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Evolving Fiduciary Duty Standards for Defined Contribution Plan Sponsors

The Impact of New Thinking About Employee Participation and Investment Selection

Do the recent dramatic changes in the defined contribution landscape mean that fiduciary duty standards have evolved, or will shortly evolve, to the point where plan sponsors may be required to make significant changes in the designs of their DC plans? The factors are in place for a rapid evolution in fiduciary standards in this area, and plan sponsors would be well-advised to consider and adapt to this evolution.

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The Impact of New Thinking About Employee Participation and Investment Selection

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In this paper, we examine the obligations of sponsors of defined contribution employee retirement plans (DC plans) relating to employee participation and investment selection.

Under the Employee Retirement Income Security Act of 1974 (ERISA), plan sponsors are fiduciaries with respect to their DC plan participants. This means that they must act prudently and look to the best interests of these participants. Fiduciaries, particularly those charged with overseeing the management of employee retirement investments, are charged with a high duty of care. Under ERISA, plan sponsors must act "with the care, skill, prudence and diligence under the circumstances *then prevailing* that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"[1] [emphasis added].

It is clear from these words that fiduciary duties are not static, but evolve as circumstances change. In other words, as our knowledge regarding investment management and its delivery improves, and better techniques and practices become widely accepted, investment fiduciaries must continually adapt their practices to meet the ERISA prudent expert test. The same is arguably true regarding the fiduciary duties of trustees of state and municipal pension plans that are not subject to ERISA.

Without question, we are experiencing a period of rapid change and improving knowledge regarding optimal methods for the long-term investment of retirement assets held in DC plans, as well as dramatic changes in the economic, demographic and regulatory landscape affecting retirement savings. We believe that all of these changes in investment-management best practices, and in our national retirement savings situation, have significantly affected the evolution of plan sponsor fiduciary duties and will continue to do so.

The primary changes that are contributing to this evolution are:

- The rapid shift from defined benefit to defined contribution plans as the primary source of retirement benefits for most employees. As a result, most private DC plans can no longer be viewed as supplemental to defined benefit pension plans. They must be viewed as primary in planning for retirement income.
- Growing concerns about the viability of our Social Security system, which reflect a dramatic demographic shift toward a more elderly population as the baby-boom generation ages and life expectancies increase.
- Behavioral research regarding employee participation rates in employer-sponsored DC plans, particularly at young ages and lower income levels, as well as research into the difficulty many employees have in selecting appropriate investment alternatives from those available through the plans.[2]
- Research regarding optimal long-term investment approaches for assets held in DC plans, including a much better understanding of the significance of asset-class diversification and rebalancing over an employee's working years.[3]

[1] ERISA Section 404(a)(1)(B)

[2] Benartzi, Shlomo, January 2006, *Implications of Participant Behavior for Plan Design* ("Benartzi, Implications of Participant Behavior").
[3] Thomas J. Fontaine, AllianceBernstein L.P., *Target-Date Retirement Funds: A Blueprint for Effective Portfolio Construction* ("Fontaine, Target-Date Retirement Funds").

- Regulatory pronouncements, including the recently enacted Pension Protection Act of 2006 (Pension Protection Act) and regulations proposed by the US Department of Labor (DOL) regarding default options in DC plans that are intended to encourage appropriate employee participation and investment behavior; and proposals by the DOL to significantly improve disclosures to plan participants of fees and expenses paid out of plan assets.

We believe that the confluence of these developments will significantly change the standards by which plan sponsors will be measured regarding both the way their DC plans operate to encourage appropriate levels of participation by all employees and the investment selections, including default options for employees who do not make their own selections.

A SEA CHANGE IN PERSPECTIVE

There is a change in perspective under way regarding the proper role of plan sponsors in increasing employee participation rates and contribution levels, and in facilitating appropriate investment selection. To understand the magnitude of this change, it is helpful to review past common practices, many of which persist today. Primarily to avoid perceived litigation risk, most plan sponsors have tried to distance themselves from employee contribution and investment decisions. Consistent with this approach, plans typically had the following features:

- Participation was completely voluntary, and no contributions were deducted from employee salaries, nor were employer-matching contributions made, unless the employee affirmatively opted into the plan.
- Contribution levels, within the limits set by Internal Revenue Service rules, were left up to the participant. Plan sponsors gave little guidance about what starting level would be prudent or about increasing savings levels over time as an effective way to save.
- Default investment options for participants who did not make their own selections were typically stable-value or money-market funds that carried little or no risk of capital loss, but that were demonstrably inappropriate for long-term growth.
- Sponsors provided a relatively long list of diverse investment options (typically mutual funds), but gave limited guidance about assembling and maintaining an appropriate mix of asset classes or about the importance of maintaining a consistent approach.

The accepted view seems to have been that providing employees with this framework for saving and investing was sufficient to satisfy a plan sponsor's fiduciary duties and that plan sponsors should distance themselves from employees' investment decisions and from providing investment advice to employees in order to avoid liability for possible investment losses. As has become abundantly clear, the results of this approach have been far from ideal for many employees. Many are not participating at all, and as a result of poor investment decisions most are not accumulating anywhere near enough to fund their retirements.[4]

The consequences of these past practices, which include many employees not accumulating the necessary retirement assets, have prompted a sweeping change in view about what should be done with respect to DC plan participation and investment selection. In terms of participation rates, the advisability of adopting automatic enrollment has become well-accepted by regulators and industry experts. Instead of adopting a laissez-faire approach, plan sponsors are being encouraged to automatically enroll their employees in their DC plans. This involves giving them adequate notice and an opportunity to opt out prior to the deduction of any amounts from their salaries or giving them an opportunity to make corrective withdrawals without penalty during a prescribed grace period. In addition, plan sponsors are being encouraged to couple automatic enrollment with automatic increases in contribution levels, again with an opt-out opportunity, so that employees gradually increase their contribution rates as their salaries increase.

With respect to investment selection, there is little question that the use of stable-value or money-market funds as long-term options for retirement savings is completely inappropriate. Research has shown that target-date retirement funds, life-cycle funds or managed investment portfolios that include a mix of asset classes weighted heavily toward equities in the initial years and adjusted along a "glide path" to gradually include more fixed-income investments as an individual approaches retirement, represent the best current thinking for individuals participating in DC plans.[5] This conclusion has been given explicit support in provisions contained in the new Pension Protection Act. For example, a new provision in the

[4] See "Default Investment Alternatives Under Participant Directed Individual Account Plans: Proposed Rule," 29 CFR Part 2550 (September 27, 2006).
[5] Fontaine, *Target-Date Retirement Funds*

Pension Protection Act extends liability protection to target-date retirement products that are used as default options by plan sponsors. In addition, for those employees who do make their own investment selections, industry experts tend to agree that plan sponsors should adopt some enrollment mechanism to guide participants toward investing in target-date retirement products. Significantly, the Pension Protection Act includes a number of provisions specifically designed to encourage plan sponsors to provide professional asset allocation advice programs to plan participants to assist them in making appropriate investment choices.[6]

It appears, then, that the confluence of these factors has in a very short period of time resulted in a dramatic change in view about what plan sponsors should be doing with respect to their DC plans. We believe that there already exists a strong consensus on the part of both investment professionals and government regulators that plan sponsors should not use stable-value or money-market funds as default options but should instead use target-date retirement products or other broad-based asset-allocation strategies for that purpose. There is also consensus that, for employees who make their own selections, sponsors should facilitate the choice of appropriate long-term investment options that represent a diversified mix of asset classes that will be rebalanced appropriately as the participant approaches retirement. This consensus was reflected in the fact that stable-value and money-market funds were not included as Qualified Default Investment Alternatives (QDIAs) in the DOL's proposed regulations, issued in September 2006, implementing the new default option provisions of the Pension Protection Act. QDIAs, which are discussed in more detail later, are default options that meet regulatory standards for providing sponsors with the same liability protection that they have when employees choose their own investments under the plan.

Due to pressure from insurance companies, which are traditional providers of stable-value funds, the DOL may permit some use of these funds as QDIAs in the final regulations. However, this would not diminish the legitimization and approval given to target-date products by the DOL in the proposed regulations, or the strong endorsement of these products by most knowledgeable investment professionals. Nor would it change the consensus that stable-value funds are not appropriate for use as core investments for long-term retirement saving.

[6] See new ERISA Section 406(b)(14) added by the Pension Protection Act.

We believe there is a growing consensus that best practice for DC plan sponsors is the adoption of automatic-enrollment and automatic-contribution-rate-increase features, even though some plan sponsors may be reluctant to adopt these features because the resulting employer-matching contributions would increase their costs.

THE KEY ISSUE: HAVE FIDUCIARY DUTY STANDARDS CHANGED?

Assuming long-term trends in thinking about DC best practices are undergoing profound change, what impact does this have on the fiduciary obligations of plan sponsors? Given the public policy considerations, it is hard to argue that plan sponsors do not have a moral duty to implement changes in their DC plans that will promote, rather than impede, appropriate levels of retirement savings and provide long-term investment alternatives designed to optimize returns. Does it also mean that fiduciary duty standards have evolved, or will shortly evolve, to the point where plan sponsors arguably are *required* to make some or all of these changes? These are difficult and sensitive legal issues that require careful analysis. We are not suggesting that plan sponsors have been violating their fiduciary duties with past widely accepted practices. We are suggesting, however, that the catalysts are in place for a rapid evolution in fiduciary standards in this area, and plan sponsors would be well-advised to consider and adapt to this evolution.

Automatic Enrollment

Traditionally, new employees are informed about the plans and, with little guidance, given the opportunity to enroll and to select the amount that will be withheld from their salaries and contributed to the plan. Many employees, particularly those who are young, do not enroll in their employer's plans and thus do not begin saving for retirement early in their careers, when it can be most beneficial. More than 25% of eligible American workers who could participate in a company-sponsored retirement plan do not.[7] Many, presumably to preserve current income, select the minimum withholding rate. These employees not only miss the opportunity to save and invest on a tax-deferred basis, but they also miss the opportunity to receive their employer's matching contributions, which can significantly increase the amount available for long-term investment.

[7] Salisbury, Dallas, May 19, 2005, *Written Statement for the House Committee on Ways and Means Hearing on the Retirement Policy Challenges and Opportunities of an Aging Society.*

An alternative to this approach is to automatically enroll new employees in an employer's defined contribution plan, while giving them adequate notice and an opportunity to opt out of the plan prior to the first scheduled deduction from their paychecks. Research has shown that employers who have used automatic enrollment have overall employee participation rates that are substantially higher than those whose enrollment is voluntary. In one study, participation rates for newly eligible employees increased from 49% to 86%, and other automatic-enrollment plans have achieved participation rates of over 90%.[8]

A valuable complement to an automatic-enrollment feature is an arrangement in which the contribution rate for the automatically enrolled participant starts out at a low level (for example, 3%) and then automatically increases each year until it reaches a maximum level (for example, 10%). This automatic-escalation approach has the benefit of matching incremental increases in the withholding rate to a likely pattern of salary increases so that the year-to-year financial impact on the employee is minimal, while the amount being set aside for retirement becomes much more substantial.

From a public policy standpoint, automatic enrollment and automatic escalation are very beneficial, even though they may increase employer costs due to matching provisions. They significantly raise the rate of participation, particularly among younger employees, and they also are a relatively gradual and painless way to increase contribution rates to levels that are more prudent from the standpoint of accumulating sufficient retirement savings. Behavioral research has indicated that few employees who become enrolled in these programs either opt out or curtail the automatic escalation.[9]

Recognition of these significant public policy benefits led to provisions in the Pension Protection Act designed to encourage automatic enrollment and automatic escalation. Under new Internal Revenue Code Section 401(k)(13), a plan that includes an automatic-enrollment feature is not required to meet certain technical nondiscrimination and "top heavy" rules for plans. In order to qualify for this treatment, the contribution rate must be at least 3% in the first year of participation and the minimum deferral percentage must increase by 1% each year until it reaches 6% for years four and thereafter. The maximum contribution rate is 10%. In order to qualify, the employer also must satisfy either a matching or nonelective contribution requirement. This provision becomes effective for plan years beginning after 2007.

Most DC plans do not have automatic-enrollment features. This reflects the fact that until recently DC plans generally have been viewed as supplemental to other retirement-income programs, which is consistent with participation being completely voluntary. In addition, employers were reluctant to implement automatic-enrollment features because they were uncertain about the permissibility under state law of withholding DC plan contributions from salary checks without specific employee consent. To address this concern, Congress included a provision in the Pension Protection Act that specifically preempts all state laws that prohibit or restrict an automatic-contribution arrangement when the plan includes a default option that is a QDIA under DOL rules, which we discuss below.

We do not believe that a typical employer-employee relationship would create a fiduciary duty on the part of the employer to add an automatic-enrollment feature to its defined contribution plan. Until an employee becomes enrolled in an ERISA plan, the employer generally has no ERISA-derived fiduciary obligations to the employee. The fact, however, that automatic-enrollment and automatic-escalation arrangements are so beneficial should, we believe, impose a moral duty on employers who are well-informed to add these features to their plans, even though it will produce an additional expense for them in the form of matching contributions. This is particularly true now that the Pension Protection Act has eliminated the most significant legal impediment to automatic enrollment and, in fact, includes provisions that provide attractive incentives.

Default Options

The primary reason plan sponsors selected stable-value and money-market funds as default options for participants who did not elect an investment option was to avoid liability for investment losses. The concern about liability stemmed from the contrasting treatment under ERISA of investment options selected by participants. Under ERISA Section 404(c), plan sponsors are protected from liability for investment losses when participants have selected their investment options. Prior to the enactment of the Pension Protection Act, this protection was not available for default options

[8] Benartzi, "Implications of Participant Behavior."
[9] Ibid.

because the participants did not select them. Plan sponsors feared that if their default options were funds with significant potential for investment losses (such as a diversified portfolio heavily weighted toward equity securities), they would be exposed to liability, and so they instead chose vehicles with very little possibility for investment losses.

Perhaps the thinking was, at least in the beginning, that plan participants who did not elect investment options would, in due course, get around to doing so. In that situation, placing their funds in a stable-value alternative would be a good short-term solution. However, the great majority of participants who are placed in default options do not change those options, and thus remain invested in stable-value funds for the long term.

This problem was corrected by provisions of the Pension Protection Act and proposed new DOL regulations implementing these provisions.[10] The Pension Protection Act added a new Section 404(c)(5) to ERISA that provides the same protection to plan sponsors for default options as is provided by Section 404(c) for options selected by plan participants. This protection will be conditioned upon the default option conforming to the characteristics contained in DOL regulations. The proposed regulations define three alternative types of investment products for Qualified Default Investment Alternatives, or QDIAs:

- Target-date retirement fund products or model portfolios,
- Target-risk fund product or model portfolio "with a target level of risk appropriate for participants of the plan as a whole,"[11] or
- An investment-management service where the manager allocates the participant's account among the plan's investment options "based on the participant's age, target retirement date…or life expectancy."[12]

The regulations permit the use of stand-alone investment fund products, such as mutual funds or collective investment trusts; "fund of funds" vehicles composed of various investment options in the plan; and customized investment-management services.

Significantly, none of these alternatives is a stable-value or money-market fund. In fact, the release accompanying the proposed regulations concludes that stable-value funds are not appropriate as sole long-term investment alternatives.[13] Also, each of the alternatives described in the regulations is either a target-date retirement arrangement selected based on the age of the participant or has similar characteristics but focuses on a target level of risk appropriate for participants of the plan as a whole.

Will a plan sponsor be considered to be meeting its fiduciary duty (i.e., using the care, skill, prudence and diligence of a prudent expert under circumstances currently prevailing) if it leaves in place a stable-value fund as a plan's default option? Notwithstanding the investment-loss protection provided by Section 404(c), the plan sponsor continues to have a fiduciary duty with respect to the selection and monitoring of investment options provided under the plan.[14] Thus, the selection of a default option (and arguably the decision to leave a default option in place) is an act that, under ERISA, requires the exercise of fiduciary duty. Our discussions with plan sponsors indicate a recognition that the long-term performance of stable-value funds used as default options has not been sufficient to provide adequate retirement resources and that this result is troubling to them. Given the shortcomings of stable-value investments for retirement savings, and particularly given what is now known about the behavior of participants who are placed in default options, we believe it will be difficult to argue that choosing or maintaining a stable-value fund is prudent.

This conclusion, if correct, has significant implications for plan sponsors. It means that they should, as promptly as possible, change their default options from stable-value funds to QDIAs. This should be done to take advantage of the new Section 404(c) safe harbor for QDIAs, but much more importantly to satisfy the plan sponsor's fiduciary obligation to select prudent investment alternatives. ERISA Section 404(a)(1)(C) requires that investments made by plan fiduciaries on behalf of participants be diversified unless, under the circumstances, it is clearly not prudent to do so. Investments in a stable-value fund do not achieve this

[10] 29 CFR Part 2550 (September 27, 2006).
[11] Ibid.
[12] Ibid.

[13] "As a short-term investment, money-market or stable-value funds may not significantly affect retirement savings. Such investments can play a useful role as a component of a diversified portfolio. However, when such funds become the exclusive investment of participants or beneficiaries, it is unlikely that the rate of return generated by those funds over time will be sufficient to generate adequate retirement saving for most participants or beneficiaries…Investments in capital preservation vehicles deprive investors of the opportunity to benefit from the returns generated by equity securities that have historically generated higher returns than fixed income investments." 29 CFR Part 2550 (September 27, 2006).
[14] 29 CFR Part 2550 (September 27, 2006).

result, while each of the QDIAs is designed to provide appropriate investment diversification.

Plan sponsors who decide to change their default options should make sure that the new default options are QDIAs under the proposed regulations. The rule also requires that the QDIA either be managed by an investment manager as defined in Section 3(38) of ERISA (which means that the manager must have discretionary authority with respect to asset allocation), or a mutual fund registered under the Investment Company Act of 1940.

Increased Flexibility and Liability Protection of Customized Format

The principal benefit of selecting an investment product that is a QDIA is that it will then qualify under Section 404(c) of ERISA, which provides protection from fiduciary liability for plan sponsors resulting from investment losses suffered by participants. Section 404(c) protection is available only for investment products selected by the participant (or deemed selected in the case of QDIAs). It is important to note that essentially the same protection is available under Section 405(d)(1) of ERISA, where the participant's assets are managed by a fiduciary investment manager, whether or not the participant selects (or is deemed to have selected) the investment product. The DOL specifically acknowledges in the QDIA regulations that Section 405(d)(1) already provides this protection where plan sponsors appoint fiduciary investment managers to manage participant assets.

This would appear to mean that if a plan sponsor adopts for its default option a customized format (not a mutual fund), where an investment manager directly manages the plan's assets, the plan sponsor will be protected from liability for the performance of those assets even though the arrangement technically does not qualify as a QDIA. On the other hand, if the plan sponsor selects a mutual fund (e.g., a target-date retirement fund) as the default option, the Section 405(d)(1) protection technically is not available because under ERISA the participants' assets are considered invested in mutual fund shares, rather than the mutual fund's underlying assets. In this circumstance, the only protection available is that provided by Section 404(c), and thus the arrangement must be a QDIA.

This provides more flexibility for plan sponsors who choose customized arrangements rather than mutual funds. For example, it is possible that a plan sponsor may want to use a customized target-date arrangement as a default option that does not technically meet all the requirements to be a QDIA. Although the protection available under Section 404(c) would not be available, essentially the same protection would be available under Section 405(d)(1).

INVESTMENT PRODUCT SELECTION

As the QDIA release makes clear, Section 404(c) does not provide relief from the general fiduciary rules applicable to the selection and monitoring of investment products, including the default options, in a DC plan. Sponsors are not exempt from liability, including liability for investment losses, that results from failure to satisfy those duties. Given the new perspective regarding appropriate long-term investment options, coupled with the new knowledge we have about participant conduct from behavioral studies, what does this imply for plan sponsors? We suggest that, in view of these factors, a prudent plan sponsor would want to include an array of investment products that in the aggregate:

- Have high-quality managers,
- Offer a range of investment alternatives representing appropriate asset classes,
- Include a stand-alone target-date retirement product or a customized arrangement that produces the same result, and designate this as the default option for the plan, and
- Charge reasonable fees and expenses, both direct and indirect, which are fully and fairly disclosed to plan participants.

High-Quality Managers

As emphasized in the QDIA regulations, plan sponsors are subject to general fiduciary rules applicable to the selection and monitoring of investment products made available through the plan. This means they must take prudent steps, by using their own expertise or retaining third-party experts, to ensure that their investment managers can reasonably be expected to provide high-quality services. In addition, this fiduciary duty extends to monitoring the performance of the investment products in the plan and taking action to replace those that do not meet quality standards.

Broad Range of Investment Alternatives

To qualify for Section 404(c) protection, a plan must offer participants the opportunity to invest in a broad range of alternatives. Meeting this requirement is also a condition for a QDIA. The QDIA proposal release indicates that the DOL believes that participants should be afforded a sufficient range of investment alternatives to achieve a diversified portfolio with aggregate and return characteristics at any point within the range normally appropriate for a pension plan participant.[15]

Although this requirement means that the plan must include enough different investment products to provide an appropriate mix of asset classes, plan sponsors should be highly selective to avoid offering a bewildering array of options. Behavioral studies indicate that the larger the number of investment options, the more difficulty participants have making decisions, and the more likely it is that they will select money-market and bond funds.[16]

Target-Date Option

There is a clear consensus among investment professionals and regulators that target-date retirement products represent an optimal investment solution for most employees. They provide an appropriate mix of asset classes, which in the initial years is weighted toward equity, and which is continually rebalanced and adjusted over time as the employee progresses toward retirement age. Most employees do not have the expertise or desire to select an appropriate mix of asset classes from a broad array of options or to rebalance regularly.

A prudent plan sponsor should make it easy for participants to select a target-date retirement arrangement. For example, a web-based enrollment and investment selection tool could prominently display a target-date arrangement as a simple and comprehensive investment solution. This could be a mutual fund or a customized arrangement through which an investment manager selects, from investment options available on the plan platform or otherwise, an appropriate mix of asset classes and then manages them along a glide path. This arrangement also should be a QDIA so that it can be used as the default option for the plan.

[15] 29 CFR 2550.404c-1(b)(3) provides that "[a] plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to: (A) 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; (B) 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.

[16] Benartzi, "Implications of Participant Behavior."

Fees and Expenses

As fiduciaries, plan sponsors are required to carefully consider investment fees and expenses in selecting investment products made available through their defined contribution plans. This includes an obligation to determine that the fees and expenses are fair and reasonable under the circumstances. In addition, plan sponsors also should confirm that there is adequate disclosure to the participants of the fees and expenses charged, both direct and indirect. Without this information, participants cannot make informed decisions.

The nature of these duties and the standard of conduct required to meet them is the subject of class action lawsuits brought recently against a number of plan sponsors. These lawsuits allege that the plan sponsors breached their fiduciary duties by permitting service providers to charge excessive fees for investment management and record keeping.[17]

The DOL has proposed amendments to its annual report Form 5500 that would significantly increase the level of disclosure required regarding fees and expenses, particularly those often characterized as revenue-sharing payments that are paid indirectly to plan service providers.

These developments indicate that standards in this area are evolving; and prudence suggests that plan sponsors should focus greater attention on protecting the interests of participants with respect to fees and expenses. In response to this new regulatory and civil litigation scrutiny, plan sponsors should gravitate toward lower-cost alternatives for investment products in their plans. This may accelerate a trend that is already apparent among larger plan sponsors toward using less expensive alternatives to traditional mutual funds, such as collective investment trust funds and separately managed accounts. Also, plan sponsors should look carefully at fees to make sure that participants are not being over-charged and that service provider profit margins are reasonable. They also should focus greater attention on making sure that disclosure of fees is adequate. In addition, plan sponsors should take steps to ensure that plan platforms are designed to facilitate easy and informed selection among all investment products available on the platform and do not artificially constrain the selection process in favor of certain products, such as those provided by the record keeper.

[17] During 2006, lawsuits making these allegations seeking class action status were brought against 10 plan sponsors on behalf of plan participants by the St. Louis, Missouri law firm Schlichter, Bogard and Denton.

MAPPING

In response to the changes and developments discussed in this paper, many plan sponsors are reexamining the investment options available on their plan platforms, particularly default options. This reexamination will result in plan sponsors changing, possibly dramatically, the investment options available to participants.

When these changes occur, participants' interests in existing investment options are redeemed and reinvested in the new options they selected. This is a complex and cumbersome process that presents a number of important legal issues for plan sponsors, particularly with respect to default options.

Plan sponsors have traditionally left participants on their own to make their new investment decisions. Given the new emphasis on helping participants to invest wisely, should plan sponsors encourage participants to invest in a target-date retirement service when it is added to the platform? And what should the plan sponsor do if the participant doesn't respond to a request to select new investments? This is often the case, particularly with participants who never made an election and thus are invested in the plan's default option. The traditional approach to dealing with participants who fail to make any election has been to "map" their investments over to a product that is substantially similar to the one they were invested in just prior to the change.

Although this may make sense when the participant has made a conscious selection, it does not seem appropriate when the participant is invested in a stable-value default option because he or she never made any investment selection. From a public policy standpoint, there is a strong argument that when there is a new default option that is a QDIA, assets of these nonelecting participants should be mapped over to the new QDIA rather than a new stable-value fund.

Complex Liability Protection Issues and Possible Benefits of a Customized Format

The legal implications for plan sponsors faced with these choices are complex. The Pension Protection Act includes a new provision that extends Section 404(c) liability protection to plan sponsors if they map participants who do not make new elections over to similar investment products. This protection is only available when the participant previously made an active investment selection. It would not be available where the assets are held in a default option because the participant never made any election, even if the new default option is a QDIA and the existing default option is not. The incongruous result is that new contributions received from such a participant must be invested in the new QDIA (with the accompanying Section 404(c) protection), while the cash generated by the redemption of the previous default option, presumably a stable-value fund, would have to be invested in a new stable-value fund.[18]

A possible solution to this problem may be found in Section 405(d)(1), which insulates plan sponsors from liability for investment losses where plan assets are managed by a fiduciary investment manager. This means that if the new QDIA default option is not a mutual fund, but is structured in a customized format directly managed by an investment manager, the plan sponsor should obtain essentially the same protection as provided by Section 404(c) if assets from existing default options are mapped over to the new default option. This would be true even though the new mapping provision in the Pension Protection Act is not available because the participant didn't previously make an active investment selection, and it would apply even if the QDIA 404(c) protection is not available because the new QDIA is different from the previous default option.

SUMMARY

As fiduciaries, plan sponsors must act prudently regarding the investment of retirement assets held by them for DC plan participants. Plan sponsor fiduciary duties are not static, but evolve as knowledge regarding investment management and its delivery improves. Thus, plan sponsors must continually adapt their practices to meet the ERISA prudent man test. Dramatic changes in investment-management techniques and in the economic, demographic and regulatory landscape are accelerating the evolution of plan-sponsor fiduciary duties. These changes include the shift from defined benefit to defined contribution plans, growing concerns about the health of our Social Security system, behavioral research, investment-management technique improvements and regulatory developments.

[18] Footnote language in the QDIA release indicates that Section 404(c) protection may be available if participant assets are placed in the new QDIA in certain mapping situations where the participant has failed to provide investment instructions, although it is not made specific in the proposed rule whether this would apply where the old default option (e.g., a stable-value fund) is different from the new QDIA (e.g., a target-date retirement fund), and would require clarification from the DOL. 29 CFR Part 2550, footnote 5 (September 27, 2006).

The confluence of these factors has in a very short period of time resulted in a dramatic change in view about what plan sponsors should be doing with respect to their DC plans. We expect a rapid evolution in fiduciary standards in this area, and plan sponsors would be well-advised to consider and adapt to this evolution. Examples of these adaptations include:

Automatic Enrollment

Although we do not believe that plan sponsors have a fiduciary duty to add automatic-enrollment features to their defined contribution plans, these arrangements are so beneficial that we believe they should impose a moral duty on employers who are well-informed to add these features to their plans.

Default Options

There is really no question that stable-value funds are inappropriate for long-term investment of retirement assets. Congress, in the Pension Protection Act, and the DOL, in the new proposed QDIA regulations, have clearly recognized this fact and have provided strong incentives to adopt target-date retirement arrangements or similar products as default options. This raises the question of whether a plan sponsor would be considered to be meeting its fiduciary duty (i.e., using the care, skill, prudence and diligence of a prudent man under the circumstances currently prevailing) if it leaves a stable-value fund in place as the plan's default option. We believe it will be difficult to argue that choosing or maintaining a stable-value fund is prudent. Thus, plan sponsors should change their default options from stable-value funds to QDIAs as promptly as possible. Services managed directly by a fiduciary investment manager, rather than mutual funds, may provide added flexibility because they offer a plan sponsor liability protection even if they do not technically meet all the requirements to be a QDIA.

Investment Product Selection

Plan sponsors have a fiduciary duty with respect to the selection and monitoring of investment products available to participants in a DC plan. We suggest that in view of changes that have occurred, a prudent plan sponsor should provide:

- Investment products that are managed by high-quality managers,
- A broad range of investment alternatives using a limited number of carefully selected investment products,
- A target-date retirement arrangement that is designated as the default option for the plan, and
- Products that charge reasonable fees and expenses, perhaps by using lower-cost vehicles such as collective investment trusts.

Mapping

Plan sponsors that elect to change their investment options should consider ways to encourage participants to select prudent and appropriate investment vehicles, such as target-date retirement arrangements, and should seek ways to map over participants who fail to make investment selections to these new target-date arrangements.

CONCLUSION

New thinking and information regarding optimal methods for encouraging employees to invest and maximize their returns, coupled with legislative and regulatory changes, are providing plan sponsors with a historic opportunity to dramatically improve the chances that their employees will save adequately for retirement. They should use this opportunity to make changes to their plan designs because it is in the best interest of their employees. They should also recognize that fiduciary liability standards in this area are poised to evolve rapidly as a result of these changes, and they may have a legal duty to implement these changes quickly. ■

Recent AllianceBernstein Publications

The Last Risk Premium Standing

Lewis A. Sanders
Chairman and CEO
May 2007

This paper explores why the US and many other countries have enjoyed a striking decline in economic volatility during the last 20 years and why, as a result, fixed-income and real-estate assets have been re-priced dramatically but equities have not. It sheds light on the nature and sustainability of some of the most important trends now shaping capital-market behavior.

Keeping 401(k) Costs Reasonable: The Return of the Collective Investment Trust

Richard A. Davies
Senior Managing Director—Defined Contribution Services
February 2007

Employers that sponsor 401(k) and other defined contribution retirement savings plans are taking a new look at a 50-year-old investment vehicle—the collective investment trust (CIT)—which can offer most of the convenient servicing features of a mutual fund with lower fees and pricing flexibility. Large plan sponsors that have not already done so should take another look at this versatile and appealing option.

The Future of Defined Contribution Plans

Seth J. Masters
CIO—Blend Strategies
June 2006

Proposed legal changes that would encourage US DC plans to make available broad asset-allocation strategies such as target-date retirement funds are necessary, but not sufficient, to solving the long-standing problems of DC plans, in our view. We advocate a new paradigm: embracing fiduciary responsibility.

Target-Date Retirement Funds: A Blueprint for Effective Portfolio Construction

Thomas J. Fontaine
Director of Research—Blend Strategies
October 2005

Target-date retirement funds can be attractive investment options as self-directed defined contribution plans replace traditional defined benefit plans as the primary retirement savings vehicle for most workers. Target-date funds offer a premixed asset-allocation strategy that automatically adjusts as a participant ages. Research shows that the funds are likely to be superior to the allocation that a participant might choose on his or her own. Our research also shows that most target-date retirement funds are not providing the high-quality investment planning and asset allocation that plan sponsors, as fiduciaries, should require.

From Boom to Bust: How Innovations in Mortgage Financing Affect the US Housing Market

Sean Kelleher
Director—Liquid Markets
February 2007

In our analysis, the US housing market's explosive growth since 2001 is due not so much to traditional factors affecting home prices as to the forms and availability of home financing. To what extent did innovations in home financing help fuel the market's stellar gain, and will such innovations slow or hasten its decline? We provide insight into the factors that drive the US housing market, identify those that have been critical to the housing boom of the past five years, and formulate an outlook for the market.

Glossary of Key Investment Terms

AllianceBernstein
January 2007

The glossary, which was compiled in response to numerous requests, helps define terminology that is commonly used in our firm's quarterly reports and other communications materials.

Target-Date Retirement Funds and the Defined Contribution Plan Sponsor's Fiduciary Responsibility

Daniel A. Notto
Senior Vice President, Senior Retirement Plan Counsel
October 2006

Choosing default investment options isn't easy: The 404(c) safe harbor doesn't protect sponsors from fiduciary liability because the participant doesn't exercise choice. And stable-value funds—a common default option—may fail the "prudent expert" standard. We think target-date retirement funds are a more prudent default choice. The Pension Protection Act of 2006 extends the safe harbor when target-date funds and certain other asset-allocation programs are used as default options in defined contribution plans. This is likely to accelerate the growth of target-date retirement funds.

SMID: An Attractive Asset Class in Its Own Right

Bruce K. Aronow
Team Leader—US Small/SMID Cap Growth

James Russo
Senior Portfolio Manager—US Small/SMID Cap Growth
October 2006

Institutions have tended to think of the capitalization spectrum in terms of small-, mid- and large-cap. But the combination of small and mid into SMID has been quickly gaining popularity for producing attractive diversification and alpha opportunities.

Stock-Return Momentum and Reversal Effects

Ilya Figelman
Quantitative Analyst
February 2007

How past stock performance affects future stock returns is a fundamental question in finance. While relative stock-return momentum and reversal are well-known phenomena to academics and investors, we reexamined these effects within a large-cap stock universe and confirmed the usefulness of intermediate-term momentum as a factor in our expected-return models. We also found evidence of two new momentum effects.

Implications of Participant Behavior for Defined Contribution Plan Design

Shlomo Benartzi, Ph.D.
Partner, Benartzi & DiCenzo, LLC
January 2006

Traditional education programs have largely failed to help DC plan participants to save for retirement, due to the predictable, but irrational, ways that human beings make decisions. Programs that "automate" improved savings and investing decisions are more effective ways to help plan participants to accumulate enough money to live on in retirement.

The Emergence of Hybrid Vehicles: Ending Oil's Stranglehold on Transportation and the Economy

Amy Raskin
Director—Research on Strategic Change

Saurin Shah
Analyst—Research on Strategic Change
June 2006

Hybrid vehicles are a breakthrough technology that will dominate road transportation within 25 years, dramatically reducing oil demand from the transportation sector and potentially breaking oil's stranglehold on the economy. Our research examines enabling technologies and the broad implications.

Credit Default Swaps: A Primer

Jeffrey S. Phlegar
CIO and Co-Head—Fixed Income
September 2005

Over the past few years, credit default swaps have become an enormously popular tool, giving investors the ability to add alpha and manage risk in ways not possible in the traditional bond markets. Even investors who do not participate in the CDS market cannot afford to ignore it.

Exploiting the Dynamic Gap: A Philosophy of Investing in Growth Companies

Paul C. Rissman
CIO—Alliance Growth Equities

John D. Marino
Director of Growth Quantitative Research
September 2005

A successful growth investment strategy, our research suggests, is one that focuses not on absolute growth forecasts, but rather on returns available from positive growth-rate surprises coupled with exit policies that are designed to preempt the negative effects of mean reversion. Moreover, we have found that earnings surprises can be predicted.

These publications, along with many others, are available at our website, www.alliancebernstein.com/institutional; or call Tonia Fraser at 212.823.3133.

AllianceBernstein

AllianceBernstein is one of the world's leading institutional investment managers. Our worldwide presence, breadth of services and depth of research allow us to offer a full array of investment products, both global and local, in every major market. AllianceBernstein encompasses several preeminent investment brands: AllianceBernstein Blend Strategies, Bernstein Value Equities, Alliance Growth Equities, AllianceBernstein Fixed Income and AllianceBernstein Alternative Investments.

Our Client-Centered Mission

- To have more knowledge and to use knowledge better than any investment firm in the world,
- To use and share knowledge to help our clients achieve investment success and peace of mind, and
- To place our clients' interests first and foremost.

Research Excellence

We believe that superior research is the ultimate source of superior investment returns.

In our view, superior research requires both knowing more and using knowledge better. Knowing more—having an information advantage over other market participants—requires doing deep fundamental and economic research on a truly global scale and being both accurate and innovative. Using knowledge better means identifying and exploiting pricing anomalies that can provide incremental return. It also means employing portfolio-construction techniques to manage risk and return efficiently at various points along the efficient frontier and customizing solutions to meet client-specific needs.

Our commitment to knowing more has led us to build one of the largest and broadest research footprints in our business. With close to 270 buy-side analysts operating in 13 countries, we cover thousands of securities in every meaningful capital market around the world. Our research effort is organized into separate groups dedicated to growth equities, value equities and fixed income, reflecting the unique needs of each investment approach.

Disciplined Investment Processes

Our investment-management teams pay close attention to fundamentals and valuations and follow clearly defined rules for security selection and portfolio construction. This helps ensure that client portfolios consistently exhibit the targeted characteristics and reflect intended performance patterns and return potential. Our robust risk-management and compliance systems provide a second layer of control.

Broad Array of Services

AllianceBernstein's services are designed to meet a broad range of client requirements. We offer value, growth and blend equity portfolios, with various risk/return goals and market-capitalization ranges, in developed and emerging markets. Similarly, we offer multi-asset portfolios and single-sector and multisector fixed-income portfolios across the risk/return spectrum in markets around the world. Our global platforms support single-country portfolios in the US, Canada, the UK, Japan, Hong Kong, Australia and New Zealand; European and Asian regional portfolios; and global portfolios including or excluding the home country.

Client Service and Communications

We recognize that client needs are varied. Our client-service and investment professionals seek to provide clients with the investment service that is best for them, sometimes modifying existing services to their specific requirements.

To give clients peace of mind, our client-service professionals provide personalized and timely service, and access to our investment professionals in one-on-one meetings and via conference calls, conferences and an array of print and Web-based publications. Our content-rich communications explain the research basis for our portfolio decisions, our analysis of recent market developments, our market outlook and our other research findings.

A Global Leader

As of March 31, 2007, our firm had US$742 billion in assets under management, including nearly US$468 billion for institutional clients around the world. These clients include private, public and Taft-Hartley pension plans; defined contribution plans; foundations and endowments; insurance companies; central banks; and governments in more than 45 countries. We believe that our range of services, global research coverage and ability to serve clients in virtually all parts of the world make AllianceBernstein a preeminent resource for institutional investors worldwide. ■

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