

Legal Alert: DOL Issues Final Default Investment Regulations

October 23, 2007

On October 23, 2007, the Department of Labor (“DOL”) released final regulations to provide ERISA relief to fiduciaries of participant-directed defined contribution plans that invest participant accounts in certain types of default investment alternatives in the absence of participant investment directions.¹ Click [here](#) for a copy of the final regulations.

Pursuant to ERISA §404(c)(5) as added by the Pension Protection Act of 2006, the regulation relieves fiduciaries of liability for loss or ERISA fiduciary breach that is the direct and necessary result of investing all or part of a participant’s account in a “qualified default investment alternative” or “QDIA” or of the investment decisions of the manager of the QDIA. In scope, this relief is intended to be the same as that provided under an ERISA §404(c) plan, although plans that do not qualify under §404(c)(1) may nonetheless take advantage of the default investment relief. (Plan fiduciaries remain responsible under §404(a) for the selection and monitoring of the QDIA, as well as for any prohibited transaction violations.) This relief is available for participant-directed plans upon or following:

- Enrollment under either automatic or voluntary enrollment procedures,
- A change in investment options under the plan,
- A rollover or transfer to the plan,

or in any other circumstance where a participant or beneficiary has the opportunity to but does not direct the investment of his or her account.

The regulations will be published in the October 24 Federal Register, with an effective date 60 days thereafter. The initial notice required by the regulations may be provided in advance of the effective date, however, and as of the effective date fiduciaries

¹ In general, references in text to participants include beneficiaries.

may avail themselves of the relief provided by §404(c)(5) for existing as well as new investments in default investments qualified as QDIA's in respect of participants and beneficiaries who, following receipt of the notice, do not give investment directions to the plan after the effective date,

The final regulations substantially follow the proposed regulations, with the following significant refinements:

- Fiduciaries qualify for relief by prudently selecting a QDIA and otherwise complying with the regulations; there is no requirement that they select the “most prudent” type of QDIA in the circumstances of their plan.
- The permitted managers for a QDIA were expanded, to include certain plan trustees (intended specifically to include bank trustees of collective investment funds) and plan sponsors that are named fiduciaries of the plan.
- DOL made several changes to the notice and disclosure requirements. An exception from the 30-day advance notice requirement was added, permitting notice to be provided simultaneously with plan eligibility (e.g., for sponsors that enroll participants on the first day of work) provided that the participant has 90 days thereafter to make a “permitted withdrawal” in accordance with the tax “unwind” rule for automatic enrollment (Internal Revenue Code §414(w)). The 30-day rule is measured in the final regulations from the date of plan eligibility or first investment in the QDIA, to better coordinate with the tax rules. Both the initial and the required annual notices must be provided in a separate document, and may not be included in the summary plan description or summary of material modifications (although they may be incorporated in a single document with the disclosure required by §414(w) and they may be included in a single mailing or other distribution with other documents provided to participants and beneficiaries), and the content of those notices was somewhat broadened. Either notice may be provided electronically, pursuant to either the DOL safe harbor or the IRS safe harbor for electronic disclosures. The material about the QDIA required to be provided to the participant or beneficiary was conformed to the “pass through” requirement of §404(c).
- With respect to the most controversial provision of the proposed regulations, DOL did not accord QDIA status to capital preservation or stable value investments on a stand-alone basis. DOL reiterated that such investments may be prudent default choices for some participants and beneficiaries (although

fiduciaries would not have the benefit of §404(c)(5) in those circumstances) and may be a component of a QDIA investment portfolio. DOL provided transition relief for contributions defaulted to certain capital preservation or stable value options prior to the effective date of the regulations, and more generally permitted contributions initially to be held in such options for up to 120 days before allocation to another QDIA (to accommodate the 90-day window noted above, plus 30 days to effect a transfer the QDIA).

- DOL restructured the requirement that the participant or beneficiary be able to transfer out of the QDIA without “financial penalty,” to provide that:
 - Defaulted participants and beneficiaries must be able to transfer out of the QDIA with the same frequency (which must be a least once within any three-month period) as other participants and beneficiaries; and
 - No restrictions, fees or expenses (other than investment management and similar fees and expenses charged on an ongoing basis for the investment itself that do not vary based on withdrawal, sale or transfer out of the investment) may be imposed during the first 90 days of a defaulted participant’s or beneficiary’s first elective contribution or other first investment in the QDIA. Thus, surrender charges, liquidation or exchange fees, redemption fees, market value adjustments, or “round trip” restrictions are impermissible during that 90-day period. (Loss of the right to elect annuity payouts under an annuity contract is not an impermissible restriction.) After the 90-day period, defaulted participants and beneficiaries may be subject to the same restrictions, fee and expenses as other participants and beneficiaries.
- In the final regulations, DOL took the position that the preemption of state law restricting “automatic contribution arrangements,” added by the Pension Protection Act in ERISA §514(e), extends broadly to any such arrangement, including those that do not satisfy the regulations.

In summary, to qualify for the fiduciary relief provided by §404(c)(5), the regulation requires that the plan make available investment alternatives satisfying the “broad range” requirement applicable to §404(c) plans, even if the plan does not intend to take advantage of §404(c). The investment alternative or alternatives utilized as the QDIA must be, in terms of structure, either:

- A mutual fund registered under the Investment Company Act of 1940; or

- Managed by:
 - An ERISA “investment manager,” i.e., a registered investment adviser under the Investment Advisers Act of 1940, a state registered investment adviser meeting certain requirements, a bank or an insurance company that is exercising discretionary investment authority and has acknowledged in writing that it is a plan fiduciary;
 - A trustee of the plan that meets the requirements of ERISA §3(38)(A), (B) and (C); or
 - The plan sponsor if a named fiduciary of the plan.

In terms of investment objective, the QDIA must constitute one of the following three types of diversified investment fund or portfolio:

- An investment fund product or model portfolio that provides “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 (which may be the plan’s normal retirement date) or life expectancy, e.g., a life-cycle or target retirement approach. Asset allocation decisions may be based only on age and need not take into account any other participant-specific characteristics. The investment fund product or model portfolio may be a “fund of funds” or a stand-alone vehicle; or
- An investment fund product or model portfolio (again, a fund of funds or stand-alone vehicle) of the specified, diversified exposures with a target level of risk exposure appropriate for the participant population as a whole, e.g., a balanced fund approach. Asset allocation decisions may be based on the demographics of the participant population as a whole (which may change over time, leading the plan fiduciary to change or add to its selection of the QDIA), and need not take into account any participant-specific characteristics; or
- An investment management service under which the investment manager allocates the participant’s account among the specified, diversified exposures based on the participant’s age, target retirement date or life expectancy, e.g., an age-based managed account approach. A “managed account” is an example of such a service. Again, asset allocation decisions may be based solely on

age and need not take into account of any other participant-specific characteristics.

In addition, during the 120 days following the first elective contribution for a participant, a capital preservation or stable value option meeting certain requirements may be utilized as a QDIA. A QDIA, other than under the balanced fund approach, will change asset allocations and risk levels over time with the objective of becoming more conservative with the participant's increasing age. These funds or portfolios may be provided through a variable annuity contract, common or collective trust fund or other pooled investment vehicle.

The QDIA may neither be nor include employer securities unless held in a mutual fund or other regulated pooled investment vehicle pursuant to stated investment objectives and independent of the plan sponsor. In addition, if the QDIA is a managed account, it may include employer securities acquired as a matching contribution or acquired prior to management of the account by the investment management service.

This fiduciary relief is subject to the following procedural conditions, which apply on a participant-by-participant basis:

- The participant is provided a notice at least 30 days in advance of plan eligibility or the first default investment for his or her account, and at least 30 days in advance of each subsequent plan year, describing:
 - The circumstances in which default investments may be made, including, if applicable, an explanation of the circumstances under which elective contributions will be made for the participant (which is intended to satisfy the notice requirement of ERISA §514(e) preempting state law restrictions on automatic contribution arrangements);
 - The participant's right to direct the investment of his or her account;
 - The QDIA, including investment objectives, risk and return characteristics, and fees and expenses;
 - The participant's opportunity to transfer his or her account out of the QDIA to other investment alternatives; and
 - Where the participant may obtain information about the other investment alternatives.

For plans that are already utilizing default investments, the initial notice may be given in respect of the effective date of the regulation. The initial notice may also be provided upon plan eligibility, if the plan permits the participant a Code §414(w) permitted withdrawal. Failure to provide the requisite notice does not permanently preclude reliance on §404(c)(5); relief remains available for default investments to a QDIA after notice is properly given.

- The participant had the opportunity but did not direct the investment of his or her account. (That is, if the participant provides affirmative directions, the default investment relief is unavailable.)
- At all times the plan otherwise permits participants to direct investments (which must be at least once within every three-month period), the participant has the opportunity to transfer all or part of his or her account invested in the QDIA to any other investment alternatives available under the plan; during the 90-day period following the first elective contribution or other first investment on behalf of the participant in the QDIA, only the ongoing fees and expenses of the investment may be charged and there may be no restrictions, fees or expenses upon liquidation or withdrawal by defaulted participants.
- The plan by its terms must provide that any material provided to the plan and relating to the QDIA – e.g., a prospectus, proxy voting materials or account statements – is provided to the participant, consistent with the “pass through” requirement of §404(c).



Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

| | | |
|----------------------|--------------|--|
| George H. Bostick | 202.383.0127 | george.bostick@sablaw.com |
| Daniel M. Buchner | 202.383.0869 | daniel.buchner@sablaw.com |
| Adam B. Cohen | 202.383.0167 | adam.cohen@sablaw.com |
| Ian A. Herbert | 202.383.0644 | ian.herbert@sablaw.com |
| Alice Murtos | 404.853.8410 | alice.murtos@sablaw.com |
| Robert J. Neis | 404.853.8270 | robert.neis@sablaw.com |
| Vanessa A. Scott | 202.383.0215 | vanessa.scott@sablaw.com |
| W. Mark Smith | 202.383.0221 | mark.smith@sablaw.com |
| William J. Walderman | 202.383.0243 | william.walderman@sablaw.com |
| Carol A. Weiser | 202.383.0728 | carol.weiser@sablaw.com |