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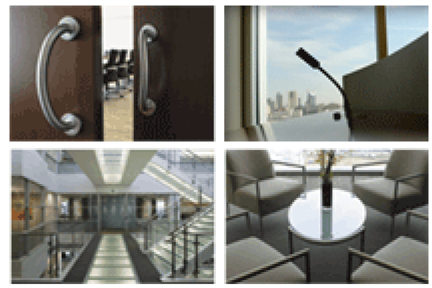
At Long Last, Final Regulations on Default Investment Options



by B.David Joffe

The Department of Labor (DOL) has issued its long-awaited final regulations on default investment options for individual account plans (such as 401(k) plans). These options are referred to in the regulations as "qualified default investment alternatives" (or QDIAs). The regulations are important because a plan fiduciary who complies with the regulations will generally not be liable for any losses or ERISA fiduciary breaches that occur as a result of investments in a QDIA, though the plan fiduciary must still prudently select and monitor the QDIA. For employers who want to offer automatic enrollment, the regulations help to limit potential fiduciary liability, provided the key requirements of the regulations are met.

Key Requirements

The key requirements to obtain fiduciary relief under the regulations are as follows:

- Assets must be invested in a QDIA.
- Participants and beneficiaries must have been given an opportunity to direct the investment of their accounts but have failed to do so.
- A notice (described below) must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter.
- Materials, such as investment prospectuses, must be furnished to participants and beneficiaries.
- Participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as other plan investments, but at least once every three months.
- Fees that can be imposed on a participant who opts out of participation in the plan or who decides to direct their investments (such as surrender charges or redemption fees) are significantly limited during the first 90 days of the QDIA investment, although ongoing expenses such as investment management fees may be imposed.
- The plan must offer a "broad range of investment alternatives" as defined in the DOL regulation under section 404(c) of ERISA.

QDIAs

The final regulations retain the types of QDIAs set forth in the proposed regulations and add a limited capital preservation option. The four types of QDIAs are as follows:

- A product with a mix of investments that take into account the individual's age, retirement date, or life expectancy (such as a life-cycle or targeted-retirement-date fund);
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (such as a professionally-managed account);
- A product with a mix of investments that takes into account the characteristics of the group of

employees as a whole, rather than each individual (such as a balanced fund); and
- A capital preservation product for only the first 120 days of participation.

The capital preservation option may be used for plans that want to simplify administration if participants opt out of participation within the 90-day period after the participant's first deferrals into the plan, which is consistent with the new tax "unwind" rule for automatic enrollment. Despite heavy lobbying by the insurance industry, the final regulations do not permit capital preservation options such as stable-value funds to be used on a continuous basis. If this option is used in the first 120 days, plan administrators will need to direct the investments to another QDIA for the period thereafter.

QDIAs must be managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary or by an investment company registered under the Investment Company Act of 1940. With limited exceptions, a QDIA may not invest contributions in employer securities. The regulations do expand the options for QDIAs to include products and portfolios offered through variable annuity and similar contracts as well as through common or collective trust funds or other pooled investment funds.

It is important to note that a fiduciary will qualify for the relief without regard to which type of QDIA is selected. There is no requirement to select the "most prudent" type of QDIA. The fiduciary is required to exercise prudence in the selection of the QDIA, but it may freely select from the different types of QDIAs. Also, the fiduciary relief is not limited to investments made in automatic contribution arrangements; it apples to other situations such as a participant's failure to provide investment direction following the elimination of a particular investment option, the failure to provide investment instruction following a rollover, or any other failure of participant or beneficiary to provide investment instructions.

The final regulations "grandfather" certain capital preservation arrangements, which should generally include stable-value funds. However, this only applies to investments made before December 24, 2007. This relief should be particularly helpful to plans that have been using stable-value investments awaiting the issuance of the final regulations. It is also welcome relief to investment managers who may have feared a mass exodus from existing capital preservation funds.

Notice Requirements

An initial notice must ordinarily be provided at least 30 days in advance of the date of eligibility or at least 30 days in advance of the date of any first investment in the QDIA. However, if the plan allows for permissive withdrawals within the first 90 days, the notice only needs to be provided on or before the date of eligibility. This is different from the proposed regulations and particularly helpful for plans that have immediate eligibility. The annual notice must be provided at 30 days in advance of each plan year.

The notice must contain the following:

- A description of the circumstances under which assets may be invested in the QDIA; and, if applicable with regard to automatic enrollment, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);
- An explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts;
- A description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative;
- A description of the right of the participants and beneficiaries on whose behalf assets are invested in a QDIA to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and
- An explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

The final regulations require that the notice to a participant be written in a manner calculated to be understood by the average plan participant. The notice may not be included in a summary plan description or summary of material modifications, but it may be provided electronically if the general electronic disclosure requirements are met. The DOL did not provide a model notice but indicated that it will consider doing so in the future. The final regulations are expected to encourage automatic enrollment now that fiduciaries will have protection in selecting default investment options.

Plan administrators need to evaluate promptly their options for QDIAs. It is important that fiduciaries devote sufficient time and effort to carefully examine their options. Certain QDIA options may be more complex such as target-date funds that have various target dates and may not have as long a manager track record as other funds. Plan administrators should also plan for advance notice to participants before the regulations become effective on December 24, 2007. On and after December 24th, the grandfathered protection for capital preservation arrangements such as stable-value funds will no longer apply.

If you have any questions about the new regulations, please contact one of the Employee Benefits and Executive Compensation attorneys at Boult, Cummings, Conners & Berry PLC:

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