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DOL Issues Default Investment Proposed Regulation Under the Pension Protection Act

By R. Bradford Huss, APM, and Amy Durgan, Trucker Huss, San Francisco, CA

On September 27, 2006, the Department of Labor issued a proposed regulation implementing provisions of the recently enacted Pension Protection Act of 2006 (PPA) relating to default investment of plan assets in individual account plans [*e.g.,* IRC §401(k) plans]. The proposed rules shield fiduciaries of individual account plans from liability for automatic enrollment and default investment plan design features, provided the safe harbor conditions are met.

PPA §624(a) amended ERISA by adding §404(c)(5), under which a participant who had the opportunity to direct the investment of his or her account but did not provide investment directions is treated as exercising control over his or her account with respect to assets that the plan invests in a qualified default investment alternative (QDIA). When it was enacted on August 17, 2006, the PPA directed the Department to issue a default investment regulation within six months. This article provides a summary of the proposed regulation.

▲ Scope of Fiduciary Relief

The regulation provides that a fiduciary of an individual account plan that allows participants to direct the investment of assets in their accounts is not liable for any loss that is the direct and necessary result of investing all or part of a participant's or beneficiary's account in a QDIA. Further, fiduciaries are not liable for investment decisions in connection with the management of a QDIA.

Nevertheless, the proposed regulation does not relieve fiduciaries from their duties to prudently select and monitor a QDIA or from liability resulting from a failure to satisfy these duties, including liability for any resulting losses. Additionally, any investment managers of a QDIA are not relieved from their fiduciary duties under ERISA or from liability for failing to satisfy these duties.

The proposed regulation also does not provide relief from the prohibited transaction provisions of ERISA §406 or from any liability for violating those provisions.

▲ Plan Fiduciary's Required Actions

In order to qualify for fiduciary relief under the proposed regulation, a plan fiduciary must take the following actions:

- Invest assets in a QDIA;
- Provide affected participants and beneficiaries an opportunity to direct the investment of assets in their accounts;
- Furnish affected participants and beneficiaries with a notice at least 30 days in advance of the first investment and within a reasonable period of time of at least 30 days in advance of each subsequent plan year;
- Give affected participants and beneficiaries any material provided to the plan relating to their investments in a QDIA (*e.g.,* account statements, prospectuses and proxy voting materials);
- Provide affected participants and beneficiaries the opportunity, consistent with the plan's terms (but not less frequently than once within a three-month period), to transfer assets to any other investment alternative available under the plan without financial penalty; and
- Offer a "broad range of investment alternatives" as defined by the Department's regulation under ERISA §404(c).

▲ Notice Requirements

The notice must be written in a manner calculated to be understood by the average plan participant. It can be provided in the plan's summary plan description, summary of material modifications or a separate notification. The notice must contain the following information:

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ASPPA
WORKING FOR AMERICA'S RETIREMENT

4245 North Fairfax Drive, Suite 750
Arlington, VA 22203
P 703.516.9300 F 703.516.9308
www.asppa.org

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- A description of the circumstances under which assets in the individual account of an affected participant or beneficiary may be invested in a QDIA;
- A description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable) and fees and expenses;
- A description of the affected participants' and beneficiaries' rights to direct investment of those assets to any other investment alternative under the plan without financial penalty; and
- An explanation of where affected participants and beneficiaries can obtain investment information concerning the other investment alternatives under the plan.

In the preamble, the Department noted that similar notice requirements are contained in IRC §401(k)(13)(E), and that it anticipates that both notice requirements could be satisfied in a single notice.

▲ Qualified Default Investment Alternatives

To be considered a QDIA, five requirements must be satisfied under the proposed regulation:

- The investment alternative must not hold or permit the acquisition of employer securities, with two exceptions. The first exception applies to securities held or acquired pursuant to the stated investment objectives of an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle regulated by a state or federal agency that are independent of the plan sponsor. The second exception is for managed accounts when employer securities were acquired as a matching contribution from the employer or plan sponsor or were acquired prior to the time the investment management service took over the management of the account.
- A QDIA also must not impose financial penalties or otherwise restrict an affected participant's or beneficiary's ability to transfer his or her investment to any other investment alternative under the plan.
- A QDIA must be managed by an investment manager as defined in §3(38) of ERISA or by an investment company registered under the Investment Company Act of 1940.
- A QDIA must be diversified as to minimize the risk of large losses.
- The QDIA must constitute one of the three types of investment products described below.

▲ Permissible Types of Investment Products

- A life-cycle or targeted-retirement-date fund or account, designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date or life expectancy. These products change their asset allocations and risk levels over time to become more conservative with increasing age. Asset allocation decisions are not required to take into account an individual participant's risk tolerances, other investments or other preferences.
- A balanced fund that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate to the plan participants as a whole. Again, asset allocation decisions are not required to take into account an individual participant's age, risk tolerances, other investments or other preferences.
- A managed account that allocates assets to an affected participant's or beneficiary's account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures. Using investment alternatives available under the plan, these allocations are based on the participant's age, target retirement date or life expectancy. The asset allocation of a managed account is also not required to consider an individual participant's risk tolerances, other investments or other preferences.

The Department noted in the preamble that, although the fiduciary relief provided is conditioned on the use of certain investment alternatives, the limitations "should not be construed to indicate that the use of investment alternatives not identified in the proposed regulation" as QDIAs would be imprudent. Investments in money market funds and stable value products, for example, may be prudent for some participants or beneficiaries, according to the Department.

One question that has been raised upon initial review of the regulation concerns how the requirement for a 30-day advance notice to affected participants and beneficiaries will apply to plans that provide for eligibility to participate immediately upon employment. Additionally, it is not clear whether the short-term redemption fees charged by many mutual funds would be considered a "financial penalty" that impedes a participant's ability to transfer from the default investment alternative to another investment option.

ASPPA's Government Affairs Committee is reviewing the proposed default investment regulation and anticipates filing comments by the November 13, 2006, deadline.