants frequently misunderstood concepts, such as life expectancies, investment returns and other variables that are elements of a proper retirement income replacement calculation.

C. Benefits of Providing Investment Guidance for Plan Sponsors.

1. Increasing Effectiveness of Retirement Program. Nothing under ERISA requires DC plan sponsors to provide investment education or advice to plan participants. However, doing so can be advantageous for plan sponsors. In terms of compensation philosophy, retirement benefits are merely another form of compensation for employees, and DC plans with successful participant education or advice programs can help employers recruit, reward and retain their employees.

2. Minimize Bad Allocation Decisions. Investment guidance can help participants make better investment allocation decisions within the DC plan. Minimizing the number of bad allocation decisions by participants, will obviously reduce the number of potential claims (legitimate or meritless) made against the plan sponsor.

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<sup>4</sup> Section 512 of ERISA provides for the establishment of the ERISA Advisory Council, whose members are appointed by the Secretary of Labor. The Council advises the Secretary of Labor and submits recommendations regarding the Secretary's functions under ERISA.

3. *Protection from Potential Liability.* In Jenkins v. Yager, 444 F.3d 916 (7th Cir. 2006), *reh'g en banc denied* (7th Cir. May 22, 2006) the court determined that the DC plan's trustee could delegate allocation-decision making authority to plan participants, even though the DC plan was not an ERISA Section 404(c) plan. The court further held that the plan fiduciaries had no duty to investigate the individual investment decisions made by participants, and instead ruled that the fiduciaries had satisfied their duty to communicate material plan-related information to participants, largely by arranging for annual meetings with a financial advisor to discuss investments in the 401(k) plan and by distributing certain investment-related materials.

Although the DOL generally takes the position that ERISA Section 404(c) is the exclusive means for transferring investment allocation responsibility to participants, the Jenkins v. Yager case is an example of a situation where the court felt that the plan fiduciary could also transfer this responsibility by implementing a strong investment education program for participants. As illustrated by this decision, regardless of whether a DC plan is intended to comply with ERISA Section 404(c), a successful investment education program for participants can protect plan sponsors from potential liability.