eBenefits Alert: Default Investment Alternatives – Final Regulations

November 1, 2007

On October 24, 2007, the Department of Labor issued final regulations relating to qualified default investment alternatives. The regulations offer fiduciary relief for fiduciaries who invest amounts contributed to participant directed accounts when participants do not provide investment instructions. If a fiduciary invests such amounts in compliance with Department of Labor Regulations Section 2550.404c-5 the participant will be deemed to have exercised control of his or her assets and the fiduciary will not be liable for any losses from such investments. The final regulations are effective December 24, 2007.

Qualified Default Investment Alternatives

The final regulations are consistent with the proposed regulations with respect to the types of investment alternatives that will be permitted as qualified default investment alternatives. The regulations authorize the use of funds based on age or a target retirement date (e.g. life-cycle funds or targeted-retirement-date funds) or funds based on a target level of risk appropriate for all participants under the plan (e.g. balanced funds). Additionally, the regulations permit the use of an investment management service wherein an investment manager allocates the assets of a participant's account based on the participant's age, target retirement date or life expectancy (e.g. a managed account).

In addition to falling into one of the above categories of investments, a qualified default investment alternative must meet certain other requirements. For example, a qualified default investment alternative cannot be employer stock, with certain limited exceptions. A qualified default investment alternative cannot impose restrictions, fees or other expenses with respect to a transfer of assets out of such investments that are not otherwise imposed on participants who affirmatively elected such investment. Finally, a qualified default investment alternative must meet certain management requirements.

Notably missing from the qualified default investment alternatives are money market or stable value funds. In the preamble to the final regulations, the Department of Labor provides commentary regarding its decision to exclude such funds as qualified default alternatives. The Department of Labor reasoned that defaulted investments ought to be and often will be long-term investments and the use of a stable value or money market fund will not provide a sufficient rate of return and therefore will decrease the likelihood that participants will have adequate retirement savings. The Department of Labor also expressed concern that if

it included stable value or money market funds in the default options, it could "impede, or even reverse, the current trend away from the use of such funds" as more plan sponsors would choose such products in order to minimize risk of litigation. Again, the Department pointed out that if more plans used capital preservation products as default investments, less participants would be adequately prepared for retirement. Finally, the Department of Labor expressed concern that if it included money market funds or stable value funds as permitted default investments, it would be viewed as an endorsement of such alternatives as an appropriate investment for long-term retirement savings, a message the Department of Labor does not want to send.

Although the final regulations do not include capital preservation funds as qualified default investment alternatives, they do allow for their use in two important circumstances. First, the regulations indicate that they will treat a money market or stable value fund as a qualified default investment alternative for a 120-day period following the participant's first elective contribution. This exception is designed to facilitate a plan's use of the permitted withdrawal period related to eligible automatic contribution arrangements. The Department of Labor recognizes plans' need to avoid a loss of principal for the period during which the participant could take the money out of the plan. The 120-day period was designed to give employers sufficient time following the 90-day withdrawal period to redirect the investment into another qualified default investment alternative. The stable value or money market fund ceases to be a qualified default investment alternative following the 120-day period.

The second exception provides a grandfather-type provision for amounts invested in capital preservation funds before December 24, 2007 (the effective date of the regulations) that do not have any fees or surrender charges imposed in connection with withdrawals initiated by the participant. This exception was designed to address concern with respect to stable value products that limit plan sponsors from unilaterally reinvesting the assets without triggering a surrender charge or other fee that would adversely affect the participant's account balance.

The preamble to the regulation also specifically notes that although capital preservation funds are not included as a qualified default investment alternative, they may still be an appropriate default investment for certain plans. The preamble and regulations emphasize that the qualified default alternatives listed in the regulations are "not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under the Act." Thus, a fiduciary may still use money market or stable value funds as default investments, however, in doing so the fiduciary will not be entitled to automatic protection from liability and must be able to establish that using such an investment was the prudent course of action.

Notice

The other notable requirement necessary for fiduciary relief under the regulations is the notice requirement. The final regulations, like the proposed regulations require that both an initial and annual notice be provided

to participants on whose behalf an investment in a qualified default investment alternative may be made. The final regulations provide additional detail regarding the timing and content of such notices. In addition, the final regulations modify the proposed regulations by requiring notice to be provided outside of the plan's summary plan description or a summary of material modifications. The Department of Labor reasons that by providing a separate notice, participants will be less likely to ignore the information regarding use of a qualified default investment alternative.

The final regulations made some adjustments to the timing of the initial notice. The proposed regulations required the initial notice be provided at least 30-days prior to the first investment. This notice requirement precluded plans with immediate eligibility and automatic enrollment from withholding contributions as of the participant's first pay period. The Department of Labor commented that it did not want to discourage plan sponsors from enrolling participants on the earliest possible date and in turn modified the timing of the initial notice to address this issue. Under the final regulations, the initial notice must be provided (a) at least 30 days prior to the date of plan eligibility or at least 30 days prior to the first investment in a qualified default investment, or (b) on or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal. Thus, plans that wish to automatically enroll participants immediately must include the 90-day withdrawal provision in their plans. (For more information on the 90-day withdrawal period see Code section 414(w).) With respect to the annual notice, the final regulations retain the requirement that the annual notice be provided at least 30 days prior to each plan year. If a fiduciary fails to provide timely notice, the fiduciary may still obtain relief under the regulations for any contributions made after a 30-day notice is given.

In addition to clarifying the timing of the required notices, the final regulations provide specific content requirements for the notices. Pursuant to section 2550.404c-5(d), the initial and annual notice must include the following:

- A description of the circumstances under which assets may be invested in a qualified default investment alternative.
- If applicable, an explanation of 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 or to have a different percentage contributed.
- An explanation of the right of participants to direct the investment of assets in their account.
- A description of the qualified default investment alternative being used by the plan, including a description of the investment objectives, risk and return characteristics, and fees and expenses attendant to the alternative.
- A description of the right of participants to direct the investment of assets to any other investment option under the plan, and a description of any applicable restrictions, fees or expenses in connection with such transfer.

- An explanation of where the participant can obtain investment information about the other investment alternatives available under the plan.

The regulations provide that a notice that meets the above requirements will be sufficient not only to satisfy the notice requirements for default investments, but will also be sufficient to satisfy the notice requirements for automatic contribution arrangements. The preamble to the regulations notes that until further guidance is issued, notices may be provided electronically in compliance with DOL regulations 2520.104b-1(c) or Treasury regulations 1.401(a)-21.

The IRS has issued a Sample Automatic Enrollment and Default Investment Notice which can be found at http://www.irs.gov/pub/irs-tege/sample_notice.pdf. The preamble to the model states that the DOL has indicated the model will satisfy the notice requirements of the final default investment regulations.

Other Requirements

In addition to using one of the qualified default investment alternatives and providing the required notices, the regulations include other requirements that must be met for fiduciary relief to be granted under ERISA section 404(c)(5):

- The participant must have the opportunity to direct investments and must fail to do so.
- The fiduciary must provide the participant with the same investment information that is provided to the plan and passed through to participants that affirmatively elect investments under the plan.
- Participants must have the ability to transfer out of the default investment into other investment alternatives under the plan with the same frequency as otherwise allowed under the plan. Any such transfer made within 90-days of the participant's first contribution cannot be subject to any restrictions, fees or expenses (other than ongoing fees such as investment management and similar fees). Any such transfer made following the 90-day period cannot be subject to any restrictions, fees or expenses that would not otherwise be applicable to a participant who had affirmatively elected to invest in the default investment alternative.
- The plan must offer a broad range of investment alternatives.

If a plan meets the above requirements, uses a qualified default investment alternative and provides the required notices in a timely manner, a fiduciary who invests a participant's contribution in such qualified default investment alternative will not be liable for any losses from such investment.

The above is only a summary of the final regulations. If you would like further assistance with compliance with these regulations, please contact a member of the Gray Plant Mooty Employee Benefits and Executive Compensation Practice Group.

specific legal questions you may have.