Using Re-enrollment to Improve Participant Investing and Provide Fiduciary Protections

A WHITE PAPER BY

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Introduction

There is tension in the world of 401(k) plans. Participants fret over the investment decisions they must make. Their employers worry about fiduciary liability for how participants are investing their accounts. In an era that has seen the proliferation of class action litigation against fiduciaries over plan investments and expenses, the concern about liability is not misplaced. Fortunately, there is a straightforward strategy for mitigating this tension—a strategy that focuses participant attention on their investment decisions, while potentially enhancing fiduciary protections to the plan sponsors and committee members—the fiduciaries—who manage those plans. This strategy is known as "re-enrollment."

The name, however, is a misnomer, since participants are not required to re-enroll in the plan. It should probably be called "re-election" because the approach means that participants are required to re-examine their investment decision during a specified time frame, even if they have previously given investment instructions. Each participant can decide to leave his or her investments "as is," to select different investments or to allow his or her account to be defaulted into a qualified default investment alternative (QDIA) (which can include target date funds [TDFs], balanced funds or managed accounts but most often is the plan's TDF).

A few years ago, when this strategy was new, some plan sponsors felt that re-enrollment was "risky," because they felt they would be making investment decisions on behalf of participants. However, now that many plans have successfully used re-enrollment, plan sponsors and consultants have become more comfortable with the concept and process of re-enrollment. Unfortunately, though, roughly 39% of plan sponsors were not aware of the potential to receive fiduciary protection for participants who were defaulted into a plan's QDIA in a re-enrollment.[1] (Common plan sponsor misperceptions about re-enrollment are reviewed and refuted in the next section of this white paper.)

As we discuss in the section on legal principles, the process has solid legal underpinnings. By re-enrolling participants, plan sponsors and committee members can take advantage of a fiduciary "safe harbor" offered by QDIAs. The protections afforded by QDIAs and re-enrollment can help both the participants—by causing them to re-examine their investment decisions—and the fiduciaries—who in absence of an election by participants, would obtain the potential for protection from investing liability.

Before going into detail, though, we will examine the benefits of re-enrollment. Later, we discuss the process and the obligation of plan sponsors to engage in a prudent process to determine whether a re-enrollment should be undertaken.

An assumption underlying 401(k) plans is that participants know how to invest their money. Based on that assumption, plan sponsors offer their participants an array of prudently selected investment options, provide investment education and believe that they have fulfilled their responsibilities. Unfortunately, the assumption may not be correct—as either a matter of fact or a matter of law.[2]

What some plan sponsors[3] fail to realize is that they are responsible—and thus potentially liable—for "participant investing," even when the plan has delegated that ability to participants and the participants have directed the investments. (By "participant investing," we mean a participant's choices about the investments to use in his or her account.) There are a few exceptions (often called safe harbors) that we will discuss later. But, unless a plan satisfies one of those exceptions, plan sponsors and committee members are still on the fiduciary "hook" for participant investment decisions.

The marketplace has developed "solutions" for the problems resulting from the lack of investment knowledge of many participants, including participant investment advice and professionally diversified portfolios, such as managed accounts, balanced funds and TDFs. The last of these, TDFs, has proven to be the most widely used QDIA, with 78% of fiduciaries selecting TDFs as the plan's QDIA.[4]

Plan sponsors have a number of ways to introduce TDFs into a plan:

- Add to the menu
  - Add TDFs to the plan's investment line-up and allow participants to choose for themselves
  - Add TDFs to the plan as QDIAs and implement automatic enrollment for new employees (and, possibly, for eligible employees who are not deferring)
- Investment reset
  - Use the "investment reset" process to move the funds from existing investments to the TDFs (often used in the context of a provider change or a change in a plan's investment line-up; in this process, the plan sponsor takes control of participant accounts and does not give participants an opportunity to opt out of the change before it is made)
- Re-enrollment
  - Adopt a "re-enrollment" strategy and ask participants to make a new investment election during a specified time period (and if they do nothing, move their assets into the QDIA based on their date of birth)

When TDFs are prudently selected and are coupled with an ERISA fiduciary safe harbor (such as the QDIA protection for defaulted participants), plan sponsors will be shielded from potential liability for participant investing (assuming they comply with all of the safe harbor requirements). (The prudent selection of TDFs is discussed later in the section titled "Discussion of legal principles and industry practices.")

Re-enrollment may present challenges in special situations, e.g., where stable value funds, employer stock, managed accounts and brokerage accounts are involved. One of the common misconceptions is that if participant assets are in a stable value fund, employer stock, a brokerage account or managed accounts, a plan cannot implement re-enrollment. This is generally not the case, but it does mean that re-enrollment needs to be done thoughtfully and with the specifics of any of these situations or other unique circumstances in mind. For example, a plan sponsor may decide to exclude brokerage account assets to avoid transaction costs.

In the case of employer stock, managed accounts and brokerage accounts, plan sponsors need to decide whether to exclude them from the process. The common thread for these "special situations" is that plan sponsors may have some additional thinking to do. (Each of these situations is discussed later in this paper.)

This white paper discusses legal principles and industry practices, and then illustrates the advantages of using the re-enrollment process to provide protection for fiduciaries.

These statistics may be partially the result of a growing use of automatic enrollment (64% of plans now automatically enroll employees).[5] Automatic enrollment overcomes the first significant barrier to the accrual of adequate retirement savings, the need to enroll in the plan and start deferring. That is, employees cannot accrue tax-favored retirement savings if they do not participate in the plan. By giving them a push into the plan, automatic enrollment is a way for plan sponsors to help new employees take advantage of the plan. Some existing employees, on the other hand, may have defaulted into something other than a QDIA or may not have reviewed their investment allocation since enrolling in the plan years ago. In understanding that inertia may often leave individuals inappropriately invested given their age, plan sponsors may want to consider asking that population to reaffirm their investment elections, and if they do not engage, move participant assets into the plan's QDIA.

Common misperceptions about re-enrollment

The following are some common misperceptions about re-enrollment. Each highlighted statement reflects a sentiment expressed by some plan sponsors. These are followed by responses based on ERISA's provisions and experience of plans that have employed a re-enrollment strategy. Legal authorities and practical experiences that support these responses appear in the next section of this white paper.

"I don't want to force my participants into investment choices"

To the extent plan sponsors have this reaction, it is based on a misunderstanding of what re-enrollment does. It does not force anyone to do anything; rather, it creates an opportunity for participants to "re-visit" their prior investment decisions. When the re-enrollment process starts, if a participant wants to keep his investments or reallocate to other options, he or she can simply indicate that preference … and the account will not be changed. But if a participant desires, or if the participant fails to do anything, the participant's account balance and future contributions will be invested in a QDIA, which may be a TDF.

Although only one legal notice is required (30 days in advance of the re-enrollment), many plan sponsors provide several notices to participants before the effective date of any changes. For example, a plan sponsor may provide three levels of communication to participants:

- The first notice is often a flyer to announce what's changing, typically distributed 60 days in advance of the re-enrollment date
- The second, 30 days in advance, highlights available investment options and describes the opt-out procedures, as well as announces any education meetings available to participants. This is often in the form of a newsletter that accompanies the legally required notice
- The third, given about seven days in advance, is a final written reminder that the re-enrollment window is ending

If such a process is followed, none of the defaults should happen without participant knowledge and implied consent. Even if the participant fails to pay attention to the notices, he or she can change how the account is invested after being notified that the default is in effect, or at any later time.

"It goes against my fiduciary responsibility"

Plan sponsors that make this statement simply misunderstand the law.

Under ERISA, the general rule is that fiduciaries have responsibility both for the quality of the investments offered by the plan and for the prudence of the participant investing. While fiduciaries can mitigate their risks for participant investing by taking certain steps short of re-enrollment, that does not mean it is a breach of fiduciary responsibility to prudently decide to engage in a re-enrollment process.

In fact, the Department of Labor has explicitly embraced fiduciary use of QDIAs, which is further discussed below.

There is no specific fiduciary obligation to conduct a re-enrollment. At the same time, there is no fiduciary prohibition on implementing a re-enrollment. If the plan sponsor determines there may be a problem, re-enrollment is one action they may want to consider. We discuss this concept later in the "Discussion of legal principles and industry practices."

"It costs too much"

There is nothing wrong with being fee-conscious. In fact, ERISA prohibits fiduciaries from spending more than reasonable amounts of plan money. However, it is also clear that under ERISA fiduciaries can spend plan money if it produces results. There are costs associated with re-enrollment, but if the expenditure of effort and money significantly improves the operation of the plan, those expenditures would be prudent. Plan sponsors may want to discuss the costs with the plan recordkeeper as well as the most effective way to implement a re-enrollment.

"Everything is fine as it is"

It is possible that this is true. However, the experience of many plans is that only a minority of the participants could be viewed, by financial experts, as being well-invested. And while this may not create liability issues for a plan sponsor—if a plan complies with 404(c), for example—the participants may not be well-served in the "fine how it is" environment.

Plan sponsors may want to request the data needed to gain transparency regarding participant allocations to help determine whether participants are "fine how they are" (this is considered in more depth in the next section of this paper).

"A re-enrollment would be too much work"

A few years ago—when re-enrollment was a new concept—that might have been a legitimate concern, simply because there was not much experience and, therefore, it was possible to fear the worst.

However, today, we know exactly how much work is involved. And, based on those years of experience, the provider typically performs most of the work, while the plan sponsor's work is to engage in a prudent process to determine whether re-enrollment is appropriate for the plan and its participants, to select the proper QDIA for re-enrollment and then to help the provider distribute the notices.

"Our recordkeeper doesn't offer re-enrollment"

This is a critical issue. If a recordkeeper cannot support re-enrollment, then it is more work for the plan sponsor to implement a re-enrollment process on its own, although it is possible. Another alternative is to change recordkeepers. While this would be a big step, a plan sponsor may determine that it is an appropriate action to take.

"We have company stock so we can't"

There is no doubt that company stock is an issue. However, it does not mean that re-enrollment is unavailable. Instead, it means that the fiduciaries need to make decisions about re-enrollment related to the company stock.

For example, company stock could be excluded from the re-enrollment. A plan committee might decide that the company stock holdings should not be affected. On the other hand, a plan committee could decide that one of the benefits of re-enrollment is to cause participants to re-evaluate their holdings of company stock, and decide to include those assets as well.

"We can't because we have brokerage accounts and managed accounts"

Similar issues occur with individual brokerage accounts and managed accounts. Although plan sponsors may choose to re-enroll these assets, practical experience is that, often, the participants in individual brokerage accounts and/or investment managed accounts are not included in the re-enrollment process. In other words, reasonable decisions can be made about specific investments or services and how they are accommodated in re-enrollment.

"We can't because we have stable value"

Stable value, like company stock, is an investment that presents special issues for re-enrollment. However, it does not mean that the plan cannot implement re-enrollment. Instead, any re-enrollment would need to be done thoughtfully and in coordination with the stable value provider. As a practical matter, the experience is that, while it may affect the pace at which the re-enrollment occurs—e.g., where the stable value investment has a 12-month waiting period for elimination of the option—stable value is not often a barrier to re-enrollment. It is just one more factor to consider, and it may require additional coordination.

For example, if there is no intent to eliminate stable value as an investment option, it can simply be excluded from the process. Similarly, if stable value is being retained as an investment option but there is a desire to reduce the percentage of participant investment in the stable value fund, it can be excluded from the initial re-enrollment process and then revisited in a second re-enrollment after the waiting period. If the plan sponsor intends to eliminate stable value altogether, but the fund requires 12 months' advance notice, re-enrollment could proceed using the same two-phase process. In the first phase, the plan sponsor would give the required 12-month notice to the stable value manager, but would exclude stable value from the initial phase of the re-enrollment process. At the expiration of the 12-month notice period, the second phase would proceed, with re-enrollment being repeated to the extent necessary to eliminate the stable value fund.

"Educating participants actually works better"

It may be correct that investment education works for a significant number of participants. There is some indication that one-on-one meetings with participants can be effective in terms of increasing savings and improving investing. On the other hand, one survey conducted by J.P. Morgan highlighted that 44% of participants felt that they were getting more information than they could absorb and about 55% indicated that they do not read all of the investment information that was provided to them about their plan.[6]

In part, re-enrollment is becoming increasingly popular because there are indications that investment education has not worked as well as was initially hoped. And, even with one-on-one meetings, the process has apparently not affected the large number of participants that are commonly impacted by re-enrollment, that is, participants who have been in the plan for a number of years.

For example, it is not uncommon for re-enrollment to result in 50%, 60% or more of the participants allowing their money to be transferred to the plan's QDIA. Nothing, other than automatic enrollment, has produced similar numbers. Even with automatic enrollment, though, the results are often less impressive. That is because automatic enrollment only affects newly eligible participants (or, if a company also includes existing, but non-participating employees, then it affects that group as well). However, automatic enrollment does not impact the vast majority of participants who are already in the plan. In fact, one argument in favor of re-enrollment is the difficulty of reaching existing participants and causing that group to re-evaluate their investment decisions.

"It's paternalistic"

Re-enrollment can be perceived to be paternalistic in the sense that plan sponsors and committee members are trying to help their employees focus on their investments. However, it may not be too paternalistic, since participants can opt out or, even if they allow the default to occur, they can subsequently change their investments at any time the plan permits (most often, daily). In other words, re-enrollment can balance paternalism with *laissez faire* by helping participants focus on their investments, without forcing them to do anything.

"As a company, we are very conservative; re-enrollment is risky"

Re-enrollment, if part of a prudent process, is generally not risky. In fact, re-enrollment can reduce risk, since it provides plan fiduciaries with QDIA "safe harbor" protection for defaulted accounts.

Discussion of legal principles and industry practices

This section discusses the fiduciary obligations of plan sponsors—and their officers and committee members who serve as fiduciaries—for plan investments. We also discuss ways to improve participant investing, while obtaining the benefit of the QDIA safe harbor for plan sponsors.

Fiduciary obligation for plan investments

Under ERISA, fiduciaries have the obligation to prudently manage a plan's investments.[7] This includes both (i) the prudent selection and monitoring of the investments offered by the plan and (ii) the investing of participant accounts.[8] The latter obligation applies to both the accounts of participants who fail to direct their investments and the accounts of participants who direct their investments (unless the plan complies with all of the 404(c) conditions, as explained below).

In addition, fiduciaries have a duty to operate the plan for the exclusive purpose of providing retirement benefits.[9] In participant-directed plans, fiduciaries face a dilemma: plan assets, including participant accounts, must be invested in a manner that meets the needs of the participant and is designed to avoid the risk of large losses. In other words, participant accounts must be prudently invested; but, many participants do not have the desire or ability to prudently invest their account because of lack of investment expertise, time or interest. As a result, fiduciaries may turn to professionally managed investment options, including managed accounts, balanced funds (risk-based investments) or target date funds (age-based investments). For purposes of this paper, we assume that the fiduciaries have selected a TDF suite as the professionally designed option.

The prudent selection of TDFs

The DOL has published "Tips for ERISA Plan Fiduciaries" on the prudent selection of TDFs. In the Tips, the DOL points out that not all TDFs are the same:

> "there are considerable differences among TDFs offered by different providers, even among TDFs with the same target date. For example, TDFs may have different investment strategies, glide paths, and investment-related fees. Because these differences can significantly affect the way a TDF performs, it is important that fiduciaries understand these differences when selecting a TDF as an investment option for their plan."

In the preamble to the QDIA regulation, the DOL also pointed out that fiduciaries must consider competing TDF families before making a selection:

> "The selection of a particular qualified default investment alternative (i.e., a specific product, portfolio or service) is a fiduciary act and, therefore, ERISA obligates fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries. A fiduciary must engage in an objective, thorough, and analytical process **that involves consideration of the quality of competing providers and investment products, as appropriate.**"[10] (emphasis added)

The Tips provide eight additional guidelines for the prudent selection of a suite of TDFs for a plan. These include:

1. **Establish a process for comparing and selecting TDFs.** This entails using an objective process to obtain information, such as information about performance and investment fees and expenses, how well the TDF's characteristics align with eligible employees' ages and likely retirement dates and other characteristics of the participant population, such as participation in a defined benefit pension plan, salary levels, turnover rates, contribution rates and withdrawal patterns.
2. **Establish a process for the periodic review of selected TDFs.** The DOL says that "at a minimum" the review should include whether there have been significant changes in the information reviewed initially, such as whether a TDF's investment strategy or management team has changed or the fund's manager is not effectively carrying out the fund's stated investment strategy.
3. **Understand the fund's investments.** This includes the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time. Fiduciaries also need to understand the principal strategies and risks of the fund, or of any underlying asset classes or investments that may be held by the TDF, the fund's glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date.
4. **Review the fund's fees and investment expenses.** This includes not just the fees and expenses of the TDF itself, but also sales loads and the fees and expenses of the underlying funds. Where the expense ratios of the individual component funds are substantially less than the overall TDF, find out what services and expenses make up the difference.
5. **Inquire about whether a custom or non-proprietary target date fund would be a better fit for the plan.** Fiduciaries need to weigh potential benefits, such as the ability to incorporate the plan's core funds and potential diversification advantages of non-proprietary TDFs that can leverage other managers within the component funds against cost and administrative tasks involved in creating a custom TDF.
6. **Develop effective employee communications.** This includes compliance with the 404a-5 disclosure requirements under ERISA, including specific fee and expense information about TDFs.
7. **Take advantage of available sources of information to evaluate the TDF and recommendations received regarding the TDF selection.** Plan fiduciaries should leverage commercially available sources of information and services to assist in the decision-making and review process. Several providers have tools to assist plan sponsors in selecting the TDF as their plan's QDIA that should help alleviate much of the fiduciary concerns that may still exist.
8. **Document the process.** Plan fiduciaries should always document the selection and review process, including how they reached decisions about individual investment options.

Prudent evaluation of the need for re-enrollment

In the prior section of this paper, we discussed the misconception about whether "the plan is fine as it is." Fiduciary decisions under ERISA, like business decisions, are data driven.[11] This means that fiduciaries need to engage in an "objective, thorough and analytical search" to identify "relevant facts and circumstances."[12] If the information that is gathered and analyzed suggests that the plan is not "fine"—for example, participants are not appropriately invested—a plan sponsor may need to do something about it.

To determine if participants are "well" invested, the plan sponsor might look at whether accounts hold only a single fund, are heavily weighted toward stable value or a money market fund or significantly invested in company stock. Other factors might include whether a participant nearing retirement is invested almost entirely in equities. The evaluation process is less complicated than might be imagined. For example, the plan sponsor is already required to and presumably is monitoring the prudence of the plan's investment line-up, including the plan's QDIA.

While it is obvious that plan sponsors need to engage in a prudent process of evaluation and look at "relevant" information, there is no formal guidance or case law so far on what a plan sponsor needs to examine. It is important to recognize, however, that fiduciary responsibilities evolve over time. The standards remain the same, but the specifics of how to act prudently may change. And often, the change only becomes apparent once a lawsuit is decided against a plan sponsor. For example, the selection of the appropriate share class of the mutual funds offered in a plan was not an issue for fiduciaries until the last few years.

From a risk management perspective, examining participant investing by reviewing information of the type mentioned earlier is something plan sponsors may want to consider. And the data will generally show whether or not re-enrollment would be a prudent course for the plan.

Fiduciary safe harbors

To provide a context for the discussion that follows, we should review the fiduciary safe harbors for participant investing. Under ERISA, a "safe harbor" protects fiduciaries from a breach of duty claim so long as the fiduciary complies with the specified conditions. That is, they are relieved of fiduciary liability for the plan participant's investment decisions. Here we address two safe harbors and a third form of fiduciary protection that is often improperly referred to as a safe harbor. This latter "safe harbor" is 404(c) protection. Unlike a true safe harbor, 404(c) only permits plans sponsors and committees to assert a defense if they are accused of a fiduciary breach.[13]

- Under ERISA section 404(c), if a plan complies with a number of disclosure and other requirements, fiduciaries are able to assert a defense to a claim of liability for investment decisions made by the participants. The disclosure requirement has been simplified by the incorporation into the 404(c) regulation of the participant disclosure rules under ERISA Regulation Section 2550.404a-5. But, there are additional 404(c) requirements. In our experience, based on legal audits we have conducted on a number of plans, some plans fail to comply with all of the conditions (even though in some of those cases the plan sponsors believed the conditions were being met); as a result, those fiduciaries remained legally responsible for investing decisions made by participants.[14]

  While 404(c) protection is helpful, it is important to recognize that fiduciaries have the burden of proving that the plan has met all of the requirements of the regulation in order to obtain the protection.

- The second arises when an investment advisor (a bank, insurance company or registered investment advisor) is given discretion over the management of investments.[15] In the context of participant investing, to obtain this protection, fiduciaries must select an investment advisor who, if used by a participant, is given discretionary control of the participant's account and manages it on an ongoing basis.

  In the case of managed accounts, the fiduciaries only obtain protection so long as they prudently select and monitor the investment manager and the participant elects to turn the investment of his account over to the manager.

- The third is available when a participant fails to exercise control over his account—that is, when the participant "defaults." In that situation, the fiduciaries have an obligation to prudently invest the participant's account.

For this safe harbor to apply, the plan must comply with specific requirements.[16] They include the selection of an appropriate default investment, referred to as a "qualified default investment alternative" or QDIA. Once these requirements are met, the defaulting participant is deemed to have exercised control over his account, so that the fiduciaries are not responsible for whether the investment is otherwise appropriate for the participant (e.g., whether the QDIA suffered losses compared to the result of a risk-free investment).[17] The key to obtaining this safe harbor, however, is that there be a default by the participant—which can occur in a number of ways.

The default situation is limited to situations where a default occurs (i.e., where there is participant inaction). Absent re-enrollment of existing accounts and automatic enrollment of newly eligible employees (and previously eligible but non-deferring employees), defaults may not be a sufficiently common event to afford wide protection to the fiduciaries. The issue of defaults is discussed later in this white paper.

Investing participant accounts in professionally designed investments

What can fiduciaries do to increase the likelihood that participant accounts are invested in professionally designated investments?

One approach is to include professionally managed investments as core options, with the goal that participants will select them on their own. However, the experience of participant uptake has not been encouraging—particularly for participants who have already directed their investments. Several studies reveal that participants tend to stick with their initial investment choices and, due to inertia, do not change their investment elections, even if more choices become available.[18]

Fiduciary protection can be enhanced if a plan satisfies the requirements of a regulation under ERISA section 404(c)(1), which provides that fiduciaries are not responsible for participant investment decisions if participants are given the opportunity to exercise control over their investments and actually do so. In order for this protection to apply, the plan must be a "404(c) plan"; that is, it must offer a "broad range" of investment options and meet a number of disclosure requirements.[19] As previously noted, some plans inadvertently fail to satisfy these requirements, making this protection somewhat illusory.

The investment reset approach

Another approach is for the plan sponsor to "reset" all the participant accounts into the plan's QDIA without providing participants the opportunity to opt out before assets are transferred.[20] In effect, the plan sponsor takes control of the participant accounts. This strategy is commonly known as "investment reset." While this may sound somewhat like re-enrollment, investment reset most commonly involves (i) a change in providers (and thus investment options), (ii) changes in investment options without changing the provider or (iii) a fiduciary decision to take control over participant accounts and move the funds to another plan investment. In all cases, participants are not asked to make a new investment decision; instead, the plan sponsor directs that the money in participant accounts be taken out of the options they have selected and transferred into the QDIA selected by the plan sponsor. Participants are able to reallocate their accounts after the fact, but they are not given the alternative of opting out or making their own allocation decision before the changes are made.

Engaging in an investment reset may not provide the protections offered by an ERISA safe harbor. This is because the decision to reset a participant's funds to another plan investment without giving participants the option to opt out would not be viewed as participant direction, but as a fiduciary decision for which there may not be a safe harbor.

The default approach

ERISA provides a safe harbor for fiduciaries if participants are given the opportunity to invest their accounts but do not, for whatever reason, do so.[21] The purpose of this safe harbor is to improve investing of defaulted participant accounts.[22] If fiduciaries comply with the QDIA requirements, they generally will not be liable for any loss that occurs as a result of the default investments, though they remain responsible for the prudent selection and monitoring of the QDIA itself. In essence, once a plan sponsor has identified the type of QDIA that is preferred for the plan, the fiduciary must engage in a prudent process to select the particular investment option and monitor that selection to ensure that it remains a prudent choice. But, if the QDIA rules are satisfied, fiduciaries will not be liable for how defaulted participants are invested.[23]

While there are several requirements that must be met for the safe harbor to be available, the key is that there be a default. Once that happens, the next step is that the participant's account be invested in a QDIA.[24] There are three types of QDIAs: a managed account service, a balanced fund (risk-based investment) or a target date fund (age-based investment).

How does a "default"—as defined for QDIA purposes—occur? There are several ways:

- A newly eligible employee enrolls in a plan, but fails to elect how his account is invested
- An employee is automatically enrolled in a plan and fails to make an investment election
- A default occurs when some or all of the assets in a participant's account need to be invested; for example, because the plan has engaged in a re-enrollment process, but, despite being asked to provide direction as to the investment of the account and told what will happen absent that direction, a participant fails to provide an investment direction

The re-enrollment approach

Re-enrollment allows fiduciaries to enjoy the protection of the QDIA safe harbor. The concept applies to new participants and to participants who have already made affirmative investment elections. Research shows, due in large part to participant inertia, even if new TDFs are offered by a plan, most participants who have already directed their investments are unlikely to act to move their accounts to the new TDFs.[25] For fiduciaries who want current participants to consider their investment decisions, re-enrollment, together with the QDIA rules, provides that opportunity.

By going through a re-enrollment process, the QDIA safe harbor will generally protect fiduciaries—if they give participants the opportunity to make a new investment decision or, if they do not make new elections, to be defaulted into a QDIA (e.g., age-appropriate TDFs). In other words, if participants are defaulted into a QDIA after re-enrollment and the QDIA conditions are satisfied, fiduciaries will generally have the QDIA safe harbor for those assets. While this issue is not directly addressed in the QDIA regulation, it is supported by expansive language in the regulation's preamble, and has been generally discussed in a 2012 court decision.

In the preamble to the QDIA regulation, the DOL discussed several situations in which participants who previously made investment elections could be defaulted into a QDIA. Under the heading "Application of the Final Rule to Circumstances Other Than Automatic Enrollment," the DOL states:

> The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, **and any other failure of a participant to provide investment instruction. Whenever a participant or beneficiary has the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation**, so long as all of its conditions have been satisfied.[26] (emphasis added).

The DOL indicates that there are four situations in which a participant who previously made an investment election may nevertheless be defaulted into a QDIA:

1. When the plan sponsor is unable to determine whether participants were defaulted into the plan's default investment or affirmatively selected it
2. When a participant fails to provide investment direction after an elimination of an investment alternative
3. When a participant fails to provide investment direction after a change in a service provider
4. **The "catch-all," where there is any other failure of a participant to provide investment instruction**

The catch-all language, read in conjunction with the quote above (**"whenever a participant or beneficiary has the opportunity to direct the investment ... but does not ... the fiduciaries may avail themselves of the relief provided by this final regulation"**), means that fiduciaries are generally entitled to QDIA protection in any situation where a participant fails to provide investment instructions, including re-enrollment (so long as the plan satisfies the notice and information conditions in the regulation).

The United States Court of Appeals for the 6th Circuit has confirmed that the fiduciaries of a re-enrolled plan were entitled to the QDIA fiduciary safe harbor.[27] The plaintiffs in the case, Bidwell and Wilson, were participants in the re-enrolled plan; and lost money due to the re-enrollment. As explained by the Court of Appeals:

> "Bidwell and Wilson first learned of the transfer upon receipt of their quarterly account statements, immediately contacted [the employer] to inquire about the change, and then switched their investments back to the Lincoln Stable Value Fund. Due to market fluctuations in the interim, however, both Bidwell and Wilson suffered financial losses prior to the return of their funds to the Lincoln Stable Value Fund."

They argued that QDIA protection applied only to participants' accounts where no existing participant investment directions had been given. Both the trial court and the appeals court disagreed; notwithstanding the losses that Bidwell and Wilson had sustained.

In its opinion, the Court of Appeals explained:

> In enacting the Safe Harbor provision, the DOL made clear that it did not agree with Bidwell's and Wilson's interpretation of the regulation. In the preamble to the final regulation, the DOL stated explicitly that "the final regulation applies to situations beyond automatic enrollment" including circumstances such as "[t]he failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant or beneficiary to provide investment instruction." 72 Fed. Reg. 60452–01, 60453 (Oct. 24, 2007). **Thus, the DOL emphasized that "[w]henever a participant or beneficiary has the opportunity to direct the investment of assets in his or account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation**, so long as" the other Safe Harbor requirements are satisfied. Id. (emphasis added). **The DOL was clear also that the "opportunity to direct investment" includes the scenario where a plan administrator requests participants who previously had elected a particular investment vehicle to confirm whether they wish for their funds to remain in that investment vehicle** (emphasis added).

In other words, the Court ruled that, if a plan required participants to make a new investment decision (and satisfied the notice and information requirements), the QDIA fiduciary protection was available. While that result is clear in the Court's quoted language, the opinion went on to explain:

> It is the view of the Department that any participant or beneficiary, following receipt of a notice in accordance with the requirements of this regulation, may be treated as failing to give investment direction for purposes of paragraph (c)(2) of § 2550.404c–5, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle of the plan.
>
> * * * *
>
> In essence the DOL explained that, upon proper notice, participants who previously elected an investment vehicle can become non-electing plan participants by failing to respond. **As a result, the plan administrator can direct those participants' investments in accordance with the plan's default investment policies and with the benefit of the Safe Harbor protections** (emphasis added).

As this decision makes clear, the QDIA safe harbor applies to defaults in a re-enrollment setting.

Before re-enrolling, though, plan sponsors may want to review their plan documents and summary plan descriptions to make sure there are no prohibitions or limitations on defaulting participants.[28] (For example, look for language in the plan's governing documents that suggests that *only* participants can make investment decisions about their accounts or language saying that once a participant has made an investment decision, only the participant can make changes.) If the plan or Summary Plan Description (SPD) has that kind of language, they may need to be amended, and any changes will need to be communicated to participants before a re-enrollment program is implemented.

As these legal authorities demonstrate, re-enrollment is a viable option for improving participant investing with TDFs and, at the same time, providing fiduciaries with QDIA safe harbor protection.

The next section of this white paper discusses the actual re-enrollment process.

The re-enrollment process

In light of the fiduciary responsibility both for managing plan investments and for participant investing, fiduciaries may want to consider the protections, especially the safe harbors, offered by ERISA. Adding TDFs to a plan's investment line-up may help by providing a professionally managed alternative for participants to choose; but this alone does not provide fiduciary safe harbor protection. Further, based on industry experience, only a limited number of participants, and very few of those who previously decided how to invest their accounts, opt to use newly added TDFs.[29]

The process itself is not complicated. A notice must be given not less than 30 days prior to the date by which participants are required to make their investment election or be defaulted into a TDF. Other than this legally mandated notice, there are no prescribed steps in the process, though the below box represents a typical re-enrollment process timeline.

The fiduciaries' responsibility extends to the prudent selection and monitoring of the QDIA investment, but not to whether a QDIA is appropriate for the particular participant. Absent a re-enrollment process, though, the QDIA safe harbor protection may not cover many participants and, therefore, may afford only limited protection to the fiduciaries. Consider the following examples:

Plan added target date funds to investment menu

Apex Industries sponsors a 401(k) plan. Over time, the fiduciaries have added new investments, including a line-up of TDFs. Consistent with the well-documented inertia of participants, even though TDFs were added to the plan, most of the existing participants left their funds invested in the same manner as they selected at their initial enrollments. Unfortunately and consistent with industry data, many were poorly invested and not well diversified.

As new participants enter the plan, some select the TDFs and some fail to designate investments and are defaulted into TDFs as the plan's QDIAs. As a result, the fiduciaries have ERISA safe harbor protection, but only for the limited number of participants who were defaulted into the TDFs.

Now, consider the example of changing providers and using the investment reset approach to move participant funds into the TDFs. (Note that this approach is different from combining a change in providers with a re-enrollment process, discussed in the example that follows this one.)

Use investment reset approach while converting to a new provider

Consolidated Corporation decides to change providers. As a part of the conversion, the committee decides to transfer all

Communication Best Practices for Re-enrollment[30]

The following are common steps plans take in order to engage in an effective re-enrollment process. The dates are based on the final point at which assets will be defaulted into a QDIA for participants who do not make an investment election:

- 60 days in advance: provide an announcement to all participants to inform them of the re-enrollment and highlight key dates. The objective is to make sure that participants are notified well in advance of the time that they must take action or permit the default.
- At least 30 days in advance: Distribute a re-enrollment newsletter highlighting information on key dates and the opt-out process for making investment elections. This is also a key date because the required notifications must be given at this time. Participants must be informed of the blackout of their accounts (if any)[31] and must be given information about the effect of failing to give investment direction, i.e., that they will be defaulted into the QDIA.[32] Among other things, the notice must highlight available investment options, provide information about the QDIA itself and provide information about how participants may opt-out of the QDIA. In addition to providing the legal notices, this piece will also remind participants about the re-enrollment and the steps they will be asked to take.
- Seven to 10 days in advance: a final reminder may be given to participants. This may be done in conjunction with education meetings made available to the participants to help reinforce the key information about the process and answer participant questions.

participant accounts into age-appropriate TDFs; participants are not given an opportunity to opt out. This approach will be used for participants who previously directed the investment of their accounts and for those who previously defaulted and had their accounts invested in a default investment.

With respect to the latter group—those who previously defaulted—the fiduciaries will obtain the safe harbor QDIA protection. With respect to the former group—those who previously directed their accounts—they will not. While the decision to move the assets of this group into TDFs may be a prudent fiduciary decision, it does not give the fiduciaries any safe harbor protection because the fiduciaries will be considered to have exercised control over the accounts of non-defaulting participants and thus remain responsible for the fiduciary decision about how to invest their assets.

Engage in re-enrollment while converting to a new provider

Delta Company decides to change providers and, as a part of the conversion, all participants will be defaulted into TDFs as QDIAs unless they make a new investment election. During the conversion, 70% of participants do not submit new investment elections. As a result, 70% of the plan's participants are defaulted into QDIAs (i.e., age-appropriate TDFs). This means that the committee members are entitled to the fiduciary protection for the investing of accounts of the participants who defaulted (that is, 70% of the participants). (Based on the experience of one provider, between 49% and 97% of plan assets typically default in a re-enrollment.)

Engage in re-enrollment while staying with current provider

Baker Industries decides to engage in a re-enrollment while staying with their current provider. To implement that process, the committee determines a re-enrollment date (i.e., an effective date when accounts will be re-invested according to new participant instructions or, if none, to the default investment—in this case, age-appropriate TDFs). Then, re-enrollment notices, along with information about the TDFs and other investments, would be given to the participants.

On the effective date, participant instructions are implemented for those who gave new directions; for those who did not, the accounts are placed (or "defaulted") into the QDIAs.

Two questions may remain about re-enrollment, however. First, how many participants actually fail to provide new investment directions? And, second, for those who do default, how long do their funds remain in the QDIA? Statistics compiled by J.P. Morgan[33] indicate that the answer to both questions is that the percentages are oftentimes high.

The following case study clearly illustrates these statistics[34]:

Re-enrollment case study

A health care company with approximately 30,000 participants and $1.25 billion in 401(k) plan assets re-enrolled its plan in October 2013. The process had a profound impact on participant investing even among those participants who did not default. Here are the results:

- Prior to re-enrollment, 25% of plan assets were invested in TDFs. That number rose to 82% post re-enrollment and remained at 74% two years later.
- After the process was completed, 93% of participants were invested in TDFs. Of those, 96% defaulted and 4% actively elected them. Two years later, 74% of participants who defaulted into a TDF were still invested in one.

Conclusion

Fiduciaries are legally responsible for:

- Prudently selecting and monitoring the investments offered under the plan
- How their participants use those investments

To fulfill these obligations, plan sponsors may want to consider engaging in a prudent process to examine how the participant accounts are invested. If the results of the investigation are not positive, plan sponsors may want to consider ways to improve those results, which may include going through a re-enrollment process. For new participants, plan sponsors can obtain fiduciary protections for those who are defaulted into QDIAs. For existing participants, fiduciaries—such as plan committee members—can generally obtain the safe harbor protection by using a re-enrollment strategy—either when going through a plan conversion to a new provider or while staying with the same provider.

In both scenarios, participants must be given the opportunity to make a new investment election (and be provided with information about the investments). If they do not make a new election, they will be defaulted into the plan's QDIA. That offers two potential benefits to plans and fiduciaries: first, the defaulted participants may be better invested; second, the fiduciaries can receive protection from the QDIA safe harbor.

About the authors

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Fred Reish is a partner in the Drinker Biddle & Reath Employee Benefits & Executive Compensation Practice Group and Chair of the Financial Services ERISA Team. He has specialized in employee benefits law since 1973 and works with both private and public sector plans and fiduciaries; represents plans, employers and fiduciaries before the IRS and the DOL; consults with banks, trust companies, insurance companies and mutual fund management companies on 401(k) investment products and issues related to plan investments; and represents broker-dealers and registered investment advisers on compliance issues. Fred serves as a consultant and expert witness for ERISA litigation.

Fred received a J.D. from the University of Arizona James E. Rogers College of Law and B.S. from Arizona State University.

Professional recognition and awards

Fred has received a number of awards for his contributions to benefits education, communication and service, including:

- In 2011, selection by *PLANADVISER* magazine as one of the 5 Legends of the retirement industry and with retirement advisors
- The 2009 American Society of Pension Professionals & Actuaries (ASPPA)/Morningstar 401(k) Leadership Award for directly and positively influencing the ability of Americans to build successful retirements
- Selection by *PLANSPONSOR* magazine as one of the 15 Legends in the development of retirement plans
- Recognition by *401kWire* as the 401(k) Industry's Most Influential Person for 2007 (and has, for every year of that survey, been in the top 10)
- The IRS Director's Award and the IRS Commissioner's Award for his contributions to employee benefits education
- The 2006 Lifetime Achievement Award from *PLANSPONSOR* magazine
- The 2006 Lifetime Achievement Award from *Institutional Investor* for his contributions to the benefits community
- The 2004 Eidson Founder's Award from ASPPA for his significant contributions to that organization and to the benefits community

On behalf of ASPPA, he has co-authored amicus curiae briefs with the Supreme Court of the United States in the case of *Patterson v. Shumate* and with the Tax Court in the case of *Citrus Valley Estates v. Commissioner of Internal Revenue Service*.

Publications

Fred has written four books and more than 350 articles. He authors a monthly column on 401(k) fiduciary responsibility for *PLANSPONSOR* magazine.

As an experienced lawyer on benefits matters, Fred is frequently quoted by both professional and public publications, including *The Wall Street Journal, Fortune, Forbes, Inc., CFO Magazine, New York Times, Washington Post, Los Angeles Times, USA Today, Institutional Investor, PLANSPONSOR* and *Pensions & Investments*.

Speaking engagements

Fred is a nationally known speaker on fiduciary responsibility. He has spoken at the annual conferences of the American Bar Association, the American Society of Pension Professionals and Actuaries, the Western Pension and Benefits Conference, the Enrolled Actuaries Conference and the International Foundation of Employee Benefit Plans.

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Bruce Ashton is a partner in the Drinker Biddle & Reath Employee Benefits & Executive Compensation Practice Group. He has specialized in employee benefits law since 1986 and works with private and public sector plans; advises and represents plans, employers and fiduciaries before the IRS and DOL; consults with financial institutions, including banks, trust companies and insurance companies on 401(k) compliance issue; and represents registered investment advisers on issues related to fiduciary status and compliance, prohibited transactions and internal procedures. Prior to focusing on employee benefits, Bruce practiced as a corporate and securities lawyer.

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Professional recognition and awards

Bruce has received a number of awards for his contributions to the employee benefits community, including:

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- Recognition by *401kWire* as one of the 401(k) Industry's Most Influential People
- Recognition as an outstanding lawyer in The Best Lawyers in America®

Publications

Bruce has co-authored four books (with Fred Reish) and more than 150 articles on employee benefits issues, including fiduciary issues, prohibited transactions, IRS and DOL correction programs, audits and investigations and plan design. He has also been widely quoted in various benefits publications.

Speaking engagements

Bruce is a frequent speaker on various employee benefits issues and has spoken at the annual conferences of the American Society of Pension Professionals and Actuaries, the Western Pension and Benefits Conference, the Enrolled Actuaries Conference, the International Foundation of Employee Benefit Plans and the National Institute of Pension Administrators.

Endnotes

1 J.P. Morgan Asset Management, "Retirement Insights: 2017 Defined Contribution Plan Sponsor Survey Findings," 2017, hereinafter cited as "2017 Plan Sponsor Survey Findings."

2 See, e.g., Gary R. Mottola and Stephen P. Utkus, "Red, Yellow, and Green: Measuring the Quality of 401(k) Portfolio Choices," (August 2007, prepared for inclusion in "Improving the Effectiveness of Financial Education and Saving Programs," published by University of Chicago Press; "The Financial Engines National 401(k) Evaluation," Financial Engines (2010), which points out that "only about one third of participants (32%) have efficient portfolios with the appropriate amount of risk…."

3 Throughout this white paper, we refer to the responsible plan fiduciary to a plan as the plan sponsor. This is based on the fact that in most cases, the plan sponsor undertakes this role rather than delegating the duties and responsibilities to third parties. While a committee may be established to carry out the fiduciary duties, the plan sponsor—the employer—has the ultimate responsibility.

4 2017 Plan Sponsor Survey Findings.

5 2017 Plan Sponsor Survey Findings.

6 J.P. Morgan Asset Management, "Retirement Insights: 2016 Plan Participant Survey Findings," 2016, hereinafter cited as "2016 Plan Participant Survey Findings."

7 ERISA §404(a)(1)(B) and ERISA Regulation §2550.404a-1.

8 ERISA §409(a). See also, Department of Labor's Amicus Brief in *Hecker v. Deere:* "It is the fiduciary's responsibility to choose investment options in a manner consistent with the core fiduciary duties of prudence and loyalty. If it has done so, section 404(c) relieves the fiduciary from responsibility for the participants' exercise of authority over their own accounts. If, however, the funds offered to the participants were imprudently selected or monitored, the fiduciary retains liability for the losses attributable to the fiduciary's own imprudence."

9 ERISA §404(a)(1)(A).

10 Preamble to QDIA regulation, 72 Fed.Reg. 60452, at page 60453.

11 See, e.g., ERISA Regulation §2550.404a-1(b)(i).

12 *Id.* See, also, ERISA Regulation §2550.404a-4(b)(i).

13 Technically, this is not a safe harbor but a defense to a claim of breach of fiduciary duty. Since it is commonly referred to as a "safe harbor," however (except by the DOL), we have elected to include the discussion of 404(c) here. This distinction was discussed by the DOL in the preamble to the final 404(c) regulation: "a number of commentators on the 1991 proposal suggested that the Department adopt the regulation as a 'safe harbor' under ERISA section 404(c), thereby providing a fiduciary of a plan which fails to comport with the requirements of this regulation the opportunity to argue that the particular plans and any particular participant directed transaction executed pursuant to such plan falls within the statutory definition, and, as such, should be afforded the exception to fiduciary liability described in ERISA section 404(c). After due consideration, the Department has decided not to adopt this suggestion. The Department continues to believe that it can best satisfy its statutory responsibility under ERISA section 404(c) by describing the basic framework necessary for a participant's or beneficiary's exercise of control, thereby providing guidance and clarification as to the application of ERISA section 404(c), while at the same time affording flexibility in the design of ERISA section 404(c) plans. Finally, as previously explained, non-complying plans do not necessarily violate ERISA; non-compliance merely results in the plan not being accorded the statutory relief described in section 404(c)." 57 Fed. Reg. 56906 (October 13, 1992).

14 See ERISA Regulation §2550.404a-5.

15 See ERISA §§3(38), 402(c)(3) and 405(d).

16 ERISA §404(c)(5).

17 *Bidwell v. University Medical Center, Inc.,* 685 F.3d 613 (6th Cir. 2012).

18 Preamble to QDIA Regulation, 72 FR 60475, FN 40. Cites to studies showing that "Participants have been found to exhibit inertia in their investment choices, being slow to rebalance or to respond to changes in the investment options offered to them (see, e.g., Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi, The Inattentive Participant: Portfolio Trading Behavior in 401(k) Plans, Pension Research Council Working Paper 2006-5 (2006) at 16, which finds a lack of rebalancing; see also Jeffrey R. Brown and Scott Weisbenner, Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans (Dec. 2004).")

19 ERISA Regulation §2550.404c-1(b)(3) provides that this requirement is met only if the investment options offered by the plan offer the participant an opportunity to "Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; [and] Choose from at least three investment alternatives: (1) Each of which is diversified; (2) Each of which has materially different risk and return characteristics; (3) Which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) Each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio…."

20 ERISA §404(c)(4).

21 ERISA §404(c)(5)

22 Preamble to QDIA Regulation, 72 FR 60463.

23 Preamble to QDIA Regulation, 72 FR 60453 and ERISA Regulation §2550.404c-5(b)(1) and (2).

24 ERISA Regulation §2550.404c-5 provides six requirements: (1) assets are invested in a qualified default investment alternative; (2) the participant had the opportunity to direct the investment of the assets in his account but did not do so; (3) the participant is furnished a notice regarding his right to direct his account, his right to move his account out of the QDIA and the other investment options available under the plan; (4) the participant receives certain information regarding the features of the QDIA; (5) the participant is given the right to transfer out of the QDIA to any other investment alternative available under the plan with appropriate frequency and without penalty; and (6) the plan offers a broad range of investment alternatives.

25 2016 Plan Participant Survey Findings.

26 Preamble to the QDIA Regulation, 71 FR 60453.

27 *Bidwell v. University Medical Center, Inc.,* 685 F.3d 613 (6th Cir. 2012).

28 *Falcone v. DLA Piper US LLP Profit Sharing Plan and 401(k) Savings Plan Committee,* No. 09-5555 (N.D. Cal. filed Nov. 23, 2009, terminated Sept. 2, 2011).

29 J.P. Morgan retirement research; data as of December 31, 2016.

30 See J.P. Morgan Asset Management, "Retirement Insights: Understanding re-enrollment", 2017.

31 ERISA §101(i) and ERISA Regulation §2520.101-3.

32 ERISA §404(c)(5) and ERISA Regulation §2550.404c-5.

33 J.P. Morgan retirement research; data as of December 31, 2016.

34 *Id.*

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TARGET DATE FUNDS: Target date funds are funds with the target date being the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis, with the asset allocation becoming more conservative as the fund nears the target retirement date. The principal value of the fund(s) is not guaranteed at any time, including at the target date.

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