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Target Date Fund with Annuity that Restricts Transfers May be Prudent Default Investment (but not QDIA)

The DOL recently concluded that a target date fund with a fixed guaranteed annuity restricting transfers or withdrawals for a 12-month period does not meet the qualified default investment alternative requirements. But noting the need for lifetime income as a public policy issue, DOL said a fiduciary could prudently select a default investment that complies with all requirements of the QDIA regulation save the liquidity and transferability rules. Fiduciaries may be hard pressed, however, to select such an investment as a plan default investment because it does not protect them from liability for investing contributions on behalf of employees.

Background

The Pension Protection Act of 2006 amended ERISA to allow relief for a plan fiduciary who, in the absence of investment direction by the participant, invests a participant's account in a specified qualified default investment alternative (QDIA).

> **Comment.** Practitioners call this relief "404(c)" protection, after the ERISA section and associated regulations that allow fiduciaries of participant-directed retirement plans to avoid liability for participants' investment choices.

For an investment to qualify as a QDIA, a participant must be able to transfer the invested assets, in whole or in part, to another investment alternative available under the plan as often as participants and beneficiaries who actively elect to invest in the option selected for the QDIA can – but not less frequently than once in any three-month period. Target date funds (TDFs) must be designed to produce varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age or target retirement date to satisfy the QDIA requirements.

> **Target date funds** – also known as lifecycle funds – are investments that change their asset mix of equity and fixed income exposures based on the participant's age, target retirement date, and/or life expectancy, with the idea of decreasing portfolio risk (as defined by market volatility) as the retirement date approaches and age increases.

In recent years, DOL and IRS have initiated efforts to encourage plan sponsors to include annuities in retirement plans as a way to address concerns about participants and beneficiaries having sufficient funds to last throughout retirement. (See our July 10, 2014 *For Your Information*

on longevity annuities.) In 2014, DOL concluded that a TDF can be a QDIA where it includes "unallocated deferred annuity contracts" for the fixed income component. This product is an insurance contract that promises to pay income to covered plan participants at some future date on a regular basis for a period of time, or for life. It is written on behalf of the group rather than a specific individual, which facilitates transferability and allocation within the group – and therefore can satisfy the QDIA liquidity and transferability requirements. (See our November 11, 2014 *For Your Information*.)

No QDIA Without Liquidity and Transferability Features – But Maybe a Prudent Default Investment Anyway

In a December 22, 2016 information letter, DOL said a TDF that meets the QDIA requirements – except that it contains a fixed guaranteed annuity (also known as an annuity sleeve) that restricts transfers or withdrawals after a 12-month period to transfers over 84-month installments – cannot be a QDIA, even though the product allows for in-plan access to an investment with a guaranteed rate of return and guaranteed income at retirement. However, recognizing that QDIA standards are not the only way a fiduciary can satisfy the responsibility for selecting a default investment in an individual account plan, DOL affirmed that an investment product or portfolio can be a prudent default investment without using the QDIA regulation.

Specifically, DOL said a fiduciary could prudently select an investment with lifetime income elements as a plan default investment if it complies with all requirements of the QDIA regulation save the liquidity and transferability rules. Noting the need for lifetime income as an important public policy issue, DOL reasoned that it supports approaches like this that could "lead to broader use of lifetime income options in defined contribution plans as a supplement to and enhancement of accumulation of retirement savings."

The prudence of this type of investment will depend on the specific facts and circumstances when the alternative falls short of the QDIA requirements. DOL suggested that a fiduciary's thorough and objective analysis in this scenario could focus on, for example:

- Plan demographics and costs associated with the investment
- Nature and duration of the liquidity restrictions
- Level of guarantees of principal and minimum interest rates
- Opportunities for guaranteed minimum interest rates to be supplemented with additional credited amounts
- Expected lifetime income to be provided in retirement
- Costs associated with the investment in light of benefits and administrative services provided

DOL also said fiduciaries wishing to select this type of product as the default investment should consider more frequent notice on the liquidity/transferability restrictions and enhanced education about the investment's features.

But Will Fiduciaries Bite?

The premise behind the QDIA is that following the QDIA requirements will generally protect fiduciaries from liability for participants' investment losses. Given the panoply of investment-related lawsuits over the last several years,

there is heightened awareness of the need to avoid any action that could raise that risk. This suggests that fiduciaries will be reluctant to make any changes to their default investments that will eliminate QDIA protection. That is not to say, however, that a fiduciary cannot – and will not – offer this type of TDF as an option (but not a default) in its investment lineup.

In Closing

Under this guidance, defined contribution plan fiduciaries wanting to offer a default investment that includes a guaranteed annuity but does not meet QDIA liquidity and transferability requirements can do so – but 404(c) protection will not apply. Many fiduciaries will be unwilling trade the security of 404(c) protection for selecting this type of fund as a plan default investment, but may wish to offer it as a part of the investment lineup.

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