United States Government Accountability Office

Report to the Honorable Elizabeth Warren, U.S. Senate

August 2015

401(K) PLANS

Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants

GAO-15-578

GAO Highlights

Highlights of GAO-15-578, a report to the Honorable Elizabeth Warren, U. S. Senate

Why GAO Did This Study

DOL created a regulatory "safe harbor" in 2007 to limit plan sponsor liability for investing contributions on behalf of employees into default investments when employees do not otherwise make an election. In addition, DOL identified three default investments that, if selected by sponsors, would qualify a plan for safe harbor protection. GAO was asked to review certain aspects of these default investment types.

This report examines: (1) which options plan sponsors selected as default investments and why; (2) how plan sponsors monitor their default investment selections; and (3) what challenges, if any, plan sponsors report facing when adopting a default investment for their plan. To answer these questions, GAO reviewed relevant federal laws and guidance; analyzed industry survey data on the prevalence of default investment use; analyzed nongeneralizable responses from 227 plan sponsors who voluntarily completed a GAO web-based questionnaire; and interviewed 96 stakeholders, including service providers, advocacy groups, and research organization representatives, as well as academicians.

What GAO Recommends

GAO recommends that DOL assess the challenges that plan sponsors and stakeholders reported, including the extent to which these challenges can be addressed, and implement corrective actions, as appropriate. DOL generally agreed with GAO's recommendation.

View GAO-15-578. For more information, contact Charles Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

August 2015

401(K) PLANS

Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants

What GAO Found

Employers who sponsor 401(k) plans report using a range of default investment types to automatically enroll employees in their plans based on each type's design and other attributes. From 2009 through 2013, the majority of employers who sponsored 401(k) plans reported using a target-date fund as their default, according to data from three annual industry surveys that GAO reviewed. A target-date fund is a product or portfolio that changes asset allocations and associated risk levels over time with the objective of decreasing risk of losses with increasing age. Fewer plan sponsors reported using the other two default investment types that the Department of Labor (DOL) identified: balanced funds—products with a fixed ratio of equity to fixed-income investments—or managed account services—investment services that use participant information to customize asset allocations. Plan sponsors completing GAO's questionnaire said that they generally looked for asset diversification, ease of participant understanding, limited fiduciary liability, and a fit with participant characteristics when selecting a default investment. Some stakeholders that GAO interviewed also identified positive attributes of each default investment type and highlighted other factors that could influence a plan sponsor's default investment selection, such as plan sponsor preferences; plan circumstances; or changes in the plan's environment like a plan merger or court decision.

Plan sponsors generally monitor plan investments, including default investments, periodically to ensure alignment with the plan's objectives and investment strategies, according to stakeholders GAO interviewed and plan sponsors responding to GAO's questionnaire. Stakeholders that GAO interviewed generally said that the type of default investment and a plan's circumstances—such as the availability of resources and expertise devoted to investment monitoring—can affect the extent of a plan sponsor's monitoring efforts and the response to monitoring results. Plan sponsors responding to GAO's questionnaire and stakeholders GAO interviewed said that after an extensive default selection process, some plan sponsors may be reluctant to change the default investment regardless of monitoring results. For example, a plan sponsor and service provider may have negotiated a reduction in overall plan investment management fees in exchange for using a provider's investment as a plan's default, making it more difficult to change.

Plan sponsors cited regulatory uncertainty, liability protection, and the adoption of innovative products as significant challenges when adopting one of the three default investments. DOL regulations outline several specific conditions that plan sponsors must adhere to in order to receive relief from liability for any investment losses to participants that occur as a result of the investment. Plan sponsors responding to GAO's questionnaire and stakeholders GAO interviewed generally said that the regulations were unclear as to: (1) how sponsors could fulfill the regulatory requirement to factor the ages of participants into their default investment selection; (2) whether each default investment provided the same level of protection; or (3) whether they were allowed to incorporate other retirement features, such as products offering guaranteed retirement income, into a plan's default investment. Such uncertainty could lead some plan sponsors to make suboptimal choices when selecting a plan's default investment that could have long-lasting negative effects on participants' retirement savings.

Contents

Abbreviations

DB	defined benefit
DC	defined contribution
DOL	U.S. Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
Form 5500	Form 5500 Annual Return/Report of Employee Benefit Plan
IRA	individual retirement account
PPA	Pension Protection Act of 2006
QDIA	Qualified Default Investment Alternative
TDF	target-date fund

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
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August 25, 2015

The Honorable Elizabeth Warren
United States Senate

Dear Senator Warren:

While 60 percent of the U.S. private-sector workforce has access to an employer-sponsored defined contribution (DC) retirement plan,[1] many of these workers choose not to participate—potentially increasing their risk in retirement. According to data from the Bureau of Labor Statistics, in 2014, 18 percent of the full-time, private-sector workforce had access to but did not participate in their employer's DC plan.[2] While employers can choose to automatically enroll nonparticipating workers into their plans, as we previously reported, some of them did not, citing fears of liability.[3] To address sponsors' concerns and to bolster participant retirement savings, the Pension Protection Act of 2006 (PPA) included provisions to facilitate plan sponsors' adoption of automatic enrollment programs—policies that allow employers to automatically enroll eligible workers in a company-sponsored plan.[4] Under those provisions, plan sponsors can automatically enroll eligible workers in an employment-based plan's

[1]Employers may sponsor DC plans and/or defined benefit (DB) plans for their employees. Under a DC plan, such as a 401(k) plan, employees have individual accounts to which the employee, employer, or both make contributions, and benefits are based on contributions, along with investment returns (gains and losses) on the accounts. See 29 U.S.C. § 1002(34) and (35). DC plans allow employees who participate in the plan to specify the size of their contributions and direct their assets to one or more investments among the options offered within the plan.

[2]Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in the United States, March 2014* Bulletin 2779 (Washington, D.C.: Sept. 2014).

[3]GAO, *Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges*, GAO-10-31 (Washington, D.C.: Oct. 23, 2009).

[4]Pub. L. No.109-280, § 624, 120 Stat. 780, 980 (codified as amended at 29 U.S.C. § 1104(c)(5)). Specifically, the law provides in such cases that plan participants will be treated as having exercised control with respect to assets in individual account plans if such amounts are invested in a default investment in accordance with DOL regulations and participants are furnished the prescribed notice.

default investment unless such workers explicitly opt out of participation or choose another plan investment option. Because an automatic enrollment program requires plan sponsors—absent a specific choice by the plan participant—to choose an investment vehicle in which to invest contributions, the provisions also provided for the Department of Labor (DOL) to promulgate regulations on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or a blend of both.

In 2007, DOL issued final regulations outlining conditions under which a plan fiduciary would generally not be liable for any investment losses that occur as a result of investing contributions on behalf of participants and beneficiaries.[5] To qualify for this fiduciary relief or "safe harbor" protection,[6] among other things, plan sponsors must select one of the following three qualified default investment alternatives (QDIA) as a plan's long-term default investment:[7]

[5]Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452 (Oct. 24, 2007) (codified at 29 C.F.R. § 2550.404c-5).

[6]Plan sponsors adopting a QDIA still need to comply with longstanding Employee Retirement Income Security Act of 1974 (ERISA) requirements that they select and monitor investment options available to plan participants, act solely in the interest of plan participants and beneficiaries in accordance with plan documents, act with prudence, and offer a diversified set of investment options with reasonable fees. 29 C.F.R. § 2550.404c-5(b)(2) and (3). Additionally, plan sponsors adopting a QDIA must notify participants prior to defaulting them into the QDIA of their ability to opt-out of the default investment, and supply them with an annual notice reminding them of this right. 29 C.F.R. § 2550.404c-5(c)(3) and (d).

[7]DOL regulations also allow plan sponsors to use capital preservation products as a short-term QDIA to afford plan sponsors the flexibility of utilizing a principal-protection investment alternative for the investment of contributions during the period of time when employees are most likely to opt out of plan participation—the first 120 days after they first make an elective contribution. 29 C.F.R. § 2550.404c-5(e)(4)(iv)(B). DOL noted that the use of capital preservation products in these circumstances will enable plan sponsors to return contributed amounts to participants who opt out without concern about loss of principal. 72 Fed. Reg. 60,463.

- a product with a mix of investments[8] that takes into account the individual's age or anticipated retirement date, such as a target date fund;

- a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual, such as a balanced fund; or

- an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date, such as a managed account.

While many plans have adopted automatic enrollment policies and QDIAs in recent years, questions have arisen regarding whether the QDIA types that sponsors select are serving the best interests of all participants or improving the prospects of a secure retirement for participants whose contributions and earnings remain in the QDIA for a lengthy period of time. Thus, you asked us to review certain aspects of the QDIAs that DOL identified.[9] Specifically, we examined:

1. Which options plan sponsors selected as QDIAs and why;
2. How plan sponsors monitor their plans' QDIAs; and
3. What challenges, if any, plan sponsors report facing with regard to the selection and use of QDIAs.

To answer these questions, we reviewed relevant federal laws, regulations, and guidance on the selection and use of QDIAs in 401(k) plans; reviewed relevant research and literature; and interviewed 96 stakeholders, including plan sponsors, service providers, participant advocates, plan sponsor advocates, and academic and other pension experts. We identified knowledgeable stakeholders and selected for interviews those who would provide us with a broad range of perspectives

[8]Investment products with a mix of assets typically include (1) an equity (or stock) component, which may consist of some funds focused on equities of large U.S. corporations, international equities, or equities of smaller companies; and (2) a fixed income component, which may consist of various bond funds, such as funds comprising government and corporate bonds.

[9]Ranking Member George Miller of the House Committee on Education and the Workforce also requested that GAO conduct this work. He subsequently retired after GAO began its work.

on issues surrounding the use of default investments in DC plans. We analyzed the content of the interview responses and identified common themes. To gather data on the prevalence of QDIA use, we used data from three industry surveys that reported consistent annual data on default investments for the most consecutive years, from 2009 through 2013.[10] We took several steps to assess the reliability of the data from the three surveys, including reviewing related documentation, interviewing knowledgeable officials, and corroborating these findings with relevant literature and interview responses. We found the data to be sufficiently reliable when aggregated, as we do in this report. To better understand the experiences of plan sponsors with respect to QDIA adoption and monitoring efforts, we developed a web-based questionnaire, which was publicized with the assistance of several professional organizations whose memberships included plan sponsors or others who act as plan fiduciaries. We received 227 completed questionnaires from plan sponsors, representing the full range of plan sizes and QDIA types. We analyzed these responses and followed up with 55 respondents who voluntarily provided their contact information—we subsequently interviewed or collected written responses from 28 of these respondents to gain additional insight into their decision to adopt a QDIA for their plan. The responses we received from the questionnaire and follow-up interviews represent the views and experiences of the individual plan sponsors who contacted GAO and cannot be generalized to represent the views of the broader universe of plan sponsors. For more information on the development of the methodology used in this report, see appendix I.

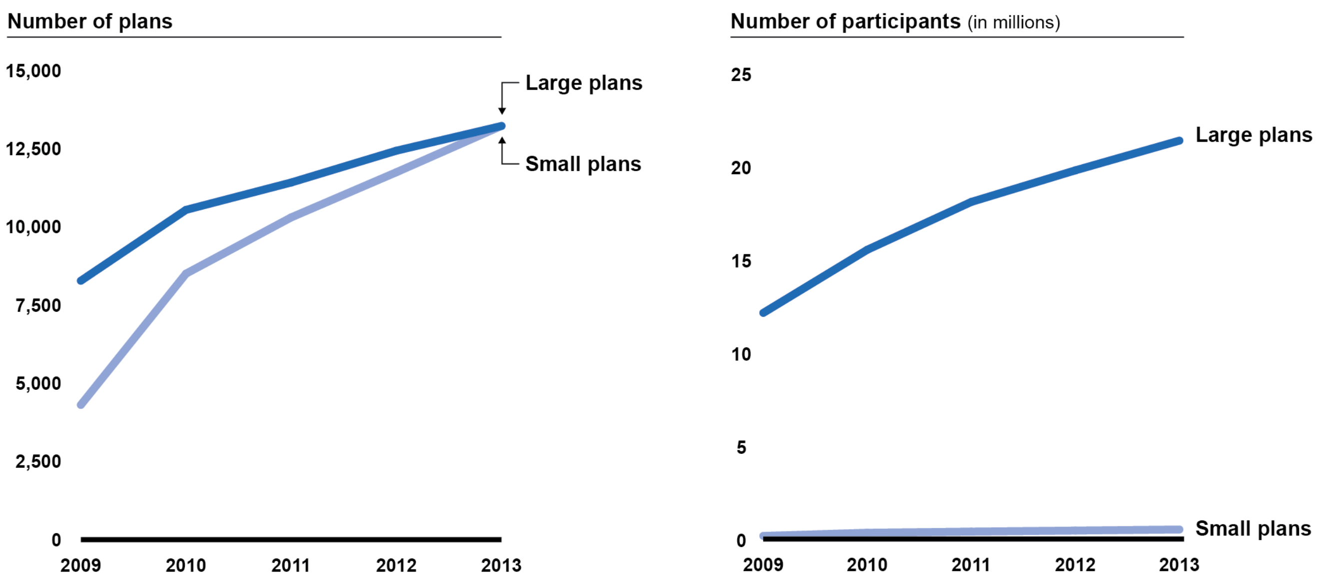
We conducted this performance audit from June 2014 through July 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[10]We examined data on plan default investments in the Form 5500 Annual Return/Report of Employee Benefit Plan (Form 5500)—the primary source of information for both the federal government and the private sector regarding the funding, assets, investments, and fees of pension and other employee benefit plans. We have previously reported on the Form 5500. See GAO, *Private Pensions: Targeted Revisions Could Improve Usefulness of Form 5500 Information*, GAO-14-441 (Washington, D.C.: June 5, 2014).

Background

As we previously reported, plan sponsors who automatically enroll employees in 401(k) plans can substantially increase participation rates among their covered employees.[11] Plan sponsors who adopt automatic enrollment policies must select a default investment—a fund or other investment vehicle into which an employee's contributions are invested—unless the employee specifies one or more investments from those available under the plan. As shown in figure 1, the number of plans that reported having automatic enrollment and a default investment has increased significantly since 2009, with more than three times the number of small plans using automatic enrollment and a default investment in 2013.

Figure 1: Automatic Enrollment and Default Investment Use among Private-Sector Defined Contribution Plans, by Plan Size and Participant Count (2009-2013)



Source: GAO analysis of annual Form 5500 data. | GAO-15-578

Note: Participant totals represent the total number of active participants in DC plans with both automatic enrollment and a default investment. DOL's Form 5500 Annual Return/Report of Employee Benefit Plan (Form 5500) is completed by plan sponsors and serves as the primary source of information for both the federal government and the private sector regarding the funding, assets, investments, and fees of pension and other employee benefit plans. The Form 5500 does not require sponsors to report the number of automatically enrolled participants.

[11] GAO-10-31.

The adoption of automatic enrollment programs is voluntary. Plan sponsors who adopt automatic enrollment must also establish default contribution rates for workers who do not specify these choices on their own. At their discretion, plan sponsors may choose to automatically enroll all employees, new or recently hired employees, or existing employees into a plan's default investment, which may be a QDIA.[12] Automatic enrollment may occur once—such as when a plan sponsor establishes a new plan or when a merger requires participants in one firm's plan to join the other firm's plan—or on a recurring basis, such as when a plan sponsor elects to re-enroll all participants, including those who have previously made investment elections. Plan sponsors may automatically re-enroll participants for a number of reasons; for example, to improve the diversification of participants' accounts, to adjust to a change in record keeper,[13] or to address the removal of certain investments from a plan's investment lineup. In all circumstances, the sponsor must notify the participants in writing of their right to opt out or to make their own investment elections.[14]

While the choice to offer a QDIA is voluntary, sponsors who choose to offer a QDIA must comply with applicable DOL regulations covering the selection of an appropriate QDIA option to use in order to receive certain fiduciary relief should participants experience investment losses. Some plan sponsors forgo the safe harbor protections and select a non-QDIA default investment, such as a money market fund or a stable value fund. There are a variety of reasons why plan sponsors do this. For example, a sponsor may have few employees and choose to require participants to make an investment election. Another sponsor may not want to assume the burden of implementing and monitoring a QDIA, including sending out multiple notices to participants. Plan sponsors who select a QDIA must adhere to several specific regulatory conditions to receive relief from

[12]While plans with automatic enrollment have a clear need for a default investment, other situations can occur in a 401(k) plan that may result in the need for a default investment, including incomplete enrollment forms, the removal of investment options, or assets rolled over from another plan.

[13]A record keeper maintains a recordkeeping system that is used to track contributions and returns. In some cases, the record keeper may serve as an investment manager and bundle these services for plan sponsors. These bundled services may also include an exchange of lower plan administration fees for the selection of a record keeper's investment product or service as a plan's QDIA.

[14]29 C.F.R. § 2550.404c-5(c)(3) and (d)(1) and (2).

liability for any investment losses to participants that occur as a result of the investment in a QDIA. To obtain relief, among other things, plan sponsors must provide participants with advance notice of the circumstances under which plan contributions or other assets will be invested on their behalf in a QDIA; a description of the QDIA's investment objectives, risk and return characteristics, and fees and expenses; and the right of participants to opt out of the QDIA.[15]

The QDIA regulations were expected to increase average retirement savings and pension retirement incomes for participants and beneficiaries by directing default investments to higher performing portfolios and by promoting the implementation of automatic enrollment programs in participant-directed individual accounts. DOL regulations describe three investment types that qualify as a QDIA that plan sponsors may choose to consider:

1. An investment product or model portfolio that applies generally accepted investment theories; is diversified so as to minimize the risk of large losses; and designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan), or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. DOL noted that an example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account.[16] This investment type is hereafter referred to as "target-date funds" (TDF) and can take two forms:[17]

[15]29 C.F.R. § 2550.404c-5(d).

[16]29 C.F.R. § 2550.404c-5(e)(4)(i). A plan sponsor selecting a TDF as a QDIA typically selects a series of individual funds that offer different asset allocations to address different lengths of time participants have until retirement. For example, a TDF series may provide funds at 5-year intervals (e.g., 2015, 2020, and 2025 to 2060) that align with participants' estimated retirement dates. While plan sponsors typically invest QDIA contributions in the fund that corresponds with a participant's targeted retirement date, participants may choose to invest in any of the funds in the plan's investment lineup, including multiple TDF series.

[17]DOL did not distinguish between these two TDF types in its final rule.

- **"Off-the-shelf" TDFs:** Pre-packaged retail products that typically use proprietary funds as their component investment options. These funds often have little overlap between the TDF's underlying funds and those in the plan's core investment lineup. Plan sponsors selecting these products have minimal control over the quality or fee levels of the component funds.

- **Custom TDFs:** Customized products for which a plan sponsor is responsible for selecting the asset classes to include, the funds to use, and the glide path that governs how those asset classes and funds will be allocated over time. Plan sponsors are able to monitor and adjust these custom TDF elements as they do for the plan's other investment options. These products can offer greater diversification than off-the-shelf TDFs because plan sponsors have access to a broader array of investment managers and the ability to incorporate the plan's existing core funds into the investment product.

2. An investment product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and designed to provide long-term appreciation and capital preservation through a mix of equity and fixed-income exposures consistent with a target level of risk appropriate for participants of the plan as a whole.[18] DOL noted that an example of such a fund or portfolio may be a "balanced" fund, and this investment type is hereafter referred to as "balanced funds."[19]

3. An investment management service with respect to which a plan fiduciary, applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income exposures, offered through investment alternatives available under the plan, and based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of

[18]The provider of these proprietary products may be an investment management firm that also serves as the plan's record keeper.

[19]29 C.F.R. § 2550.404c-5(e)(4)(ii).

losses) with increasing age. DOL noted that an example of such a service may be a "managed account" and this investment type is hereafter referred to as "managed accounts."[20]

Rather than prescribing the specific actions that a sponsor must take when selecting and monitoring plan investment options the Employee Retirement Income Security Act of 1974 (ERISA) requires that all plan fiduciaries, including plan sponsors,[21] discharge their plan duties solely in the interest of plan participants, with the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use.[22] To comply with this requirement when selecting plan investments, including a QDIA, a plan sponsor "must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate."[23] Plan fiduciaries that breach any of their fiduciary duties can be held personally liable to repay any losses, and restore any profits that have been made through use of the assets. They may also face other sanctions—including their removal as a plan fiduciary. Nothing in the QDIA safe harbor relieves any plan fiduciary from the duty to prudently select and monitor any default investments under the plan.[24] According to DOL officials, the monitoring process should

[20] 29 C.F.R. § 2550.404c-5(e)(4)(iii).

[21] ERISA defines a plan fiduciary as anyone who (1) exercises any discretionary authority or control over plan management or the management or disposition of plan assets; (2) renders investment advice respecting plan money or other property for any compensation, or has any authority or responsibility to do so; or (3) has any discretionary authority or responsibility for plan administration. 29 U.S.C. § 1002(21). DOL recently published a proposed rule that would treat persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner as plan fiduciaries; ensure that such investment advice is in the best interest of their clients; and allow clients to hold those who provide investment advice to them accountable. Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (Apr. 20, 2015).

[22] 29 U.S.C. § 1104(a).

[23] 72 Fed. Reg. 60,453. DOL guidance suggests that plan sponsors document decisions and the basis for those decisions. For example, a fiduciary may want to survey a number of potential providers, asking for the same information and specifying the same requirements. Such methods allow a plan sponsor to make a meaningful comparison and selection. See DOL, EBSA, *Meeting Your Fiduciary Responsibilities* (Government Printing Office: Washington, D.C.: Feb. 2012)

[24] 29 C.F.R. § 2550.404c-5(b)(2).

examine whether there have been any significant changes in the information fiduciaries considered when the QDIA was first selected or last reviewed. Plan sponsors are typically plan fiduciaries. In certain circumstances, other entities may also assume a fiduciary role. As we previously reported, managed account providers and record keepers may be fiduciaries, depending on their roles and the services they provide.[25] As with other investment alternatives made available under the plan, fiduciaries must carefully consider investment fees and expenses when choosing a QDIA.

DOL's Employee Benefits Security Administration (EBSA) is the primary agency tasked with enforcing Title I of ERISA, including the PPA provisions, to protect plan participants and beneficiaries from the misuse or theft of their pension assets.[26] To carry out its responsibilities, EBSA issues regulations and guidance; investigates plan sponsors, fiduciaries, and service providers; seeks appropriate remedies to correct violations of the law; and pursues litigation when it deems necessary. As part of its mission, DOL is also responsible for assisting and educating plan sponsors to help ensure the retirement security of workers and their beneficiaries.

[25]Plan service providers that have investment discretion or provide investment advice about how to invest participant accounts are generally referred to as either "3(38) Investment Manager" fiduciaries or "3(21) Investment Adviser" fiduciaries, depending on their role in the plan. GAO-14-310. Under section 3(38) of ERISA, "3(38) Investment Manager" fiduciaries have the power to manage, acquire, or dispose of plan assets, and they acknowledge, in writing, that they are a fiduciary with respect to the plan. 29 U.S.C. § 1002(38). In contrast, under section 3(21) of ERISA, 3(21) Investment Adviser fiduciaries usually do not have authority to manage, acquire, or dispose of plan assets, but they are still fiduciaries because their investment recommendations may exercise some level of influence and control over the investments made by a plan. 29 U.S.C. § 1002(21). When managed account services are offered as QDIAs, the managed account provider is generally required to be a 3(38) Investment Manager fiduciary. 29 C.F.R. § 2550.404c-5(e)(4)(iii) and (e)(3)(i).

[26]Title I of ERISA applies to private-sector pension plans (29 U.S.C. § 1003(b)); EBSA is not responsible for enforcement pertaining to public-sector plans.

Several Factors Led a Majority of Plan Sponsors to Use Target-Date Funds over Other Default Investments

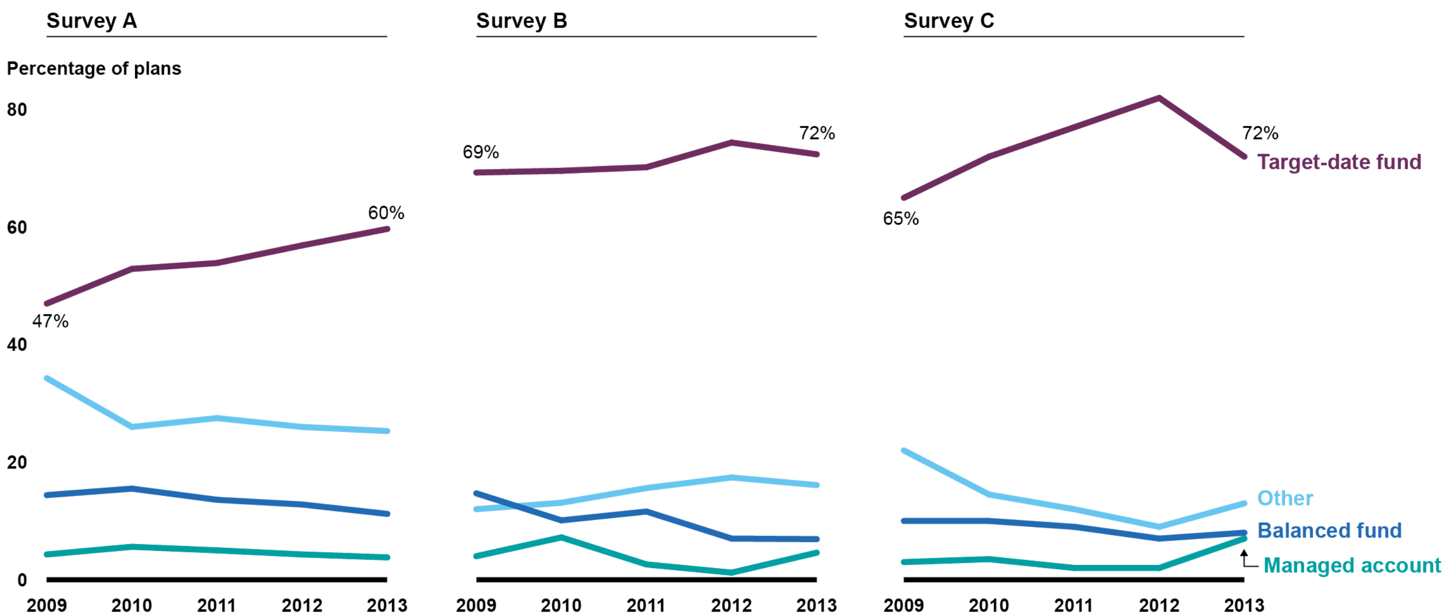
Plan Sponsors Use All Default Investment Types, but Most Use Target-Date Funds

Although there are no nationally representative data on the universe of 401(k) plan sponsors' default investment use,[27] data from three industry surveys indicated that, while plan sponsors used a range of default investment types from 2009 through 2013, the majority of plan sponsors surveyed used a TDF for this purpose.[28] Smaller groups of sponsors surveyed selected balanced funds or managed accounts as a default investment. In fact, in most years a greater percentage of plan sponsors surveyed reported using non-QDIA products—such as stable value funds or money market funds—as their default investments than used balanced funds and managed accounts combined. (See fig. 2)

[27]DOL collects limited data on plans' use of default investments from plans required to file the Form 5500. Since 2009, DC plans have been required to indicate on their annual Form 5500 filings whether (1) a plan "provides for automatic enrollment in a plan that has elective contributions deducted from payroll," and (2) if, in case of participant directed account plans, a plan "uses default investment account for participants who fail to direct assets in their account." Sponsors do not have to identify the default investment they use or whether it is a QDIA.

[28]We reviewed the results of several annual industry surveys of plan sponsors, selecting three that reported consistent annual data on sponsors' use of default investments for the most consecutive years since DOL issued final QDIA regulations (i.e., 2009-2013). PLANSPONSOR (Survey A), the Callan Investments Institute (Survey B), and Deloitte (Survey C) conducted the annual surveys that we reviewed. In 2013, the surveys collected 5,342; 107; and 265 responses, respectively. For more information on the surveys, including the industries and the amount of plan assets that each survey represented, see appendix I.

Figure 2: Use of Default Investments in Defined Contribution Plans with Automatic Enrollment, by Investment Type (2009-2013)



Source: GAO analysis of three industry surveys of sponsors of defined contribution plans. | GAO-15-578

Note: Given that our focus was the prevalence of the use of QDIAs among plan sponsors, we combined all other categories of non-QDIA default investment vehicles that plan sponsors listed in the surveys, reflected as "other" in this figure.

Some Sponsors Consider Design Features, Fiduciary Protections, and Participant Characteristics When Selecting a Default Investment

Several stakeholders[29] that we interviewed generally said that plan sponsors looked for design simplicity, fiduciary protection, and a fit with participant characteristics when selecting a default investment. Given that QDIA adoption is voluntary and sponsors have broad discretion in choosing a QDIA, plan sponsors with similar plans may select different QDIA types for the same reason. For example, 2 of the 28 sponsor respondents to our questionnaire that we subsequently interviewed told us that they chose their QDIA type because, in their view, the QDIA they chose best fit the age distribution of their participant population. In one case, the sponsor stated that the age demographics of the plan's employees were diverse, ranging from 21 to 71. As a result, the sponsor chose a TDF, believing that the funds' many target dates best fit the wide spectrum of participant ages within the plan. In contrast, another sponsor noted that the plan's participants had uneven age distribution, with higher percentages of older and younger participants. This sponsor chose a managed account, reasoning that a balanced fund or TDF would have been inappropriate for all employees. Of the 222 plan sponsors who responded to our questionnaire and selected a default investment that was a QDIA, 156 listed asset diversification, 141 listed the ease of understanding by participants, 132 listed limiting fiduciary liability, and 86 listed the appropriateness of a QDIA for a plan's participant demographics among the top reasons for selecting a QDIA.[30] Stakeholders identified a number of attributes of each QDIA type that could make it a good choice for a plan, as shown in table 1.

[29]We use the general term "stakeholders" in this report to refer to a wide range of individuals knowledgeable of different aspects of 401(k) plans, participants, and investments. We obtained stakeholder views directly through semi-structured interviews and indirectly through content analysis of the literature on QDIAs in 401(k) plans. The views presented here may not incorporate all stakeholder viewpoints. References to plan sponsors' views are based on responses obtained from plan sponsors who responded to our questionnaire. Similarly, these views are not generalizable and may not incorporate all plan sponsor views.

[30]Plan sponsors responding to the questionnaire may have included more than one reason why they selected a particular type of QDIA.

Table 1: A Comparison of Attributes Associated with Each Qualified Default Investment Alternative (QDIA)

Theme	Attributes	Balanced funds	Off-the-shelf target-date funds	Custom target-date funds	Managed accounts
Design simplicity	Easy to implement	✔	✔		
	Design easy to communicate to participants	✔	✔		
	"One-size-fits-all" design	✔			
Investment performance	Access to best-in-class managers and funds			✔	
	Builds on underlying core investments			✔	✔
Fiduciary protection	Perceived as low cost	✔	✔	[a]	[a]
	Allows performance comparisons within QDIA type	✔	✔		
	Easy to monitor	✔		✔	✔
	Allows partial transfer of fiduciary responsibility				✔
Customization	Asset allocations change as participants age		✔	✔	✔
	QDIA portfolios can be tailored to individual participant				✔[b]
	QDIA portfolios customized to plan features			✔	
	Uses participant information to assign portfolios				✔
	Focus on participant's retirement goals				✔

Source: GAO analysis based on stakeholder interviews and plan sponsor responses to GAO's questionnaire. | GAO-15-578

[a]While many sponsors and stakeholders said that the cost of custom target-date funds and managed accounts is high, others stated that this is not necessarily the case. For example, sponsors with large plans may achieve economies of scale that can significantly lower the costs of the QDIA product or service. In addition, higher returns achieved by these QDIA types could offset their higher cost. However, the customized nature of these QDIA types and the lack of comparable performance data make it difficult to determine how the net costs for managed accounts compare with net costs of other QDIA types.

[b]DOL regulations require that funds be allocated among investment alternatives available under the plan. 29 C.F.R. § 2550.404c-5(e)(4)(iii). As a result, the ability of a managed account provider to individualize a QDIA participant account may depend on the variety of asset classes available under the plan. Some managed account providers told us that they either advise or require a plan to be adequately diversified.

Even though some attributes are unique to a single QDIA type, the combination of features that each QDIA type contains can affect a plan sponsor's choice. Stakeholders we interviewed and plan sponsors responding to our questionnaire highlighted specific reasons that could make a QDIA type an appropriate choice for a plan.

- **Off-the-shelf TDFs:** Several stakeholders stated that plan sponsors generally selected off-the shelf TDFs because they are a conceptually simple, low-cost product that provides diversification and dynamic asset allocation throughout a participant's career. Some plan sponsors responding to our questionnaire who selected off-the-shelf TDFs as QDIA said that these products had beneficial characteristics, such as being tailored for a workforce that spanned diverse age groups, having a simple design, providing age-based asset allocations at a low cost, and creating appropriate retirement outcomes for participants who had little interest in investing and tended not to change their investment selections over time.

- **Custom TDFs:** Stakeholders stated that plan sponsors generally selected custom TDFs because these products provide plan sponsors with a more hands-on approach to investment management. For example, three stakeholders noted that, unlike off-the-shelf TDFs, custom TDFs allow sponsors to select best-in-class asset management to build a TDF series that meets the needs of the plan.[31] A plan sponsor responding to our questionnaire who selected a custom TDF as QDIA told us that her plan set out to develop a custom target-date glide path using plan specific demographic information and the current plan investment fund managers. As part of this process, a service provider selected a glide path that provided the best return for risk, based on participant demographics, income needs, and behavioral investment patterns.

- **Balanced funds:** Several stakeholders indicated that plan sponsors generally selected these funds for their simple design, which makes them easy to understand, manage, and monitor. Stakeholders noted that, in many cases, balanced funds had been in a plan's investment lineup for years and were familiar to sponsors and participants. Some

[31]For example, sponsors with a custom TDF can design a glide path that incorporates the interaction among multiple factors, such as other retirement benefits or assets, contribution and payout patterns, and inflation. These sponsors can also have greater control over plan design, fees, and asset managers, and can address known risks that are specific to the organization or employees. Used primarily by large plans, custom TDFs can be cost-effective because sponsors can reduce fees by placing more assets with fewer managers.

plan sponsors responding to our questionnaire who selected balanced funds as QDIA said that these products had beneficial characteristics, such as having a simple design, low costs, asset diversification, and a proven investment approach with a performance track record.

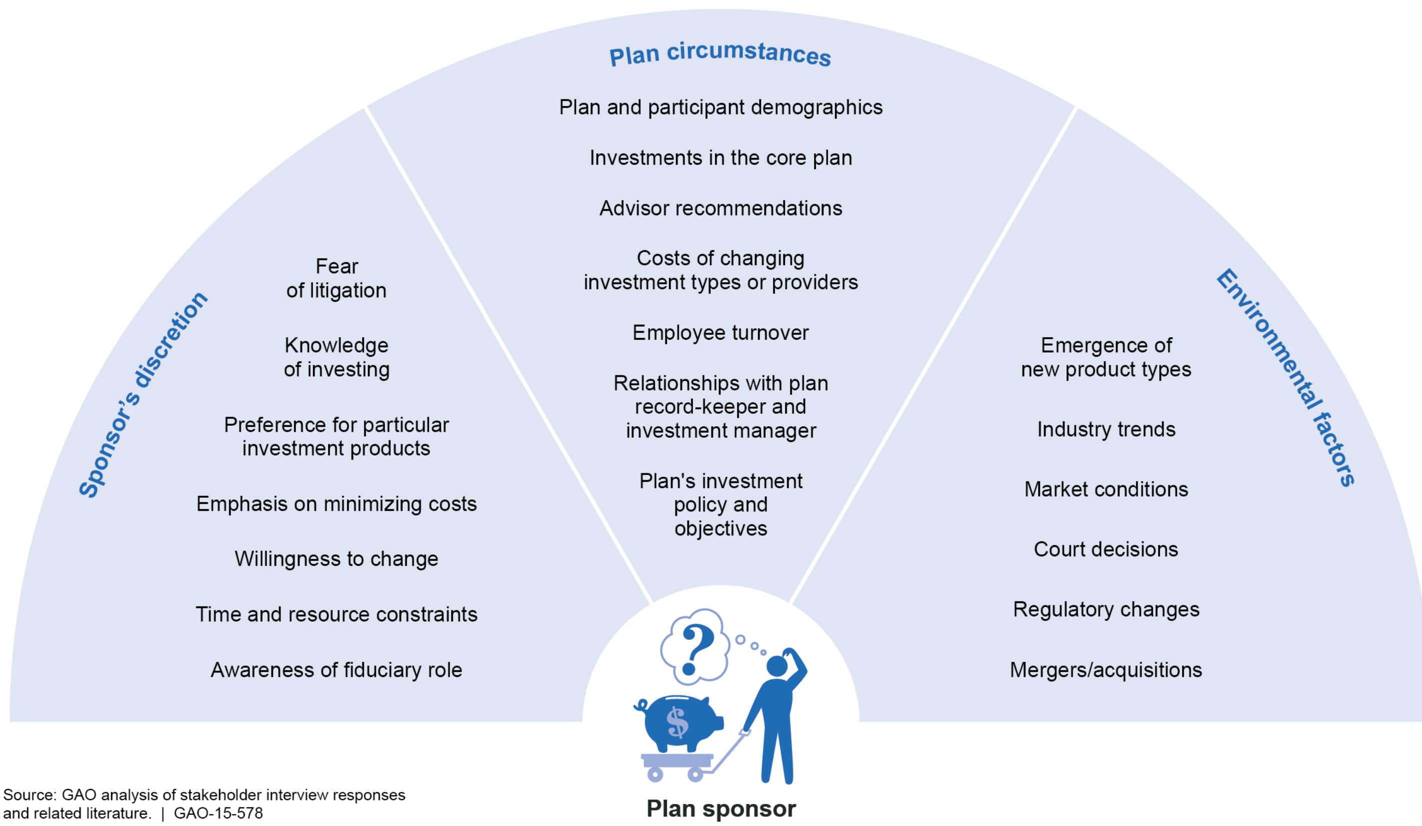
- **Managed accounts:** Several stakeholders stated that plan sponsors generally selected managed accounts because they offered the greatest level of fiduciary protection among QDIA types and aligned with participants' unique characteristics or workforce demographics, such as (1) having been grandfathered into a plan, (2) having pension benefits or deferred compensation, or (3) being salaried or hourly wage earners. Some stakeholders noted that sponsors also preferred that managed account providers have full discretion over participant portfolios being managed in a QDIA and viewed managed accounts as a retirement planning tool with the long-term focus on getting participants retirement income for life. Two stakeholders also noted that plan sponsors can input additional employee data to help managed account providers customize participant portfolios. Two plan sponsors responding to our questionnaire who selected a managed account as a QDIA said that managed accounts had beneficial characteristics, such as (1) being appropriate for all employees (including mid-career hires who may have assets outside the plan), (2) offering the best asset diversification, and (3) having the ability to take into account an employee's risk tolerance as well as age. In addition, one respondent with a managed account QDIA said that managed accounts had a superior level of customization that could lead to better participant outcomes, while another respondent indicated that managed account services are offered at costs competitive to other available investment advice services.

Exercising due diligence when selecting a QDIA type that aligns with a plan's objectives can involve a complex process with many steps.[32] Several stakeholders identified additional factors beyond the favorable attributes of each QDIA type that can influence a plan sponsor's QDIA considerations, such as sponsor preferences, plan circumstances, and environmental conditions. For example, one stakeholder noted that a plan sponsor can reject a consultant recommendation and select an investment option already in the plan or choose a QDIA frequently used

[32]We did not undertake a compliance assessment to determine the extent to which plan fiduciaries included in our study had exercised due diligence in selecting, monitoring, or comparing various QDIAs because this was outside the scope of our work.

among peers. Other stakeholders said that a sponsor may also decide against selecting a QDIA to avoid any risk of having to assume fiduciary responsibility if the investment does not perform well. Changes in the environment in which a plan is situated, such as a plan merger or court decision, could lead a sponsor to change a plan's QDIA, according to stakeholders.[33] As shown in figure 3, stakeholders identified how a combination of plan sponsor's perceptions, plan circumstances, and environmental factors can influence how a plan sponsor approaches QDIA selection and the type of QDIA selected.

Figure 3: Select Factors That Stakeholders Said Might Influence a Plan Sponsor's Default Investment Selection



Source: GAO analysis of stakeholder interview responses and related literature. | GAO-15-578

[33]A plan merger may change the overall participant demographic profile of a plan, leading a plan sponsor to have to consider whether the current QDIA is still appropriate for the participant population or a change is required.

Plan Sponsors Consider Multiple Factors When Monitoring Default Investments, and Results Depend on Plan-Specific Considerations

Plan sponsors responding to our questionnaire told us that they performed periodic monitoring of plan investments, including any default investments, by conducting quantitative and qualitative analysis to ensure the investments aligned with the plan's objectives and investment strategies. According to DOL officials, a plan sponsor should periodically compare the performance of its investment options, including its QDIA, against other similar investment products and against applicable performance benchmarks. Plan sponsors stated that they compared different quantitative metrics, such as investment returns, risks, and costs for the QDIA against comparison groups or indices, commonly across 1-, 3-, and 5-year time periods. For example, plan sponsors told us that they examined: (1) investment returns on an absolute basis, as well as relative to the performance of comparison groups or other relevant benchmarks; (2) volatility of investment returns or returns adjusted for risk; and (3) the percentage of assets deducted for fund expenses, sales fees, or other charges associated with the investment.

Plan sponsors told us that they also examined several different qualitative metrics when monitoring a QDIA to determine whether significant changes had occurred since the QDIA was selected or last examined.[34] For example, sponsors stated that they monitored changes in:

- **Plan characteristics:** With respect to TDFs and managed accounts, DOL regulations require plan sponsors to take participant age into account when selecting a QDIA that has portfolios that become less risky as the participant ages.[35] With respect to balanced funds, plan sponsors are required to consider the age of plan participants as a whole. [36] An employer with an older workforce might reconsider using a balanced fund as a QDIA if the plan's demographics changed by a significant number of younger participants enrolling in the plan. Some plan sponsors also consider other plan characteristics, such as the existence of a DB plan or average job tenure, in determining the suitability of their QDIA, but DOL regulations do not require them to do so.[37] Regardless of whether a sponsor only considered age or

[34]According to DOL officials, the frequency of monitoring depends on a plan's facts and circumstances. Sponsors and stakeholders stated that QDIA monitoring is typically conducted as part of a plan's review of its investment lineup.

[35] 29 C.F.R. § 25.404c-5(e)(4)(i) and (iii).

[36] 29 C.F.R. § 25.404c-5(e)(4)(ii).

[37]72 Fed. Reg. 60,461.

additional plan characteristics when the QDIA was selected, substantial changes in any of these factors could determine whether the QDIA continued to be a suitable investment.

- **Plan investment policies and objectives:** Plan sponsors reported that they monitored how well a QDIA aligned with the plan investment policies and objectives. For example, a plan sponsor stated that the plan's policy statement required investments not meeting pre-established benchmarks for 2 consecutive quarters to be placed on a watch list for more frequent in-depth monitoring.[38] Similarly, because a plan's investment objectives can change over time, plan sponsors monitor how well the QDIA aligns with new objectives. For example, one plan sponsor responding to our questionnaire said that his plan changed from an actively managed QDIA to a QDIA that consisted of index funds—passively managed products with the objective of approximating the same return as particular market indices (such as the S&P 500)—in order to align the QDIA investment strategy with the passive savings approach of defaulted participants.[39]

- **Service providers:** Plan sponsors stated that they monitored service provider adherence to the plan's investment management strategy. For example, plan sponsors stated that they examined the extent to which the provider faithfully implemented the investment strategy outlined in the QDIA's fund prospectus by, for example, tracking the performance of an index fund relative to that of the market index it tracked. One plan sponsor responding to our questionnaire said changes in fund management or investment processes would cause him to place the fund on a watch list and ask the plan's investment consultant to engage in additional discussions with the fund managers. Other sponsors stated they monitored fee structures, portfolio composition, asset allocations, and investment diversification, as well as the service provider's qualifications.

[38]Other plan sponsors stated that their plans' investment committees retained sufficient discretion to take current circumstances into account when making decisions on their investments so that they are not compelled to take actions that may not be in the best interest of participants.

[39]Index funds are generally passively managed funds that seek to track the performance of a market index, such as the S&P 500. In contrast, actively managed funds have specific investment goals (e.g., outperforming a market index or peer groups) and strategies that inform investment managers' research and selection of investments.

Default Investment Type and Resource Availability Can Affect Plan Sponsors' Monitoring Efforts

Plan sponsors responding to our questionnaire and stakeholders we interviewed stated that the structure and features of each QDIA type affects how they monitor them. For example, plan sponsors and stakeholders told us that quantitative performance data across similar investments varied by QDIA type, with balanced funds and off-the-shelf TDFs having more data with which to compare peer funds and benchmarks than custom TDFs and managed accounts. Some sponsors noted that the fixed asset allocation of balanced funds facilitated easy comparisons of the QDIA's returns, risks, and costs against other individual balanced funds, a balanced fund peer group, or other relevant benchmarks. A TDF's glide path, on the other hand, required plan sponsors to monitor the performance of the entire target-date series as well as each of the individual funds within it. They stated that the variation in glide paths among target-date series made it difficult for the sponsor to identify peer TDFs (or appropriate benchmarks) with similar objectives, asset allocations, and risk attributes.[40] In contrast, plan sponsors with a managed account reported that they monitor only the managed account provider to ensure that the contracted services are being provided rather than considering investment performance. Plan sponsors are generally unable to compare managed account services across providers because of a lack of consistent performance information;[41] however, plan sponsors with managed accounts told us that they periodically reviewed the performance of their QDIA.

The availability of resources and expertise devoted to investment monitoring can affect the extent of QDIA monitoring that plan sponsors can conduct.[42] Stakeholders we interviewed generally said that small plan

[40]Some stakeholders said that in contrast to custom TDFs, off-the-shelf TDFs were more likely to use funds not part of a plans' existing investment lineup, making it necessary for sponsors to perform an additional step in their due diligence review of the underlying funds. However, other stakeholders indicated that because most off-the-shelf TDFs were publicly traded funds, sponsors who selected them as QDIAs could benefit from available performance information and third-party analysis that may not be available for custom TDFs.

[41]We previously reported that more consistent performance information from managed account providers would allow plan sponsors to more effectively make comparisons in their selection and monitoring. GAO-14-310.

[42]Stakeholders spoke of general trends and behavior among "large" and "small" plans in the overall plan sponsor industry and noted that resources and expertise vary among similarly-sized plans. They said that there are small plans that are as sophisticated as many of their larger counterparts but that these instances were more exceptions than the norm. For more information on recent trends in 401(k) plans, see GAO, *401(k) Plans: Survey of 401(k) Plan Sponsors on Fees*, GAO-12-550SP (Washington, D.C.: April 2012).

sponsors typically have fewer resources to devote to more in-depth investment analysis and often rely on outside advisors, while large plans often have in-house expertise and resources to devote to conducting more in-depth investment analysis.[43] Consequently, according to stakeholders, small plan sponsors are more likely to rely on simple peer-relative return or fee comparisons, while large plan sponsors are more likely to have access to sophisticated analytics and perform more in-depth analysis. Some plan sponsors responding to our questionnaire and stakeholders we interviewed stated that, in addition to monitoring general performance metrics, a sponsor may examine asset allocations and glide paths, underlying assets of investments, and associated fund managers and investment strategy. Table 2 shows examples of some activities that plan sponsors used when performing more in-depth analysis.

[43]Some stakeholders stated that the resource and expertise discrepancy between large and small plan sponsors partly explains why large plan sponsors are more likely than small plans to use TDFs, especially custom solutions. For example, TDFs are more complicated to monitor, and larger plans—which typically have the resources and expertise to monitor them—are more likely to select them. However, some stakeholders stated that many plan sponsors—especially smaller plan sponsors—may choose a QDIA simply because they observe or perceive other plans doing the same, without consideration for the resources or expertise that may be required to monitor it.

Table 2: Types of Analysis Sponsors and Stakeholders Reported Conducting When Monitoring a Plan's Qualified Default Investment Alternative

Analysis conducted	Examples of activities performed
Examine asset allocation and glide paths[a]	Determine whether the asset allocation and glide path as set forth in the fund prospectus or service agreement have been adhered to for the monitoring period. Compare the performance of investment alternatives by identifying those products or services that have the same or similar asset allocation and glide path.
Examine underlying assets[b]	Examine performance of the underlying investment products or services at the sub-asset class, such as looking at technology stocks within the overall stock asset class, or individual stocks or bonds comprising the asset class. For each sub-asset or individual security examined, monitor the investment managers and determine whether the investment strategy as outlined in the fund prospectus have been adhered to for the monitoring period.

Source: GAO interviews with plan sponsors and stakeholders and analysis of DOL and industry publications | GAO-15-578

[a]Balanced funds generally have a fixed asset allocation so their glide paths, to the extent that they can be said to have one, go neither up nor down but remain constant over time.

[b]Examining underlying assets is a complex process, because three funds with similar equity and fixed-income allocations may use different stocks and bonds, each with varying levels of risk that can affect performance and costs. Furthermore, a sponsor may need to monitor each underlying fund, which likely has separate investment strategies and managers that can vary.

Plan Circumstances Dictate Sponsors' Responses to Monitoring

Plan circumstances affect a sponsor's response to their periodic QDIA monitoring. According to DOL officials, in cases where a plan's objectives in choosing a particular investment are no longer being met due to a fund's investment fee structure, investment strategy, or management team change, it may be necessary for a plan sponsor to consider replacing the investment. Whereas plan sponsors reported generally retaining QDIAs that meet performance expectations, a sponsor's decision to change course can depend on circumstances specific to the plan if monitoring indicates that a QDIA may no longer be suitable for the plan. For example, one sponsor stated that his plan was in the process of changing the QDIA to a publicly-traded TDF because they thought it would provide better transparency for participants. Another plan sponsor said his plan would consider changing a QDIA that was performing well if another option in the marketplace appeared to better serve plan participants. Another sponsor said that the popularity of TDFs as QDIAs among peers in the marketplace led his plan to change the QDIA to a TDF. As shown in table 3, changes to a plan's QDIA can range from minor modifications to comprehensive changes in a QDIA investment's features, options, provider, or even type.

Table 3: Changes Plan Sponsors Can Make to a Plan's Qualified Default Investment Alternative (QDIA)

Type of change	Description	Examples
Change investment features	This change involves modifications to an existing investment used as a QDIA. Features that could be modified include the investment strategy, asset allocation, glide path, risk profile, and customization, among others.	A plan sponsor with a custom TDF that wants to adjust its risk exposure may change its asset allocation or glide path accordingly. A plan sponsor with a managed account that wants to enhance its account customization may provide additional information about defaulted participants to the provider so that it can be considered in the portfolio allocation decisions.
Change investment options	This change involves making adjustments to the investments that make up a plan's QDIA and could include modifying the plan's investment options. (This type of change may be unavailable to sponsors who use a QDIA made up of proprietary funds.)	A plan sponsor could decide to incorporate additional asset classes (e.g., alternative investments, real estate, etc.) into the investment menu. A plan sponsor that wants the ability to include non-proprietary funds from any provider may change to an approach that allows them to customize the underlying assets. A plan sponsor with a QDIA made up of proprietary funds wanting to adopt a custom TDF with "best-in-class" funds for all asset classes will most likely need to change to a non-proprietary approach that allows use of funds from other providers.
Change investment fund or service provider	This change involves replacing the provider of an existing QDIA with another while maintaining the same type of QDIA.	A plan sponsor with a balanced fund from one company could choose another balanced fund with similar allocation, objectives and risk characteristics from another company. For investment management services, such as managed accounts, the change would similarly replace one provider with another.
Change QDIA type	This change involves replacing an existing QDIA with another type of QDIA. Changing a QDIA type can also include modifications to any of the above categories.	A plan could change their QDIA from a passively managed proprietary balanced fund to an actively managed custom TDF. Such a change would involve not only changing the QDIA type, but also the plan investment architecture and the investment strategy. The change could also involve a change to the provider.

Source: GAO analysis of interviews with plan sponsors and industry publications. | GAO-15-578

Plan sponsors responding to our questionnaire and stakeholders we interviewed stated that after an extensive QDIA selection process, sponsors may be reluctant to make changes to the investment due to cost considerations, existing service provider arrangements, and fiduciary concerns.

- **Cost:** Stakeholders noted that changing a QDIA can be costly and may require considerable time and resources. For example, one stakeholder noted that QDIA changes require plan sponsors to notify participants, explaining the reasons for any changes and how it will affect their accounts. Sponsors said that the significant time and cost needed to implement a change could outweigh any perceived short-term benefit. One stakeholder noted that a plan sponsor who changes a QDIA for underperformance could find the plan in the same situation should the replacement QDIA underperform within a few years.

- **Existing service provider arrangements:** A plan sponsor's existing relationship with a service provider can limit plan sponsors' access to certain QDIA types and may make it challenging to change a QDIA. For example, a sponsor using a proprietary off-the-shelf TDF as a QDIA has limited options to change the QDIA if funds in the TDF series (or underlying funds) perform below expectations. Stakeholders stated that, in cases where a sponsor had negotiated reduced fees for using a certain QDIA, a change of QDIA could jeopardize the arrangement and increase the costs for managing or administering the investments. Similarly, a plan sponsor deciding to use a managed account as its QDIA may find that the record keeper had not partnered with a managed account provider, leaving the sponsor to either select a different QDIA or change record keepers—both options that plan sponsors cited as highly disruptive and costly.

- **Fiduciary concerns:** Plan sponsors and stakeholders stated that any change to a QDIA could expose sponsors to additional fiduciary liability. One plan sponsor stated that fear of potential litigation led the plan's investment committee to decide against changing a QDIA, even though the committee believed that initial selection decisions had been prudent and participants would be better served by the change.

Plan Sponsors Cite Regulatory Uncertainty, Extent of Fiduciary Protection, and Ability to Adopt Innovative Products as Significant Challenges

Stakeholders Noted That Information Provided by DOL on Consideration of Participant Demographics Is Unclear and Difficult for Some Plan Sponsors to Follow

Stakeholders we interviewed generally said that plan sponsors had particular difficulty understanding how to account for plan demographics when selecting a QDIA. Federal agencies are generally required to draft regulations that are easy to understand with the goal of minimizing uncertainty and potential litigation.[44] DOL's regulations prescribe, and the preamble accompanying its publication discuss, one specific demographic characteristic—ages of the participants—that sponsors must always consider when making their QDIA selections, and the regulations prescribe two sets of criteria for sponsors to apply when considering the ages of plan participants:

1. sponsors considering a TDF or managed account service as a QDIA should consider a product or service that includes a mix of equity and fixed income allocations *"based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy."* [45]

2. sponsors considering a balanced fund as a QDIA *"are not required to take into account the age of an individual participant,"* [46] but rather *"focus on the participant population as a whole."* [47]

[44]Exec. Order No. 12866, 58 Fed. Reg. 51,735 (Sept. 30, 1993).

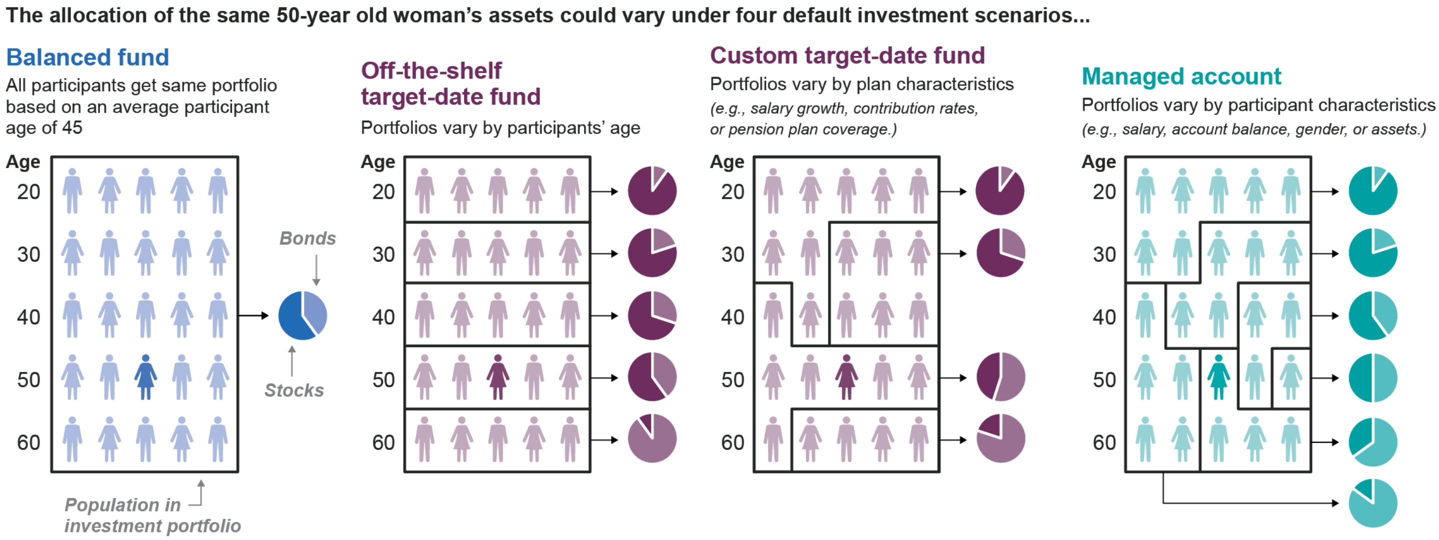
[45]29 C.F.R. § 2550.404c-5(e)(4)(i) and (iii).

[46]29 C.F.R. § 2550.404c-5(e)(4)(ii).

[47]72 Fed. Reg. 60,461.

The QDIA type that a sponsor selects based on these age determinations can alter the asset allocation of QDIA participant accounts and how the allocation may change over time. For example, a 50-year old QDIA participant could end up in a much different investment portfolio in a balanced fund than he or she would in a managed account, as shown in figure 4.

Figure 4: Illustration of How Plan Sponsors Might Consider Age When Determining Asset Allocation Strategies for Qualified Default Investment Alternative (QDIA) Participants, by QDIA Type



Source: GAO analysis of industry descriptions of the features of Qualified Default Investment Alternatives (QDIA). | GAO-15-578

In connection with prior work, stakeholders stated that age should not be the sole determinant for whether a QDIA met the needs of affected participants and recommended that DOL amend the QDIA regulations to require fiduciaries to document whether they had considered participant characteristics other than age when choosing a QDIA.[48] DOL disagreed with this recommendation, noting that its intent in requiring the consideration of one factor—age—was to give plan sponsors certainty that they were complying with the regulations and that nothing in the regulations precluded the consideration of other factors. However, DOL agreed that it may be appropriate for a fiduciary to consider other

[48]GAO, *Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*, GAO-11-118 (Washington, D.C: Jan. 31, 2011)

characteristics and indicated that it would include such considerations in its guidance to plan fiduciaries, which it did in a 2013 publication designed to assist plan fiduciaries in selecting a TDF.[49]

Stakeholders we interviewed generally said that plan sponsors were unsure of which population of participants they should consider when making their QDIA selections. Some stakeholders noted that sponsors did not know whether they should consider the demographics of (1) all potential and existing plan participants together, (2) the plan as a whole, or (3) only the demographics of those participants defaulted into—or likely to be defaulted into—the plan's QDIA. Other sponsors responding to our questionnaire noted that, while sponsors could determine the average age of the plan as a whole, they could not determine the ages of participants unlikely to direct their investments and thus be in need of a QDIA. One sponsor suggested that, even with the DOL regulations, sponsors would benefit from knowing how other plans considered participant demographics. Sponsors selecting managed accounts as a QDIA do not face this issue because the managed account providers consider each participant's age regardless of whether the participant opted-in to the service or were defaulted into the service by a plan sponsor.

Plan sponsors responding to our questionnaire also stated that it was difficult to find a QDIA that best fit the age range or distribution of a plan's participant population. For example, more than half of the plan sponsors responding to our questionnaire indicated that it was challenging to select a QDIA that best fit all plan participants. Two plan sponsors noted that they were unsure how to apply the DOL regulations to plans with varied demographic profiles, making it difficult to select a single fund as a QDIA. One sponsor stated that many QDIA models rely on a hypothetical average participant and result in a portfolio, which by definition is unlikely to match the investment needs of other plan participants. Another sponsor noted that for plans in which participants tend to retire at age 55 or at age 69, an off-the-shelf TDF that assumes a retirement age of 65 may not match a plan's demographics. Other sponsors stated that plan demographics were neither uniform nor constant over time, making it difficult to identify a QDIA that would meet the needs of plan participants on a long-term basis. Some sponsors stated that it was difficult to select a TDF series that applied to a plan's age distribution. For example, one

[49]DOL/EBSA, *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries*. (Washington, D.C.: Feb. 2013).

sponsor noted that his plan had “barbell demographics”—with clusters of participants at each end of the age spectrum and few in between—making it difficult to find an off-the-shelf TDF series, which can include funds for many age groups, to fit the plan. Another sponsor noted that some plans may have an overly narrow age demographic—young or old—that made the adoption of an entire TDF series unnecessary and expensive.

Some plan sponsors responding to our questionnaire stated that they had particular difficulty applying the DOL regulations when selecting a balanced fund and that regulatory uncertainty made it less likely that sponsors would adopt this QDIA type. The DOL regulations state that when considering a balanced fund as a QDIA, a sponsor must determine a level of risk that is appropriate for all affected participants,[50] but DOL noted when it published the final regulations that an appropriate level of risk is unlikely to be optimal for all participants.[51] Although DOL recognized this as one disadvantage of balanced funds, DOL also identified several advantages—balanced funds are simpler, less expensive, and easier to explain and understand than the other QDIA types—and noted that these advantages may sometimes outweigh the potential disadvantage of more customized risk levels offered in the other QDIA types. Two stakeholders noted that, without additional information about a participant’s financial situation outside of the plan, a plan sponsor could have insufficient information to determine which asset allocation provided an appropriate level of risk. Others stated that the regulations do not provide sponsors with sufficient guidance to choose a balanced fund.

Some plan sponsors also may have concerns about how to address changing demographics in a plan that uses a balanced fund as a QDIA, according to stakeholders. For example, one stakeholder noted that it was unclear what a sponsor should do if plan demographics change, how a sponsor would monitor those changes, and how quickly a sponsor would need to respond to those changes to meet regulatory requirements. This stakeholder also noted that the requirement to consider age in the context of the plan as a whole discourages the use of balanced funds as QDIAs because it would require a sponsor to track and react to demographic changes, making potential for liability high. Changes in the age of the plan’s participants can also change the extent

[50] 29 C.F.R. § 2550.404c-5(e)(4)(ii).

[51] 72 Fed. Reg. 60,477.

to which a QDIA aligns with the average participant's retirement needs. Another stakeholder noted there is a need to be sensitive to the possibility that two participants could be the same age but have different investment strategies, or conversely, share the same investment strategy at different ages.

Some Plan Sponsors Are Unsure of the Extent of Fiduciary Protection

Stakeholders we interviewed generally said that plan sponsors selected a QDIA specifically for the additional fiduciary protection it provided under DOL's safe harbor. Despite the requirement that regulations be easy to understand with the goal of minimizing uncertainty and potential litigation, some sponsors were unsure of the extent of this protection or whether each QDIA type provided the same level of protection. For example, more than half of the 227 plan sponsors responding to our questionnaire indicated that the three QDIA types did not offer the same fiduciary protection, or they said that they did not know or had no basis to judge. Although DOL indicated when it published its final regulations that "[a]s long as a plan fiduciary selects any of the qualified default investment alternatives, and otherwise complies with the conditions of the rule, the plan fiduciary will obtain the fiduciary relief described in the rule,"[52] some sponsors stated that they believed the level of fiduciary protection that each QDIA type provided was not equal. Plan sponsors shared a general perception that certain QDIA types offered greater fiduciary protection than others, but they offered divergent opinions on which type or design provided the most protection.

Despite the stated status of the QDIA as a safe harbor, some plan sponsors who adopted a QDIA described what they perceived to be a sliding scale of fiduciary protection ranging from "one-size-fits-all" balanced funds to custom TDFs and managed account services; however, they offered no consensus on which QDIA types offered the greatest protection. One sponsor we interviewed and three sponsors who responded to our questionnaire reported that they did not adopt a QDIA. Of this group, two reported having difficulty seeing the advantage in assuming more risk for the possibility of achieving better retirement outcomes for participants who choose not to direct their investments and

[52]72 Fed. Reg. 60,453. According to DOL officials, a plan fiduciary may, at its discretion, select any of the eligible investment products to be a QDIA, and the choice among the three options is itself not a separate fiduciary decision. DOL does not require that plan fiduciaries separately, and without the benefit of the fiduciary relief provided by the rule, make their own determination whether one of the categories is more appropriate than the others.

two indicated that they believed requiring participants to make an investment election provided the best fiduciary protection. Plan sponsors' views of fiduciary protection varied depending on the importance they placed on the QDIA design and costs.

- **Design:** Some plan sponsors indicated that the level of fiduciary protection could vary depending on the complexity of the QDIA design. Some sponsors expressed the belief that the simple design of balanced funds and off-the-shelf TDFs—which apply one or similar investment strategies to large groups of participants—provided more fiduciary protection. Other sponsors viewed the design simplicity of these QDIA types as a potential liability and preferred what they perceived to be the added protection of a customized QDIA design. For example, two stakeholders said that sponsors viewed the ability of the more complex customized QDIA types, such as managed accounts, to address specific plan or individual participant objectives helped reduce their fiduciary liability.[53]

- **Costs:** Some plan sponsors said that they believed the level of fiduciary protection could vary depending on the costs associated with the QDIA type. Some sponsors selecting balanced funds or off-the-shelf TDFs said that, by selecting a low-cost QDIA option and closely monitoring fees, they felt that they could demonstrate that they acted in the best interests of participants. Others noted that costs alone should not be the determining factor and that sponsors with more customized QDIAs, such as custom TDFs, obtained greater fiduciary protection by tailoring the QDIA to meet the needs of the plan and participants. For example, one stakeholder noted that, unlike off-the-shelf products, custom TDFs can include more diversified investments, such as hedge funds, commodities, and other asset classes, that can provide greater diversification and inflation protection. Two sponsors using a

[53]Some sponsors found DOL's 2013 tip sheet on TDF selection to be helpful. Among other things, it encouraged plan sponsors to inquire whether off-the-shelf or custom TDFs would be a better fit for their plans. One stakeholder told us that sponsors may interpret this guidance as endorsing custom TDFs as a better QDIA solution. DOL officials stated that while customized investment products may offer advantages, a plan fiduciary must weigh the possible advantages of using a customized investment product against potential costs and administrative burdens involved in creating and maintaining such a product. Sponsors also noted that they would welcome similar guidance on the other QDIA types. See DOL/EBSA, *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries*.

managed account QDIA noted that managed accounts can take into account a participant's extended investment portfolio beyond the 401(k) plan and thereby provide an individualized account that aligns with a participant's financial circumstances. In addition, by serving as a co-fiduciary, a managed account provider told us that he offered sponsors an added layer of protection by assuming responsibility and discretion for managing plan investments. In addition, one managed account provider noted that off-the-shelf TDFs, often seen as a low-cost option, can cost more than some managed account services, which have the ability to use available participant information to place participant contributions into an account that is both age- and risk-appropriate.

Stakeholders we interviewed generally said that some plan sponsors were unsure whether the QDIA safe harbor extended to the re-enrollment of participants—a process by which sponsors may re-invest all of a participant's existing assets in a plan's QDIA unless the participant opts out.[54] The final DOL regulations and the preamble that accompanied their publication do not explicitly refer to re-enrollment, but the preamble describes three circumstances in which fiduciary relief may be available under the regulations to plan sponsors who, in effect, re-enroll participants: (1) the failure of a participant to provide investment direction following the elimination of an investment alternative from the plan[55] or a change in service provider, (2) failure of a participant to provide

[54]Re-enrollment can involve enrolling employees who previously elected not to participate in or left a plan, switching participants enrolled in one plan into another plan, and changing a participant's investment allocations within a plan. Sponsors are required to notify participants of their right to make an election at least 30 days prior to any first investment in a QDIA being made on their behalf. 29 C.F.R. § 2550.404c-5(c)(3)(i)(A). In addition, they must send an annual notice to affected participants reminding them of their right to direct the investments in their accounts. 29 C.F.R. § 2550.404c-5(c)(3)(ii).

[55]Funds that experience sustained poor performance, a failure to gather assets, or a combination of performance and operational failure are often closed by the provider. Vanguard recently reported that from 1997 through 2011, more than 2,000 mutual funds had either been merged with other funds or been liquidated.

investment direction following a rollover from another plan,[56] and (3) any other failure of a participant to provide investment instruction. In some cases, plan sponsors have indicated that they use re-enrollment in an attempt to improve the investment outcomes for participants who the sponsor believes have made poor investment decisions. Some viewed this process as controversial and contrary to the purpose of a self-directed account. DOL officials told us they fashioned the QDIA regulation to cover a variety of circumstances in which participants are given the opportunity to direct their investments, but do not do so. They also noted that some sponsors relied on the regulation to justify re-enrollment and that at least one court has held that the regulations covered re-enrollment, as long as conditions in the regulations are met.[57] However, some sponsors said that they worried about exposing themselves to potential liability considering that the re-enrollment process could effectively override participants' investment elections by placing assets in an investment that a participant specifically did not select. A suboptimal choice of QDIA could have long-lasting negative effects on participants' retirement savings if the choice does not align with a participant's needs. One stakeholder noted that more sponsors would be inclined to implement re-enrollment to improve participant outcomes if DOL confirmed that re-enrollment was a reasonable application of the QDIA rules and provided examples of how sponsors should implement re-enrollment.

[56]In prior work, we recommended that DOL expand the investment alternatives available for forced-transfer IRAs to include additional investments, such as ones that qualify as QDIAs to prevent forced-transfer IRA balances from decreasing due to the low returns of the safe-harbor investment options. DOL disagreed with our recommendation saying that Congress intended these assets to be invested in a way that preserved the principal transferred out of plans. However, our analysis showed that many forced-transfer IRAs have experienced very large and even complete declines in principal. We continue to believe that our recommendation should be implemented and encourage DOL to expand the safe harbor under 29 C.F.R. § 2550.404a-2 to include investment alternatives more likely to preserve principal and even increase it over time. See GAO, *401(k) Plans: Greater Protections Needed for Forced Transfers and Inactive Accounts* GAO-15-73 (Washington, D.C.: Nov. 21, 2014).

[57]*Bidwell v. Univ. Med. Ctr. Inc.*, 685 F.3d 613 (6th Cir. 2012). The trial and appellate courts both ruled in favor of the plan sponsor. The appellate court noted that the preamble to the final QDIA regulations emphasized that whenever a participant has the opportunity to direct the investment of account assets but does not, plan fiduciaries may receive fiduciary relief under the regulations so long as all the other safe harbor requirements in the regulations are met.

Some Plan Sponsors Are Unsure Whether Regulations Allow for the Adoption of Innovative Solutions

Stakeholders we interviewed generally said that some sponsors would like to incorporate other retirement features, such as annuitization,[58] in their plan's QDIA to improve retirement outcomes for participants; however, they were unsure whether such products would qualify for fiduciary protection. One stakeholder stated that one of the benefits of DB plans is the provision of a lifetime annuity upon retirement and that replicating this feature in the DC plan context warranted further attention. Another stakeholder noted that it was important for participants invested in a QDIA for an entire career to have some means to accrue lifetime retirement income. Without such a plan feature, another stakeholder noted, participants defaulted into a QDIA would likely be at a disadvantage compared to those with accrued lifetime retirement income, when faced with the decision about what to do with their accumulated assets at retirement.

DOL officials said that they anticipated and encouraged innovation in the plan investment marketplace, including lifetime retirement income features. In the preamble to the final QDIA regulations, DOL indicated that the regulations are sufficiently flexible to accommodate future innovations and developments in retirement products. Specifically, DOL officials noted that the examples were included solely for the purpose of providing guidance as to what might be within the defined categories and were not intended in any way to limit the application of the QDIA regulations to other products. In 2014, DOL outlined specific conditions under which a TDF series could incorporate some form of deferred annuity contract and remain a QDIA.[59] One plan sponsor said that until sponsors were certain that other products qualified for QDIA protection,

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[58]Annuities are guaranteed payments that are normally secured through a contract with an insurance company for either a set period or for the participant's lifetime. Annuities come in a variety of forms. For example, deferred annuities allow participants to delay the start date of payments to a later point in retirement. Variable annuity payments are not guaranteed and vary based on the performance of underlying investments selected by the participant. For more information on annuities and other spend-down options in the United States and other countries, see GAO, *401(k) Plans: Other Countries' Experiences Offer Lessons in Policies and Oversight of Spend-down Options*, GAO-14-9 (Washington, D.C.: Nov. 20, 2013).

[59]In a letter to the Department of the Treasury, DOL addressed the application of the QDIA regulations and annuity selection safe harbor (29 C.F.R. § 2550.404a-4) to a series of TDFs that included unallocated deferred annuity contracts as part of the funds' "fixed income" component. The letter concluded that the use of these types of TDFs met the requirements of the QDIA regulations. DOL, *Letter to the Department of Treasury's Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy*, dated Oct. 23, 2014.

they were unlikely to deviate from strict adherence to the safe harbor conditions or consider products other than the three named QDIA types. However, the regulations indicate that the QDIAs are not the exclusive means by which a plan fiduciary may satisfy plan responsibilities respecting the investment of participant assets of their behalf.[60]

Several stakeholders stated that the current QDIA types require greater scrutiny to ensure that they will lead to better default investments. For example, one stakeholder stated that QDIAs can be improved to mitigate the down-side risk of TDFs and provide participants with lifetime retirement income.[61] Another stakeholder noted that no QDIA type provides explicit inflation protection, saying that QDIAs should include an inflation-indexed investment to protect inattentive participants and beneficiaries. One stakeholder said that the regulations should allow flexibility for more hybrid approaches to a plan's QDIA, such as multiple plan QDIAs to cater to different segments of plan populations.[62] However, this stakeholder concluded that product developers would be unlikely to take initiative to create new QDIA products and services as long as uncertainty in the regulations persists.

Conclusions

QDIAs have been a significant development for increasing worker participation in defined contribution plans since they were first authorized under PPA. DOL's safe harbor has encouraged many plan sponsors to adopt automatic enrollment policies and invest the assets of defaulted participants into investments they have deemed appropriate for long-term retirement savings. While PPA encouraged the adoption of QDIAs through the creation of safe harbor plan designs, some plan sponsors find the final DOL regulations to be unclear, especially with regard to the consideration of participant ages when selecting a QDIA, the extent of

[60]29 C.F.R. § 2550.404c-5(a)(2).

[61]As we previously reported, some TDFs experienced large losses in the 2008 recession due to high concentrations in equities. See GAO-11-118. In our review of recent data from TDF series offered by three large service providers—Vanguard, Fidelity, and T. Rowe Price—we found equity allocations in TDFs with a 2015 target retirement date ranging from 44 to 57 percent.

[62]According to DOL's Field Assistance Bulletin 2008-03 (issued April 29, 2008), its QDIA regulations do not preclude a plan fiduciary from selecting more than one of the eligible QDIAs. DOL officials noted that the QDIA regulations would allow a plan to continue to use a balanced fund from one plan and the managed account from another plan following a corporate merger.

fiduciary protection, and the flexibility to allow innovations in QDIA products. This lack of clarity could lead some plan sponsors to make suboptimal choices when selecting a plan's default investment and could have long-lasting negative effects on participants' retirement savings.

As a consequence, plan sponsors remain concerned about their liability and are looking for additional clarification of existing laws and regulations. Without a better understanding of the requirements, plan sponsors—including those that have already adopted a QDIA—face difficulties trying to balance participant safeguards with solutions that can help them establish and sustain financially secure retirement plans for their employees.

Recommendation for Executive Action

To encourage plan sponsors to continue efforts to improve plan participation and overall retirement savings through the use of QDIAs, we recommend that the Secretary of Labor direct the Assistant Secretary for the Employee Benefits Security Administration to assess the challenges that plan sponsors and stakeholders reported, including the extent to which these challenges can be addressed, and implement corrective actions through clarifying guidance or regulations, as appropriate.

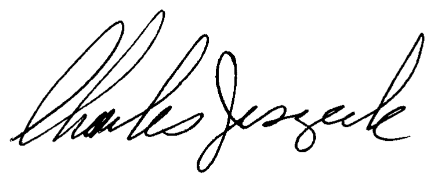
Agency Comments

We provided a draft of this product to the Department of Labor for review and comment. In its written comments, which are reproduced in appendix II, DOL generally concurred with our findings and recommendation. In its comments, DOL officials stated that they would review the challenges that GAO reported, consider how best to assess those challenges, and determine whether additional actions would be beneficial to stakeholders. DOL also provided technical comments that were incorporated, as appropriate.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of Labor and other interested parties. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or jeszeckc@gao.gov.Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff making key contributions to this report are listed in appendix III.

Sincerely yours,



Charles A. Jeszeck, Director
Education, Workforce, and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

The objectives for this study were to determine: (1) which options plan sponsors selected as QDIAs and why; (2) how plan sponsors monitor their QDIA selections; and (3) what challenges, if any, plan sponsors report facing when adopting a QDIA for their plan.

Overall Methodology

Each of the engagement's three researchable objectives required us to gain the insights of plan sponsors of 401(k)-type plans. For all objectives, we reviewed relevant federal laws, regulations, and guidance on the use of QDIAs in 401(k)-type plans. To learn about the issues facing sponsors when selecting and monitoring a QDIA, we interviewed 96 stakeholders knowledgeable of the topic of QDIA use—including plan sponsors, plan sponsor advocates; plan service providers, plan consultants, plan record keepers, investment managers, and managed account providers; participant advocates; and academicians—who provided us with a broad range of perspectives on issues surrounding the use of QDIAs. In each interview, we solicited names of additional stakeholders to interview until we had coverage of a broad range of perspectives.

To determine the prevalence of default investment use in DC plans, we examined annual data for the years 2009 through 2013 on private-sector DC plans included in (1) DOL's Form 5500 database that identified the number of plans that reported having automatic enrollment and default investments and (2) selected industry surveys of plan sponsors that identified types of default investments that plan sponsors used.

To better understand the experiences of plan sponsors with respect to QDIA selection and monitoring efforts, we developed a web-based questionnaire that was publicized with the assistance of several professional organizations whose memberships included plan sponsors and others who act as plan fiduciaries.

To better understand the types of performance information that plan sponsors could use to monitor the three QDIA types—target-date funds, balanced funds, and managed accounts—we analyzed available financial market data on target-date funds and balanced funds for a number of returns, risk, and cost metrics for different time periods. For managed accounts, we also reviewed sample performance reports obtained from selected providers.

All data collected through these methods are nongeneralizable and reflect the views and experiences of the respondents and not the entire population of employer-sponsored 401(k)-type plans. However, we believe the insights gained through these methods produced valuable information to better understand the effect of the QDIA regulations on selected plan sponsors.

Industry Surveys

Because there are no nationally representative data on the universe of 401(k) plan sponsors' default investment selections, we used data from three industry surveys that were publicly accessible and provided consistent annual data on default investment use for the most consecutive years, from 2009 through 2013. Given that our focus was the prevalence of QDIA use among plan sponsors, we combined all other categories of non-QDIA default investment vehicles that plan sponsors listed in the surveys. We assessed the reliability of the survey data from the three surveys by ensuring consistency of (1) data reporting and identifying the number of respondents, (2) the variation of plan sizes, and (3) the industry sectors represented in each survey. We found these data to be sufficiently reliable when aggregated, as we did in this product. The survey results, while the best available data, are not generalizable to the universe of DC plans. See below for additional information on the survey respondents in the most recent year that we used.

- **Survey A:** From late June through early September 2013, an industry organization, PLANSPONSOR, conducted a survey of DC plan sponsors and received 5,342 usable responses.[1] Employers that participated in the survey represented a broad variety of U.S. industries and plan sizes. About 71 percent of the 5,342 respondents had less than $50 million, 23 percent had between $50 million and $1 billion, and 6 percent had more than $1 billion in plan assets.

- **Survey B:** In the fall of 2013, a second industry organization, Callan Investments Institute, conducted an online survey of DC plans, and 107 sponsor responses were incorporated in the results.[2] Survey respondents represented a wide range of industries and plan sizes, with the top three industries represented

[1]Asset International, *2014 Plan Benchmarking Report: Overall Results from the 2013 Plansponsor Defined Contribution Survey*, Downloadable for a fee from http://www.assetinternational.com/research-library.aspx.

[2]Callan Investments Institute, 2014 Defined Contribution Trends. Downloadable for a fee from https://www.callan.com/research/DC/

being government (18 percent), manufacturing (14 percent), and technology (11 percent). About 6 percent of the 107 respondents had less than $50 million, 36 percent had between $50 million and $1 billion, and 58 percent had more than $1 billion in plan assets.

- **Survey C:** In 2013 and early 2014, a third industry organization, Deloitte, conducted an online survey of DC plans, collecting data from 265 plan sponsors.[3] Employers that participated in the survey represent a comprehensive range of industries and employer sizes, with the top three represented industry sectors being manufacturing (22 percent), consumer business and transportation (20 percent), and financial services and insurance (17 percent). About 38 percent of the 209 plan respondents who provided information on plan assets had less than $50 million, 43 percent had between $50 million and $1 billion, and 19 percent had more than $1 billion in plan assets.

GAO Questionnaire

To better understand the experiences of plan sponsors with respect to QDIA selection and monitoring efforts, we developed a web-based questionnaire that was publicized with the assistance of four professional organizations—PLANSPONSOR, National Association of Plan Advisors, Plan Sponsor Council of America, and the Stable Value Investment Association— whose memberships included plan sponsors or others who serve as plan fiduciaries. As part of our general interview process, we met and interviewed representatives of several industry groups that had large and diverse memberships of plan sponsors. Four groups agreed to publicize our questionnaire in their communications to group members. Each group publicized the questionnaire and provided their members with a link to access it directly. The web-based questionnaire remained open from October 1, 2014, through January 30, 2015. When the questionnaire closed, we had collected responses from 227 plan sponsors. We analyzed the questionnaire responses as a group and then by QDIA type and plan size. Of these respondents, 40 reported that they had selected a balanced fund, 14 had selected a professionally managed account, 170 had selected a TDF as QDIA, and 3 respondents had selected a plan default investment that was not a QDIA. Respondents were distributed across all plan sizes, defined both by the number of participants and by

[3]Deloitte, *Annual Defined Contribution Benchmarking Survey*. Downloadable at no cost from http://www2.deloitte.com/us/en/pages/human-capital/articles/annual-defined-contribution-benchmarking-survey.html

volume of assets under management. We also followed up with 55 respondents who voluntarily provided their contact information.

To gather more granular anecdotal detail on sponsors' personal experiences with QDIAs, we developed semi-structured interview questions for a subset of survey respondents representing each QDIA type. We tailored the questions based on the responses provided to the questionnaire by each of the respondents who had provided complete contact information. We then e-mailed questions to these respondents asking them to voluntarily provide additional responses in writing or in a follow-up telephone interview. We collected written or interview responses from 28 plan sponsors using this method and analyzed the content of the responses.

Default Investment Selection

To examine which QDIA types plan sponsors use and why, we examined several quantitative and qualitative sources. To determine the number of plans that provide for automatic enrollment and use a default investment account, and the number of active participants in these plans, we examined Form 5500 data sets for the years 2009 through 2013 downloaded from the Department of Labor's website http://www.dol.gov/ebsa/foia/foia-5500.html. While the Form 5500 collects data on whether plans had a default investment for participants automatically enrolled in the plan, it does not allow plan sponsors to identify the default investment they select or whether it qualifies as a QDIA. In addition, as described above, we located and analyzed results from recurring industry surveys of plan sponsors that asked relevant questions about plans' default investment selections and corroborated these results with relevant literature and interview responses.[4]

To learn more about the attributes of each QDIA type, we collected data through our stakeholder interviews, responses to our questionnaire, and follow-up contacts with selected questionnaire respondents. In each of our stakeholder interviews, we asked which default investments plan sponsors preferred and why some sponsors might decide to select or forego QDIAs. In addition, we asked about the process sponsors used to select a specific type of QDIA, the advantages and disadvantages of each type of QDIA, and the direct and indirect factors that affected sponsors' QDIA selection process. In our questionnaire, we asked plan sponsors to

[4]We did not undertake a compliance assessment to determine the extent to which plan fiduciaries included in our study had exercised due diligence in selecting, monitoring, or comparing various QDIAs because this was outside the scope of our work.

comment on several aspects of QDIA selection, including the factors that most influenced their QDIA choice. We then conducted follow-up discussions with selected sponsors to obtain additional detail on why they selected their QDIAs, the role of advisors or others who provided input to their decisions, and the process they followed when making their selections. We included sponsors who selected each of the QDIA types and one sponsor who did not select a default investment.

We performed content analysis of the qualitative data to identify the primary reasons why respondents selected each type of QDIA and aspects of the selection process. In particular, we identified common themes, including the effect of plan size, sponsors' familiarity with investment vehicles, the influence of previous investment choice, and the role of third-parties such as service providers and consultants. The results of this content analysis formed the basis for our discussions in the report of the attributes for each type of QDIA and the underlying factors that influence plan sponsors' decisions.

Default Investment Monitoring

To examine how plan sponsors monitor their QDIA, we analyzed data from the same sources as we did for QDIA selection and examined selected quantitative market data on balanced fund and target-date performance. To learn more about plan sponsors' QDIA monitoring practices, we interviewed stakeholders about the frequency of sponsors' QDIA monitoring, as well as factors that might lead a sponsor to change a QDIA. In addition, we asked service providers about the performance information they provided to plan sponsors to help them monitor the QDIA and the frequency with which they provided it. In our questionnaire, we asked plans sponsors how frequently they monitored their plan's QDIA and conducted follow-up discussions with selected sponsors to obtain additional detail on their monitoring practices, including who conducted the monitoring, what performance information they used, the actions taken when warning signs appear, and the circumstances that would lead them to change a QDIA.

To better understand the types of performance information that plan sponsors use to monitor QDIAs, we reviewed relevant industry literature, analyzed sample performance reports that managed account providers sent to plan sponsors, and analyzed publicly available financial market data on balanced fund and TDF returns, risk characteristics, and cost metrics for 1-, 3-, and 5-year periods. To ensure that we examined data for funds that plan sponsors selected, we cross-referenced financial market data with select information that sponsors reported on the Form 5500 regarding the composition of a plan's investment lineup. Because the Employee Retirement Income Security Act of 1974 does not prescribe specific actions that a sponsor must take when selecting and monitoring plan investment options and, as such, two prudent plan fiduciaries with the same QDIA may look at same monitoring outcomes and arrive at different conclusions about its performance, we decided not to include quantitative illustrations of these funds' performance in the report.

Identifying Challenges

To identify challenges plan sponsors face when administering QDIAs in their 401(k)-type plans, we analyzed qualitative information from the same sources as the other objectives. As part of our interview process, we asked stakeholders to comment on sponsors' views on the sufficiency of the QDIA types, challenges plan sponsors experienced when selecting and monitoring a QDIA, and the extent to which these challenges may vary by plan size. In addition, as part of our web-based questionnaire, we asked plan sponsors to select the top three challenges they faced when selecting a specific QDIA type. Sponsors made their selections from 11 possible options or provided a narrative response. We followed up with selected questionnaire respondents to confirm their responses and solicit additional detail on why the saw these factors as challenges.

Appendix II: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210

AUG 10 2015

Charles A. Jeszeck
Director, Education, Workforce, and Income Security
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "401(k) Plans: Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants." We welcome your examination of ways in which the Department of Labor could encourage plan sponsors to continue efforts to improve plan participation and overall retirement savings through the use of qualified default investment alternatives (QDIAs).

As your report notes, the Pension Protection Act of 2006 (PPA) included automatic enrollment provisions that were designed to encourage employers to adopt provisions into their 401(k) and other individual account plans that would increase worker participation and expand retirement savings. The PPA also directed the Department of Labor to issue a regulation to assist employers in selecting default investments that best serve the retirement needs of automatically enrolled workers who do not direct their own investments. The Department issued a proposed regulation on September 27, 2006, and, after considering many issues raised by employers, plan sponsors and other public commenters, promulgated a final regulation on October 24, 2007.

Your draft report concludes that plan sponsors that participated in a GAO survey cited uncertainty concerning (1) applying some regulatory provisions, (2) the extent of liability protection, and (3) the ability to adopt innovative products, as significant challenges when adopting one of the three types of default investments that can be QDIAs under the Department's regulation. The draft report recommends that the Department of Labor assess the challenges that plan sponsors and stakeholders reported to GAO, including the extent to which these challenges can be addressed, and implement corrective actions through clarifying guidance or regulations, as appropriate.

As your report points out, the Department's QDIA regulation has encouraged many plan sponsors to adopt automatic enrollment policies and invest the assets of defaulted participants into QDIAs for long-term retirement savings. Since publication of the final QDIA, EBSA has issued guidance clarifying and supplementing the QDIA regulation. Specifically, EBSA issued Field Assistance Bulletin 2008-03, in a question and answer format, on a number of the most frequently asked questions. Further, as noted in GAO report, in 2013, EBSA issued guidance to assist fiduciaries in selecting a target date fund (TDF). As your report acknowledges, the QDIA regulation expressly provides plan sponsors with protection from associated liability, subject to certain requirements. A critical requirement is the prudent selection and monitoring of the QDIA since they can vary greatly in approach, cost, and asset allocation. As also noted in your report, the Department has broadly interpreted the QDIA regulation as applying to a variety of circumstances in which participants are given the opportunity to direct their investments, but do not do so. The Department stated explicitly that "the final regulation applies to situations beyond automatic enrollment" including circumstances such as "[t]he failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant or beneficiary to provide investment instruction." 72 Fed. Reg. 60452-01, 60453 (Oct. 24, 2007). The Department also attempted to anticipate and encourage innovation in the plan investment marketplace, including with respect to income solution features. The final QDIA regulation adopted a flexible QDIA definition. Recent guidance issued by EBSA evidences the Department's continued effort to encourage the use of lifetime income solutions in QDIAs when doing so is in the best interest of participants and beneficiaries. Specifically, a DOL Information Letter to the Department of the Treasury, dated October 23, 2014, addressed the application of the Department's QDIA regulation and annuity selection safe harbor regulation to a series of target date funds that include unallocated deferred annuity contracts as part of the funds' "fixed income" component.

The Department adopted the QDIA regulation and engaged in its related efforts to help produce greater retirement savings, better investing practices, and a larger population of retirement savers. Accordingly, we welcome GAO's suggestions on how we can further those goals. We will review GAO's report and assess the challenges that plan sponsors and stakeholders reported to GAO. We will consider whether a broader public comment process (such as a Request for Information) or a research project would aid that assessment and will determine whether other actions such as issuing clarifying guidance or regulations would be beneficial to our stakeholders.

Sincerely,

Phyllis C Borzi

Phyllis C. Borzi
Assistant Secretary

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Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact:

Charles Jeszeck, (202) 512-7215 or jeszeckc@gao.gov.

Staff Acknowledgments:

In addition to the contact named above, David Lehrer (Assistant Director), Jonathan S. McMurray (Analyst-in-Charge), Cheryl L. Jones, Stu Kaufmann, David Lin, and Daren Sweeney made key contributions to this report. James Bennett, Holly Dye, Mark Glickman, Gene Kuehneman, Kathy Leslie, Ashley McCall, Sheila McCoy, Walter Vance, Yiyang Wang, and Craig Winslow also provided support.

Related GAO Reports

401(k) Plans: Improvements Can Be Made to Better Protect Participants in Managed Accounts, GAO-14-310 (Washington, D.C.: June 25, 2014).

Private Pensions: Targeted Revisions Could Improve Timeliness and Content of Form 5500 Pension Information, GAO-14-441 (Washington, D.C.: June 5, 2014).

401(k) Plans: Other Countries' Experiences Offer Lessons in Policies and Oversight of Spend-down Options, GAO-14-9 (Washington, D.C.: Nov. 20, 2013).

401(k) Plans: Increased Educational Outreach and Broader Oversight May Help Reduce Plan Fees, GAO-12-325 (Washington, D.C.: April 24, 2012).

401(k) Plans: Survey of 401(k) Plan Sponsors on Fees, GAO-12-550SP (Washington, D.C.: April 2012).

Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants, GAO-11-118 (Washington, D.C.: Jan. 31, 2011).

Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges, GAO-10-31 (Washington, D.C.: Oct. 23, 2009).

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