Department of Labor Issues Final Regulations on Qualified Default Investment Alternatives

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On October 24, 2007, the Employee Benefits Security Administration of the U.S. Department of Labor (“DOL”) published final regulations on the use of default investment alternatives. The DOL expects the use of default investments through automatic enrollments to increase total 401(k) account balances between 2.6 percent and 5.1 percent, or an additional $70 billion to $134 billion in investments directed towards retirement plans.

Background

Under the Employee Retirement Income Security Act of 1974 as amended (“ERISA”), anyone exercising discretionary control over the investment of plan assets is considered a fiduciary and subject to fiduciary liability. Section 404(c) of ERISA, however, limits fiduciary liability in participant-directed individual account plans (e.g., 401(k) and 403(b)) if the requirements of ERISA Section 404(c) are met. In such a case, plan fiduciaries are protected from fiduciary liability for losses resulting from the participant’s investment decisions. Until the final regulations were issued, fiduciary protection under Section 404(c) did not extend to default investments because the participant did not direct the investments. That is, default investments were selected by the employer, and the DOL did not accept the argument that the default investment option was a “negative election” by the participant.

When participants actively elect to participate in a plan, they usually actively elect their investment options. However, plans using passive or so-called “automatic” enrollment tend to have substantial amounts invested in the employer-selected “default” investment fund. To avoid fiduciary liability claims for losses stemming from default investments, most employers that adopted an automatic enrollment provision tried to limit their liability exposure by selecting default investments that emphasized the preservation of capital, such as money market funds, instead of investments with an eye toward long-term growth, such as equity funds. In response to these and other concerns, Congress included automatic enrollment protections in the Pension Protection Act of 2006 (“PPA”).

Signed into law by President Bush on August 17, 2006, the PPA includes a provision amending ERISA Section 404(c) to extend fiduciary liability protection to default investments if plan assets are invested in specific types of default investment alternatives. The PPA directed the DOL to issue regulations on the different types of default investment alternatives and conditions that must be satisfied for fiduciary liability relief to apply. On September 27, 2006, the DOL published proposed regulations, which generated more than 120 public comments. The final regulations adopted in significant part the proposed regulations, but also included modifications reflecting commenters’ suggestions.

Final Regulations: Six Conditions for Fiduciary Relief

The final DOL regulations establish six conditions that must be met for the plan fiduciary to be protected under ERISA Section 404(c) from claims related to losses incurred in default investments. The scope of relief granted is the same as that extended to plan fiduciaries under Section 404(c) plans in connection with carrying out investment directions. Additionally, the final regulations make clear that a fiduciary still is accountable under general fiduciary liability rules (i.e., prudence, competence, and loyalty) applicable to selecting and monitoring default investment alternatives. The final regulations also extend fiduciary relief to other default investment events, for example in a plan merger where a fiduciary must invest the rollover amounts because the participant or beneficiary has failed to make an election. The six conditions are as follows:

1. Assets must be invested in a “qualified default investment alternative.” To meet the DOL’s qualified status, the default investment must satisfy the following requirements:
Subject to two exceptions, the default investment alternative may not hold employer stock. The first exception applies to employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle, which could occur where the plan sponsor is publicly traded and the mutual fund happened to acquire the shares as part of its investment policy, and the fact that the employer has selected the funds as a qualified default investment alternative is a coincidence. The second exception applies to employer securities acquired as a matching contribution from the employer or from prior direction by the participant, so long as the managed account alternative (discussed below) has been selected and the investment manager has the authority to dispose of the securities;

The default investment alternative must be managed by an investment manager, as defined in ERISA Section 3(38), a trustee, as defined in ERISA Section 3(38)(A-C), or a plan sponsor who is a named fiduciary. Alternatively, it can be managed by an investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund company) or a capital preservation fund or product entitled to limited qualified default investment alternative status (discussed below); and

One of the following four types of investment products is used as the default investment alternative: i.) A life-cycle fund, target retirement-date fund, or a similar fund or model portfolio that is designed to provide 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, or life expectancy. Such funds change their asset allocation and associated risk levels over time with the objective of becoming more conservative with the participant’s increasing age. ii.) A balanced fund or a similar fund or model portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for the participants of the plan as a whole. iii.) A managed account or a similar investment management service where an investment advisor allocates the assets of a participant’s account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures offered through investment alternatives under the plan and based on the participant’s age, target retirement date, or life expectancy. iv.) A stable value fund or money market fund that is designed to preserve principal and provide a reason-
• The circumstances in which elective contributions will be made on behalf of the participant, the contribution percentage, and the right of the participant to opt-out of participation, or elect a different percentage (if applicable);
• An explanation of the participant’s and beneficiary’s right to direct investments in his or her account;
• The type of qualified default investment alternative, including objective, risk and return characteristics (if applicable), and fees and expenses;
• The right of the participant or beneficiary to direct the investment to any other investment alternative under the plan, including a description of any restrictions, fees, or expenses in connection with such transfers; and
• The person and address where the participant or beneficiary should direct his or her request for investment information concerning the other investment alternatives offered under the plan.7

The Internal Revenue Service has published a four-page sample notice in the November 15, 2007, issue of Employee Plans News.8 The sample notice, which was written based on a hypothetical automatic contribution arrangement, provides helpful guidance on meeting the content requirements of the final regulations. An employer wanting to use the sample as a starting point will need to modify the notice to conform to the terms and operation of their plan.

As to distribution of the notice, the final regulations provide that to limit the chance of participants overlooking or ignoring the information relating to their participation and the investment of their contributions, the notice may not be included in the summary plan description or a summary of material modifications. However, the regulations allow the initial and the annual notice to be distributed with other notices (e.g., the 401(k) safe harbor notice, automatic enrollment notice, and quarterly statements) in a single mailing or other transmittals. The final regulations also clarify that electronic delivery of the notice is permissible if it conforms to other guidance provided on the use of electronic media.

4. The plan or third-party administrator also must send participants and beneficiaries investment materials relating to the default investment alternative (e.g., prospectuses, proxy voting material, and annual operating expenses).

5. The participant or beneficiary must have the ability to transfer the default investment alternative to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who voluntarily elected to invest in the qualified default investment alternative, but no less frequently than once within any three-month period. Thus, if a plan permits daily investment direction, participants in a default investment alternative must be permitted to direct their investment daily. Additionally, in response to numerous comments, the final regulations were modified to preclude restrictions, fees, or expenses (other than investment management and similar types of fees and expenses)9 on such transfers during the first 90 days of an investment in a qualified default investment alternative.10 Thereafter, restrictions, fees, and expenses may be imposed in the same amount as those charged to other participants who elect to invest in the qualified default investment alternative.

6. The plan must offer participants and beneficiaries the opportunity to invest in a “broad range of investment alternatives.” A “broad range of investment alternatives” is defined as a minimum of three investment alternatives with materially different risk and return characteristics allowing any participant or beneficiary to create a risk and return investment portfolio in an appropriate range. The DOL expects that virtually all 401(k) and 403(b) plans that allow participants or beneficiaries to direct their own investments in an arrangement that satisfies the ERISA Section 404(c) requirements to meet this standard without having to make significant changes in available investment alternatives.

Conclusion

The final regulations adopted in significant part the proposed regulations and provide much-needed guidance to employers on fiduciary liability protection extended to investments in qualified default investment alternatives. Though the final regulations are not intended to be effective until 60 days after publication, December 24, 2007, employers who have already amended their 401(k) or 403(b) plans for automatic enrollment should update their administrative processes and review their current default investments for compliance with the final regulations. For example, as quickly as possible, employers will want to review the content of the initial notice, and then distribute the notice to participants and beneficiaries. Employers who have not amended their plans for automatic enrollment should give careful consideration to making such amendments in light of the new fiduciary liability protection extended to qualified default investment alternatives.

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4. The DOL added stable funds to the list of qualified default investment alternatives for the limited duration of 120 days as an administrative convenience to help provide a short-term investment alternative that is near risk-free during a period when employees are most likely to decide whether to opt-out of the plan or actively choose their investments. The 120-day period was intended to provide a reasonable amount of time following the end of the 90-day period to allow for a transfer of a participant’s assets to another qualified default investment alternative. Note that under Section 415(w)(2)(B) of the Internal Revenue Code of 1986, as amended (“Code”), if a participant elects to opt-out of the plan within 90 days of his or her first contribution, the withdrawal will be treated as wages and will not be subject to the 10-percent additional tax under Code Section 72(t) for early withdrawals.

5. This grandfathered provision is limited to stable value products and funds that provide a guaranteed rate of return, and therefore generally does not extend to money market funds or other stable value funds because they do not typically provide a guaranteed rate of return.

6. Note that the phrase “in advance of the first investment . . . or any first investment in a qualified default investment alternative” is not intended to foreclose liability protection where, prior to the effective date of the final regulations, plan assets were invested in a qualified default alternative that otherwise met the conditions of a “qualified default investment alternative.”

7. The DOL broadened the content requirements of the proposed regulations such that if the final regulations are satisfied as to content and timing, then the preemption notice under ERISA Section 514, applicable to automatic contribution arrangements, also will be met. Section 514 of ERISA preempts any state law that would restrict the use of automatic contribution arrangements. The final regulations help to clarify that any plan providing for an automatic contribution arrangement, regardless of whether it meets all of the requirements of the final regulations, preempts any state law that would restrict the use of the automatic contribution arrangement.


9. These fees include distribution fees and service fees (e.g., 12b-1 fees) and administrative-type fees (e.g., legal, accounting, and transfer-agent expenses).

10. Surrender charges, liquidation or exchange fees, redemption fees, and any market value adjustment or “round trip” restriction on the ability of the participant or beneficiary to reinvest within a defined period of time cannot be imposed during the 90-day period.