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PRIVATE SECTOR SOLUTIONS FOR LEGAL AND REGULATORY BARRIERS TO ANNUITIES IN 401(K) PLANS

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INTRODUCTION

The most important legal and regulatory barriers to annuities in 401(k) plans arise under the Employee Retirement Income Security Act (ERISA), enacted on September 2, 1974,[1] and rulings thereunder by the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS). In this regard, the most important single section of ERISA is § 404(a), which requires fiduciaries[2] of an employee benefit plan to discharge their duties with respect to the plan solely in the interest of the plan participants and beneficiaries. Section 404(a)(1)(A) states that the fiduciary must act for the exclusive purpose of providing benefits to the participants and beneficiaries and defraying reasonable plan administration expenses. Section 404(a)(1)(B) requires a fiduciary to act with the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person acting in a like capacity, and familiar with such matters, would use.

Over the past 30 years, the number of traditional (defined-benefit) pension plans in the private sector has declined dramatically, and the dominant form of retirement plan is now the 401(k) plan. The focus of concern has recently shifted from accumulating 401(k) plan assets to providing greater retirement income security for 401(k) plan participants and beneficiaries. In 2010 the DOL and the U.S. Department of the Treasury (the Treasury) solicited information on how they might enhance retirement security by facilitating access to, and use of, lifetime income or other arrangements designed to provide a lifetime stream of income after retirement (the request for information).[3] The request for information generated considerable public comment but there were few actual developments. Part of the delay may be attributed to a certain ambivalence on the part of the DOL. On the one hand, the DOL wanted to encourage lifetime income; on the other hand, it was wary of relaxing the strict fiduciary standards of ERISA. The Setting Every Community for Retirement Enhancement (SECURE) Act, enacted in December 2019, includes major lifetime income–related provisions that will reduce some of the barriers that have discouraged the use of lifetime income products by defined-contribution plans, and hopefully will also encourage participants to think about their retirement savings as being capable of producing a lifetime income stream.[4]

The U.S. retirement system is huge. According to the Federal Reserve Board, total financial assets of pension funds were $23.4 trillion as of March 31, 2020, of which $7.5 trillion was attributable to defined-contribution plans, including 401(k) plans but excluding individual retirement accounts (IRAs), which hold more assets than 401(k) plans.[5] Given the uncertain state of the economy as a result of the business disruption caused by the coronavirus, and the difficulty of enacting bipartisan solutions, it will be difficult for the federal government to enact significant legislation or issue major regulatory guidance. Accordingly, this is a good time for the Alliance for Lifetime Income, other industry groups, and groups advocating for the U.S. retirement system (such as the ERISA Industry Committee, the American Benefits Council, and the American Retirement Association) to think creatively about how to develop and implement private sector solutions to improve retirement income security. This paper considers some of the possible industry solutions and discusses changes that can be accomplished only by means of legislation or regulatory guidance.

Increasing the use of lifetime income solutions in 401(k) plans is not a short-term endeavor. Extensive targeted education of plan sponsors, investment advisors, recordkeepers, and individual plan participants will be essential. Product development and redesign to meet the needs of plan sponsors and plan participants will be important. Individuals' aversion to annuities, though often irrational, is deep seated, partly because they have been encouraged to focus on the accumulation of assets as an end in itself, rather than as a means of providing retirement income.[6] Hopefully, the insurance industry will be willing to invest the necessary resources, to change long-established marketing and distribution practices, and to allow time for the initiatives to bear fruit.

1. Pub. L. 93-406, codified in scattered sections of Titles 26 and 29 of the U.S. Code. ERISA has been amended numerous times over its 46-year history.
2. The term "fiduciary" is broadly defined by § 3(21) of ERISA.
3. 75 Fed. Reg. 5,253 (Feb. 2, 2010), 2010-1 C.B. 443.
4. See, e.g., Groom Law Group, "Lifetime Income Provisions."
5. Board of Governors of the Federal Reserve System, "Financial Accounts of the United States."
6. Mrs. John Dashwood had strong views on annuities: "If you observe, people always live for ever when there is an annuity to be paid them; and she is very stout and healthy, and hardly forty. An annuity is a very serious business; it comes over and over every year, and there is no getting rid of it." Austen, Sense and Sensibility.

1. IS A 401(K) PLAN TRULY A RETIREMENT INCOME PLAN?

When ERISA was enacted in 1974, the dominant form of retirement plan was still the defined-benefit plan, which, like Social Security, typically provided a fixed monthly pension for life. It is important to remember that the acronym "ERISA" stands for the *Employee Retirement Income Security Act*. The Treasury regulations[7] still reflect the long-obsolete distinction between pension plans—primarily defined-benefit plans—and what were then called profit-sharing plans (technically, though not popularly, now called discretionary contribution plans).

Section 401(k) of the Internal Revenue Code (the Code) was enacted four years after ERISA, by the Revenue Act of 1978, and attracted very little notice until some years later. A 401(k) arrangement must be part of a profit-sharing plan or (rarely) a pre-ERISA money purchase pension plan. Thus, since 401(k) plans fall on the profit-sharing side of the divide, they are significantly less retirement income–oriented than is a pension plan and, for instance, can provide for in-service distributions and hardship distributions. There is no requirement for them to offer any annuity or other lifetime income options.

In the early days of what became the 401(k) behemoth, 401(k) plans, like profit-sharing plans before them, were regarded primarily as plans that supplemented a pension plan, so their lack of retirement orientation was not seen as a problem. Future retirees are far less likely to have any guaranteed lifetime income other than Social Security, which itself is under threat, and it is time for 401(k) plans to grow up. The process of growing up will not be easy or popular.

2. WHAT IS A LEGAL OR REGULATORY BARRIER TO ANNUITIES IN 401(K) PLANS?

For purposes of this paper, I regard a barrier as any law or regulation whose effect in practice (direct or indirect) is to make it more difficult to provide annuities in 401(k) plans. Thus, the rule that only a pension plan (defined-benefit or money purchase) generally needs to offer any annuity option[8] is a barrier: because compliance with the joint and survivor annuity rules is seen as complex and cumbersome, very few 401(k) plans include any annuity options.

The average monthly Social Security benefit for a retired worker was $1,522 in October of 2020.[9] Any additional annuity from a 401(k) plan must provide more than a trivial monthly benefit for the exercise to be worthwhile. Unfortunately, many 401(k) plan participants have account balances that are too small to provide a worthwhile annuity benefit. For example, according to the American Academy of Actuaries, a $10,000 lump sum would produce only a $50 per month life annuity for a 65-year-old man and $47 per month for a 65-year-old woman.[10] Accordingly, barriers also include all the features of 401(k) plans that make it difficult for employees to accumulate or maintain adequate account balances, including restrictions on eligibility to participate,[11] delayed vesting in employer contributions,[12] and the various forms of preretirement leakage: lump-sum distributions on termination of employment at any age, hardship distributions, plan loans that are not repaid, mandatory cash-outs of relatively small account balances, and difficulties in effecting rollovers. Delayed eligibility and delayed vesting could be addressed easily and unilaterally by employers by changing their plans to allow immediate eligibility and full and immediate vesting. Issues related to the various forms of leakage are discussed below in section 10, "Leakage and Insufficient Accumulations."

7. Treas. Reg. 1.401-1(a)(2)(i), (ii).
8. ERISA § 205(b)(1).
9. Social Security Administration, "Monthly Statistical Snapshot, October 2020."
10. American Academy of Actuaries, "Impact of the SECURE Act." According to one recent report, the median combined 401(k)/IRA balance for working households nearing retirement was $144,000 in 2019. This would provide a married couple with $570 per month. Only half of households have any 401(k)–related assets: the main reason for low savings is lack of continuous coverage. Munnell and Chen, "401(k)/IRA Holdings in 2019."
11. A 401(k) plan may generally require completion of one year of service, comprising at least 1,000 paid hours, and attainment of age 21 before an employee is eligible. Given the frequency of job changes in the American economy, this can result in many years when an employee is not eligible. Furthermore, a plan is generally not required to cover more than 70% of the employees who have satisfied these requirements, which can be particularly burdensome for nontraditional (e.g., gig) workers.
12. A plan can provide for graduated vesting over six years of service, or cliff vesting after five years of service.

Similarly, there are all the problems employees face in keeping track of, and consolidating, numerous retirement accounts accumulated over a lifetime spent working in multiple jobs. The employees most vulnerable in this regard are those who can least afford to lose any of their retirement assets. Some countries have retirement clearinghouses to consolidate and keep track of multiple accounts. Others have what is called a pension dashboard, a resource where individuals can access all of their retirement accounts, including public pension benefits, in one place; Australia, Britain, the Netherlands, and Sweden have pension dashboards.[13]

3. THE EVOLUTION OF THE ANNUITY SELECTION SAFE HARBOR

The fiduciary responsibilities involved in selecting an annuity provider for retirement plan benefits received little attention, and resulted in no guidance from the DOL, for almost 20 years after ERISA was enacted. Those responsibilities became a central concern in the early 1990s when Executive Life Insurance Company, an insurance company that had been prominent in writing annuity contracts for terminating defined-benefit plans, failed. Executive Life undercharged its competitors by investing heavily in junk bonds. When the junk bond market collapsed, Executive Life became insolvent and was able to pay annuitants only about 70 cents on the dollar. Another major insurer, Mutual Benefit Life Insurance Company of New Jersey, became insolvent in 1991, also as a result of bad investments. Pension annuity defaults, although feared, did not occur.[14]

The DOL, plan participants, and retirees brought lawsuits for breach of fiduciary duty. In 1994 the Pension Annuitants Protection Act added ERISA § 502(a)(9), authorizing suit by a former plan participant or beneficiary, the secretary of labor, or a plan fiduciary, in cases alleging breach of fiduciary duty arising from the purchase of insurance contracts. The cause of action is not limited to defined-benefit plans.

Unfortunately, fiduciary concerns and regulatory principles that arose in connection with defined-benefit plans, and situations that involved direct conflicts of interest for plan sponsors, are now inhibiting fiduciaries of 401(k) plans who seek to offer annuities without unduly exposing themselves to liability.

3.1. Interpretive Bulletin 95-1

The DOL's Interpretive Bulletin 95-1 (IB 95-1) sets out the ERISA fiduciary standards applicable to the selection of an annuity provider for benefit distributions from a defined-benefit plan.[15] In Advisory Opinion 2002-14 the DOL clarified that IB 95-1 also applied to defined-contribution plans.[16]

Under IB 95-1 the selection of an annuity provider is a fiduciary decision. The obligation of prudence under ERISA § 404(a)(1)(B) requires that fiduciaries conduct an objective, thorough, and analytical search to identify and select annuity providers. A fiduciary must evaluate factors relating to a potential annuity provider's claims-paying ability and creditworthiness. Reliance solely on ratings would not be sufficient. The factors a fiduciary should consider include, among others, (1) the quality and diversification of the annuity provider's investment portfolio, (2) the size of the insurer relative to the proposed contract, (3) the level of the insurer's capital and surplus, (4) the lines of business of the annuity provider and other indications of an insurer's exposure to liability, (5) the structure of the annuity contract and guarantees supporting the annuities (e.g., the use of separate accounts), and (6) the availability of additional protection through state guaranty associations and the extent of their guarantees. Unless they possess the expertise to evaluate such factors, fiduciaries need to obtain the advice of a qualified independent expert.

IB 95-1 imposed a "safest available annuity" standard. The DOL recognized that there were limited situations where it might be in the interest of the participants and beneficiaries to purchase other than the safest available annuity, but noted that unsafe annuities could put benefits of participants and beneficiaries at risk, and that increased cost does not justify that risk.

In 2007 Pamela Perun wrote, "The real reason why plan sponsors don't offer annuities" is that legal advisors strongly advise against them, because offering annuity options "expose[s] plan sponsors to a significant and

13. See John et al., "A Retirement Dashboard"; and John et al., "Creating a Retirement Dashboard."
14. Langbein et al., Pension and Employee Benefits Law.
15. 60 Fed. Reg. 12,328 (Mar. 6, 1995), 29 CFR § 2509.95–1.
16. Employee Benefits Security Administration, "Advisory Opinion 2002-14A.".

long-term risk of fiduciary liability."[17] She pointed to the perceived weaknesses of the state insurance guaranty funds as bearing on this liability, because they were thought to increase the riskiness of annuity products.[18]

In evaluating a fiduciary's conduct, a court is supposed to evaluate the procedures the fiduciary followed and the facts known at the time, not the success or otherwise of the decision. Nevertheless, there is a real danger of hindsight bias in the courts when an annuity provider fails.

3.2. The Pension Protection Act

In 2002 the DOL clarified that the safest available annuity rule applied to annuities purchased by defined-contribution plans, despite the fact that annuities purchased by defined-contribution plans, unlike those purchased by defined-benefit plans, generally do not involve any conflict of interest for the employer.[19] In response to concerns expressed by plan sponsors and advisors, section 625 of the Pension Protection Act of 2006[20] included a further clarification that directed the secretary of labor to "issue final regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary... is not subject to the safest available annuity standard under Interpretive Bulletin 95–1," but is otherwise subject to all applicable fiduciary standards. Consequently, the applicable regulation was so revised.[21]

3.3. The 2008 Annuity Selection Safe Harbor

In 2008 a regulatory safe harbor was issued in response to the directive contained in the Pension Protection Act.[22] If the plan fiduciaries satisfied the requirements of this safe harbor, the selection of an annuity provider and annuity contract for benefit distributions from an individual account plan were deemed to satisfy the prudence requirements of ERISA § 404(a)(1)(B). The regulation did not establish minimum requirements or the exclusive means for satisfying these responsibilities.

The requirements of the regulation were satisfied if the fiduciary (1) engaged in an objective, thorough, and analytical search to identify and select providers from which to purchase annuities; (2) *appropriately* considered information *sufficient* to assess the ability of the annuity provider to make all future payments under the annuity contract; (3) *appropriately* considered the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract; (4) *appropriately* concluded that, at the time of the selection, the annuity provider was financially able to make all future payments under the annuity contract, and the cost of the annuity contract was reasonable in relation to the benefits and services to be provided under the contract; and (5) if *necessary*, consulted with an appropriate expert or experts for purposes of meeting these conditions.[23]

3.4. Criticisms of the 2008 Safe Harbor

The 2008 regulatory safe harbor was widely criticized, by (among many others) the U.S. Government Accountability Office (GAO),[24] economists,[25] and ERISA attorneys,[26] and many of these comments are still pertinent today since they speak to areas that still require investigation by fiduciaries. The GAO reported being told that there were only a few big consulting firms that would be able to help plan sponsors, and indicated it would be expensive to contract with them. One of these firms told the GAO that they did not select annuity providers for plan

17. Perun, "Putting Annuities Back."
18. Ibid.
19. Employee Benefits Security Administration, "Advisory Opinion 2002-14A."
20. The Pension Protection Act of 2006 (Pub. L. No 109-280), 120 Stat 780.
21. 29 CFR § 2509.95–1.
22. 29 CFR § 2550.404a-4, 73 Fed. Reg. 58,447 (Oct. 7, 2008). See, e.g., Ashton, Kronheim, and Reish, "Fiduciary Considerations."
23. 29 CFR § 2550.404a-4, 73 Fed. Reg. 58,447 (Oct. 7, 2008); emphasis added. The preamble to the regulation states, "An annuity provider's ratings are not part of the safe harbor, though they are encouraged to be used." The preamble noted that ratings can be misleading. Plan sponsors were encouraged to assess the protections available through state guaranty associations—not an easy task, since they are far from uniform. See also DOL: "A fiduciary's selection and monitoring of an annuity provider is judged based on the information available at the time of the selection, and at each periodic review, and not in light of subsequent events. The frequency of periodic reviews to comply with the Safe Harbor Rule depends on the facts and circumstances." DOL, "Field Assistance Bulletin 2015-02."
24. GAO, "401(k) Plans: DOL Could Take Steps."
25. See, e.g., Abraham and Harris, "Better Financial Security."
26. See, e.g., Reish and Ashton, "Lincoln Secured Retirement"; Groom Law Group, "Lifetime Income Provisions"; Toth and Giller, "Regulatory and Fiduciary Framework"; Iwry et al., "Annuities: When Income."

sponsors "because the costs and liability risks of doing so are prohibitive."[27]

In its response to the GAO, the DOL suggested instead that the plan fiduciaries could outsource these decisions to a financial institution as an investment manager under ERISA § 3(38).[28]

3.5. Employer Concerns about Fiduciary Responsibility

For many years the fear of fiduciary liability has been cited in reports and polls as one of the leading reasons why plan sponsors do not include annuities in their 401(k) plans.[29]. These fears intensified as, beginning around 2006, 401(k) plans became the targets of numerous lawsuits alleging breach of fiduciary duty, often with respect to the investment menu and/or plan fees.[30]

For example, one 2019 article suggests that "Many employers are genuinely concerned; many others find the risk of liability a convenient reason to avoid the cost or trouble of offering annuities. In any event, the industry narrative regarding a need for a safe harbor to limit fiduciary risk has become so entrenched that progress on offering annuities in 401(k) plans will not occur without one."[31] Recent surveys suggest that this may be changing, albeit slowly. More sponsors cited administrative complexities as a barrier than cited fiduciary risk.[32]

3.6. The New SECURE Act Safe Harbor

Ultimately, Congress addressed many of the concerns of plan sponsors when it enacted H. R. 1865, the Further Consolidated Appropriations Act, 2020, Pub. L. 116-94. That Act includes, as Division O, the long-pending SECURE Act, the most important pension legislation since the Pension Protection Act of 2006. Section 204 of the SECURE Act adds a new § 404(e) to ERISA, a statutory (partial) safe harbor for annuity selection.

The SECURE Act deems fiduciary obligations related to assessing the insurer's ability to satisfy its financial obligations under the contract to be met if the insurer delivers specified written representations to the fiduciary.[33] After receiving those representations, the fiduciary must not have received notice of any change, or other information, which would cause it to question the representations provided. The required representations are that[34]

1. the insurer is licensed to offer "guaranteed retirement income contracts";[35]
2. the insurer, at the time of selection and for each of the immediately preceding seven plan years, operates under a certificate of authority from the insurance commissioner of its domiciliary state that has not been revoked or suspended; has filed required audited financial statements; maintains and has maintained reserves that satisfy all the statutory requirements of all states in which the insurer does business; and is not operating under an order of suspension, rehabilitation, or liquidation;
3. the insurer undergoes, at least every five years, a financial examination by the insurance commissioner of its domiciliary state; and
4. the insurer will notify the fiduciary of any change in circumstances, which would preclude the insurer from making such representations at the time of issuance of the contract.

The fiduciary must also periodically review the continuing appropriateness of its conclusions regarding the financial capability of the insurer. A fiduciary is deemed to perform a periodic review if it receives the written representations from the insurer annually, unless it receives notice of a change in

27. GAO, "401(k) Plans: DOL Could Take Steps," fn47.
28. Ibid., Appendix VI. In a 2017 report, the Treasury made a similar recommendation. Treasury: A Financial System, 143.
29. See, e.g., the Fred Reish testimony before the 2018 ERISA Advisory Council (Reish, "Testimony").
30. Martin and Golumbic, "The War on Retirement Plan Fees."
31. Iwry et al., "Annuities: When Income."
32. See, e.g., Willis Towers Watson, "More Employers Are Adopting."
33. Groom Law Group, "Lifetime Income Provisions."
34. ERISA § 404(e)(2).
35. The term "guaranteed retirement income contract" refers to an annuity contract for a fixed term or a contract (or provision or feature thereof) that provides guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan (ERISA § 404(e)(6)).

circumstances or becomes aware of facts that would cause the fiduciary to question the representations.[36]

In addition, the fiduciary must, similarly to the obligations under the 2008 regulatory safe harbor, (1) engage in an objective, thorough, and analytical search to identify insurers from which to purchase contracts; (2) with respect to each insurer identified under (1), consider the cost (including fees and commissions) of the contract offered in relation to the benefits and product features of the contract and the administrative services to be provided under the contract; and (3) conclude that the relative cost of the selected contract, as described in (2), is reasonable.

A fiduciary is not required to select the lowest-cost contract and may consider the value of the contract (such as features and benefits and attributes of the insurer, including the insurer's financial strength) in conjunction with the cost.[37]

The new safe harbor provides that, where a plan fiduciary satisfies these conditions, the fiduciary is relieved of all liability for any losses that might result from the insurer's inability to satisfy its financial obligations under the contract with respect to (1) the distribution of any benefit, or (2) an investment in the contract by or on behalf of a participant or beneficiary pursuant to the contract.

The safe harbor is limited: it protects the fiduciary only against liability "due to an insurer's inability to satisfy its financial obligations under the terms of such contract." The fiduciary must still satisfy the other requirements of the safe harbor, including determining whether the costs are reasonable. This is essentially the same standard that applies to the selection of any other investment or service for the plan and should be manageable, with assistance, assuming access to industry benchmarking data on costs.[38]

The statutory safe harbor relief includes the selection of both (1) providers of payout annuities, and (2) providers of products that provide for the accumulation of retirement income guarantees on an in-plan basis.[39]

As under prior law, the selection of a lifetime income solution requires the prudent choice of both the provider and the product offered by that provider.

3.7. Comments on the New Safe Harbor

The safe harbor changes enacted by the SECURE Act were under discussion for several years before the statute was enacted, so some comments made before its enactment are still relevant today, including these five: (1) The fiduciary must identify qualified insurers. There is no guidance on the extent of the search, but an evaluation of several companies who provide competitive products should be enough. (2) Generally, as with other plan investments, the reasonableness of costs is determined by the marketplace and is highly dependent on the features of the individual contract and the services provided by the insurer. (3) The statute requires that the fiduciaries evaluate the cost of the contract in light of the benefits and product features of the contract, so the fiduciaries must review and understand the benefits and features. (4) The safe harbor does not include the provision of the 2008 safe harbor requiring that fiduciaries consult with experts, when necessary. However, most plan fiduciaries will need to retain independent and qualified advisors to help them evaluate the insurer and the contract, and whether the cost of the contract is reasonable. Given the prevalence of benchmarking in the context of 401(k) plan fees, it is expected that comparable benchmarking services will become available in this area. Many retirement plan experts argue that greater transparency with respect to annuity fees and costs is essential.[40] (5) Advisors can also help the fiduciary to confirm that the representations made by the insurer satisfy the statutory requirements. Because the safe harbor sets a relatively low bar, the fiduciaries still need to confirm that the insurer is financially strong.[41] Unlike more typical 401(k) plan investments, such as mutual funds, an annuity contract, unless it

36. ERISA § 404(e)(4)(B). Clarification regarding the scope of a fiduciary's duty under this rule is needed. "For example, what information might reasonably cause the fiduciary to question an insurer's initial representations of financial capability? Additionally, what might reasonably justify questioning an insurer's annual representations of financial capability? Further, is the "financial capability" of an insurer as under this provision different than the annuity provider's "ability to make all future payments under the contract" as under 29 CFR § 2550.404a-4?" (Letter from the American Retirement Association to Preston Rutledge of DOL, Feb. 17, 2020).
37. ERISA § 404(e)(3).
38. ERISA § 404(e)(5), quote; emphasis added. Reish and Ashton, "Guaranteed Income."
39. Groom Law Group, "Lifetime Income Provisions."
40. As one industry leader commented to the author, "They thought it was the solvency issue. If they want to be in the ERISA world, they have to understand the ERISA world."
41. "The commercial annuity market—even where ERISA does not apply—ordinarily gives careful attention to insurers' relative financial strength. . . . Since the market and ERISA fiduciary analysis cannot and do not turn a blind eye to relative claims-paying ability (see Appendix, Sections 1 and 2), neither should an ERISA safe harbor." Iwry et al., "Annuities: When Income."

is underwritten by two or more insurers, is not diversified but relies on the financial strength of a single insurer.

3.8. Private Sector Solutions

Because of the widespread practice of benchmarking other plan investments and the prevalence of litigation over plan costs and fees, plan sponsors will need assistance in the difficult task of comparing features, costs, and value of retirement income products. The process is made harder because lifetime income contracts are complex, and their features are not standardized.

Before the SECURE Act was enacted, several expert ERISA practitioners published checklists that could be modified to track the new requirements under the statute.[42] These checklists typically suggested that a fiduciary should review and consider these factors, among others:

- **The financial strength of the company:** Publicly available financial information about the insurance company, including its reserves, its surplus, and its risk-based capital; and the company's ratings, over a period of years, from the major rating agencies (Best's, Fitch, Moody's, Standard & Poor's, Weiss).
- **The actuarial opinion of the company:** This is the opinion filed with state regulators; it should confirm that the company has adequate funds to make anticipated payments over the projected life of outstanding annuities.
- **The track record of the company:** Does the company have a strong reputation in the annuity field? How long has the company been in business? Does the company have a large volume of annuity business? Does the insurer have a good reputation? Has there been material adverse information regarding the company in the news? Is the company's regulatory history and material litigation history good or bad?
- **Cost of the annuity:** These costs include any sales charges, commissions, surrender fees, and other actual or potential expenses.[43]
- **The benefits provided by the policy:** The benefits include performance of a variable annuity or a guaranteed minimum withdrawal benefit; for a fixed annuity, benefits include the crediting rate, guaranteed rate or range, and history of actual crediting rates over various economic cycles.
- **Transparency:** Is the information to be reviewed both clear and readily available? Is there adverse information that the insurer is reluctant to disclose?
- **State guarantees:** Consider the state guarantee insurance in the states where the plan sponsor is located (and where plan participants reside) and the extent of guarantee coverage for annuity contracts.[44]
- **Recommendation:** Unless and until further official guidance is issued, industry thought leaders can help plan sponsors by identifying the steps required to satisfy their obligations under the statute, and where the necessary information can be found; listing best practices; guiding them in considering the cost (including fees and commissions) of each contract in relation to the benefits, contract features, and administrative services to be provided; and identifying factors to be considered in concluding whether the relative cost of a contract is reasonable.[45]

Since the decision of whether a product has reasonable costs is subjective, employers' concern about fiduciary risk may shift from insurer selection to product selection. Estimating the costs for nonguaranteed lifetime income (e.g., managed payout funds) is generally relatively straightfor-

42. See, e.g., Ashton, Kronheim, and Reish, "Fiduciary Considerations," at §9.06; and Toth and Giller, "Regulatory and Fiduciary Framework." See also the detailed checklist included in Reish and Ashton, "Lincoln Secured Retirement," listing approximately 15 broad categories of information to be reviewed, where or how to obtain the information, and benchmark/parameters for what is considered prudent by fiduciaries; see also Toth and Giller, "Regulatory and Fiduciary Framework," at §§ 13.03[2] (Proposed Fiduciary Standards for Selecting a Fiduciary Provider) and [3] (Selection of the Annuity Product) (consider costs, expenses, annuitization assumptions, general account crediting rate and restrictions, appropriateness for plans, benefit sensitivity, product harmonization, advisor rules, portability).
43. For consumer-oriented advice that may be helpful to nonexpert fiduciaries, see, e.g., Fidelity, "A Shopper's Guide to Annuity Fees"; Lake, "Breaking Down Annuity Fees"; Annuity Expert, "Annuity Fees"; Motley Fool, "How You Can Find the Fees."
44. Why are people generally so poorly informed about the state guaranty funds? The National Association of Insurance Commissioners (NAIC), the chief regulatory body overseeing insurance activity, has specifically prohibited insurance companies and agents from advertising the existence of the state guaranty funds, in § 19 of its Model Act 520, passed in July 2009. It should be possible, without violating this prohibition, to make available to plan sponsors and other potential annuity purchasers, information about the guaranty system and limitations on coverage. Information is available from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and state insurance departments.
45. For recent guidance, see, e.g., Newport Retirement Services' White Paper that recommends evaluation of the efficacy of the underlying investment process, the nature of the lifetime income guarantee, counterparty strength, the cost of the product (both investment management and insurance), and operational flexibility. Newport Retirement Services, "Evaluation Scorecard."

ward: by reviewing the expense ratio. For a guaranteed lifetime income solution, it is more complex to estimate the costs.[46] For any kind of annuity one can estimate the mortality-weighted net present value of the annuity, compare that to the cost, and determine the net value (the money's worth). This can be relatively straightforward for fixed annuities, but it is more involved for variable annuities.[47] Annuity exchange platforms or annuity quotation services may be an effective way to compare fixed annuities for participants, as long as the contract terms are standardized. The more complex and less standardized the products become (in particular, incorporating guaranteed or variable features), the more challenging the assessment becomes.

It could be helpful for insurance companies and 401(k) plan thought leaders to initiate a dialog with plan sponsors, large and small, and with associations that are active in the retirement plan industry to determine what is needed to make plan fiduciaries comfortable with a process that is not a full safe harbor, and to help them to identify advisors with the necessary expertise. Another possibility would be to establish a credentialing process for advisors.

4. PORTABILITY OF LIFETIME INCOME

4.1. The Statute

The SECURE Act seeks to address the following problem: Many lifetime income products can be supported only by certain investment platform providers. If a plan that allowed participants to invest in such a product wished to move to a new platform that did not support the product, and if the plan elected to surrender the product to transition to the new platform, the lifetime income benefits associated with the product would typically be lost. In order for the plan to maintain the accumulated lifetime income benefits after the transition, it often would need to leave its existing lifetime income product with the original recordkeeper. It was difficult for plan sponsors and recordkeepers to coordinate two sets of records.[48]

Section 109 of the SECURE Act adds a new § 401(a)(38) to the Code that generally provides that a trust forming part of a defined-contribution plan will not fail to be a qualified trust solely by reason of allowing (1) qualified distributions of a lifetime income investment,[49] or (2) distributions of a lifetime income investment in the form of a "qualified plan distribution annuity contract,"[50] on or after the date that is 90 days prior to the date on which the lifetime income investment is no longer authorized to be held as an investment option under the plan. The term "qualified distribution" means a direct trustee-to-trustee transfer to an eligible retirement plan (as defined in § 402(c)(8)(B), which includes an IRA). The SECURE Act allows both in-service trustee-to-trustee transfers of annuity contracts to other eligible plans, including IRAs; and the distribution of annuity contracts.[51]

One issue on which the new provision provides no guidance is how to value an annuity contract that is transferred from one plan to another. Perhaps the most pertinent official guidance is Treasury Regulation § 1.408A-4, A-14, which provides that, when part or all of a traditional individual retirement annuity is converted to a Roth IRA then, for purposes of determining the

46. See, e.g., Reish and Ashton, "Lincoln Secured Retirement."
47. See, e.g., Pfau, Safety-First Retirement Planning, 127 et seq.
48. Groom Law Group, "Lifetime Income Provisions."
49. The term "lifetime income feature" means—(I) a feature which guarantees a minimum level of income . . . for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (II) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments . . . over the life of the employee or the joint lives of the employee and the employee's designated beneficiary. Code § 401(a)(38)(B)(iii). The term "lifetime income feature" means—(I) a feature which guarantees a minimum level of income . . . for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (II) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments . . . over the life of the employee or the joint lives of the employee and the employee's designated beneficiary. Code § 401(a)(38)(B)(iii).
50. The term "qualified plan distribution annuity contract" refers to an annuity contract purchased for a participant and distributed to the participant by a plan or contract" described in Code § 402(c)(8)(B)(iii)-(vi), namely a qualified plan, a 403(a) annuity plan, an eligible governmental deferred compensation plan, or a 403(b) plan (Code § 401(a)(38)(B)(iv)). Similar amendments are made to Code §§ 403(b)(7), 403(b)(11), and 457(d)(1) to extend this portability to § 403(b) arrangements and governmental deferred compensation plans.
51. "One little mentioned detail in these rules is the fact that 'insurance' is not required for portability, even though that is the only way currently to "guarantee" lifetime income." (Toth, "Tontines and PEP Late Deferrals." See also Toth, "SECURE Act."

amount includible in gross income as a distribution, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. (This rule applies if it is converted otherwise than by the complete surrender of contract for its cash value and the reinvestment of the cash proceeds in a Roth IRA, if the surrender extinguishes all benefits and other characteristics of the contract. In that case, the cash from the surrendered contract is the amount reinvested in the Roth IRA.)

Treasury Regulation § 1.408A-4, A-14(b) sets forth methods that may be used to determine the fair market value of an annuity. "However, if, because of the unusual nature of the contract, the value determined under one of these methods does not reflect the full value of the contract, that method may not be used."[52]

For example, under the gift tax method, if there is a comparable contract issued by the company that sold the annuity, the fair market value of the annuity may be established by the price of the comparable contract. If there is no comparable contract available, the fair market value may be established through an approximation.[53]

Alternatively, the accumulation method may be used for an annuity contract that has not been annuitized. The fair market value may be determined using the methodology provided for purposes of the required minimum distribution rules in Treasury Regulation § 1.401(a)(9)-6, A-12. The entire interest under the annuity contract is treated as the value. The entire interest is (1) the dollar amount credited to the employee or beneficiary under the contract, plus (2) the actuarial present value of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract. The actuarial present value is determined using reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health. The regulations include two examples illustrating how they apply to a variable annuity contract with a guaranteed death benefit. The 408A regulations require certain modifications to the value determined under § 1.401(a)(9)-6.

4.2. Private Sector Solutions

The new rule appears relatively straightforward from a legal viewpoint, despite its awkward wording. The problems could be practical: Will the various providers and platforms involved in a transaction be able to exchange data seamlessly?[54]

There are a couple of areas in which plan sponsors will need assistance. First, in amending their plan documents to provide correctly for portability; model language from the IRS would be helpful. Second, sponsors must issue updated communications and election forms to plan participants to describe the new options,[55] and to assist plan participants to use the new portability option. The issuers of the contracts could provide invaluable assistance in order to further their interest in keeping contracts in force.

5. ESTIMATES OF INCOME

5.1. Prior Law

ERISA § 105(a), as amended by the Pension Protection Act of 2006, requires a benefit statement to indicate the participant's or beneficiary's total benefits accrued; for a 401(k) plan, that means the participant's total account balance. Benefit statements must be provided at least annually. If the plan permits participants and beneficiaries to direct their own investments, benefit statements must be provided at least quarterly.

Comments have pointed out that encouraging the participant to focus on the account balance is the wrong emphasis: instead, the participant should be encouraged

52. Treas. Reg. § 1.408A-4, A-14(b)(1)(i).
53. The approximation is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion that covers the period extending beyond that date. Treas. Reg. § 1.408A-4, A-14(b)(2)(ii).
54. See, e.g., Pechter reporting in the summer of 2020 that Micruity, a tech startup, says it has the middleware that can integrate 401(k) plans and annuity issuers. "Micruity's solution can accommodate the inclusion of any type of annuity in a 401(k) plan." Pechter, "The Key to Turning on 401(k) Annuities."

to consider the amount of lifetime income that can be generated by the account balance.

On May 8, 2013, the DOL issued proposed regulations on Pension Benefit Statements.[56] The proposed regulations, which were never finalized, would have required (1) a participant's accrued benefits to be expressed on the pension benefit statement as an estimated lifetime stream of payments in addition to being presented as an account balance, and (2) the accrued benefits to be projected to retirement date and then converted to and expressed as an estimated lifetime stream of payments. The DOL also made available on its website an interactive tool that calculates lifetime income streams in accordance with that regulatory framework.[57]

The preamble to those proposed regulations noted that, among those responding to the DOL's 2010 request for information, there were competing views as to whether a lifetime income illustration should be based on the current account balance or on a projected account balance. The projected balance and related monthly payment would be discounted by an inflation factor in order to be shown in today's dollars. The 2013 proposed regulation described the methodology for projecting an account balance and the methodology for converting an account balance into a lifetime income stream, and required clear disclosure of assumptions.

5.2. The SECURE Act Amendments and the Interim Final Regulation

The 2019 SECURE Act requires that all individual account plans add a lifetime income disclosure to at least one benefit statement furnished to participants during a 12-month period. This requirement will become applicable to benefit statements furnished more than 12 months following the latest of the DOL's issuance of (1) interim final rules (IFRs), (2) a model lifetime income disclosure, or (3) assumptions used to convert accrued benefits to lifetime income streams.[58]

Section 203 of the SECURE Act amends ERISA § 105. Unlike the 2013 proposed regulation, the estimate of income is based solely on the current account balance, and not on a projected account balance.

The Act required the DOL to issue IFRs by December 20, 2020, prescribing the assumptions plan administrators are to use. The DOL could prescribe a single set of assumptions or ranges of permissible assumptions. Where a participant invests in a lifetime income product inside the plan, the assumptions prescribed by the DOL are required, to the extent appropriate, to use the amounts payable as a lifetime income stream under the investment product. Within the same period, the Act also requires the DOL to issue a model lifetime income disclosure containing a series of prescribed explanations.[59]

Two lifetime income illustrations are required: a qualified joint and survivor (as defined in ERISA § 205(d)) lifetime income stream, based on the assumption that the participant has a spouse of equal age; and a single life annuity.[60] *All* persons are relieved from *any* liability under Title I of ERISA for providing lifetime income disclosures (including disclosures made more frequently than annually) that (1) are based on the assumptions and rules specified by the DOL, and (2) include the explanations contained in the DOL's model lifetime income disclosure.[61]

Having an officially sanctioned methodology for providing lifetime income illustrations should alleviate plan sponsor concerns as to potential fiduciary liability associated with educating participants and beneficiaries on the payout and may encourage some plan sponsors to offer lifetime income distribution options. Before many plan fiduciaries consider offering lifetime income distribution options and not just lifetime income illustrations, however, the liability concerns addressed in other parts of this paper must be addressed.[62]

The DOL issued an IFR on August 18, 2020.[63] The rule was published in the Federal Register on September 18,

55. See, e.g., Toth, "SECURE Act."
56. 78 Fed. Reg. 26,727 (May 8, 2013).
57. The lifetime income calculator can be found at DOL, "Lifetime Income Calculator."
58. ERISA § 105(a)(2)(E)(vi).
59. ERISA §§ 105(a)(2)(E)(iii), (iv).
60. ERISA § 105(a)(2)(E)(i)(III).
61. ERISA § 105(a)(2)(E)(v).
62. Pavlick, "DOL Issues Initial Guidance."
63. 85 Fed. Reg. 59, 132, Sept. 18, 2020.

2020, will become effective on September 18, 2021, and will apply to benefit statements furnished after that date.[64] The rule addresses the assumptions to be used in preparing the estimates and provides model disclosures that can be used. Use of the model language is not mandatory, but gives plan sponsors greater assurance that they will qualify for liability relief. Additional disclosures are permissible. There are special disclosures for in-plan annuities. The main advantage of the rule, on which the DOL has invited comments, is that it is relatively easy to apply. The main disadvantage is that it will often generate lifetime income illustrations that bear little relation to reality, particularly for participants who are not close to retirement:

For example, assume two participants, ages 40 and 60, each has a $200,000 account balance. Based on the Aug. 3, 2020, 10-year Constant Maturity Treasury (CMT) rate of 0.56% and the 2020 Section 417(e) mortality table, the single life annuity factor for a 67-year-old participant is 18.5. Both participants would see a monthly annuity value of $901 ($200,000 / 18.5 / 12), even though the 60-year-old is much closer to retirement.

Even for participants retiring immediately, the disclosed amount may bear very little relation to the actual benefit they could purchase. In the example above, the immediate annuity, calculated using the prescribed assumptions, would be $423 for the 40-year-old and $703 for the 60-year-old.

The average participant likely will be unable to quantify how much the statement's estimates will differ from actual annuity amounts on retirement. This could limit the disclosure's value to all but the most financially savvy participants.[65]

The IFR does invite comments, so it is to be hoped that the final rule, while remaining employer friendly, will provide information that is more useful to the average plan participant. Merely disclosing that the estimate is only an estimate is not enough, since many (if not most) participants will ascribe undue weight to the monthly estimates given in the disclosure.

5.3. Recommended Private Sector Solutions

The lifetime income disclosure may help to address what economists call a framing problem: to encourage participants to view the account as a source of lifetime income rather than as a lump sum, to help them to understand the benefits of lifetime income, and to make them more willing to accept a lifetime income distribution option, if the plan makes one available. This will require extensive new educational efforts by plan sponsors and others.[66]

The disclosures, and the materials accompanying the disclosures, should be designed to change the participant focus from where it is now—the account balance—to the amount of lifetime income that the account balance, plus future contributions, and investment earnings, will provide. One way of changing the focus would be to make the lifetime income illustration rather than the account balance the centerpiece of the annual disclosures; it might also make sense to stress that the account balance is merely a snapshot in time that is of limited relevance unless the participant is planning to take a distribution in the relatively near future.[67]

The plan sponsor should also be encouraged to suggest that participants go beyond the disclosures and use a lifetime income calculation tool available to them on the web.[68] Participants can investigate lifetime income using retirement ages and assumptions that are different from those specified by the DOL and could estimate future income streams based on future contributions input by the participant. They could also include other sources of income (such as Social Security) available to them or their spouses. The DOL could also use this opportunity to improve its own online calculation tool (the Lifetime Income Calculator), provide a link to it in the model disclosure, and explain in the model disclosure why participants should visit the website and use the tool rather than simply relying on the disclosed income streams from the current account balance in this plan. Several actuarial organizations have already developed retirement income calculation tools that

64. Ibid.
65. Mercer, "DOL Takes First Stab."
66. For a helpful review of information that could be provided in connection with the disclosures, see American Academy of Actuaries, "Impact of the SECURE Act."
67. Brown, "Income as the Outcome."
68. DOL, "Lifetime Income Calculator."

are, at least arguably, better than the DOL's Lifetime Income Calculator.[69]

The participant should also be encouraged to input into an online calculation tool personalized data that reflect the actual ages, marital status, genders, additional financial resources, and anticipated retirement ages of the participant and beneficiaries.

We need to track how effective these disclosures are in increasing participant savings rates or improving participant retirement planning. Required disclosures and optional additional disclosures can be modified in the light of experience. Some illustration of the value of future contributions would be extremely helpful in building participant understanding, even if it is provided in a generic format.

In addition to providing these new disclosures and supplementary material, plan sponsors need to communicate to their employees, from the first day of participating in the 401(k) plan, that the real purpose of the plan is not to accumulate a large lump sum but rather to provide retirement income. This should be reflected in the name of the plan: it should be the XYZ Company Retirement Income Plan, not the XYZ Company Savings Plan. This shift should be reflected consistently in all participant communications, education programs, and benefit statements.

6. LIFETIME INCOME AS A DEFAULT

6.1. Lifetime Income as a Default Under the Plan

A 2018 report from a committee of the British House of Commons correctly notes that, there as here, there is a profound philosophical difference between the government's approach to the accumulation (saving) and decumulation (receiving) phases of a pension.[70] Accumulation is now largely passive. In the payout phase, however, individuals must actively choose what to do with their savings, and many have little or no idea how to choose.

ERISA § 404(c) and 29 CFR § 2550.404c-1 provide defined-contribution plan fiduciaries with limited relief from the fiduciary responsibility provisions of ERISA where a participant or beneficiary exercises control over the assets in his or her account. Before enactment of the Pension Protection Act in 2006, this protection did not extend to default investments made for participants who had failed to make an affirmative investment election, a phenomenon that became more prevalent as 401(k) plans increasingly used automatic enrollment.

ERISA § 404(c)(5) now provides that, for purposes of ERISA § 404(c)(1), a participant in a defined-contribution plan will be treated as exercising control over the assets in the participant's account if, in the absence of an investment election by the participant, such assets are invested by the plan in accordance with DOL regulations. The DOL's regulation[71] describes the types of investment products that are qualified default investment alternatives (QDIAs) under § 404(c)(5).

In order for an investment product or service to qualify as a QDIA under the current rules, it must (1) be managed by a fiduciary (ERISA § 3(38)) investment manager, and (2) fall into one of three categories: balanced or risk-based funds, target date funds (TDFs), or managed accounts. Although the regulation specifically envisages the inclusion of an annuity in a TDF, certain features of the regulation are problematic, notably a 90-day liquidity requirement[72] and a requirement that a participant must be allowed to transfer assets held in the QDIA "to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elected to invest in the qualified default investment alternative, but not less frequently than once within any three month period."[73]

Many of the witnesses testifying before the 2018 Advisory Council on Employee Welfare and Pension Benefit

69. See, e.g., the Actuarial Lifetime Income Retirement Estimator (ALRIE) tool at Steiner and Kalben, "The SECURE Act."
70. House of Commons Work and Pensions Committee, "Pension Freedoms."
71. 29 CFR 2550.404c-5, 73 Fed. Reg. 23349, Apr. 30, 2008.
72. 29 CFR 2550.404c-5 (e)(4)(vi).
73. 29 CFR § 2550.404c-5(c)(5)(i). These issues were considered in detail in ERISA Advisory Council, Lifetime Income Solutions.

Plans (usually referred to as the ERISA Advisory Council[74]) stressed the importance of modifying the QDIA regulation to accommodate a variety of lifetime income solutions within a QDIA.

6.2. Informal Guidance

On October 23, 2014, Assistant Secretary Phyllis Borzi of the DOL wrote to Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy Mark Iwry of the Treasury in response to the latter's request for the DOL's views on whether a series of TDFs could serve as QDIAs, in light of the funds' investments in unallocated deferred annuity contracts, as described in IRS Notice 2014-66.[75] Iwry also asked whether, and to what extent, the DOL's annuity selection safe harbor was available in connection with the selection of the contracts as investments of the TDFs. Borzi wrote that, in the DOL's view, the use of unallocated deferred annuity contracts would not cause the TDFs to fail to meet the requirements of the QDIA regulation.[76]

The DOL has also indicated that a fiduciary might be able to conclude, without regard to the fiduciary relief available for QDIAs under ERISA § 404(c)(5) and the regulation, that an investment product or portfolio is a prudent default investment for a plan. In a letter to Christopher Spence of TIAA, Louis J. Campagna of the DOL wrote, "Whether the selection of any particular investment alternative, including the ILCP [Income for Life Custom Portfolios], as a default investment alternative satisfies the fiduciary duties of prudence and loyalty in ERISA section 404(a) with respect to any particular plan would depend on the facts and circumstances."[77]

Annuity providers should not have to establish that their annuity investment alternatives satisfy a facts-and-circumstances test to qualify as appropriate default investment alternatives.[78] However, unless and until authoritative guidance is issued by the DOL, it is entirely possible for plan sponsors to craft an investment approach that follows the signposts in the DOL letters and is designed to qualify for the annuity selection safe harbor and/or the protection of the QDIA regulation. Clearly, the sponsor must follow and document a prudent process and involve and rely on a qualified ERISA § 3(38) fiduciary.

6.3. Private Sector Solutions

Will plan sponsors include annuities or other lifetime income in 401(k) plans without new legislation or additional (authoritative) guidance? Some have done so, and more will do so, but far fewer than if there were formal guidance. There are several alternatives:

1. Include an annuity as an optional investment feature in a participant-directed plan that satisfies the requirements of ERISA § 404(c) and the DOL regulations. The likelihood is that, unless and until participant education begins to have an effect, very few participants will choose this option.
2. Include an annuity as the default investment under a participant-directed plan, following the informal DOL guidelines laid down in the DOL letters discussed above. Most experts agree that the best way to do this is by having an annuity sleeve attached to a TDF. To protect against the risk that the arrangement is held not to be a QDIA, document the prudence of the investment selection process and obtain advice from qualified experts.

74. "Section 512 of ERISA provides for the establishment of an Advisory Council on Employee Welfare and Pension Benefit Plans, known as the ERISA Advisory Council. The duties of the council are to advise the Secretary and submit recommendations regarding the Secretary's functions under ERISA." ERISA Advisory Council, "About."
75. Borzi, "Letter to J. Mark Iwry." IRS Notice 2014-66 described a series of funds, each of which was limited to persons born in certain years. IRS ruled that the series could be considered a single fund for purposes of applying the Code's nondiscrimination rules under § 401(a)(4), Notice 2014-66, 2014-2 CB 820.
76. She continued, Under the annuity selection safe harbor, the selection of the provider and the unallocated deferred annuity contracts satisfies the requirements of section 404(a)(1)(B) of ERISA if the designated investment manager satisfies each of the conditions of the annuity selection safe harbor. The plan sponsor, as the appointing fiduciary, must prudently select the investment manager and appropriately monitor the selection at reasonable intervals to assure the prudence of maintaining the appointment. . . . Assuming the plan sponsor appropriately discharges its duties as the appointing fiduciary, it will not be liable for any acts or omissions of the investment manager, except for any potential co-fiduciary liability under section 405(a) of ERISA. </> Borzi, "Letter to J. Mark Iwry."
77. Campagna, "Letter to Christopher Spence," in response to a request for guidance on its ILCPs. In the Campagna letter, TIAA is quoted as stating that the ILCP product met all the conditions of a QDIA, except that the ILCP contained certain liquidity and transferability restrictions, attributable to an annuity component, that failed the frequency of transfer requirement described in paragraph (c)(5)(i) of the regulation.
78. "EBSA should craft a specific safe harbor for annuities and similar life-contingent income streams that relaxes that periodic transfer condition. While some annuity providers do permit transfers from annuity products to other investments, any new QDIA safe harbor for life-contingent products should permit at least some of those products to be nontransferable and nonrefundable." Forman, "Removing the Legal Impediments."

3. Include an annuity into which a portion of the annual contributions is automatically directed, under the terms of the plan. The consensus is that, to avoid participant pushback, employer matching or nonelective contributions should be used for this purpose. Document the prudence of the investment selection process and obtain advice from qualified experts. One advantage of this approach is that, by using incremental purchases, dollar cost averaging is achieved, and the participant does not have to face the trauma of a large one-time annuity purchase.

Alternatively, under Option 2 or 3 above, plan fiduciaries can prudently select and monitor an investment manager or other independent fiduciary to assume fiduciary responsibility for the arrangement.[79] If the annuity is originally bought as a plan investment (a fiduciary decision), it can also be used as a mechanism for distributing plan benefits (generally not a fiduciary decision unless there is a new selection of a provider or product).

An alternative approach is to amend the plan to change the available forms of distribution. Unlike expanding the menu of investment options, expanding the types of distribution is not a fiduciary issue, though selection of an annuity provider or contract would be. However, restricting or limiting an optional form of benefit, with respect to the account balance already accrued, may be problematic, particularly if the effect is to restrict or eliminate a lump-sum distribution.[80] Perversely, in the context of the current discussion, the IRS regulations[81] allow 401(k) and other defined-contribution plans to eliminate essentially all forms of distribution other than a lump sum.

In terms of available forms of distribution, the plan sponsor could do the following:

1. Add an annuity as an optional form of distribution, potentially as the default method. This is not a fiduciary decision. However, the selection of the annuity provider and annuity contract would be a fiduciary decision. The likelihood is that, unless and until participant education begins to have an effect, very few participants will choose this option.
2. Require that a minimum percentage of the value of the distribution be paid as an annuity. This is not a fiduciary decision, though it could possibly be challenged by disgruntled participants under some creative theory. The minimum percentage could conceivably vary from participant to participant based on objective criteria described in or pursuant to the plan document. The selection of the annuity provider and annuity contract would be a fiduciary decision.
3. Require that the entire distribution be paid as an annuity. This would be unpopular with participants and would almost certainly be inappropriate for many of them, particularly those who are very low earners (who receive a higher level of income replacement from Social Security) and those with substantial other assets.

Option 2 or 3 would require that the lump-sum option be retained for the current account balance, as at the time of the amendment.[82]

The annuity provider and contract could be selected in the following ways:

1. By the participant, without assistance. The plan could permit the participant to buy an annuity from any licensed insurer. This would entail relatively little potential liability for the plan fiduciaries, but would be highly inappropriate for most participants, who would not know how or where to begin. Many might consult financial advisors who, by reason of ignorance or investment bias, would not provide good advice.
2. By the participant, with assistance from the plan sponsor or an agent of the plan sponsor. In the absence of authoritative guidance, the problematic issue for the sponsor is what levels and types of assistance could be given without exposing the sponsor to fiduciary liability. Unless and until IB 96-1, dealing with the borders between investment advice and

79. "Ultimately, if responsible financial providers have sufficient interest and capacity, and if appropriate regulation can be achieved, this may hold the most promise, especially for mid-market and smaller DC plans." John et al., "From Saving to Spending."
80. Treas. Reg. 1.411(d)-4, Q & A 2 (e).
81. Ibid.
82. Ibid. In his testimony to the 2018 ERISA Advisory Council, Anthony Webb said, "I remain skeptical that even well-crafted defaults will significantly increase annuitization rates. . . . Given likely high levels of annuity aversion, by far the most effective way of reducing adverse selection is to mandate annuitization." Webb, "Testimony."

investment education, is expanded to cover this type of assistance, the plan sponsor would have to try to limit the assistance to activities that would constitute education rather than advice under IB 96-1.

3. By the plan sponsor, with or without expert advice. The plan sponsor should document the prudence of its process in selecting the annuity or the prudence of its process in selecting and monitoring the expert, as the case may be.
4. By an independent fiduciary retained for that purpose. The plan sponsor should document the prudence of its process in selecting and monitoring the fiduciary, and the fiduciary should acknowledge in writing that it is acting as an ERISA fiduciary.

Some insurance providers have built (or are building) annuity-based options, designed for inclusion in defined-contribution plans, that provide for transferability and that will satisfy the current QDIA rules. As always, there are trade-offs between cost and liquidity. Accordingly, one challenge for plan sponsors, most of which are unlikely to be able to meet without expert advice, is to keep abreast of the array of alternatives that are currently available or will be available soon.

The 2018 ERISA Advisory Council[83] reported on "Lifetime Income Solutions as a Qualified Default Investment Alternative (QDIA)–Focus on Decumulation and Rollovers."[84] Many of the witnesses who testified before the Advisory Council, and the Council's report, recommended that the DOL develop educational materials to assist employers and plan sponsors in evaluating and selecting income replacement options. The recommendation was that the materials should focus on aspects such as (1) the need to accomplish a shift in the perception of defined-contribution plans, to include the importance of the decumulation (retirement distribution) process; (2) commonly applied definitions; (3) features, designs, risks, and trade-offs; (4) roles of a plan sponsor/employer when offering income replacement options, education, and advice; (5) review and evaluation of projection tools used for income replacement stream; and (6) lessons from behavioral finance and research about misconceptions related to income strategies, planning horizons, and understanding of longevity risks.

In the absence of action by the DOL, interested parties (including representatives of plan sponsors, the insurance industry, investment advisors, and recordkeepers) could cooperate in preparing materials that meet these criteria. In addition to the items listed above, these educational materials could address issues frequently cited as deterrents to including lifetime income options in 401(k) plans: fear of fiduciary liability, complexity of lifetime income products[85] portability and transferability, compatibility with recordkeeping systems, and high costs of the products.

7. QUALIFYING LONGEVITY ANNUITY CONTRACTS

One of the biggest and least understood risks faced by retirees is longevity risk, or the risk that they will outlive their money. Longevity annuities that, unlike immediate annuities, do not begin payments until an advanced age, such as 80 or 85, are designed to ameliorate or eliminate that risk.

In 2014 the IRS finalized a rule to provide specifically for the use of qualifying longevity annuity contracts (QLACs) in 401(k) plans and IRAs, and amended its required minimum distribution regulations to provide that the value of annuities beginning payment after the participant reaches age 70 1/2 will not be included when calculating required minimum distributions.[86] Under the regulations, the minimum distribution requirements do not apply to the assets used to purchase a QLAC until payments begin, which can be as late as age 85.

To date, use of QLACS has been almost nonexistent.[87] Some analysts suggest that better guidance on select-

83. ERISA Advisory Council, "About."
84. For information on the Advisory Council, see ERISA Advisory Council, Lifetime Income Solutions.
85. Complexity is not limited to lifetime income products. There are regular suggestions that many if not most retirement plan fiduciaries do not adequately understand the TDFs that they have selected.
86. Longevity Annuity Contracts, 79 Fed. Reg. 37,633 (July 2, 2014).
87. Abraham and Harris, "Better Financial Security."

ing QLACs and other deferred income annuities would increase their use.[88] One downside to QLACs, as with annuities generally, is their lack of liquidity. Some industry insiders suggest that the primary reason why there has not been a rush to obtain longevity annuities is the low commission paid to the selling agent.

By using a QLAC in conjunction with a TDF it would be possible to allocate a relatively small part of a participant's accumulated assets to guaranteed income. Incorporating QLACs into 401(k) plans would allow participants to insure against the risk of a very long life and correspondingly spend their remaining assets at a faster rate. For example, "Based on reasonable assumptions, including use of 25% of the Target Date Fund to purchase the QLAC, we estimate that a participant in such an arrangement could expect to extract about 10% more income from their retirement savings compared to a participant who used a conservative drawdown rate to self-insure against longevity risk."[89]

The IRS issued a notice providing guidance for plans to integrate deferred annuities into a TDF intended for workers close to retirement, without violating nondiscrimination rules.[90] The DOL clarified that the use of these types of TDFs may meet the requirements of the QDIA regulations and that a deferred annuity embedded in a TDF can be used as a QDIA.[91] One 2019 study estimated that "if you had at least $65,000 in your 401(k) plan or more, then all you would need to do is put 10% of that amount into a deferred annuity, and you would be better off by doing so."[92]

8. PARTIAL ANNUITIZATION

8.1. In General

Before the enactment of ERISA, it was common for defined-contribution plans to offer at least three alternative forms of distribution: a lump sum, periodic payments over a period of years, and an annuity. In many 401(k) plans today, the only distribution option is a lump-sum distribution. In those plans that do allow a choice, the choice is typically all or nothing: either 100% in a lump-sum distribution or 100% in periodic payments. Most retirees do not want to annuitize all of their retirement savings; they want more flexibility to be able to respond to changing needs and may also have a bequest motive.[93]

Partial annuitization (including the option to buy a QLAC) allows participants to buy only the amount of annuity that they want and need. This amount varies significantly between different households, and is often based on factors the plan sponsor has no knowledge of. Participants can take into account income from sources outside the plan, such as Social Security, a spouse's pension, or regular income from assets or part-time employment. Partial annuitization increases both the percentage of people who annuitize and the average percentage of balances that is annuitized.[94]

According to a Treasury fact sheet on retirement security, all-or-nothing choices could lead participants to decline a plan's annuity option, leading some plan sponsors to perceive participant demand to be low and the option to be unnecessary.[95]

In a 2009 paper, Mark Iwry and John Turner articulated three principles: (1) Avoid all-or-nothing decisions, (2) avoid now-or-never decisions, and (3) avoid never-or-forever decisions.[96] They advocated the gradual acquisition of annuity income units that would "circumvent the wealth illusion or 'sticker shock' that tends to discourage individuals from paying a 'large' amount to an insurance company in exchange for an ostensibly 'small' regular monthly payment."[97]

88. Forman, "Removing the Legal Impediments."
89. Ireland, "Testimony."
90. IRS Notice 2014-66, 2014-2 C.B. 820.
91. Borzi, "Letter to J. Mark Iwry."
92. Horneff, Maurer, and Mitchell, "Automatic Enrollment in 401(k) Annuities." See also Jack VanDerhei, "How Much Can Qualifying."
93. Pozen, "401(k) Retirees Won't Buy Annuities."
94. GAO, "401(k) Plans: DOL Could Take Steps."
95. Treasury, "Treasury Fact Sheet."
96. Iwry and Turner, "Automatic Annuitization."
97. Ibid. A variation was suggested by Professor Ghilarducci's testimony to the 2018 ERISA Advisory Council: encourage workers to postpone claiming Social Security, using their 401(k) benefits to finance consumption between actual retirement and claiming Social Security. A temporary annuity would bridge the gap between retirement (at or after age 62) and claiming (at age 70). The monthly Social Security benefit at age 70 is approximately 67% higher than at age 62 and 33% higher than at age 66. See Social Security Administration, "Workers with Maximum," for examples. Ideally, the recipient would become accustomed to receiving monthly checks and would continue to receive lifetime income from the 401(k) plan even after claiming Social Security.

In a 2016 report[98] the GAO noted that the DOL had not issued any guidance on how plan sponsors might minimize their legal risk of offering a mix of options, and suggested that a plan sponsor could increase its risk of legal liability for each option it offered. It is not clear that this is necessarily the case, although it does make it more difficult for plan sponsors to describe adequately the alternatives available and the advantages and disadvantages of each.

8.2. Plans Should Offer Alternatives

Today, many 401(k) plans offer only lump-sum distributions. The participant can, indeed, make a tax-free rollover of the lump sum into another employer plan or, more frequently, into an IRA. This, however, imposes on the participant the responsibility of investing the lump sum successfully over his or her lifetime, with no continuing guidance from the employer and often in investments that carry higher fees.

A plan sponsor can add new distribution options at any time. The only practical limitation is the difficulty of explaining each option adequately to the participants. Ideally, participants should have more than one lifetime income option, because no one option works for everyone, but this may be an aspiration rather than a realistic current option.

The GAO recommended in 2016 that the DOL consider "providing legal relief for plan fiduciaries offering an appropriate mix of annuity and withdrawal options, upon adequately informing participants about the options, before participants choose to direct their investments into them."[99] The DOL expressed concern that this could shift the responsibility for annuity selection from the fiduciary to the participant. However, as the GAO pointed out, the DOL already offers fiduciary relief under § 404(c) related to the investments offered under a plan. Why would it not be appropriate for the DOL to provide, once plans have selected an appropriate mix of annuity and withdrawal options, for participants to bear the risk of selecting from among them?[100]

Under another proposal, assets in 401(k) plans would be automatically defaulted into a two-year trial income product when retirees take distributions, unless they affirmatively choose not to participate. At the end of the trial period, retirees may elect an alternative distribution option or, if they do nothing, would be defaulted into a permanent income distribution plan.[101] The plan sponsor could decide to apply the automatic trial-period income option only to accounts that exceeded a specified amount.

Why do most employees reject annuities when given the option of all or nothing? James Choi explains: "If you anticipate lumpy expenditure needs in retirement (e.g., out-of-pocket medical expenses), you want some liquid wealth to cover those expenses. Annuities are not particularly liquid, since you're constrained by the pre-fixed monthly payout. So you wouldn't want to annuitize all of your wealth. I think this is one reason why people incline towards 'nothing' when they are given an 'all or nothing' option."[102]

A Vanguard report indicated that simply offering partial distributions produced notably different participant behavior: more participants and more assets remained in the employer plan when partial distributions were allowed.[103]

9. INFORMATION AND EDUCATION

9.1. The Background

One category of fiduciary under ERISA § 3(21) is a person who renders "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or [has] any authority or responsibility to do so." In 1996, to alleviate the concerns of plan sponsors, the DOL issued IB 96-1 to distinguish activities that are investment education (non-fiduciary)

98. GAO, "401(k) Plans: DOL Could Take Steps."
99. Ibid.
100. Ibid.
101. John et al., "Increasing Annuitization."
102. Choi is quoted in Carosa, "New Research Suggests." Carosa's article refers to Beshears et al., "What Makes Annuitization."
103. Proctor and Young, "Retirement Distribution Decisions."

from those that are investment advice (fiduciary). Since at least 2003, the GAO,[104] a 2007 ERISA Advisory Council Working Group,[105] a 2008 ERISA Advisory Council Working Group,[106] the 2012 ERISA Advisory Council, and numerous experts have recommended that the DOL assist employers and plan sponsors in evaluating distribution options.[107] Progress was delayed by the long fight over the DOL's new fiduciary rule, originally finalized in 2016 but ultimately withdrawn after it was struck down by the 5th Circuit Court of Appeals in 2017. The DOL recently proposed a prohibited transaction exemption that addresses the topic of investment advice.[108] The new DOL position is tied to the SEC's "Regulation Best Interest."[109]

The 2012 report recommended that the materials should focus on aspects such as the need to accomplish a shift in the perception of defined-contribution plans, to include the importance of the decumulation (retirement distribution) process; commonly applied definitions; features, designs, risks, and trade-offs; roles of a plan sponsor/employer when offering income replacement options, education, and advice; review and evaluation of projection tools used for income replacement stream; and lessons from behavioral finance and research about misconceptions related to income strategies, planning horizons, and understanding of longevity risks.

The ERISA Advisory Council also recommended that the DOL develop educational materials to assist individuals in understanding and choosing income replacement options to best suit their retirement needs, including the importance of understanding the life-cycle approach to planning; key features, designs, risks, and trade-offs; the importance of understanding the tools and assumptions used to project income streams; the need to evaluate all household sources of retirement income, including survivor benefits and Social Security; the impact of inflation and inflation assumptions; the impact of longevity and longevity risk; the need for a long planning horizon and potential benefits from mortality risk pooling; and the timing of decisions and alternatives.

In 2016 the GAO reported that participants cited obtaining advice as a key step in selecting lifetime income options offered by a 401(k) plan; that participants preferred to obtain financial advice through their plans as opposed to obtaining it from other sources; and that participants had competing priorities for their retirement savings, which can ultimately drive them toward complex products. "Lawyers representing 401(k) plans told us they counsel their clients against providing access to advice because of legal liability."[110]

The report also found that the materials that plan sponsors provide to educate participants about lifetime income options might in many cases not be adequate to help them learn to make informed use of their plans' withdrawal options and annuities. The GAO also found that most packets were not written in a way that participants could easily and clearly understand.[111]

9.2. Private Sector Solutions

Ideally, the DOL should offer new guidance to expand IB 96-1 so as to add education about distribution planning,

104. "Currently, the notices that plan sponsors must furnish to retiring participants are not sufficient to help them choose payout options that suit their individual circumstances, while assuring adequate levels of such income to the extent possible. Our expert panel suggested that providing several types of information, such as on risks that could affect retirement income security, could help retiring participants make more informed decisions regarding how they balance income and expenditures during retirement." GAO, "Private Pensions: Participants Need."
105. "The Working Group recommends that the Department of Labor expand the reach of [IB 96-1] by changing and updating it. As innovation continues in the financial marketplace, educational initiatives will need to address items heretofore not necessarily addressed in 96-1. 96-1 needs to address information, education, and advice in the de-accumulation stage as well as the accumulation phase. Further, as innovation continues in this area, 96-1 needs to be continually updated." ERISA Advisory Council, "Advisory Council Report 2007."
106. The Working Group issued a report including the following recommendations: (1) expand the reach of IB 96-1 by adapting it to the spend-down phase; (2) clarify that products that are eligible qualified default investment alternatives while participants are actively participating in the plan will continue to be qualified; (3) encourage, authorize, endorse, and facilitate plan communications that use retirement income replacement formulas based on final pay and other reasonable assumptions in employee benefit statements on an individual participant basis; and (4) enhance plan sponsor and participant education by publishing and regularly updating information about the distribution options available to participants in defined contribution plans. ERISA Advisory Council, "Advisory Council Report 2008."
107. ERISA Advisory Council, "Report to the Honorable Hilda L. Solis."
108. Employee Benefits Security Administration, "Improving Investment Advice."
109. U.S. Securities and Exchange Commission (SEC), "Regulation Best Interest."
110. GAO, "401(k) Plans: DOL Could Take Steps."
111. Ibid.

or issue a separate bulletin incorporating similar principles. Meanwhile, there are actions that plan sponsors can and, I believe, should undertake without taking on an undue level of risk.

Targeted messaging about how to combine investments and guarantees into a lifetime income stream should occur throughout the participant's participation in the plan. Participants would be helped to understand that the primary goal of their retirement plan savings is to create a personal pension—in other words, an income stream throughout retirement.

Throughout the individual's employment, employers can provide illustrations that focus on generating retirement income to replace the paycheck, in addition to the new required estimates of income. The employer communications can consistently focus on the importance of paycheck replacement; offer education, both before and at retirement; or offer advice through an advice service, or by hiring advisors to work individually with employees. As people near retirement, employers can offer in-plan income options, serve as a purchasing agent, or offer purchase of lifetime income through a purchasing platform. If the employer has a defined-benefit plan, it can permit a transfer from the 401(k) plan to provide additional benefits under the defined-benefit plan. The employer can and should permit employees to leave their funds in the plan after retirement, and should offer investment options, managed accounts, and installment payouts. The employer could offer investment options to retirees that are different from those offered to current employees.

Almost all witnesses who testified before the 2018 ERISA Advisory Council agreed that, if annuities were offered to and were actually chosen by participants, there must be considerable education, given the low level of financial literacy and the lack of understanding of the benefits of annuities.[112] Some witnesses want materials to be provided by the DOL, while others want the DOL to comprehensively revise IB 96-1 and expand it to cover lifetime income products.[113]

There is clearly a need for plan sponsors to provide more—and more-timely—information to plan participants. There are two major problems: (1) how to persuade participants to read the information;[114] and (2) unless and until IB 96-1 is revised and updated to address changes in the investment world since 1996, and to add specific guidance on lifetime income, plan sponsors are likely to be unduly conservative in their attempt to ensure that they stay on the investment education side of the line.

Educational materials could assist individuals in understanding

- how to choose income replacement options to best suit their retirement needs, including key features, designs, risks, and trade-offs;
- the importance of understanding the tools and assumptions used to project income streams;
- the need to take into account all household sources of retirement income, including survivor benefits and social security;
- the impact of inflation and inflation assumptions;
- the impact of longevity and longevity risk, the need for a long planning horizon, and potential benefits from mortality risk pooling; and
- the timing of decisions and alternatives.

Plan sponsors are in the unique position of both being trusted by plan participants and not having a conflict of interest in the selection of products or in educating or encouraging their participants about decumulation strategies: there is no compensation to plan sponsors. Plan sponsors want and need the flexibility to offer programs, products, and services that best serve their participant populations, which is why the guidance should be broadly supportive of all lifetime income alternatives. Lawyers representing 401(k) plans have freely admitted that they counsel their clients against

112. See, e.g., Fisch, Lusardi, and Hasler, "Defined Contribution Plans," 743, 772: "As we document, data from the National Financial Capability Study (NFCS) demonstrates that workplace-only investors suffer from higher levels of financial illiteracy than other investors. These involuntary investors are particularly vulnerable to poor financial choices. . . . [The] limited financial literacy suggests a level of incapacity that renders true employee choice illusory." The authors suggest that ERISA or DOL should mandate financial education for plan participants.

113. For example, Alison Borland of Alight recommended, "Revise Interpretive Bulletin 96-1 to promote LTI [lifetime income] utilization through highly relevant lifetime income education to participants. . . . Importantly, this guidance should incorporate generally accepted investment principles and reasonable assumptions, but it does not need to be specific to annuities or any product. Such a revision—if it encompasses a modeling format/approach similar to the allowable asset allocation models under the current DOL Interpretive Bulletin 96-1—would not be investment advice, but could remain on the side of investment education." Borland, "Testimony."

114. The Supreme Court discussed this issue in Intel Corp. Inv. Policy Com. v. Sulyma, 140 S. Ct.768 (2020). See Pratt, "Focus On . . . The Supreme Court Rules."

providing access to advice because of legal liability: this undue conservatism often represents a disservice both to the employer and to its employees.

The best practice would be to change the emphasis as the employee's career progresses. During the early and mid-career accumulation phase, focus should be on participation in the plan, on saving as much as reasonably possible, and on investing for growth at a level of risk appropriate for the individual. Participant education should focus both on the growth of the account balance and on the lifetime income benefit that can be generated by that account balance. As a participant approaches retirement age, the value of lifetime income would be communicated in more detail at appropriate points—for example, at age 50, when catch-up contributions become available; and at ages 55 and 60, when the participant is increasingly beginning to think in terms of retirement. The focus gradually shifts from accumulation to retirement income planning.

With regard to participant education, the DOL should expand IB 96-1 to allow plan sponsors to provide, without fear of fiduciary liability, education regarding retirement income and the risks (such as the risks of longevity, sequence of return, cognitive, and market) inherent in managing retirement assets. Unless and until the DOL does so, plan sponsors should do so, following the guidance of IB 96-1 in confining themselves to information rather than to participant-specific advice and erring on the side of caution. The information can describe options to draw down assets and provide information relating to the probable implications (including risks and rewards) of these options. The information should not endorse any particular approach for an individual participant.

About five to ten years before the employee's anticipated retirement date (which could be individualized or simply assumed to be the same age for all employees approaching retirement), the employer should discuss with the employee his or her options. To delay this discussion until the point of or shortly before retirement does not allow time for a careful consideration of the alternatives and may encourage the participant to take the quick and easy option, which will often be a rollover into an IRA offered by the plan's recordkeeper. Ideally, the plan will offer a wide range of options, including these:

1. Leaving all or part of the money in the plan, to the extent permitted by the required minimum distribution rules, which currently do not kick in until age 72.
2. Taking a complete distribution and rolling it over to an IRA, after being advised of the pros and cons of IRA rollovers and being advised that the IRA offered by the plan recordkeeper might not be the best option.
3. Taking a partial distribution, which may or may not be part of a planned series of distributions. In the latter case, the distribution might not be an eligible rollover distribution subject to 20% withholding. The partial distribution may be coordinated with the participant's Social Security claiming strategy, to give the individual sufficient funds to live on while delaying Social Security, ideally to age 70, and thus receive significantly increased Social Security benefits.
4. As part of any of the above options, an annuity contract, immediate or delayed.
5. Around the time a participant reaches age 65, and if the plan so provides, discuss using a portion of the account to purchase a QLAC. This can happen automatically as part of the default and within the plan. Allowing participants to opt out of the QLAC would provide them flexibility if they believe a QLAC is not right for their situation.

9.3. Encourage Plan-to-Plan Rollovers and Retention of Plan Assets

A March 2013 GAO report[115] found that rollover processes are inefficient, that IRAs are heavily marketed, and that participants are often given incomplete, misleading, or false information about IRA rollovers. In some cases, the advice was given by a party that had a direct financial interest in steering the participant to a particular IRA provider.

115. GAO, "401(k) Plans: Labor and IRS." The Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers, issued Reg. No. 13-45. That notice states that a recommendation to roll over plan assets to an IRA typically involves securities recommendations subject to FINRA rules regarding suitability, and that related marketing must be "fair, balanced and not misleading." FINRA, "Rollovers to Individual Retirement Accounts."

Alicia Munnell has noted, correctly, that in the majority of cases the most effective option is rolling over money to a new employer, but this option is often also the most difficult.[116]

Employers, the DOL, and the Treasury should do more to encourage plan-to-plan rollovers and the retention of assets by a prior employer's plan after termination of employment. The current system discourages plan participants from consolidating their plan assets in an employer plan as they change jobs and encourages them to roll over assets to IRAs, rather than keeping money in an old employer's plan or transferring that money to the new employer's plan. The rollover regulations are perceived as being unnecessarily complicated: the current rules do, in fact, provide substantial qualification protection to both the old and new employers, to encourage them to transfer and accept transfers of assets, but the language could be made more explicit.

The Code allows former employers to force participants with vested balances of $5,000 or less out of their 401(k) plans.[117] In determining whether the $5,000 threshold is exceeded, rollovers into the plan are disregarded.[118] Defined-contribution plans should be required both to allow former employees to leave account balances of at least $1,000 (including rollovers) in the plan and to allow new employees to roll over account balances of at least $1,000 into the plan, provided that minimal paperwork requirements are satisfied. Even without any change in the regulations, employers can voluntarily adopt these changes. Consolidation of assets in a single plan provides a greater asset base from which to purchase lifetime income and eliminates the risk that some or all of the retirement savings will be misplaced. Pending adoption of regulatory changes, plan sponsors can voluntarily help their employees by removing unnecessary barriers to the retention of former employees' funds or the acceptance of rollovers from new employees.

Implementing a lifetime income solution may require plan recordkeepers to develop new functionality or to allow an external middleware provider to integrate into the recordkeeping platform. Some plan sponsors have encountered resistance from their recordkeepers to implementing these solutions. Many recordkeeping platforms may be more incentivized to promote rollovers into their own IRA-based solutions than to help the employer keep the assets in the plan.

10. LEAKAGE AND INSUFFICIENT ACCUMULATIONS

10.1. Introduction

Effective annuitization requires an adequate account balance. A 2015 GAO report found that about half of households whose household head is age 55 or older have no retirement savings in a 401(k) plan or IRA. About 29% have neither retirement savings nor a defined-benefit plan. Among the 48% of households with some retirement savings, the median amount is approximately $109,000, equivalent to an inflation-protected annuity of $405 per month for a 65-year-old.[119]

According to one 2016 report, based on data from the Federal Reserve Survey of Consumer Finances, the median family has $5,000 saved. "Even for people between the ages of 56 and 61, the median retirement account is a paltry $17,000."[120]

A 2015 report from the Center for Retirement Research[121] found that about 1.5% of assets leak out of the 401(k)/IRA system each year; that, among the different forms of leakage, in-service distributions and cash-outs (on termination of employment) appear to be the most significant; and that aggregate 401(k) and IRA retirement wealth is at least 20% lower than it would have been without the current leakage rules. The report points out that the barriers to accessing funds are even lower in IRAs (which

116. Munnell, "401(k) Accounts Need to Be Easier."
117. Code § 411(a)(11).
118. Code § 411(a)(11)(D).
119. GAO, "Retirement Security." For comments on the report, see VanDerhei, "GAO Report on Retirement Savings." See also EBRI, "Retirement Savings Shortfalls." It notes "the extreme importance of longevity risk and nursing home and home health care costs in simulating Retirement Savings Shortfalls." See also Bipartisan Policy Center, "Securing Our Financial Future."
120. Dayen, "The Retirement Revolution."
121. Munnell and Webb, "The Impact of Leakages."

now hold more assets than 401(k) plans) than in 401(k)s. In other countries, similar plans are more restrictive in allowing withdrawals.[122]

Unsurprisingly, leakage is greater in periods of financial stress. According to a 2013 study by the Federal Reserve Board, 40 cents of every dollar contributed to 401(k) plans by people under age 55 leaked out of the system in 2010. About 75% of cash-outs involve accounts with a balance under $20,000.[123]

Studies have consistently shown that participants in plans with a loan option and/or provision for hardship withdrawals have higher contribution rates. "The potential reduction in participation and contribution rates from reducing or eliminating access to cashouts at job change would likely be even greater."[124] Also, as a 2009 GAO report pointed out, "retirement experts have noted that prohibiting hardship withdrawals and loans also can make workers worse off in the short term if they face a financial emergency, such as a pending home foreclosure, and do not have other savings to draw from."[125]

In the short term, participants will have more access to their 401(k) plan funds, rather than less, because of the liberalized loan and hardship rules introduced to help workers affected by COVID-19, and because restrictions on access to retirement savings are unlikely to be introduced. Indeed, the Coronavirus Aid, Relief, and Economic Security (CARES) Act and guidance thereunder have given many plan participants increased access to their retirement funds.[126]

10.2. Reducing Access to 401(k) Plan Funds

As noted in section 1 above, "Is A 401(k) Plan Truly a Retirement Income Plan?," 401(k) plans were intended to be supplements to pension plans, and not the primary source of retirement income. The GAO and many other commenters have noted that 401(k) plan participants have far more preretirement access to their retirement savings than do savers in other countries, and there are even fewer limitations on preretirement access to IRAs.[127] This ready access erodes retirement security, makes annuitization more difficult, and undermines the premise for granting tax-favored treatment to 401(k) plans. The most serious causes of leakage are hardship distributions, distributions on termination of employment at any age, and in-service distributions at or after age 59 1/2.

1. **Hardship Distributions** permanently remove funds from the retirement system to finance current consumption, are currently taxable, and (if received before age 59 1/2) are generally also subject to a 10% additional income tax. Hardship withdrawals, freely available under current law,[128] should be limited to serious, unpredictable hardships. The current rules allow distributions in cases that cannot reasonably be described as hardships, such as costs related to the purchase of a principal residence (not including mortgage payments) and tuition and related expenses for postsecondary education for the participant, his/her spouse, dependents, or beneficiaries. By contrast, the rules for deferred compensation plans under Code § 457 permit hardship withdrawals

122 . See White, "Can 401(k) Plans Be Improved?," finding that, compared with Australia, Canada, Germany, Singapore, and the United Kingdom, "the U.S., far and away, has the most lenient policies toward retirement withdrawals and also the largest problem with overall wealth inequality." See also Beshears et al., "Liquidity in Retirement Savings Systems." These authors find that the six countries studied, "with the sole exception of the United States, have made their DC [defined-contribution] systems overwhelmingly illiquid before age 55."

123. Barney, "Leakage Is a Serious Problem." See also Akbas, "Plan Leakage." See also Argento, Bryant, and Sabgelhaus, "Early Withdrawals." Argento, Bryant, and Sabgelhaus found, "Perhaps most telling, taxable distributions summed to almost half the value of total new contributions for the less than 55 age group; for every dollar that was contributed according to the SCF [Survey of Consumer Finances], 45 cents came out as a taxable distribution according to the SOI [Statistics of Income]. Thus, at least in 2010, early withdrawals are quantitatively important in terms of the effect on the overall retirement accumulation process."

124. VanDerhei, "The Impact of Leakage."

125. GAO, "Private Pensions."

126. See, e.g., Feuer, "How the CARES Act"; Feuer, "Insight: How the IRS"; Feuer, "What Savings and Retirement Plans."

127. The following recommendations are based partly on a 2015 report by the Center for Retirement Research. See Munnell and Webb, "The Impact of Leakages."

128. For a distribution from a 401(k) plan to be on account of hardship, it must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. . . . Whether a need is immediate and heavy depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including: (1) certain medical expenses; (2) costs relating to the purchase of a principal residence; (3) tuition and related educational fees and expenses; (4) payments necessary to prevent eviction from, or foreclosure on, a principal residence; (5) burial or funeral expenses; and (6) certain expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under IRC Section 165. Expenses for the purchase of a boat or television would generally not qualify for a hardship distribution. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee. Reg. Section 1.401(k)-1(d)(3)(iii)). </> IRS, "Retirement Plans FAQs."

only for unforeseeable emergencies. Hardship withdrawals could also be limited to the amount of the participant's contributions. Even without a change in the law, plans could be so amended, subject to preserving distribution rights with respect to currently accrued benefits.

2. **Distributions on termination of employment at any age.** Many 401(k) plans allow in-service distributions at age 59 1/2, and most allow distributions on termination of employment at any age. The Code allows former employers to force participants with vested balances of $5,000 or less out of their 401(k) plans.[129] In determining whether the $5,000 threshold is exceeded, rollovers into the plan are disregarded.[130] Subject to numerous exceptions—some of them bizarre—taxable distributions from 401(k) plans before age 59 1/2 are subject to a 10% additional income tax. The age for non-penalized withdrawals could and should be raised to at least Social Security's earliest eligibility age, currently 62, and preferably to the full retirement age, currently 66.[131] Again, this change could be implemented by plan sponsors, subject to preserving distribution rights with respect to currently accrued benefits.
3. **In-Service Distributions at or after age 59 1/2.** The law could be changed to prohibit (1) in-service distributions and (2) lump-sum distributions upon termination of employment before attaining age 62 or age 66.[132] Even without a change in the law, plans could be so amended, subject to preserving distribution rights with respect to currently accrued benefits. Plans are not currently required to accept rollovers. On April 3, 2014, the IRS issued guidance to ease the process and make plan-to-plan rollovers less burdensome for plans. The ruling provides a simple method for receiving plans to verify the tax-qualified status of sending plans by checking a recent annual report (Form 5500) filing for the sending plan on a public database.[133] Another way to protect participants' 401(k) plan savings is by ensuring that all accounts with balances over $5,000 may remain in the plan environment, even when portions of those balances are from rollovers.
4. **Plan Loans:** Most 401(k) plans allow loans to participants. In order to avoid current taxation and violation of the DOL-prohibited transaction rules, plan loans are generally limited to the lesser of $50,000 or 50% of the vested account balance, are amortized over five years, and are repaid by payroll deduction.[134] The data indicate that most plan loans are repaid, so the funds remain within the retirement system. One frequent cause of loan default is termination of employment, since the former employer is no longer able to take repayment by payroll deduction. Some plans do permit continued loan repayments after termination of employment, and all plans should be encouraged to do so, perhaps by establishing a clearinghouse to allow continued repayments. Starting in 2018, if a participant terminates employment with an outstanding loan balance, the loan is treated as a withdrawal if it is not repaid by the due date of the tax return for the year of termination. Employers should try to educate participants on using participant loans responsibly, and advise them of the opportunity costs of taking plan loans.

There is more money in IRAs than in 401(k) plans, and there are even fewer restrictions on withdrawals from IRAs. Accordingly, if the lifetime income problem is to be addressed adequately, the rules for IRAs must also be

129. Code § 411(a)(11).
130. Code § 411(a)(11)(D).
131. "In-service withdrawals after 59 1/2 from 401(k) plans have grown dramatically. Although recent information suggests that the bulk of the money is rolled over, roughly 30 percent leaks out. And post-59 1/2 distributions must certainly account for growing leakages from IRAs. Given the need to work longer as a result of increased life expectancy and a contracting retirement income system, age 59 1/2 is too early in most cases to be withdrawing money from either a 401(k) plan or an IRA." Munnell and Webb, "The Impact of Leakages."
132. The allowable options could be limited to leaving the money in the prior employer's plan (even balances under $5,000), to transfer the money to the new employer's 401(k), or, for those leaving the labor force, to roll over the plan balance into an IRA. Under such limitations, sponsors would no longer be able to compel cashouts of accounts with less than $1,000. And the new employer would be compelled to accept the rollover. In addition, the procedures for rolling over balances, which are now a cumbersome and paper-intensive process, could be streamlined. If the option of cashing out—even with a 10-percent penalty—is left open, participants will continue to withdraw money at termination instead of keeping it intact until retirement.</> Ibid.
133. Rev. Rul. 2014-9, 2014-7 IRB [Internal Revenue Bulletin] 975.
134. The plan loan rules have been temporarily liberalized by the CARES Act.

modified. This is likely to be met with enormous resistance from both IRA owners and IRA custodians.

10.3. Emergency Savings

Enactment of these recommendations would likely reduce significantly the amount of leakage. Another approach, recommended recently by several commentators, would be to encourage employers to facilitate saving by employees in a separate rainy-day fund. This would eliminate or reduce the need for employees to withdraw retirement funds to cover unexpected, but often relatively small, expenses.

10.4. Keeping Track of Multiple Accounts

n 2015 the GAO reported that some 401(k) plan participants find it difficult to keep track of their retirement savings, particularly when they change jobs, because of challenges with consolidation, communication, and information.[135]

The six countries the GAO reviewed address challenges of inactive accounts by providing a variety of tracking tools referred to as pension registries. Without a pension registry, the challenges U.S. participants face in tracking accounts over time will continue.[136]

On July 1, 2020, Senators Elizabeth Warren and Steve Daines reintroduced the bipartisan Retirement Savings Lost and Found Act (S. 4192). This bill would use data that employers are already required to report to create a database and would require plan sponsors to send uncashed checks of less than $1,000 to the Treasury so that individuals can locate their money. The bill would also make it easier for plan sponsors to move small accounts into age-appropriate TDFs.[137]

In addition, Alight Solutions will lead a nationwide launch of the Retirement Clearinghouse that "makes it easier for U.S. workers to move 401(k) assets from one employer plan to another, thereby reducing premature cash-outs, preserving retirement savings, and improving financial wellbeing."[138]

10.5. Education and Financial Counseling

Plans that permit loans and in-service distributions can and should provide education and financial counseling to help employees identify cost-saving exercises, make them aware of other financial help, and help them to appreciate the long-term cost of tapping into the retirement account.[139]

The opportunity cost of taking a 401(k) distribution is significantly more than the amount actually withdrawn plus the taxes. Many 401(k) plans offer, and more of them should offer, personalized advice that can help workers work through difficult financial situations. Plan sponsors need to remind employees about these tools and resources so they can access the guidance they need to make the best financial decisions for their personal situation.

11. FUTURE LEGISLATIVE AND REGULATORY GUIDANCE: A WISHLIST

This paper has suggested certain actions that can be taken by plan sponsors without further guidance from Congress, the DOL, or the IRS. However, further legislation or guidance in the following areas would be very helpful, not least in delineating the ground rules more clearly, and in assuaging plan sponsors' fears of being swept away on a tsunami of litigation.

1. Repeal of the rule exempting 401(k) plans from having to provide any annuity option.[140]

135. GAO, "Greater Protections Needed."
136. Ibid.
137. Croce, "Bipartisan Bill Seeks."
138. CISION PR Newswire, "Alight Solutions." See also PlanSponsor, "Firm Ready to Launch 401(k) Account," describing a new firm, Capitalize, that "says its platform supports employers by helping them lower fees paid to administer their 401(k) plans and by freeing up HR time otherwise spent communicating with former employees."
139. Recent reports suggest that many employers are devoting more attention and resources to improving financial wellness of their employees. See, for instance, Bank of America, "2020 Workplace Benefits Report"; Olds, "Pandemic Sharpens Focus"; Umpierrez, "Financial Wellness Programs Should"; Umpierrez, "Financial Wellness Program Trends"; Umpierrez, "Options to Help Participants."
140. ERISA § 205(b)(1).

2. Guidance on the application of the joint and survivor annuity rules to 401(k) plans, particularly with reference to lifetime income provided other than through a traditional immediate annuity.
3. Legislative consideration of the Supreme Court decision requiring employer plan annuities to be provided on a gender-neutral basis,[141] a rule that does not apply to annuities provided by IRAs or in other non-employment contexts.
4. Legislative or regulatory guidance that gives fiduciaries a clear path to follow in selecting an annuity provider or contract. The guidance should be based on process rather than on invoking general principles; inclusion of one or more checklists would be very helpful. In addition, the guidance should provide a safe harbor for selection of a fiduciary to select the annuity provider or contract.
5. Revision of the regulations under ERISA § 404(c), specifically addressing lifetime income investment options.
6. Revision of the QDIA regulation, specifically addressing annuities and modifying the current liquidity requirements.
7. Revision of the QLAC regulation to allow more flexibility and hopefully encourage more use of longevity annuities.
8. Information prepared by the DOL, giving clear and practical guidance to participants on the risks of retirement and the importance of lifetime income.
9. A comprehensive revision of IB 96-1 to address lifetime income and other recent developments in plan investments.
10. Limitations on leakage from both employer plans and IRAs, bearing in mind the possible danger of discouraging employee participation. This would address (1) cash-outs on termination of employment, (2) in-service distributions, before or after age 59 1/2, (3) mandatory distributions, (4) loans, and (5) hardship distributions. In addition to limitations on leakage, repeal of the rule disregarding rollover amounts in determining whether an account balance exceeds $5,000, and a requirement that employer defined-contribution plans make and accept rollovers.
11. An easier and more-efficient rollover process, with a view to facilitating consolidation of accounts and keeping the assets in an employer plan. This could include establishment of a clearinghouse. To the extent possible, differences in the rollover rules applicable to different types of plans (IRAs, Roth IRAs, qualified plans, 403(b) plans, and governmental 457 plans) should be eliminated.
12. Revising or repealing the IRS regulation[142] that generally allows elimination of optional forms of benefit but not the elimination or curtailment of lump-sum options.
13. A thorough review of the rules governing safe harbor 401(k) plans. At present, there are three separate safe harbor designs, described in Code §§ 401(k)(11), (12), and (13), with different operating rules. This is redundant. Also, consideration should be given to making safe harbor treatment contingent on the plan offering at least one lifetime income option.
14. Consideration of a minimum employer contribution to 401(k) plans. This was originally suggested in 1980. The minimum could, perhaps, be reduced for plans where at least a percentage of the account balance is mandatorily annuitized at retirement or termination of employment after a certain age.
15. Improved access to retirement plans. The Bureau of Labor Statistics reported in March 2020 that only 67% of employees in private industry have access to any type of retirement plan, and only 51% actually participate.[143]

141. Arizona Governing Comm. v. Norris, 463 U.S. 1073 (1983).
142. Treas. Reg. 1.411(d)-4, Q & A 2(e).
143. Bureau of Labor Statistics, "Table 1: Retirement Benefits."

CONCLUSION

This paper has suggested steps that can be taken to facilitate the provision of annuities in 401(k) plans, and that the cumulative effect of such actions could be substantial. However, these approaches would be greatly strengthened by additional encouragement of annuities by Congress, the DOL, and the IRS. Accordingly, proponents of lifetime income should argue that the SECURE Act is only a beginning, and they should continue to stress to legislators and agency officials, by any and all means possible, the importance of providing more guaranteed lifetime income to retirees.

There is some evidence of improved interdisciplinary cooperation in the wake of the SECURE Act. A recent article discusses Geoffrey E. Dietrich saying that the insurance, asset management, and advisory sides of the retirement plan industry, which have often battled over retirement plan assets, have started to collaborate and work on what's best for participants.[144]

The Pension Benefit Guaranty Corporation (PBGC) has extended its missing participant program to defined-contribution plans and defined-benefit plans of small professional service employers, which are exempt from the pension insurance program under Title IV of ERISA. PBGC will provide annuities to participants in plans that terminate after 2017.[145] A recent paper suggests further expanding the program to allow participants in ongoing defined-contribution plans to transfer all or part of their account balances to PBGC and receive annuity distributions from PBGC.[146] It is unlikely that such a proposal will be enacted any time soon, but the rationale for such legislation would be significantly weakened if 401(k) plans provided more lifetime income options.

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144. Moore, "PSNC 2020."
145. ERISA § 4040(d); PBGC Reg. 4022.8, 82 Fed. Reg. 60,800, Dec. 22, 2017.
146. Poerio, "Improving Individual Annuity Choices."

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