PRI Member Brief

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"Process-Based" & "Asset-Neutral" Proposal Outlines Safe Harbor for Participant-Directed Plans

Satisfying specific criteria would provide presumption of prudence for DC plan fiduciaries

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Coverage Extends to all Designated Investment Alternatives

While Executive Order was focused on alts, the proposal is broader

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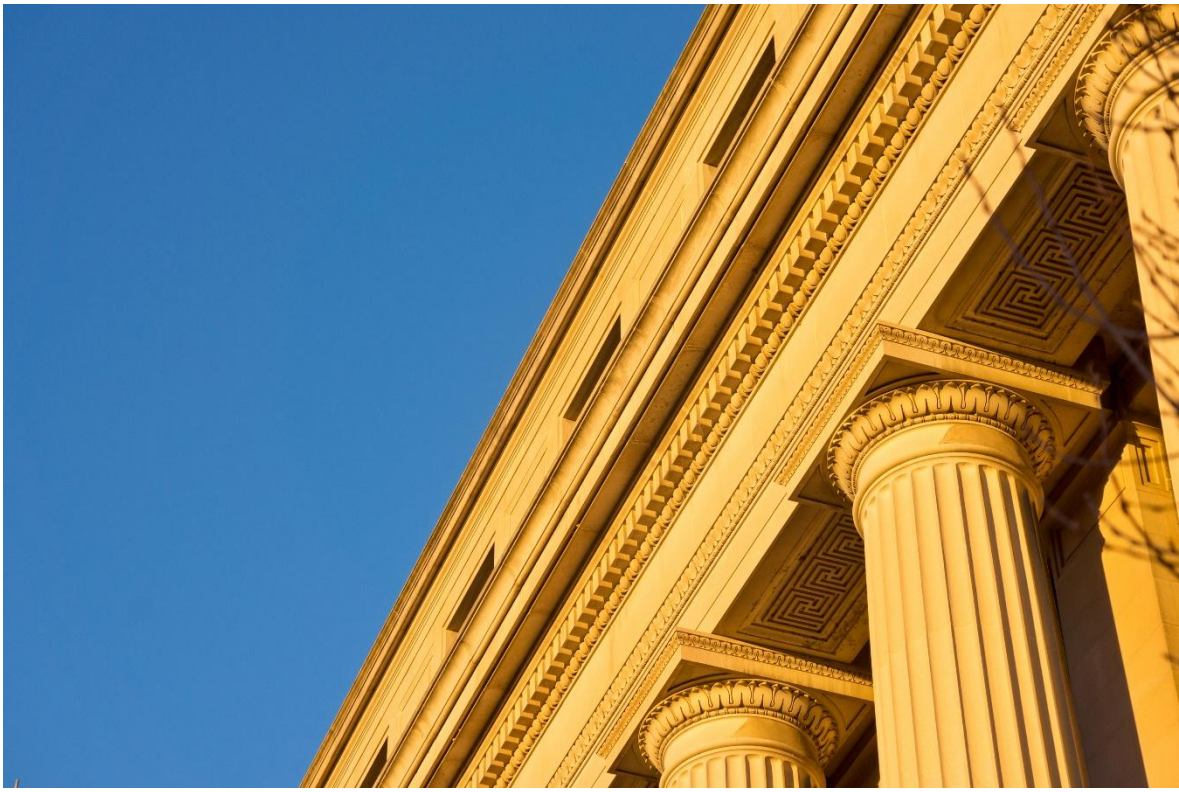
Big Takeaway

Proposal highlights consultation with professional fiduciaries as a hallmark of duty of prudence



New Framework for Prudence:

What DOL's most recent proposal means for DC Plan Fiduciaries

On March 31st, the Department of Labor ("DOL") published a proposed rule entitled "Fiduciary Duties in Selecting Designated Investment Alternatives." It seeks to clarify how the fiduciary duty of prudence can be satisfied in the context of selecting investments for participant-directed ERISA plans (i.e., 401(k) plans).

Firms should consider commenting to help shape the requirements and prepare to adapt their processes to align with safe harbor criteria once the rule is finalized.

First, it is crucial to note that the recently proposed rule is not another attempt to define how one becomes a fiduciary under ERISA. Rather, it seeks to outline how fiduciaries of participant-directed individual account plans can satisfy the duty of prudence when selecting (or replacing) designated investment alternatives or DIAs. This Member Brief is intended to provide an overview to allow member firms to understand the proposed requirements in order to evaluate the potential impact on their current practices.

Background

Sec. 404(a) of ERISA provides, in relevant part, that: "a fiduciary shall discharge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Existing DOL regulations further define the duty of prudence. Specifically, the Investment Duties Regulation states that ERISA's duty of prudence is satisfied by a plan fiduciary when selecting an investment if the fiduciary meets two conditions. First, the fiduciary must give "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment . . . including the role the investment or investment course of action plays in that portion of the plan's investment portfolio or menu with respect to which the fiduciary has investment duties." And second, the fiduciary must have "acted accordingly."

While the proposal makes clear that it is not intended to "disturb" the Investment Duties Regulation, it does seek to "supplement and expand" it specifically in the context of selecting DIAs for participant-directed individual account plans. According to the proposal, it does this, first, by identifying six relevant factors, and second, by demonstrating what it means for a fiduciary to "act accordingly"—and therefore to be prudent—in the circumstances addressed in the examples.

Who is Affected?

Discretionary investment fiduciaries, including plan fiduciaries and ERISA 3(38) investment managers that have the final authority to select (and replace) designated investment alternatives for participant-directed individual account plans. The term designated investment alternative (or DIA) is what the DOL uses to refer to investment options that are more commonly known as those available within a plan's "core menu" or "investment line-up" – meaning that participants can elect to invest in them directly.

Why was it Issued?

President Trump issued an Executive Order (the "EO") in August of last year directing the DOL to "clarify [its] position on alternative assets and the appropriate fiduciary process associated with offering asset allocation funds containing investments in alternative assets under ERISA." According to the EO, "a combination of regulatory overreach and encouragement of lawsuits filed by opportunistic trial lawyers has stifled investment innovation and largely relegated 401(k) and other defined-contribution retirement plan participants to asset classes whose returns lack the very same long-term net benefits allowed for and achieved by public pension plans and other institutional investors."

The EO contains a definition of alternative assets which includes the following:

- private market investments, including direct and indirect interests in equity, debt, or other financial instruments that are not traded on public exchanges, including those where the managers of such investments, if applicable, seek to take an active role in the

management of such companies;

- direct and indirect interests in real estate, including debt instruments secured by direct or indirect interests in real estate;
- holdings in actively managed investment vehicles that are investing in digital assets;
- direct and indirect investments in commodities;
- direct and indirect interests in projects financing infrastructure development; and
- lifetime income investment strategies including longevity risk-sharing pools.

What are its Primary Goals?

According to the proposal, its key principles are: to affirm "ERISA as a law grounded in process" that "gives maximum discretion and flexibility to plan fiduciaries in selecting designated investment alternatives, including the alternative investments described in [the EO]" and to create a presumption of prudence when "ERISA fiduciary decision-making follows a prudent process—such as the process reflected in the proposed regulation … ."

How Does it Work?

Paragraphs (a) and (e) establish the foundation for the safe harbor by first making clear that the scope is limited to interpreting the duty of prudence for fiduciaries in the context of selecting DIAs for participant-directed plans. Paragraph (c) addresses the question of whether any DIA is *per se* prudent or imprudent. It clarifies that ERISA confers on plan fiduciaries "maximum discretion" to select different types of DIAs but not a "license to ignore other applicable laws." Fiduciaries may not select DIAs that are illegal, in other words. Paragraph (d) reminds fiduciaries that duty of prudence applies not just to the selection of each investment but also to the collection of DIAs as a whole—i.e., to both the individual parts and the sum. And paragraph (e) clarifies that nothing in the proposed regulation excuses a fiduciary from complying with its obligations to act loyally or avoid prohibited conflicts of interest and reinforces the idea that it also may be appropriate for a plan fiduciary to enlist the services of professional advisors, to carry out the necessary objective, thorough, and analytical analysis.

Paragraph (f) of the proposed regulation introduces the safe harbor. The DOL refers to it as both "process-based" and "asset-neutral." The process-based component is designed to provide a mechanism to mitigate frivolous lawsuits by creating a presumption of prudence that is "entitled to significant deference." The safe harbor's presumption is achieved when a plan fiduciary "objectively, thoroughly, and analytically considers and makes a determination regarding" any or all of the following six factors: i) performance, ii) fees, iii) liquidity, iv) valuation, v) benchmarking, and vi) the complexity of the designated investment alternative.

A DIA may or may not be an asset allocation fund and that is an important distinction because the proposal is broader in scope than the Executive Order. The EO instructed DOL to clarify its position on alternative assets and the appropriate fiduciary process for "including alternatives within asset allocation funds." In the proposal, however, the DOL states that it "decided to take a more expansive approach regarding both the class of investments and the investment vehicles to which the safe harbor applies."

According to the proposal, "[b]y remaining neutral on the types of assets and vehicles, defined contribution plan fiduciaries can apply the specified review methodology outlined in this proposed rule to an array of potential designated investment alternatives." In this regard, the proposal sets forth one "asset-neutral safe harbor, rather than a specialized safe harbor only for specific asset classes.

Paragraphs (g) – (l) provide examples in the format of i) facts; ii) analysis; and iii) conclusion for each of the six factors.

Paragraph (m) defines the term "designed investment alternative" to mean any investment option designated by the plan into which participants may direct the investment of assets held in, or contributed to, their individual accounts, including qualified default investment alternatives or QDIAs and managed account services. It also excludes from the term DIA investments accessed by participants through self-directed brokerage accounts.

When will it be Finalized?

The deadline for written comments is June 1st. Once the DOL processes the comments and hears any oral testimony from stakeholders, it will begin drafting a final rule. It can take anywhere from 4 to 12 months to publish a final rule.

When are the Potential Impacts?

Keeping in mind that there will be changes between the proposed and final rules, the idea of a safe harbor and more specific guidance for fiduciaries should be welcome news, irrespective of whether a fiduciary might be interested in adding alternative investments to their plan.

ERISA and DOL regulations often leave it up to fiduciaries to interpret concepts such as prudence, relevance, and reasonableness based upon their unique "facts and circumstances" without clear direction concerning what facts are more or less relevant or how different circumstances can tip the scales in one way or another. Paragraphs (g) – (l), however, set forth concrete examples upon which fiduciaries can rely and from which they can reasonably extrapolate.

Whether or not a final rule will result in a wave of plan sponsors adding alternative investments to their plans remains to be seen. While the proposal provides a framework to lessen the fear of litigation, it does not provide immunity from being sued. Fiduciaries' reliance upon the safe harbor should result in more dismissals and, over time, fewer frivolous claims being filed.

A more immediate change we are expecting is that both plan sponsors and service provider fiduciaries will begin to incorporate the safe harbor's factors and organize their reporting and documentation in a way that evidences their "objective, thorough, and analytical" consideration of the relevant factors. This shift will require firms to reevaluate investment policy statements and analytical tools to ensure they are aligned with the safe harbor, and financial professionals (and their supervisors) will need to be retrained on the updated process.

At PRI, we will continue to monitor developments and update members as more details emerge. Once the rule is finalized, we will begin updating our plan sponsor-facing content, including any affected fiduciary training modules. As always, we will make basic training concerning the rule's requirements available to financial professionals and supervisors via the Advisor Resource Center and our staff will be available to work with members to develop custom training that reflects their firm's unique approach.

In the meantime, the proposal can be accessed here, and please feel free to call or email us at info@pension-resources.com if you have any questions.