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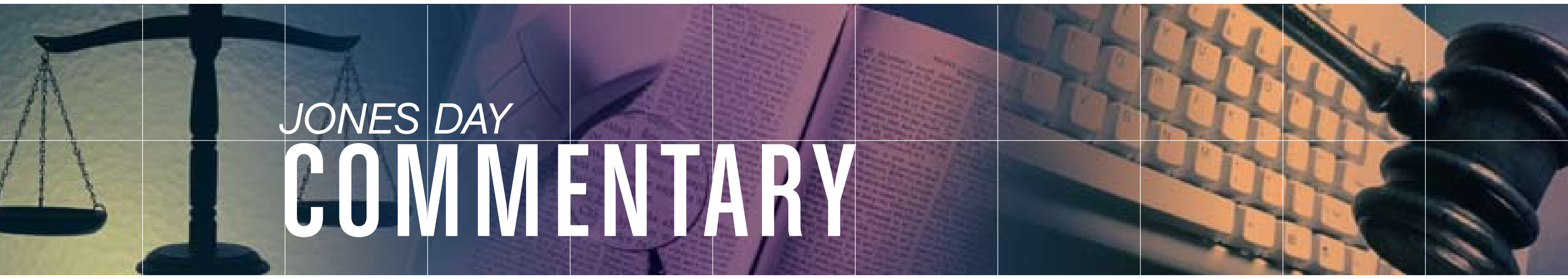

DOL ISSUES FINAL RULES FOR QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

On October 24, 2007, the Department of Labor published final regulations on "qualified default investment alternatives" ("QDIAs") for 401(k)-type retirement plans. The regulations, effective 60 days after the date of publication, detail the conditions—including a required notice to participants and beneficiaries—under which plan fiduciaries will be protected against liability for investment performance of so-called "default" investment funds in the absence of an investment election by a participant.[1] Although most default investment funds are maintained in plans that are intended to satisfy the conditions of Section 404(c) of ERISA, a plan need not be a "404(c) plan" to obtain relief under the regulations.

BACKGROUND

The regulations arose out of ERISA Section 404(c)(5), a provision added to ERISA by Section 624(a) of the Pension Protection Act of 2006, which directs the Secretary of Labor to issue regulations to provide "guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both." That section and the new regulations are designed to encourage employers to implement automatic enrollment features. The DOL reports that approximately one-third of eligible workers do not participate in their employers' 401(k)-type plans and that studies suggest such "automatic enrollment plans" could reduce this rate of nonparticipation to less than 10 percent, with retirement savings increasing significantly as a result.

1. Unless otherwise noted herein, reference to "participants" includes beneficiaries as well.

IMPACT ON PLAN SPONSORS AND FIDUCIARIES

QDIAs will be a key component of participant-directed defined-contribution plans such as 401(k) plans. With the continued movement away from defined-benefit plans, employers increasingly will consider automatic enrollment features in 401(k) plans to boost employees' retirement savings. A major concern with automatic enrollment designs is that employees may permit automatic contributions to be made to a 401(k) plan but not direct the investment of their accounts. In the absence of participant direction, plan fiduciaries need to select a default investment fund. If participants later are dissatisfied with the results of the default investment, they may bring claims against the fiduciaries. The QDIA regulations provide protection against these potential claims.

As a consequence of these finalized regulations, companies that move quickly and have not yet done so can implement automatic enrollment provisions effective January 1, 2008, not just for new employees but for existing employees who do not participate in the company's 401(k) or other form of individual account retirement plan. Increasing employees' plan participation often will aid a company's ability to satisfy tax-code discrimination testing and lengthen employee tenure. The implementation effort will involve amending the plan, contracting with an outside vendor to provide for one of the four approved forms of qualified default investment alternatives, and providing the required notices, all as discussed below.

FIDUCIARY LIABILITY RELIEF

The regulations provide relief to the fiduciary of an individual account plan for any loss or breach that is the "direct and necessary result" of investing all or part of a participant's account in any QDIA, including QDIA investment-management decisions made by certain entities. The regulations explicitly limit this fiduciary liability relief, however, by excluding from its coverage (i) a fiduciary's duties to prudently select and monitor a QDIA under the plan, and liability for any losses resulting from a failure to satisfy these duties, and (ii) the prohibited transaction provisions of ERISA. The preamble indicates that any of the four QDIAs satisfies the regulations and that a fiduciary would not need to determine which is the "most prudent."

ERISA Section 404(c)(5) is a "safe harbor" provision. The preamble to the regulations confirms that the QDIA standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under ERISA with respect to participants who fail to provide investment directions. However, even though the statute itself is a "safe harbor," the requirements of the regulations are not written as safe harbors. In other words, in order to obtain the fiduciary relief afforded by the statute, the regulations require compliance with each and every condition detailed in the regulations.

CONDITIONS FOR QUALIFICATION

Like the proposed regulations, the final rules impose seven conditions for fiduciary liability relief:

- The assets must be invested in a "qualified default investment alternative" as defined in the regulations.
- Participants must have been given an opportunity to provide investment direction with respect to their individual accounts but must not have done so.
- Notice, as detailed below, generally must be furnished to participants in advance of the first investment in the QDIA and annually thereafter.
- Material describing the chosen QDIA, such as investment prospectuses, must be furnished to participants.
- Participants must have the opportunity to direct investment out of a QDIA as frequently as afforded to other participants, but at least quarterly.
- The fees that are imposed on a participant who, during the first 90 days of participation, opts out of participation in the plan or who decides to transfer his investments into another option must be limited.
- The plan must offer a "broad range of investment alternatives" as set forth in the Department's regulations under 404(c).

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

The regulations set forth four categories of investments that will constitute QDIAs, rather than any specific product, portfolio, or service (along with one additional "grandfathered" exception for pre-effective-date investments in "stable value" products):[2]

- A product with a mix of investments that takes into account the individual's age or retirement date (*e.g.*, a life-cycle or target-retirement-date fund).
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than of each individual (*e.g.*, a balanced fund).
- An investment-management service that allocates a participant's contributions among existing plan options to provide an asset mix that takes into account the individual's age, target retirement date, or life expectancy (*e.g.*, a professionally managed account).
- A capital-preservation investment product designed to preserve principal and provide a reasonable rate of return, but only for a period of 120 days after the date of a participant's first elective contribution under Section 414(w)(2)(B) of the Internal Revenue Code ("Code"). Note, however, that at the end of the 120-day period, the product would cease to be a QDIA, and to continue to obtain relief under the regulation, the fiduciary would have to redirect such investment into another QDIA before the end of the 120-day period. This category provides a nearly risk-free option that will preserve principal during the limited period when an employee is most likely to opt out of participation and request a return of his or her contributions.

Finally, consistent with the Department's decision to describe QDIAs as categories of investments with particular features, rather than specific products, the regulations make clear that a variable annuity or similar contract, as well as common and collective trust funds or other pooled investment funds, will satisfy the definition of a QDIA as long as it otherwise satisfies the requirements of the regulations.

EMPLOYER STOCK

QDIAs are prohibited from acquiring or holding employer stock,[3] except that matching contributions made in employer stock are afforded relief under the regulations if—and only if—(i) the QDIA is a "managed account" (as described above) in which the manager has full discretionary authority over the disposition of such employer securities, and (ii) there are no restrictions on the transferability of the employer securities. If these requirements are not met, no relief would be provided by the regulations with respect to the employer-stock portion of a participant's account.

NOTICE

Advance notice generally must be provided to participants at least 30 days before the date of plan eligibility (or 30 days in advance of the first investment in a QDIA for a participant who failed to provide investment direction). In addition, to accommodate immediate participation plans, the notice may be provided on or before the date of eligibility, but only if withdrawals are permitted under Section 414(w) of the Code. Finally, a separate annual notice must be provided at least 30 days before the end of each subsequent plan year.

The required contents of the notice are as follows:

- A description of the circumstances under which assets may be invested on behalf of the participant in a QDIA, including the percentage of any elective contributions, and the right to elect not to have such contributions made on the participant's behalf (or to elect a different contribution amount).
- An explanation of each participant's right to direct the investments in his individual account.

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2. The stable-value products must have been designed to guarantee principal with a rate of return generally consistent with that earned on intermediate investment-grade bonds.
3. This aspect of the rule does not apply to employer stock acquired by an investment company registered under the Investment Company Act of 1940 (*e.g.*, a mutual fund), so long as the acquisition was consistent with the stated investment objectives of the investment vehicle. *See* 29 C.F.R. 2550.404c-5(e)(1)(ii)(A).

- A description of the QDIA, including a description of the investment objectives, risk, and return characteristics, and the fees and expenses attendant to the investment alternative.
- A description of the right of participants to transfer assets from a QDIA to other investment alternatives offered under the plan, including a description of any fees or expenses in connection with such transfer.
- An explanation of where participants can obtain information concerning the other investment alternatives available under the plan.

The preamble states that if a plan fails to satisfy the 30-day notice requirements with respect to a participant's initial contributions and investments, plan fiduciaries may obtain relief for later contributions with respect to which the 30-day advance notice requirements are satisfied. For example, an immediate participation plan that provides notice on the date of hire but does not want to allow withdrawals of contributions under Code section 414(w) may obtain relief for default investments made at least 30 days after the initial notice is provided.

In a change from the proposed regulations, the preamble states that the required notices may not be included in SPDs or SMMs for the plan (although this limitation is not included in the text of the regulations), but instead must be provided as separate notices. But the preamble also provides that a plan is not prevented from furnishing the QDIA notices with other materials being furnished to plan participants.

PREEMPTION

The regulations also clarify the application of the additional preemption provision that was added in the Pension Protection Act of 2006 at ERISA Section 514(e). The regulations explain that ERISA supersedes any state law that would prohibit or restrict automatic contribution arrangements, regardless of whether such arrangements qualify for the relief in the regulations. In this regard, the regulations resolve employer concerns with respect to automatic enrollment and compliance with some state wage-withholding laws.

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