MAPPING - WHAT THE NEW REGULATIONS SUGGEST FOR DEFINED CONTRIBUTION PLANS

Jennifer Heilig, Consultant
Brian Donoghue, Consultant
Christine Loughlin, CFA, Partner

Introduction

On October 24, 2007, the final regulation regarding Qualified Default Investment Alternatives (QDIA) was released by the U.S. Department of Labor (DoL). It amends ERISA to include language about the types of default investments sponsors can use to avail themselves of a "safe harbor" or relief from liability for any loss, or by reason of any breach, that occurs as a result of investing employees/plan participants in such investments. The QDIA rule is a comprehensive, thorough piece of regulation that has applications beyond auto enrollment.

Our intent for writing this paper to our defined contribution clients is to generate a conversation across our client base about mapping fund replacements to the QDIA as a preferred approach. As the selection of the QDIA is a fiduciary decision, so too is the decision of how to move participant asset balances and deferrals when funds are replaced, plans are merged (M&A) or administrative service providers are changed. The QDIA regulation includes language on the flexibility plan sponsors and fiduciaries have with making "mapping" decisions, by either mapping "like-to-like" for protection under the ERISA 404(c)(4), or by mapping to the plan default under the QDIA safe harbor, ERISA 404(c)(5). After about six months of consulting to the QDIA, and hearing views from across the industry, we think the idea of mapping to the default, rather than like-to-like, is more appealing in many instances. Our clients should hear from us in a single clear voice that this is a new, and perhaps better, alternative to the traditional approach of mapping like-to-like.

Our paper is set out as follows:

- Section one discusses mapping and fiduciary risks generally
- Section two discusses 404(c)(4) mapping, or mapping "like-to-like"
- Section three discusses 404(c)(5) mapping, or mapping to the QDIA

NEPC'S INTENT FOR WRITING THIS PAPER IS TO GENERATE A CONVERSATION ACROSS OUR CLIENT BASE ABOUT MAPPING TO THE QDIA AS A PREFERRED APPROACH.

Mapping and Fiduciary Risks

Mapping refers to the process where fund assets are sold and the proceeds are wired to the new investment manager/provider where they are reinvested, at the direction of the plan sponsor. Mapping serves as an alternative to collecting new investment instructions from plan participants as to how they would like to direct their investments when a plan event occurs.

Although mapping may be the most commonly acceptable approach, it may deprive plan fiduciaries of protection under 404(c)[1] following the completion of the event. Some interpretations of 404 (c) suggest that 404(c) relief is only available if the participant has exercised actual control over the investment of his or her account. With mapping,

[1] The 404(c) regulations are lengthy and formidable, but they provide the basic over-arching guidelines to assist plan sponsors in complying with the requirements so that they can obtain Section 404(c) relief (i.e., limited liability protection from claims by participants and beneficiaries arising from investment losses).

the participant never actually selects the new fund. Rather, the participant selected the discontinued fund from which the participant's account was transferred by the plan sponsor. For this reason, the mapping process has historically been regarded as one of the more significant sources of potential liability. That was until the Pension Protection Act codified the "like-to-like" mapping practice, as described next.

THE PENSION PROTECTION ACT CODIFIED THE LIKE-TO-LIKE MAPPING PRACTICE.

404(c)(4) Mapping ("Like-to-Like")

ERISA 404(c) relieves plan sponsors from fiduciary responsibility for affirmative investment elections made by participants.

The Pension Protection Act (PPA) extends 404(c) relief to the mapping of a participant's assets from one fund to another if a "qualified" change in investment options occurs. A "qualified" change is conditioned on the following:

- The participant exercised control over their investments prior to the change (i.e. the participant and not the plan's fiduciaries made the original investment allocation decision),
- The change results in a reallocation of amounts invested in the discontinued option to a new or remaining investment option under the plan,
- The remaining or new investment option is "reasonably similar" in terms of risk and return to the discontinued option,
- Participants are notified of the change at least 30 but not more than 60 days prior to the effective date of the change. The notice must inform participants that the change will occur unless instructions are received to the contrary, and
- The participant has not provided affirmative investment instructions to move to another investment option prior to the effective date of the change.

With the advent of the PPA, plan sponsors and fiduciaries now have a higher level of protection when choosing to follow a "like-to-like" mapping approach. As prescribed above, if these conditions are met with respect to timing, communication and, most importantly, the similarity of characteristics between the investment option receiving participant assets and that of the investment option being removed, then a qualified change in investment options will have taken place. Under such conditions, the mapping could be considered a continuation of the participant's initial directions, and the sponsor is therefore protected under 404(c).

From a Consulting perspective, however, these are not the easiest conditions to satisfy. Practically speaking, here are some of the hurdles:

- How do we satisfy that the investment option from which assets are being transferred was chosen by the participant or beneficiary? In most plans today, assets have been mapped before; participants may not have made an affirmative election into the investment that is being discontinued.
- How liberally can you extend the "reasonably similar" language? How do you address the mapping of dissimilar investment options?
- Do you ignore fund strategy and characteristics in mapping on a risk and return basis? This is counter to current practice where a large cap value fund would be mapped to a replacement large cap value fund, rather than, say, to a balanced fund, if it was more similar in return and risk.

As mentioned, like-to-like fund mappings have been the historical, normative practice. Unfortunately, however, when the Pension Protection Act codified like-to-like fund mappings, new constraints were placed on plan sponsors' ability to affect them. While these certainly are not insurmountable, we have over the past six months, seen our clients' ERISA counsels pose challenges to fund replacement and other mappings on the basis of the above conditions not being satisfied, or at least, not obviously satisfied. This new red tape, if you will, does concern us and does further our interest in 404(c)(5) mappings, as described next.

404(c)(5) Mapping ("Mapping to the QDIA")

A 404(c)(5) mapping can be described rather simply. It is plan sponsor or fiduciary-directed transfer of participant asset balances and deferrals from a discontinued option to a plan's default. As long as the default is a QDIA, plan sponsors or fiduciaries obtain safe harbor relief from fiduciary liability for investment outcomes.

According to the QDIA regulation, 404(c)(5), unlike 404(c)(4), can apply to the selection of an investment alternative by a plan fiduciary in the absence of any affirmative direction by the participant or beneficiary.

WE BELIEVE THAT MORE SPONSORS WILL FIND THAT MAPPING TO A QDIA MAKES MORE SENSE.

Given the access to a ***safe harbor*** with mapping to the QDIA, and the absence of the conditional hurdles associated with a "like-to-like" mapping, NEPC views a QDIA mapping as the preferred approach. Further, our belief in automating plans to help participants make better investment decisions supports mapping to a QDIA – as with that portion of assets we know participants have achieved diversification in a mix of assets considered appropriate for their age. This ensures that participants are never placed by the sponsor or fiduciary in any plan offering other than the plan's default – which in our view is a very defensible fiduciary position. Going-forward, no fund in the program will receive participant assets unless a participant made an active decision to invest in it.

While this approach may have potential challenges (plan pricing, participant communications, potential for longer black-out period or out of market exposure during conversions), we believe that sponsors should consider mapping to the QDIA going forward when funds are replaced, plans are merged (M&A) or administrative service providers are changed.

Summary and Conclusion

In the context of changing investment options under a plan, ERISA sections 404(c)(4) and 404(c)(5) provide fiduciaries flexibility in implementing changes. As one of these treatments is, in our view, easier to effect, better for participants, and more clearly affords plan sponsors with a ***safe harbor,*** we believe it is compelling to consider breaking from historical practice and embracing it. This treatment is mapping to the plan's default (QDIA), rather than "like-to-like", in instances of fund replacements, plan mergers or service provider changes.

We acknowledge that some sponsors may have valid reasons to accept the fiduciary risk associated with mapping "like-to-like". But we believe that more sponsors will find that mapping to a QDIA makes more sense from a fiduciary and best practice perspective. We hope this letter initiates robust discussions among our clients, as it intended to advance a very important policy discussion within your programs.