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RISK MANAGEMENT SYSTEM

6th Circuit Rules in favor of Fiduciaries – Good News for 3(38) Investment Managers



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ONE of the many responsibilities of an ERISA § 3(38) Investment Manager ("IM") is the selection, monitoring and replacement of investment alternatives including a Qualified Default Investment Alternative ("QDIA"). A QDIA was enacted as a "safe harbor" under the Pension Protection Act of 2006. The purpose of the QDIA was to mitigate fiduciary liability for investment losses tied to investment decisions made by the fiduciary on behalf of the participant who gave no investment direction. By establishing a QDIA, in strict adherence to the regulatory guidelines, a fiduciary automatically defaults a participant's account balance into the QDIA if no affirmative election is made by the participant. A fiduciary can default a participant's account balance into a QDIA upon plan entry or any time thereafter. Participants that exercised discretionary investment control over their account balance can be overridden by a fiduciary decision to re-allocate all monies held in a core fund to the QDIA. In this situation, a participant is forced to reassert their discretionary control.

Adopting a QDIA is a fiduciary decision that is best determined in collaboration with the 3(38). If a 3(38) is appointed to select or replace the QDIA, the Plan Administrator is ultimately responsible for ensuring all disclosure obligations are provided.[1] However, few plan administrators are familiar with their responsibilities. In practice, many plan sponsors contractually rely on the 3(38) to support or coordinate the following ten responsibilities…

1. Monitoring performance and confirm the QDIA investment(s) are not subject to fees or penalties for transfers out of the QDIA within the first 90-days[2],
2. Determining if and when to replace a QDIA,
3. Ensuring the drafting of a QDIA notice[3] is written in a manner calculated to be understood by the average participant[4],
4. Ensuring the QDIA notice includes the required information including QDIA name, investment objectives, risk and return characteristics and applicable fees and/or expenses[5],
5. Ensuring the annual QDIA notice is prepared that inform participants of their right to transfer or opt out,
6. Ensuring the plan administrator is provided with the QDIA notice for distribution to each participant at least 30 days before each plan year, the participant's first date of eligibility, or when a participant's account balance is first invested in a QDIA[6],
7. Ensuring the plan administrator is provided with the necessary notice to distribute to participants at least 30 days prior to implementing a change that maps an existing fund or QDIA to the QDIA replacement,
8. Ensuring participants are provided with mapping instructions and information on how to avoid being mapped to the QDIA,
9. Ensuring blackout notices are provided to participants when a QDIA is implemented or replaced, and
10. Ensuring the plan terms and design features comply with the DOL's QDIA requirements. This would also require an analysis of the summary plan description to review any QDIA wording and determine if it should be re-written or added.

[1] The term "administrator" means the person specifically so designated by the terms of the instrument under which the plan is operated. ERISA § 3(16)
[2] DOL Reg. §2550.404c-5(c)(5)(ii)
[3] 29 CFR §2550.404c-5(d)
[4] DOL Reg. §2550.404c-5(c)(4)
[5] DOL Reg. §2550.404c-5(d)(3)
[6] DOL Reg. §2550.404c-5(c)(3)

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Although many IMs assume the third-party administrator ("TPA") is responsible for preparing the QDIA notice, the decision to select or replace the QDIA resides with the IM. Since the IM is the impetus for any QDIA selection or change, it is the IM that may have fiduciary exposure if its actions cause a failure. While it is possible that a TPA will provide support, a non-fiduciary TPA is not responsible for the IM's actions or their failure to act unless the TPA assumes ministerial liability for disclosures by contract. A word to the wise, make sure your TPA contractually accepts responsibility for QDIA disclosures.

Failure to meet the disclosure obligations voids the QDIA safe harbor thus opening the plan sponsor and IM to liability for prudence, causation, and loss attribution. That is why establishing a formal QDIA risk mitigation strategy is so important. Take for example a recent Sixth Circuit Court decision.

The case I am referring to is *Bidwell vs. University Medical Center, Inc.* ("UMC")[7] wherein the Sixth Circuit affirmed the judgment of the District Court. According to the judgment, UMC made a decision to replace a stable value fund as the default option with a more aggressive life-cycle fund in 2008. Since UMC did not have the necessary records to identify which participants explicitly elected to invest in the stable value fund from those who were defaulted, a decision was made to transfer all dollars from the stable value fund to the life-cycle fund. Prior to the transfer, UMC provided the required notices to all plan participants via first-class mail. The 6th Circuit acknowledged this was acceptable. The notice informed participants that their investment in the stable value fund would be transferred to the life-cycle fund unless they elected otherwise. Shortly after the change, the markets tanked and participants that held the life-cycle QDIA suffered losses. Those participants that had previously elected the stable value fund filed suit. The plaintiffs claimed they never received the QDIA notice; therefore, the transfer was involuntary and the fiduciaries are liable for the losses incurred as a result of the fiduciary's investment decision.

The Sixth Circuit Court determined that UMC did exercise discretionary control over plan assets as a fiduciary, but did so in compliance with the QDIA safe harbor rules. As a result, UMC did not breach its fiduciary duties and is not liable for the losses. The Court even acknowledged the UMC fact pattern closely mirrored examples in the final safe harbor regulation; therefore, participants who previously elected to invest in the stable value fund but failed to opt out, failed to convince the Court they deserved any monetary award to offset losses incurred.

Bidwell serves as an important case to a plan sponsor that retains the services of an ERISA § 3(38) for their expertise and ability to mitigate fiduciary risk. To maximize risk mitigation, the plan sponsor should

1. Validate the 3(38)s qualifications since there are many 3(38)s claiming expertise they don't have,
2. Confirm the 3(38)s service agreement acknowledges responsibility for QDIA oversight,
3. Confirm either the TPA or the 3(38) contract accepts responsibility for preparation of the QDIA notices,
4. Confirm the plan document and the summary plan description include terms and design features that comply with the QDIA requirements.

CONCLUSION

Plan sponsors are obligated to retain expertise when that expertise is lacking. Retaining a 3(38) is a prudent course of action that serves the best interests of the participants when internal resources are not investment experts. However, not all 3(38)s are alike. To maximize risk mitigation your 3(38) must be intimately familiar with the QDIA requirements regardless of who prepares and disseminates the notices. If the 3(38) exercises investment discretion but fails to meet the QDIA safe harbor requirements, both the 3(38) and the plan sponsor could be liable for investment losses. Bottom line, if the 3(38) you retained is not able to articulate their ERISA expertise as it relates to QDIAs or if they are unable to prepare QDIA disclosures or coordinate the accurate preparation and timely delivery of the QDIA notices then another 3(38) should be considered. Remember, a safe harbor is only a benefit if you follow the requirements explicitly.

Fiduciary Risk Assessment ("FRA") provides consulting, expert witness and assessments of advisor expertise. PlanTools™, a wholly owned subsidiary, delivers web-based expense analysis, benchmarking, 408(b)(2) reporting, revenue sharing database, standards-based risk management and fiduciary governance solutions. For more information about FRA/PlanTools contact David J Witz, AIF® GFS™ at 704-564-0482 or dwitz@fraplantools.com

[7] *Bidwell v. Univ. Med. Ctr., Inc.*, No. 11-5493 (6th Cir. June 29, 2012), *available at* http://www.ca6.uscourts.gov/opinions.pdf/12a0203p-06.pdf

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