

Department of Labor Issues Long-Awaited Guidance on Defined Contribution Plan Default Investments

DrinkerBiddle

After much delay, the Department of Labor (DOL) has issued final regulations setting forth the conditions for fiduciary relief when plan assets are invested in a qualified default investment alternative (QDIA) in the absence of participant direction. The final regulations are generally effective on December 24, 2007. The final regulations follow in large part the previously proposed regulations but add a transition provision for stable value funds and permit capital preservation vehicles to be used on a short-term basis.

CONDITIONS FOR FIDUCIARY RELIEF

While the final regulations do not relieve a fiduciary from general fiduciary responsibilities, including the duties of prudently selecting and monitoring QDIAs and avoiding prohibited transactions, there is relief for losses resulting from investment in a default investment alternative provided each of the following six conditions are met:

- 1) *Default Investment Alternative Must Be a QDIA.* The assets must be invested on behalf of participants or beneficiaries in a default investment alternative that satisfies the requirements of a QDIA, discussed further below.
- 2) *Existence of Opportunity to Self-Direct Investment.* The participant or beneficiary whose assets are invested in a QDIA must have had the opportunity to direct the investment of his or her assets, but failed to do so.
- 3) *Initial and Annual Notice Must Be Provided.* Participants and beneficiaries must receive information regarding the investments that may be made on their behalf. Both an initial and an annual notice are required, as discussed below.
- 4) *QDIA Material Provided to Plan Must Be Furnished.* Certain material provided to the plan relating to the investment in a QDIA must be provided to the participant or beneficiary and should consist of the same information that is provided to those participants who elected to

direct their investments into the investment serving as the QDIA. This includes items such as prospectuses and proxy voting material.

- 5) *Transferability Requirements Must Be Satisfied.* A participant or beneficiary must be given the ability to move assets out of a QDIA to any other investment available under the plan. This opportunity must be afforded with the same frequency given participants and beneficiaries who direct their own investments, subject to a minimum frequency of at least once in a three-month period.

In addition, any transfer or permissible withdrawal by the participant or beneficiary within the 90-day period, starting on the date of the participant's first elective contribution or other first investment in a QDIA, must not be subject to any restrictions, fees or expenses, such as surrender charges or liquidation or redemption fees. The only allowable fees are those charged on an ongoing basis for the operation of the investment, such as investment management fees and "12b-1" fees, and not those charged solely because of the decision to transfer assets out of the QDIA.

After the end of the 90-day period, no fees, restrictions or expenses may be imposed for any transfer or permissible withdrawal from a QDIA that would not be applicable to a participant or beneficiary who elected to invest in the QDIA.

- 6) *Broad Range of Investment Alternatives Must Be Offered.* The final condition requires that the plan offer participants and beneficiaries a broad range of investment alternatives within the meaning of the regulations promulgated under Section 404(c) of the Employee Retirement Security Act of 1974 (ERISA).

QDIA: INVESTMENTS THAT "QUALIFY"

In order to qualify as a QDIA, the investment option must:

- 1) not hold or permit the acquisition of employer securities (except in limited circumstances);
- 2) permit the transfer of the investment from the QDIA to any other investment alternative available under the plan (see the discussion of transfers above);
- 3) be either (a) managed by an investment manager, a trustee that satisfies the ERISA definition of investment manager or a plan sponsor that is a named fiduciary under ERISA; (b) an investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund); or (c) an investment product or fund that satisfies the capital preservation requirements described below; and,
- 4) be one of the specified types of investment fund products, model portfolios or investment management services described below.

Available Types of Investments. As under the proposed regulations, there are generally three types of investments that may qualify as QDIAs. Each type of investment must be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income investments, and must be diversified to minimize the risk of large losses. Types of investments which may qualify include:

- 1) A fund product or portfolio with a strategy is tied to a participant's age, target retirement date or life expectancy and becomes more conservative over time (e.g., a "life-cycle" or "target retirement date" fund or account).
- 2) A fund product or portfolio with a target level of risk appropriate for the plan's participants as a whole (e.g., a "balanced" fund).
- 3) An investment management service provided by a plan fiduciary that allocates contributions among existing plan options and takes into account the participant's age, target retirement date or life expectancy and becomes more conservative over time (e.g., a "managed account").

In addition to these three basic types of investments, the final regulations permit capital preservation vehicles, such as money market or stable value funds, to be used as a short-term investment for not more than 120 days after a participant's first elective contribution. A capital preservation vehicle is an acceptable QDIA

if it is designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, and is offered by a state or federally regulated financial institution.

Drinker Biddle Comment:

The new opportunity for using a capital preservation vehicle allows the risk of loss to be minimized during the period when employees are most likely to opt out of participation in an automatic enrollment arrangement. However, the use of such a vehicle will require a transfer of assets to one of the other investment options after 120 days and, therefore, creates additional administrative burdens on the plan sponsor.

The final regulations also provide that a stable value fund will be a QDIA with respect solely to assets invested in such fund before December 24, 2007, provided the fund is designed to guarantee principal and a rate of return consistent with that earned on intermediate investment grade bonds, no fees or surrender charges are imposed when a participant or beneficiary transfers out of the fund and the principal and rates of return are guaranteed by a state or federally regulated financial institution.

NOTICE REQUIREMENTS

As noted above, the fiduciary seeking relief must provide participants and beneficiaries whose accounts are invested in a QDIA with certain information about the nature of the default investment and their right to elect other investment options. Initially, this notice must be distributed at least 30 days before the date of plan eligibility or the first investment in the QDIA. The final regulations provide a limited exception to this 30-day advance notice requirement. In particular, for a plan with an automatic enrollment feature, the notice may be provided on or before the date of plan eligibility if the plan includes the special Pension Protection Act (PPA) rule permitting automatically enrolled participants to withdraw their pre-tax contributions during the first 90 days of participation (i.e., the participant can "unwind" the automatic enrollment without paying the penalties that might otherwise be incurred with such distributions). In addition, the notice must be distributed at least 30 days before the beginning of each subsequent plan year.

Drinker Biddle Comment:

The DOL's intention is that QDIA fiduciary relief is available in a broad range of instances when a participant or beneficiary has failed to make an investment election – not just automatic

enrollment. For example, it might be appropriate to send this notice to employees who are about to become eligible for employer profit-sharing contributions and have not previously elected to make pre-tax deferrals. Plan sponsors should evaluate their plan terms and administration to assess when these notices should be distributed.

At a minimum, each notice must include the following information:

- 1) the circumstances in which a participant's or beneficiary's account may be invested in a QDIA, including, if applicable, an explanation of any automatic enrollment feature;
- 2) an explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts;
- 3) a description of the QDIA, including its investment objectives, any risk and return characteristics, and fees and expenses related to the QDIA;
- 4) a description of the right to transfer assets invested in a QDIA to any other investment alternative under the plan, including a description of any related restrictions, fees or expenses; and,
- 5) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

Drinker Biddle Comment:

The description of any automatic enrollment feature should include 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). This will ensure that the QDIA notice also satisfies the notice requirement for ERISA preemption of any state wage laws that would otherwise prohibit an automatic enrollment arrangement.

Under the final regulations, it is no longer permissible to include this notice in the plan's summary plan

description (SPD) or a summary of material modifications updating that SPD. However, the QDIA notice may be included in the notice required to be distributed by plans intending to satisfy the Internal Revenue Service's nondiscrimination requirements through the PPA automatic enrollment safe harbor. In addition, the DOL recognizes that the QDIA notice may be distributed with other materials being sent to participants and beneficiaries. Electronic distribution is permitted when it is consistent with the same electronic disclosure requirements applicable to other similar required disclosures.

PREEMPTION OF STATE WAGE LAWS

The final regulations also clarify that state wage laws are preempted for all automatic enrollment arrangements, including those which do not use a QDIA as the default investment.

DECISIONS FOR PLAN SPONSORS

In order to comply with the new regulations, plan sponsors must take the following actions:

- 1) determine whether the plan's current default fund qualifies as one of the three permitted types of QDIAs. If not, a decision will have to be made as to which other investment option offered by the plan should serve as the new QDIA;
- 2) if a qualifying stable value fund served as the default investment option before December 24, 2007, decide whether to retain that fund as the QDIA for pre-December 24, 2007, investments or to transfer funds to the new QDIA;
- 3) decide whether to use a capital preservation fund as the QDIA for the initial 120 days after a participant's first elective contribution;
- 4) make appropriate changes to plan documents, including the SPD;
- 5) prepare the required initial and annual notices; and,
- 6) communicate with participants concerning any changes made to the plan's default investments.

Questions regarding this or any other employee benefit issue may be directed to the members of our Employee Benefits and Executive Compensation Team listed below.

Employee Benefits & Executive Compensation Team

Kathleen O'Connor Adams
(312) 569-1306
Kathleen.Adams@dbr.com

Gary D. Ammon
(215) 988-2981
Gary.Ammon@dbr.com

Marla B. Anderson
(312) 569-1314
Marla.Anderson@dbr.com

Jason L Brodsky
(215) 988-2581
Jason.Brodsky@dbr.com

Mark M. Brown
(215) 988-2768
Mark.Brown@dbr.com

Barbara A. Cronin
(312) 569-1297
Barbara.Cronin@dbr.com

Mona Ghude
(610) 993-2241
Mona.Ghude@dbr.com

Megan Glunz Horton
(312) 569-1322
Megan.Horton@dbr.com

Sharon L. Klingelsmith
(215) 988-2661
Sharon.Klingelsmith@dbr.com

David Levin
(202) 230-5181
David.Levin@dbr.com

Howard J. Levine
(312) 569-1304
Howard.Levine@dbr.com

Benjamin S. Lupin
(215) 988-2905
Benjamin.Lupin@dbr.com

Joyce L. Meyer
(312) 569-1305
Joyce.Meyer@dbr.com

Sarah Bassler Millar
(312) 569-1295
Sarah.Millar@dbr.com

Joan M. Neri
(973) 549-7393
Joan.Neri@dbr.com

Jean D. Renshaw
(610) 993-2259
Jean.Renshaw@dbr.com

Michael D. Rosenbaum
(312) 569-1308
Michael.Rosenbaum@dbr.com

Dawn E. Sellstrom
(312) 569-1324
Dawn.Sellstrom@dbr.com

Lori L. Shannon
(312) 569-1311
Lori.Shannon@dbr.com

Veronica Silva-Minin
(312) 569-1323
Veronica.Silva-Minin@dbr.com

David L. Wolfe
(312) 569-1313
David.Wolfe@dbr.com

Anika A. Yusaf
(312) 569-1316
Anika.Yusaf@dbr.com

PARALEGALS

Carol C. Abing
(414) 221-6045
Carol.Abing@dbr.com

Mary K. Meschler
(215) 988-2751
Mary.Meschler@dbr.com

Carrie Roberts Rivera
(312) 569-1514
Carrie.Rivera@dbr.com



LAW OFFICES | CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN

© 2007 Drinker Biddle & Reath LLP. All rights reserved.
A Delaware limited liability partnership

Jonathan I. Epstein and Edward A. Gramigna, Jr., Partners in Charge of the Princeton and Florham Park, New Jersey offices, respectively.

This Drinker Biddle & Reath LLP communication is intended to inform our clients and friends of developments in the law and to provide information of general interest. It is not intended to constitute advice regarding any client's legal problems and should not be relied upon as such.