

Monday, October 29, 2007

## ERISA and Employee Benefits Update: Department of Labor Issues Final Default Investment Regulations - Action is Required by December 24, 2007

By Erwin D. Kratz

### Are You Properly Investing Retirement Plan Assets When Participants Fail To Make an Investment Election? A New Standard of Care.

Plan sponsors and fiduciaries of participant-directed individual account pension plans have typically provided that, in the absence an affirmative election by a participant, account balances will be invested in a conservative default investment, such as a money market, fixed income or stable value fund. This was thought the best way to reduce a fiduciary's potential liability under the Employee Retirement Income Security Act (ERISA) when a participant does not exercise the control granted to the participant over the investment of his or her account. Avoiding losses, rather than securing appropriate returns, has traditionally been the overriding concern. This conservative approach is no longer acceptable under new Department of Labor (DOL) regulations issued on October 24, 2007.

The Pension Protection Act of 2006 (PPA) expanded the relief from fiduciary liability for investment decisions available under Section 404(c) of ERISA to plan fiduciaries who give participants the right to make investment choices, to include relief from liability if the fiduciaries direct a participant's assets to a "qualified default investment alternative" (QDIA) when a participant fails to provide investment direction. The final regulations implementing this provision are effective as of December 24, 2007 for all individual account plans with participant direction, not just default investments occurring under 401(k) plans that allow for automatic enrollment. Any individual account plan that allows participant direction of investments and has the potential to receive assets without investment direction from participants (such as profit sharing plans, and plans that accept rollover contributions), must comply with the new regulations by December 24, 2007 in order to receive the new safe harbour protection from fiduciary liability. This alert summarizes the regulations.

This change effectively presents a new standard of care for all fiduciaries in plans that provide for participant direction of investment. Even if plan fiduciaries choose not to seek the additional safe harbor protection from fiduciary liability by providing the required notices, they should examine all default options and bring them into the categories of qualified default investment alternatives described below before **December 24, 2007**.

### How to Get The New Relief

The regulations provide fiduciary protection to a plan fiduciary who invests a participant's account in a QDIA by deeming the affected participant to have exercised control over the assets, even though the participant did not, in fact, make an affirmative election.

## quick links

- [ERISA and Employee Benefits Practice](#)
- [Labor and Employment Practice](#)
- [Unsubscribe](#)
- [Acrobat Reader](#)

Phoenix  
3003 N. Central Ave.  
Suite 2600  
Phoenix, AZ 85012  
(602) 916-5000

Tucson  
One S. Church Ave.  
Suite 1000  
Tucson, AZ 85701  
(520) 879-6800

Nogales  
420 W. Mariposa Rd.  
Suite 200  
Nogales, AZ 85621  
(520) 281-3480

Las Vegas  
300 S. Fourth St.  
Suite 1400  
Las Vegas, NV 89101  
(702) 692-8000

Denver  
1700 Lincoln St.  
Suite 2900  
Denver, CO 80203  
(303) 291-3200

This relieves the fiduciary of responsibility for the investment decision. The regulations establish the following conditions for fiduciary relief:

1. The assets must be invested in a QDIA (the requirements of which are summarized below).
2. The participant whose account is invested in a QDIA must have been given an opportunity to provide investment direction, but failed to do so.
3. A notice must be furnished to the affected participant before initial plan eligibility or 30 days before the first investment in a QDIA is made, as well as annually thereafter. The notice must include:
  - A description of the circumstances under which assets will be invested in a QDIA. If the assets will be contributed pursuant to an automatic 401(k) enrollment arrangement, the notice must include an explanation of the circumstances under which automatic elective contributions will be made, the percentage of such contributions, and the right of the participant to elect not to have the contributions made (or to elect to have them made at a different percentage);
  - An explanation of the right of participants to direct the investment of their assets in their individual accounts;
  - A description of the investment objectives, risk and return characteristics, fees and expenses of the QDIA;
  - A description of the right of participants to direct investment of the QDIA assets to other investment options under the plan; and
  - An explanation of where the participants can obtain investment information concerning the other investment alternatives available under the plan.
4. Any material, such as investment prospectuses, account statements, proxy voting material and other notices provided to the plan by the QDIA must be furnished to participants.
5. Participants whose assets are invested in a QDIA must have the opportunity to direct investments out of a QDIA with the same frequency available for other participants who affirmatively elected to invest in the QDIA, but no less frequently than once within any 3-month period.
  - Any such transfer (and any permissible withdrawal of automatic contributions under Code Section 414(w)(2) within 90 days after automatic contributions are first made) cannot be subject to any restrictions, fees or expenses charged in connection with the liquidation or transfer (such as surrender fees).
  - After the 90-day period, any restrictions, fees or expenses must apply equally to default investors and to participants who affirmatively elected to invest in the QDIA.
6. The plan must continue to offer a “broad range of investment alternatives” as defined in the DOL regulations under section 404(c) of ERISA.

## QDIA Examples

The final regulations give examples of acceptable QDIAs. A QDIA may be:

- A life-cycle or targeted-retirement-date fund based on the participant’s age, target retirement date, or life expectancy.

# Need to Know

- A balanced fund or model portfolio that is consistent with a target level of risk appropriate for participants of the plan as a whole (i.e., not necessarily of the particular participant).
- A professionally managed account (managed by a fiduciary) that allocates a mix investments available under the plan based on the participant's age, target retirement date or life expectancy. This is like an individually designed life-cycle or targeted-retirement-date fund.
- For funds invested before December 24, 2007, bond funds designed to guarantee principal and a rate of return generally consistent with the return on intermediate investment grade bonds qualify as "grandfathered" QDIAs.
- If a 401(k) plan uses automatic enrollment, for the first 120 days after a participant's first automatic elective contribution, certain money market or stable value funds also qualify.

## What To Do Now

All individual account plans should evaluate their default investments elections and move them to the categories described under the regulations, while adequately documenting their evaluation because the selection of a QDIA option is a fiduciary act. If the fiduciaries wish to obtain the additional protection afforded under the PPA, they should also examine all the notices and disclosures used in connection with their default investments.

Plan sponsors and fiduciaries that currently provide conservative default investments funds that are geared solely to preservation of capital, such as money market and fixed income funds, should (1) ensure default investments previously made comply with the grandfathered QDIA alternative, or are reinvested in one of the other acceptable QDIAs; and (2) switch their default investment option to another QDIA going forward.

## Learn More

The he final regulations can be found at <http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf>

Erwin Kratz is an attorney with Fennemore Craig, P.C., focusing his practice in employee benefits matters. He may be reached at [ekratz@fclaw.com](mailto:ekratz@fclaw.com) or (520) 879-6401. Other members of our employee benefits practise group include Cindy Shupe at [cshupe@fclaw.com](mailto:cshupe@fclaw.com) or (602) 916-5437, David Heap at [dheap@fclaw.com](mailto:dheap@fclaw.com) or (602) 916-5326, and Jennifer Mammano at [jmammano@fclaw.com](mailto:jmammano@fclaw.com) or (602) 916-5425.

