

# **Plan Sponsor ERISA Fiduciary Issues Regarding Guaranteed Lifetime Withdrawal Benefits**

## **A WHITE PAPER**

*by*

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**April 2010**



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## **EXECUTIVE SUMMARY**

There is a growing concern that people will outlast their retirement plan savings. To address this concern, the retirement plan industry has developed a retirement plan feature called a guaranteed lifetime withdrawal benefit (“GLWB”). For plans that offer a GLWB, a participant can effectively guarantee lifetime distribution amounts without giving up his or her principal. The participant must invest some or all of his or her account in certain GLWB-qualified investment option(s), pay a fee for the guarantee and follow distribution limits. If these conditions are satisfied, the participant will receive the guaranteed distribution amount each year for life. A participant may withdraw from his account value more than the guaranteed distribution amount, but if he does so, the amount guaranteed for future withdrawals will decrease. However, market declines will not decrease the distribution amount. Any account balance remaining at the participant’s death will go to the participant’s beneficiaries.

The decision to offer a GLWB is a fiduciary decision under the Employee Retirement Income Security Act of 1974 (“ERISA”). This White Paper examines the key fiduciary issues and explains how to satisfy the ERISA fiduciary standards when selecting a GLWB.

Under ERISA, fiduciaries have a duty to prudently select and monitor the GLWB provider and the underlying GLWB investment options. For the GLWB investment options, fiduciaries should perform the same selection process as with selecting any other investment options offered under the plan. When considering whether one of the GLWB investment options should be used as the plan’s default investment, fiduciaries should be aware that Department of Labor guidance indicates that the GLWB feature will not prevent the fund from being a qualified default investment alternative (“QDIA”) that provides fiduciary protection.

With respect to the GLWB provider, fiduciaries should engage in a process to consider competing GLWB providers and their respective GLWB programs, the relative fees (including, for example, investment, guarantee and plan administration fees) and the value of the benefits, and the GLWB providers' ability to make payments. Further, once selected, the fiduciaries should periodically monitor both the GLWB provider and its underlying investment options to determine whether their selection continues to be appropriate.

When deciding to implement a GLWB feature, fiduciaries may be concerned about whether changing the plan's recordkeeper will result in some participants losing the GLWB feature. However, from an ERISA standpoint, plan decisions must be made with a view towards benefiting participants as a whole. If a decision is right for the participants in general, the fact that some participants may be disadvantaged does not cause a fiduciary breach. Further, practically speaking, fiduciaries can take steps to minimize the portability concern — allowing in-service distributions, for example. In addition, some providers offer services to allow transferred plans to continue to hold the GLWB feature and investment options of the prior recordkeeper.

A GLWB feature can help ease participants' retirement savings concerns. Engaging in a prudent selection and monitoring process can help fiduciaries feel comfortable that they have satisfied their ERISA fiduciary obligations with respect to offering such a benefit. Even if a plan fiduciary ultimately decides not to offer GLWB benefits in a plan, by at least considering their appropriateness fiduciaries can illustrate that they are considering plan options that may benefit participants and address their retirement savings concerns. Further, in the event a plan's investments take a severe downturn, the fact that participants with GLWB protection have a

guaranteed distribution amount despite their decreased account value, may make the participants less likely to assert a claim and may help the fiduciaries defend a breach of duty claim.

**Plan Sponsor  
ERISA Fiduciary Issues  
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Guaranteed Lifetime Withdrawal Benefits**

**INTRODUCTION**

Plan sponsors (and, as a result, their consultants, insurers, and other service providers) are becoming concerned about whether their employees will have enough retirement benefits to last throughout retirement. One reason for the concern is that people are generally living longer than in the past. There is a 50% chance that for a couple age 65, one of them will live to age 92.<sup>1</sup> Of individuals within two years of retirement, 93% expect to live 20 to 30 years in retirement.<sup>2</sup> As life expectancies increase, the retirement plan industry is working on ways to address concerns that retirees will outlive their savings.

A recent innovation is the guaranteed lifetime withdrawal benefit (“GLWB”). This White Paper includes a detailed description of a GLWB; however, in a nutshell, a GLWB is a guarantee that a participant purchases to ensure that he or she will receive guaranteed distribution amounts for life, regardless of whether the participant’s account balance allocated to the GLWB-qualified investment option is exhausted during his or her lifetime. The GLWB essentially protects the participant’s account value allocated to the GLWB-qualified investment option against market and longevity risks while allowing the participant the benefit of being invested in the securities markets.

Plan fiduciaries considering offering a GLWB as a plan feature have a number of questions regarding their fiduciary obligations under the Employee Retirement Income Security Act of 1974 (“ERISA”). This paper examines ERISA fiduciary issues associated with offering a GLWB: selecting and monitoring the GLWB-qualified investment options; selecting and

monitoring the GLWB provider; fiduciary concerns with the portability of GLWBs; whether investment options with a GLWB can still be treated as qualified default investment alternatives in order to provide fiduciary relief for default investments; and the fee and benefit analysis for GLWBs. While governmental plans are not subject to ERISA, some states have adopted fiduciary rules for governmental plan sponsors substantially similar to ERISA.<sup>3</sup> Thus, while governmental plan sponsors should consider the fiduciary rules applicable in their state, often the ERISA fiduciary duties discussed herein will apply to governmental plans in a similar fashion.

Finally, we conclude that, when fiduciaries engage in a prudent process to inform themselves and to reach a reasoned decision, a plan may select a GLWB arrangement for its participants in a way that satisfies ERISA's high standards.

## **DESCRIPTION OF GUARANTEED LIFETIME WITHDRAWAL BENEFIT**

*“For many Americans, retiring in this new century is a mystery. Earlier generations of workers could rely on employer-provided pensions, but now many workers will need to rely on their own work-related and personal savings plus Social Security benefits. These savings have to last longer because Americans are living longer, often into their eighties and nineties.”<sup>4</sup>*

Employees who are covered by individual account plans (for example, 401(k) plans) are justifiably concerned that they will outlive their retirement savings. Specifically, they are at risk that their retirement savings will not last for their lifetimes due to market losses and/or living longer than expected.

The internet has many links to websites that contain retirement calculators designed to help retirees determine how much they will need for retirement and how much they will be able to withdraw during retirement. Such calculations can come as a huge shock to individuals nearing retirement who expect to withdraw 8-9% of their savings each year. Obviously there are multiple factors that affect retirement savings and needs – asset allocation, market returns, inflation, and length of retirement for example. However, even with different asset allocations, studies have shown that only a withdrawal rate of about 4% has a reasonable chance of providing retirement income that lasts thirty years.<sup>5</sup>

A traditional solution for this concern is the purchase of an annuity. Individuals who purchase annuities turn over their account balances to insurance companies in exchange for guaranteed payments for life (or the joint lives of the individual and his or her spouse). However, history has shown that retiring participants do not generally select annuities. One possible reason may be

that, if the participant dies after only a short time, the participant has given up his or her entire account balance for a limited number of payments. A GLWB, however, provides a participant with annual payments for life without requiring the participant to give up his or her account balance.

By purchasing GLWB protection, a participant guarantees the minimum distributions he or she will receive. When the participant elects a GLWB, the participant's initial "Benefit Base" is determined based on the participant's account value allocated to the GLWB-qualified investment options (defined below). That date is referred to as the "Ratchet Date." As long as the participant remains invested in the GLWB-qualified investment options, his or her Benefit Base will change based on the account value of each GLWB-qualified investment option as of each annual Ratchet Date. The Benefit Base will also increase immediately on a dollar for dollar basis with each contribution or transfer allocated to the GLWB-qualified investment option. However, the Benefit Base will only decrease if the participant takes excess distributions. For example, consider a participant whose Benefit Base on August 1, 2010 (the Ratchet Date) is \$400,000. If the participant makes no additional contributions or transfers to the GLWB-qualified investment option and due to market returns, the account value increases to \$425,000 on August 1, 2011, the participant's new Benefit Base is then \$425,000. However, if, due to market losses, the account declines to \$410,000 on August 1, 2012, the participant's Benefit Base is still \$425,000.

The Benefit Base is important because it is used to determine a participant's guaranteed distribution amount. Participants may take an annual distribution equal to a specified percentage of his or her Benefit Base (the "Guaranteed Distribution Amount"). The specified percentage may vary based on age or other criteria, but the specified percentage for a 65 year old participant is typically 5% for a guarantee for the participant's life and about 4.5% for a guarantee for the

joint lives of the participant and his or her spouse. (While both single life and joint life guarantees are generally available, for simplicity purposes we base our discussions in this White Paper on single life guarantees.) The GLWB typically does not allow participants to begin taking Guaranteed Distribution Amounts prior to age 55.

Upon becoming eligible for distribution, the participant may take the Guaranteed Distribution Amount each year for the participant's lifetime, despite declines in the value of the participant's account. Thus, even if the participant's account value decreases to \$0 due to market losses or a long period of taking distributions, the participant will continue to receive the Guaranteed Distribution Amount each year. Additionally, the Guaranteed Distribution Amount may increase if the Benefit Base increases — but will not decrease unless the Benefit Base decreases, which only occurs if the participant moves assets out of a GLWB-qualified investment fund (defined in the next paragraph) or takes a distribution in excess of the Guaranteed Distribution Amount. At the time of a participant's death, the market value of the account will be distributable to the participant's beneficiaries.

The GLWB option is offered in connection with certain specified investment options (which we refer to as "GLWB-qualified investment options"). These typically include target date options, as well as a balanced fund; for purposes of our discussions we will refer to these as the GLWB Target Funds and the GLWB Balanced Fund. The GLWB Target Funds are an evolving mix of investments in underlying mutual funds designed to meet investment goals based on different anticipated retirement dates. The GLWB Balanced Fund is a mix of equities, bonds and cash or cash equivalents that seeks a combination of long-term appreciation and capital preservation. Collectively, those funds are referred to as the GLWB Funds.

In order to receive the GLWB protection, participants must pay an annual fee based on their account balance allocated to the GLWB Funds. The GLWB fee is in addition to any management fees or other expenses of the underlying investment. With respect to some funds, the fee will begin immediately upon the participant's investment – essentially the participant elects the GLWB guarantee and pays the fee as long as he or she is invested in that GLWB Fund. However, for other funds (generally target date funds), the guarantee is deferred and the fee typically begins when the participant gets closer to the target date (often ten years before the target date). The fees continue to apply as long as the participant is invested in the GLWB Fund. At retirement, the participant can leave the GLWB in the plan, or roll over into an eligible IRA, continue to pay the fee and continue the protection afforded by the GLWB guarantee. When considering the GLWB fee, it is worth noting that balanced funds are generally designed to have more long-term capital growth potential than stable value or fixed income funds. As a result, participants may find that in addition to having the larger upside potential of a balanced fund compared to a stable value fund, over the long-term the amount by which the balanced fund's return exceeds the stable value fund return may more than cover the fee for the GLWB guarantee.

Essentially, the GLWB feature guarantees that, if a participant meets certain conditions (invests in a GLWB-qualified investment option, pays the annual fee, and follows withdrawal provisions), the participant will receive payments throughout retirement equal to the Guaranteed Distribution Amount. This is the case regardless of the actual market value of his or her account. Thus, even if the participant's account value has diminished, the GLWB provider still must pay the participant the Guaranteed Distribution Amount each year — using the Benefit Base, rather than the lower account value. However, if the participant's account has not been depleted at his

or her death, the participant's beneficiaries will receive the account balance based on its then market value.

The growing concern over retirement savings and the need for solutions such as GLWBs is reflected by the fact that governmental agencies are examining the issue. On February 2, 2010, the Department of Labor and the Department of Treasury issued a Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans.<sup>6</sup> Service providers, consultants and other industry experts are currently preparing comments to submit to the two Departments regarding this issue.

## ANALYSIS AND DISCUSSION

### *The Underlying Investment Option v. The Guarantee*

As described above, one component of a GLWB is that the participant must invest some or all of his or her account in one or more of certain GLWB-qualified investment options (the GLWB Target Funds or the GLWB Balanced Fund). That being said, it is important to understand that the investment options and the related fiduciary obligations should be viewed both in combination with, and separate and apart from, the GLWB.

In any individual account plan, fiduciaries are responsible for selecting the investment options offered under the plan. Participants may then allocate their accounts among the various investments. If a participant decides to purchase GLWB protection offered by a plan, the participant must invest in either a GLWB Target Fund or the GLWB Balanced Fund. Thus, in addition to evaluating the prudence of offering GLWB protection, the plan fiduciaries must consider the underlying investment options associated with the GLWB feature. When selecting the investment options linked to the GLWB, plan fiduciaries must satisfy their fiduciary duties under ERISA.

ERISA imposes certain obligations and duties on the fiduciaries of an employee benefit plan. The most fundamental of these duties are the duty of loyalty and the exclusive purpose requirement. These duties are described in ERISA as follows:

A fiduciary shall discharge his duties with respect to a plan  
solely in the interest of the participants and beneficiaries  
and

(A) for the exclusive purpose of:

- (i) providing benefits to participants and their beneficiaries; and
- (ii) defraying reasonable expenses of administering the plan.<sup>7</sup>

ERISA further provides that such duties be exercised:

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.<sup>8</sup>

Thus, fiduciaries must generally act for the exclusive purpose of providing retirement benefits to participants and, when doing that, the fiduciary's conduct is measured by the prudent man rule.

When selecting a plan's investment lineup, the fiduciaries must do so with a view toward the benefits of the participants and beneficiaries. Further, the fiduciaries must act prudently when making such decisions. The duty to act prudently has generally been described as requiring procedural diligence, but is also referred to as the "prudent expert" rule due to the requirement that fiduciaries act as a prudent man "*familiar with such matters*" would.<sup>9</sup> The main focus of this requirement is that fiduciaries engage in an appropriate process for making their decisions.<sup>10</sup>

The Department of Labor (the "DOL") has provided guidance about the process fiduciaries should follow for selecting investments.<sup>11</sup> Specifically, when making investment decisions, fiduciaries must appropriately consider the facts and circumstances that the fiduciaries know or should know are relevant to the decision and must act accordingly.<sup>12</sup> Appropriate consideration includes (but is not limited to) determining that the investment option is reasonably designed to

further the needs of the participants.<sup>13</sup> Further, in describing the fiduciary duties associated with selecting a qualified default investment alternative (“QDIA”), the DOL indicated that fiduciaries must consider “the quality of competing providers and investment products, as appropriate,” and “investment fees and expenses.”<sup>14</sup>

A key responsibility for fiduciaries is to select the investment options for their plan; however, that does not finish the work. The prudence rule in ERISA Section 404(a)(1)(B) requires that fiduciaries act “with the care, skill, prudence, and diligence *under the circumstances then prevailing.*” (Emphasis added.) Based on this “ongoing circumstances” requirement, fiduciaries must periodically monitor the plan’s investments to make sure they continue to be appropriate for the plan. Such monitoring should consider any changes to the information previously considered by the fiduciaries.<sup>15</sup> Typically, fiduciaries perform reviews at least annually to monitor a plan’s investment choices. The investments linked to a GLWB are no exception and are also subject to this ongoing duty to monitor.

Presumably, fiduciaries considering a GLWB are familiar with, and have already gone through, the process of selecting their existing investment line-up. Further, we expect that they have procedures in place to periodically monitor the investments as well. Similar considerations and review should be applied to the GLWB Target Funds and GLWB Balanced Fund from an investment standpoint when the fiduciaries are considering offering a GLWB.

### ***Selecting and Monitoring the Product and Insurance Company***

In addition to considering the underlying investment options, fiduciaries must engage in a prudent process to select the GLWB provider. The key is to consider the relevant information that a knowledgeable person would consider.

The DOL addressed a similar fiduciary issue in 2008.<sup>16</sup> Specifically, the DOL created a safe harbor for satisfying the prudence requirement when fiduciaries select an annuity provider for benefit distributions from defined contribution plans, which would include participant-directed 401(k) plans. The Annuity Safe Harbor refers to selecting an annuity provider and does not mention other lifetime income options, such as GLWBs. Because GLWBs differ from traditional annuities, the regulation does not provide an explicit safe harbor for selecting GLWB providers; however, the regulation provides insights about the steps that fiduciaries should take to prudently select an insured guarantee — like a GLWB and its provider. As described below, the safe harbor regulation sets out five requirements that fiduciaries must satisfy.

- (i) The fiduciaries must engage “in an objective, thorough and analytical search for the purpose of identifying and selecting providers.”<sup>17</sup> Even without using the safe harbor as guidance, as an initial step it makes sense for the fiduciaries to gather information regarding GLWBs and competing providers. While GLWBs are relatively new, there are multiple providers offering similar products. Gathering information about the competing providers (for example, through a request for proposal (RFP) process or working with an experienced advisor) gives fiduciaries a starting point to consider their options. This will help the fiduciaries compare the pricing, features, financial stability, administrative capabilities, and overall benefit of the competing providers.
- (ii) The fiduciaries must consider information to assess the ability of the provider to make future payments under the contract.<sup>18</sup> While there is little guidance on exactly what should be considered as part of this evaluation, the DOL does mention ratings by appropriate rating agencies, such as insurance ratings

services.<sup>19</sup> Fiduciaries may also consider other publicly available information, such as securities analysts research reports and the providers' annual reports.

- (iii) The fiduciaries must consider the cost, such as fees and commissions, of the contract in relation to the benefits and administrative services to be provided.<sup>20</sup> As described in more detail below, the cost of the GLWB is an important factor for the fiduciaries to consider. The prudence requirements do not require that fiduciaries select the "cheapest" provider. However, each provider's costs should be considered relative to the features, benefits and services that will be provided. The competitive market place is a good source of the information for this analysis.
- (iv) The fiduciaries must conclude that the provider, at the current time, is financially able to make future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services to be provided under the contract.<sup>21</sup> However, fiduciaries are not expected to have crystal balls about the future; instead, the analysis is of the insurance company's current claims paying ability. The fiduciaries make that conclusion *when the provider is selected* to provide contracts at future dates, and periodically reviews the appropriateness of the conclusion.<sup>22</sup> Arguably, the analysis should be whether there is any information the fiduciaries know or should know that would suggest that a GLWB provider will not be able to make payments.
- (v) If necessary, the fiduciaries must consult with an appropriate expert. The DOL makes it clear that engaging an expert is not required.<sup>23</sup> Rather, the fiduciaries must decide whether and to what extent they need assistance in considering and

evaluating the GLWB providers. While seeking advice from a consultant should help demonstrate prudence when selecting a GLWB provider, it is not a complete absolution of fiduciary duties. The fiduciaries must still review and consider the expert's recommendations.

It is important to remember that, while the prudence standard is a high standard, it does not require plan fiduciaries to predict the future.<sup>24</sup> Rather, the law requires that fiduciaries engage in a careful and thoughtful process to consider the relevant information and make an informed decision based on such information. While the safe harbor selection process described above is for annuities rather than GLWBs, it is important to note that safe harbors are necessarily very conservative. Safe harbors are designed to address a situation that will always meet the fiduciary requirements, even if there are other ways to satisfy them as well. Thus, even if the safe harbor does not apply to GLWBs, if fiduciaries follow an equivalent process with respect to selecting a GLWB provider, they should have a high degree of confidence they have satisfied their fiduciary duties.

Finally, as mentioned above with respect to selecting investment options, fiduciaries who have engaged in a prudent process to select a GLWB provider are not done with their duties. Fiduciaries must periodically monitor their selection to make sure it continues to be in the best interests of the participants and beneficiaries as facts and circumstances change. As with the investment options offered under the plan, fiduciaries must monitor the GLWB provider to make sure the decision continues to be valid.

### *Issues Concerning Portability*

GLWBs are relatively new products. As a result, fiduciaries considering GLWBs may be concerned about portability issues. Practically speaking, as GLWBs and similar products continue to grow in popularity, this issue will likely become irrelevant.

However, for the time being there are two main portability issues: (1) what happens if the plan sponsor changes to a different provider, and (2) what happens if a participant leaves the plan (*e.g.* upon termination of employment). Both issues stem from the fact that participants pay a fee for the lifetime distribution guarantee (including the Benefit Base), but may lose their Benefit Base and guarantee if the plan switches to a provider that does not offer the GLWB or the participant moves to a plan or IRA that does not offer the GLWB.

### Change of Recordkeeper

Fiduciaries have an ongoing duty to monitor a plan's service providers to determine if using that service provider continues to be prudent.<sup>25</sup> However, with respect to a GLWB, if the fiduciaries decide to change to a different provider, participants who had elected the guarantee may lose that guarantee. Thus, plan sponsors currently considering GLWBs may be concerned if they decide to offer a GLWB and cannot later change the GLWB provider. Essentially, the question becomes whether it is prudent for fiduciaries to select a provider who cannot be removed without causing participants to suffer a loss (*i.e.*, the protection of the GLWB).

As a practical matter, even if there is legal protection for acting prudently for the benefit of the participants as a whole, the sponsor may still want to avoid the issue of disgruntled participants. As a result, providers offer several solutions to address the portability issue.

First, the plan may arrange to have the existing GLWB provider retain the GLWB accounts even though the rest of the plan switches to a successor provider. The GLWB provider could continue to hold those investment options, receive new contributions, provide the guarantee and communicate the information to the successor provider that is needed for reporting purposes (e.g., quarterly statements and annual reports). With this approach, the guarantee and its investment funds remain an available option for all participants.

Second, if the plan does not already provide for in-service distributions for participants who have attained age 59½, a plan sponsor may amend the plan to permit such distributions.<sup>26</sup> Typically, the class of participants electing a GLWB is closer to retirement and may already be over 59½. Providing for an in-service distribution would give those participants the opportunity to take a distribution and roll the account, and the GLWB, over to an IRA.

Third, the plan sponsor could decide to freeze the GLWB option with respect to new money and keep it with the existing GLWB provider. The rest of the plan accounts could then be moved to the new provider for the plan. The third party administrator would then coordinate the accounts held with the two separate providers. In this case, new money cannot be contributed to the GLWB option but participants whose accounts were covered by the GLWB do not lose their guarantee.

Fourth, when changing service providers, the plan fiduciaries could consider other providers that also offer GLWBs or similar products. While guaranteed income products are relatively new, there are multiple service providers offering similar products. If the plan sponsor switches to a new service provider that offers a GLWB or similar product, there may be differences in the products, but in many cases the participants could continue to have substantially similar

distribution guarantees. Further, when the market is up, a participant's account value and Benefit Base may be the same. If this is the case when a plan moves to a new GLWB provider, it is likely that the participant's Benefit Base will not change much, if at all.

Fifth, as GLWBs become more popular, some recordkeepers are updating their software so that they can recordkeep a GLWB even if they do not offer a GLWB. Thus, a plan could switch to a recordkeeper that does not offer its own GLWB but supports another provider's GLWB. This is similar to a recordkeeper allowing a plan to offer self-directed brokerage accounts with brokers that are unrelated to the recordkeeper.

Through these alternatives — alone or in combination — fiduciaries may fulfill both their legal responsibilities and practical objectives for providing continuing GLWB protection for their participants.

With regard to the legal issues when recordkeepers are changed, under ERISA, fiduciaries are required to act “solely in the interest of the participants and beneficiaries” and for the exclusive purpose of providing benefits to participants and their beneficiaries.<sup>27</sup> Both the DOL and the courts have agreed that, when acting in the interest of the plan's participants and beneficiaries, fiduciaries must consider what is best for the participants as a *whole* rather than on an individual basis.<sup>28</sup> The fact that a fiduciary's decision may disadvantage an individual or a group of individuals does not mean the fiduciary breaches his or her duties, as long as the fiduciary acted prudently and in the best interests of the plan participants as a whole.

In DOL Field Assistance Bulletin 2006-01, the DOL considered how to allocate market timing proceeds among plan participants and noted that an approach may be detrimental to some participants but reasonable for the plan as a whole. The DOL explained that:

In addition, a fiduciary's decision must satisfy the "solely in the interest of participants" standard of section 404(a)(1) of ERISA. *In this regard, a method of allocation would not fail to be "solely in the interest of participants" merely because the selected method may be seen as disadvantaging some affected participants or groups of participants.* In deciding on an allocation method, the plan fiduciary may properly weigh the competing interests of various participants or classes of plan participants (*e.g.*, affected versus current participants) and the effects of the allocation method on those participants provided a rational basis exists for the selected method and such method is reasonable, fair and objective.

(Emphasis added.)

In other words, fiduciaries could determine a reasonable method of allocation that satisfied their fiduciary duties — even if the method chosen disadvantaged some participants. By analogy, as long as the fiduciaries determine that transferring to a new provider benefits the participants as a whole, the loss of features for limited individual participants would not be a fiduciary breach.

Further, in *Borneman v. Principal*, the court considered a participant's claim that Principal had breached its fiduciary duty to him when Principal required that he submit written instructions to make trades instead of making such requests over the internet.<sup>29</sup> Principal took this action after the participant repeatedly ignored warnings that he should not engage in market timing. As market timing can be detrimental to the plan as a whole, the court found that Principal did not breach its fiduciary duties by limiting the participant's trading ability. The court noted that:

As a fiduciary, Principal has a duty to act in the best interests of *all plan participants* and beneficiaries, not simply a duty to act in the best interests of each individual plan participant or beneficiary. (Emphasis added.)<sup>30</sup>

Thus, when considering a change of providers — and the related portability issues, fiduciaries should consider what will benefit the participants as a whole rather than individual participants.

#### Participant Takes a Distribution

When considering the portability concerns for a participant taking a distribution, one important point to remember is that, subject to two exceptions, the decision is voluntary on the part of the participant. More specifically, participants can only be forced to take a distribution if (1) the participant's account is less than \$5,000 (in which case, and as a practical matter, it is doubtful the participant had elected a GLWB), and (2) the participant has reached age 70½.<sup>31</sup> Absent these two scenarios, a participant may leave his or her account in the plan and retain the GLWB feature as long as the plan continues to offer it. Further, with respect to the required minimum distributions at age 70½, many GLWBs will allow such minimum distributions, even if they exceed the Guaranteed Distribution Amount, without affecting the participant's Benefit Base.

When a participant decides to take a distribution, GLWB providers generally offer the same guarantees in individual retirement annuities or accounts (IRAs) that they provide for participants. In that case, a participant who is eligible for a distribution could roll the account over to an IRA and continue the GLWB feature. The participant thus retains the protection for which he or she has been paying.

### ***QDIA Requirements***

Fiduciaries are responsible for prudently selecting and monitoring the investment options made available to participants in a participant-directed plan.<sup>32</sup> However, if the plan meets the requirements under ERISA Section 404(c), the fiduciaries are not liable for the investment decisions made by the participants.<sup>33</sup> Thus, if Section 404(c) is satisfied and a participant allocates his or her account among different investment options, the plan fiduciaries are only liable for selecting the available investment options and not the investment decisions made by the participants. Participants, however, do not always make investment elections. When that is the case (*i.e.*, when participants “default”), their accounts are allocated to default investment options chosen by the fiduciaries. Until recently, fiduciaries did not receive the 404(c) protection for default investments. Instead, fiduciaries were viewed as having made the investment decision to invest the participant in the default investment fund.<sup>34</sup>

The Pension Protection Act of 2006 added ERISA Section 404(c)(5) to provide relief for fiduciaries when a participant fails to make an investment election — if the fiduciaries satisfy notice and information requirements and the default investment meets certain requirements established by regulation.<sup>35</sup> In 2007, the DOL issued a final regulation defining qualified default investment alternatives (QDIAs) for 404(c)(5) relief.<sup>36</sup> Essentially, if a fiduciary meets the requirements in the QDIA regulation, the fiduciary is not responsible for losses resulting from

the use of the default investment alternative.<sup>37</sup> In order to obtain this fiduciary protection, many plan sponsors changed the plan's default investment to a QDIA.

One obvious question for fiduciaries considering a GLWB is whether the QDIA relief is lost when a GLWB is offered in connection with an investment option that otherwise meets the requirements. Commenters to the proposed QDIA regulation raised a similar question, specifically asking for confirmation that the availability of certain guarantee or annuity features would not cause an investment alternative to fail to qualify as a QDIA.<sup>38</sup> Further, these commenters "emphasized that the regulation should not stifle creativity in the development of the next generation of retirement products." The DOL agreed with the comments and added a new paragraph to the regulation to address the issue. Specifically, ERISA §2550.404c-5(e)(4)(vi) provides:

An investment fund product or model portfolio that otherwise meets the requirements of this section shall not fail to constitute a product or portfolio for purposes of paragraph (e)(4)(i) or (ii) of this section solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and *without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio.* (Emphasis added.)

Thus, the regulation specifically addresses investment guarantees and notes that the guarantee will not cause an investment to lose QDIA status if the requirements are otherwise satisfied.

An investment option will not be a QDIA if the fund imposes restrictions, fees or expenses on a transfer out of the fund or during the 90-day withdrawal period for initial allocations.<sup>39</sup> However, QDIA status is not lost if the fund charges ongoing fees for the operation of the investment (*e.g.* investment management fees, distribution and/or service fees, 12b-1 fees, or administrative expenses) provided the fees do not vary based on a decision to withdraw or transfer from the fund.<sup>40</sup> With respect to a GLWB fund, participants are charged a fee for the guarantee in addition to the fund management fee. The guarantee fee, however, is an ongoing fee for the guarantee and does not increase or change due to a transfer or withdrawal from the fund; quite the opposite, the fee will no longer apply if the participant transfers to a fund not provided in connection with the GLWB.

In the preamble to the QDIA regulation, the DOL notes that the fee language is “intended to ensure that defaulted participants and beneficiaries are not subject to restrictions, fees or penalties that would serve to create a greater disincentive for defaulted participants and beneficiaries, than for other participants and beneficiaries under the plan, to withdraw or transfer assets from a qualified default investment alternative.”<sup>41</sup> Participants transferring out of a GLWB fund lose the guarantee, but are not required to pay any transfer or penalty amount. The DOL further noted “to the extent that a participant or beneficiary loses the right to elect an annuity as a result of a transfer out of a qualified default investment alternative with an annuity feature, such loss would not constitute an impermissible restriction for purposes of paragraph (c)(5)(ii) inasmuch as the annuity feature is a component of the investment alternative itself.”<sup>42</sup> The DOL links annuity features and investment guarantees together when saying they do not cause a fund

not to be a QDIA. Thus, they should be treated similarly for purposes of saying the loss of such a feature upon transfer will not cause conflict with this criteria.

Even if the GLWB fee will not cause the GLWB to fail to be a QDIA, fiduciaries may want to consider whether a GLWB Fund that imposes a fee immediately upon investment (*e.g.*, a balanced fund) is desirable compared to a GLWB Fund that imposes a fee starting nearer the fund's target date. If the GLWB Fund used as a default investment imposes a fee immediately, defaulted participants of all ages start paying the guarantee fee even for relatively small accounts. On the other hand, if the GLWB Funds with deferred fee dates (often target date funds) are used as default investments, only those participants near retirement (*i.e.*, those who most likely would materially benefit from the guarantee in the relatively near future) will pay the GLWB fee.

### ***Fees and Value of Benefits***

The fees associated with a GLWB must be considered as part of the fiduciaries' selection and monitoring process. As part of this, fiduciaries must engage in a prudent process to evaluate the fees associated with a GLWB in relation to the value of the benefits provided by the GLWB.<sup>43</sup> Further, the fees paid must be no more than a reasonable amount.<sup>44</sup> There is no set definition in ERISA for what is a reasonable fee. Fiduciaries should evaluate various factors in considering whether the fees are reasonable, including the value of the benefits offered to the participants and the services offered by the GLWB provider. In considering such information, there is not necessarily one particular fee that is right. Rather, in considering the GLWB's fees, they should be within a range of reasonableness for the value of the benefits of the GLWB.<sup>45</sup>

One aspect of considering a GLWB's fees is how they compare to the fees charged by other GLWB providers. While not required, the DOL has indicated that one method of obtaining information for comparison purposes is through an RFP process.<sup>46</sup> By comparing the fees charged by competing GLWB providers, fiduciaries can understand what is reasonable in the marketplace. Further, such fees should be considered relative to the benefits and services to be provided by each GLWB provider considered.<sup>47</sup> In addition to comparing fees relative to benefits, fiduciaries should consider whether the fees are subject to change and, if so, when and within what limits.

As indicated above, fiduciaries must consider both the GLWB feature as well as the underlying GLWB Funds. Similarly, the costs associated with both aspects of the GLWB are relevant to the fiduciaries' decision. By carefully reviewing the GLWB investment and provider fees, comparing the fees of competing providers, analyzing the fees relative to the value of the benefits provided, and thoroughly understanding the overall cost structure, fiduciaries can feel comfortable that they have acted appropriately when considering the cost component of selecting a GLWB.

### ***Fiduciary Protections***

Few, if any, ERISA practitioners would argue that fiduciaries are obligated to consider offering GLWB benefits in a plan. That being said, fiduciaries are charged with acting in the interest of plan participants. When participants are concerned about their retirement savings and there is an option for the plan to address such concerns, it may make sense for the fiduciaries to at least consider such an option. When selecting the different investment options to offer under a plan, fiduciaries typically select options in multiple asset classes. By offering a range of asset classes, the fiduciaries are acting in the best interests of participants by giving them the opportunity to

allocate their accounts in a manner that makes sense based on specific risk and return needs. Similarly, by considering ways to help participants gain retirement security, fiduciaries are acting in the interests of the participants.

There may also be fiduciary protection provided by GLWBs. Consider a plan whose investments have taken a severe downturn. Participants who have lost money as a result may argue that the fiduciaries breached their duties in prudently selecting the investment options.<sup>48</sup> However, for participants with GLWB protection, they have not suffered a loss — if the plan benefits are equated to retirement income — because they will still receive the guaranteed distribution amount under the GLWB. For example, if a participant's Benefit Base is \$1,000,000 and the participant's account value drops to \$600,000, as long as the participant has satisfied the GLWB conditions, he or she will still be entitled to Guaranteed Distribution Amounts based on \$1,000,000 and not \$600,000. Fiduciaries may defend or mitigate the breach of duty claim by pointing to the fact that the participants with GLWBs did not suffer an actual loss of retirement income. In addition, and as a practical matter, the participants may be more secure in their financial situation and thus less likely to assert a claim.

## CONCLUSION

There is a growing concern in this country — among policymakers, plan sponsors and participants — that retirees will outlast their retirement savings. One solution for this concern is the GLWB, which will provide participants with a guaranteed stream of income without giving up the principal of their 401(k) accounts or rollover IRAs. As with any benefit or service being offered in a retirement plan, fiduciaries must satisfy their legal obligations when selecting a GLWB for their participants. The fiduciaries must engage in a thorough and thoughtful analysis regarding both the GLWB provider and the underlying investment options associated with the GLWB.

### IRS Circular 230 Disclosure

To ensure compliance with Internal Revenue Service Circular 230, recipients of this White Paper are hereby notified that: (1) any tax advice contained herein is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code; (2) any such advice is written to support the promotion or marketing of the matters described herein; and (3) they should seek advice based on their particular circumstances from an independent tax advisor.

*The law and our analysis contained in this White Paper are current as of April 15, 2010. Changes may have occurred in the law since this paper was drafted. As a result, readers may want to consult with their legal advisers to determine if there have been any relevant developments since then.*

## ENDNOTES

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- <sup>1</sup> National Center for Health Statistics, 2006.
- <sup>2</sup> *Retirement Income Trade-offs, Implication for Product Development*, LIMRA 2009
- <sup>3</sup> See e.g., Article XVI, Section 17 of the California Constitution.
- <sup>4</sup> DOL Publication, *Taking the Mystery out of Retirement Planning*.
- <sup>5</sup> See *Retirement Savings: Choosing a Withdrawal Rate that is Sustainable*, Philip L. Cooley, Carl M. Hubbard and Daniel T. Walz, AAI Journal February 1998, Volume XX, No. 2.
- <sup>6</sup> 75 Fed. Reg. 5253 (February 2, 2010).
- <sup>7</sup> ERISA § 404(a)(1).
- <sup>8</sup> ERISA § 404(a)(1)(B).
- <sup>9</sup> ERISA § 404(a)(1)(B).
- <sup>10</sup> See *In re Unisys Savings Plan Litigation*, 74 F.3d 420, 434 (3<sup>rd</sup> Cir. 1996).
- <sup>11</sup> ERISA Regulation § 2550.404a-1.
- <sup>12</sup> ERISA Regulation § 2550.404a-1(b)(1).
- <sup>13</sup> See ERISA Regulation § 2550.404a-1(b)(2).
- <sup>14</sup> See 72 Fed. Reg. 60453 (preamble to ERISA Regulation §2550.404c-5).
- <sup>15</sup> DOL Field Assistance Bulletin No. 2007-01.
- <sup>16</sup> ERISA Regulation § 2550.404a-4.
- <sup>17</sup> ERISA Regulation § 2550.404a-4(b)(1).
- <sup>18</sup> ERISA Regulation § 2550.404a-4(b)(2).
- <sup>19</sup> 73 Fed Reg. 58448 (Preamble to ERISA Regulation § 2550.404a-4)
- <sup>20</sup> ERISA Regulation § 2550.404a-4(b)(3).
- <sup>21</sup> ERISA Regulation § 2550.404a-4(b)(4).
- <sup>22</sup> ERISA Regulation § 2550.404a-4(c).
- <sup>23</sup> ERISA Regulation § 2550.404a-4(b)(5).
- <sup>24</sup> See *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 7 (1<sup>st</sup> Cir. 2009); *DeBruyne v. Equitable Life Assurance Society*, 720 F. Supp. 1342, 1349 (N.D. Ill. 1989).
- <sup>25</sup> See ERISA § 404(a)(1)(B).
- <sup>26</sup> See Internal Revenue Code § 401(k)(2)(B)(i)(III).
- <sup>27</sup> ERISA § 404(a)(1).
- <sup>28</sup> See DOL Filed Assistance Bulletin 2006-01.
- <sup>29</sup> *Borneman v. Principal*, 291 F. Supp. 2d 935 (S.D. Iowa 2003).
- <sup>30</sup> *Id.* At 945.
- <sup>31</sup> Internal Revenue Code §§ 401(a)(31)(B), 411(a)(11), and 401(a)(9).
- <sup>32</sup> See ERISA § 404(a).
- <sup>33</sup> See ERISA § 404(c).
- <sup>34</sup> See *id.*
- <sup>35</sup> ERISA § 404(c)(5).
- <sup>36</sup> ERISA Regulation § 2550.404c-5.
- <sup>37</sup> *Id.*
- <sup>38</sup> 72 Fed. Reg. 60460.
- <sup>39</sup> ERISA Regulation § 2550.404c-5(c)(5)(ii).
- <sup>40</sup> ERISA Regulation § 2550.404c-5(c)(5)(iii).
- <sup>41</sup> 72 Fed. Reg. 60456.
- <sup>42</sup> 72 Fed. Reg. 60456.
- <sup>43</sup> See DOL Advisory Opinion 97-16A and ERISA Reg. § 2550.404a-4(b)(3).
- <sup>44</sup> ERISA §§ 404(a)(1)(A), 406(a)(1)(C), and 408(b)(2).
- <sup>45</sup> See DOL Publication, *A Look at 401(k) Plan Fees*; *Dupree v. The Prudential Insurance Company of America*, 2007 WL 2263892 (S.D. Fla. 2007)
- <sup>46</sup> See DOL Information Letter to Diana Orantes Ceresi dated February 19, 1998.
- <sup>47</sup> See 73 Fed. Reg. 58447 (preamble to ERISA Regulation § 2550.404a-4).
- <sup>48</sup> The merits of such a claim are beyond the scope of this White Paper. We reference the claim merely to illustrate that when large plan losses occur, participants sometimes make fiduciary breach claims.