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What Happens When Participants In Self-Directed Plans Don't Direct?

By: Edward F. Martin

These days most defined-contribution plans, such as 401(k) Plans, are **self directed plans**. They allow participants to decide for themselves how their accounts are invested by selecting from a menu of investment funds chosen by the plan administrator. While many participants are happy to make their own investment decisions, others are not, and many participants either make poor decisions or make no decisions at all.

When a participant makes no decision, the participant's accounts are invested in a "**default**" investment fund selected by the plan administrator. Plan administrators, reluctant to risk any loss of participant funds, often choose as the default a fund that pays interest and keeps the value of principal constant. It is questionable whether that is truly prudent. Certainly a professional investment manager would not invest a defined-contribution plan solely in a money-market or stable-value fund. Historically, such a policy over the long term results in inferior performance.

Congress and the Department of Labor have provided new rules designed to discourage use of no-risk investments as default investments. Under Section 624 of the Pension Protection Act of 2006, and Department of Labor regulations proposed almost immediately thereafter, the default investment must be a diversified investment fund that has a mix of stocks and other securities, with the amount invested in stocks varying depending on the age of the participant. If a plan administrator follows these guidelines the investment choice will be deemed to have been made by the participant, not the plan administrator, so that the plan administrator gets the benefit of ERISA Section 404(c)'s protection from liability. No-risk investments will not provide that relief.

The proposed regulations provide an **enormous incentive to use "life-cycle" funds for self-directed plans**. Life-cycle funds have varying target dates. The further away the target date is from the current date, the larger the investments in stocks, as opposed to investments in no-risk securities. The regulations also permit use of a single "balanced" fund as the default for all, but the choice of a balanced fund has to take into account the demographics of the work force.

Section 624 goes into effect January 1, 2007. The regulations do not go into effect until 60 days after they are made final, and therefore will not have an effective date until some time next year.

Although the regulations are not final, it is unlikely that they will change significantly. Therefore, **we recommend that administrators of self-directed plans consider now adopting life-cycle funds as a self-directed plan's default funds**, and complying with the other requirements of the law, including giving notices to participants.

Section 624 will assure that default investments include stocks. The hoped-for result is larger savings for retirement. By encouraging plans to make use of life-cycle and similar investment funds, the law may have the additional effect of causing many participants who do make investment decisions -- but are unsophisticated investors – also to invest in life-cycle funds, with improved performance for them as well.

Keep in mind that a plan administrator's fiduciary obligation with regard to self-directed plans is two-fold: (1) prudent selection of the menu of investment funds, and (2) selection of the default investment fund. This E*Zine has focused on the second duty, but the first must also be kept in mind.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact any of the attorneys listed below.

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