Date: November 12, 2007

TCRS 2007-07: Final Regulations Relating To Default Investment Alternatives Under The Pension Protection Act of 2006

On October 24 the Department of Labor (DOL) published final regulations which provide relief to plan fiduciaries who invest participant assets in certain types of default investment alternatives in the absence of participant investment direction. The regulations are effective for contributions made on and after December 24, 2007.

Background

The final regulations were promulgated under section 404(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA) which was added by the Pension Protection Act of 2006. Proposed regulations were published by the DOL on September 26, 2006 (see TCRS 2006-06 for a summary of the proposed regulations).

Highlights of the final regulations include:

- **Scope of Fiduciary Relief**

  The plan fiduciary will not be liable for any loss or ERISA breach of fiduciary duty that is the direct result of investing such assets in a qualified default investment alternative (QDIA).

  Note: A plan fiduciary is not required to determine which QDIA is the most prudent for the plan. If all of the requirements of the final regulations are met, any of the QDIAs will satisfy the plan fiduciary's obligations.

  The standards set forth in the final regulations apply solely for purposes of determining whether a plan fiduciary meets the requirements of the regulations and are not intended to be the exclusive means by which a plan fiduciary might satisfy his or her duties under ERISA with respect to the investment of assets for those participants and beneficiaries who fail to give investment directions. Fiduciary relief applies even though a plan is not an ERISA section 404(c) plan, provided the plan fiduciary complies with the requirements of these regulations. The regulations do not provide relief from the general fiduciary rules applicable to the prudent selection and monitoring of the default investment or from any liability which results from the failure to satisfy these duties or the associated losses.

  Like the proposed regulations, the final regulations apply to situations beyond automatic enrollment. Such situations include the elimination by a plan of an investment option, a change in service provider, a rollover contribution for which no investment instructions are provided by the participant or any other failure of a participant to provide investment direction.

- **Conditions for Fiduciary Relief**

  There are 6 conditions that must be met in order for a plan fiduciary to obtain relief under the final regulations:

  1. A participant or beneficiary's assets must be invested in a QDIA described in the regulations.

     The following are the QDIAs permitted under the final regulations:

     - A "life-cycle" or "target retirement date" fund
     - A balanced fund
     - An individually managed fund
     - A capital preservation product (includes a stable value fund or money market fund), but only for the first 120 days after investment is made to a QDIA. After 120 days, the capital preservation product ceases to be a QDIA with respect to any assets of the participant invested in such product.

  2. The participant or beneficiary must have been provided with an opportunity to direct the investment of his/her accounts but failed to do so.
  3. The plan must provide both an initial and an annual QDIA notice to a participant or beneficiary (described further below). The initial QDIA notice must be provided at least 30 days before plan eligibility or at least 30 days before the first investment in the QDIA. For plans that permit immediate eligibility, the initial QDIA notice may be given on or before the date of plan eligibility provided participants are given the opportunity to withdraw their elective contributions.

The annual QDIA notice must be provided to all participants and beneficiaries at least 30 days before the beginning of each plan year. The DOL notes that in the absence of guidance to the contrary, plans that wish to use electronic means to satisfy the notice requirements may rely on either the DOL's guidance or the guidance issued by the Internal Revenue Service relating to the use of electronic media. Unlike the proposed regulations, these final regulations do not permit the inclusion of the QDIA notice in the plan's summary plan description or summary of material modifications, although distribution of these QDIA notices with other materials being furnished to participants and beneficiaries is permitted.

Note: The final regulations permit a plan that uses automatic enrollment to combine the QDIA notice with the notice required for automatic enrollment. Further, the initial QDIA notice may be combined with the 2008 annual notice.

The QDIA notice must be written in a manner calculated to be understood by the average employee and contain the following information:

- a description of the circumstances under which assets in the accounts of a participant or beneficiary may be invested in a QDIA and if applicable, an explanation of the circumstance under which elective contributions will be made for the participant;
- a description of the QDIA, its investment objectives, risk and return characteristics and the fees and expenses attendant to the QDIA;
- a description of the participant's or beneficiary's right to redirect the QDIA investment to any other plan investment alternatives, including a description of any applicable restrictions, fees, or expenses in connection with the transfer; and
- an explanation of where to find information concerning other plan investment alternatives.

Note: The final regulations provide that the furnishing of the QDIA notice will also satisfy the notice requirements pertaining to ERISA preemption of State laws in a plan that uses automatic enrollment.

4. The plan fiduciary must provide participants and beneficiaries any materials provided to the plan relating to their investment in a QDIA. These materials may include a description of the annual operating expenses, copies of financial statements and reports, any prospectuses, a list of assets comprising the portfolio of each QDIA, information concerning the value of shares or units, and past and current investment performance, net of expenses.

5. A QDIA must permit transfers to other investment options under the plan at least quarterly without financial penalty. The final regulations impose 3 conditions on a defaulted participant's or beneficiary's ability to move assets out of a QDIA:

   - Defaulted participants and beneficiaries must be provided the same rights afforded other participants and beneficiaries under the plan with respect to the frequency with which they may transfer defaulted assets.
   - No restrictions, fees or expenses may be imposed during the first 90 days of the participant's first elective contribution, or other first investment in a QDIA, except investment management and similar types of fees and expenses. The final regulations provide examples of restrictions and fees that may not be charged during the first 90 days. These include surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from the QDIA. The regulations also provide examples of fees and expenses that may be charged during the duration of the defaulted investment, including the first 90 days. These include investment management fees, distribution and/or service fees, "12b-1 fees" or legal, accounting, transfer agent and similar administrative expenses. These fees, however, may not be imposed, or may not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the QDIA.
   - After the first 90 days, the QDIA may not be subject to restrictions, fees or expenses not otherwise applicable to participants and beneficiaries whose assets were <u>not</u> defaulted.

6. The plan must offer a "broad range of investment alternatives" as defined in ERISA section 404(c)[1].

- **<u>Plan Sponsor Permitted To Manage QDIA</u>**

  Unlike the proposed regulations which did not permit a plan sponsor to manage a QDIA, the final regulations permit a plan sponsor that is a named fiduciary to manage a QDIA.

- **<u>Grandfathering of Investments Defaulted Into Certain Stable Value Products Before December 24, 2007</u>**

  The final regulations provide that an investment product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate grade bonds while providing liquidity for withdrawals and transfers (stable value product) will constitute a QDIA solely for purposes of assets invested before December 24, 2007. It is important to note, however, that the Supplementary Information to the final regulations state "this exception (referring to the grandfathering of certain stable value products) is intended to be limited to stable value products and funds with respect to which plan sponsors are typically limited by the terms of the investment contracts from unilaterally reinvesting assets on behalf of participants who fail to give investment direction without triggering a surrender charge or other fees that could directly and adversely affect participant account balances". The stable value product must meet the final regulations and the following requirements in order to be grandfathered as a QDIA:

- there are no fees or surrender charges; and
- the principal and rates of return are guaranteed by a State or federally regulated financial institution.

Stable value products and other capital preservation funds will not qualify as stand-alone QDIAs under the final regulations on and after December 24, 2007. However, the final regulations do not preclude their use as a component of a diversified portfolio that constitutes a QDIA.

- **Transition Issues**

  The DOL addressed a number of transition issues in the Supplementary Information to the final regulations.

  - How to distinguish defaulted participants and beneficiaries from those who affirmatively elected – It is the DOL's view that to ensure QDIA status with respect to pre-December 24, 2007 contributions in a grandfathered stable value fund, the QDIA notice requirements of the regulations must be met and must be provided to all participants and beneficiaries with assets in the grandfathered default fund. According to the DOL, each participant and beneficiary following receipt of a QDIA notice may be treated as failing to give investment direction, without regard to whether he/she was previously defaulted or affirmatively elected (if no redirection of assets occurs). If the requirements of the final regulations are satisfied the plan fiduciary may be able to obtain relief under these circumstances.
  - Mapping – The DOL clarified the interrelationship between ERISA section 404(c)(5) and these final regulations and ERISA section 404(c)(4)(A) dealing with the issue of "mapping". While the fiduciary relief afforded by these 2 sections of ERISA is similar, the DOL notes that the relief applicable to mapping requires only that the new investments be reasonably similar to the prior investments, whereas relief under these regulations requires investments in QDIAs. It appears more guidance is required in mapping situations.
  - Market value adjustments – It is the DOL's view that plan fiduciaries must follow ERISA's prudence and exclusive purpose requirements in deciding whether or not to move assets from a current default investment that imposes a market value adjustment on a QDIA. The DOL reminds fiduciaries that their decision cannot be based solely on their desire to take advantage of the relief provided by the final regulations without regard to the financial consequences to plan participants and beneficiaries.

- **ERISA Preemption**

  Unlike the proposed regulations which conditioned preemption on compliance with the requirements of the proposed regulations, the final regulations make clear that the preemption supercedes any State law that would directly or indirectly prohibit or restrict the inclusion in a plan of any automatic contribution arrangement.

In TCRS 2006-06, we listed 7 issues requiring additional guidance. Most of those issues were addressed in the final regulations and in this summary.

It is our understanding that the DOL is compiling questions and comments received on some issues which will require additional guidance.

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[1] *29 CFR 2550.404c-1(b)(3) provides that "[a] plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to: (A) materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; (B) choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics; (3) which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio;..."*