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The Wait Is Over: DOL Issues Final Default Investment Regulations

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The U.S. Department of Labor (DOL) recently issued a final regulation addressing the selection of default investment options for defined contribution plans (29 CFR 2550.404c-5). The regulation sets out the types of products in which participant contributions can be invested in the event the participant has failed to provide investment instructions. It should provide a significant degree of certainty that will be helpful to plan sponsors and plan service providers.

Background

Under the Employee Retirement Income Security Act of 1974 (ERISA) and the accompanying regulations, a plan sponsor is generally not responsible for investment losses to participants' accounts if those losses are the direct and necessary result of the participants' exercise of control over the account, provided that a variety of disclosure and notice requirements are met. In the past, DOL took the position that the protection afforded under ERISA for participant directed accounts was not available in the absence of affirmative participant investment elections.

> *The regulation sets out the types of products in which participant contributions can be invested.*

DOL's position was problematic for plans with automatic enrollment features. Through automatic enrollment, employees are enrolled in a defined contribution plan and contributions are made unless the employee affirmatively opts out of the plan. Although the prospect of increasing plan participation was generally appealing, many plan sponsors were reluctant to adopt these features because of concerns that they would be liable for investing participant account balances without affirmative investment instructions.

In August of 2006, Congress passed the mammoth Pension Protection Act (PPA), which substantially affected much of the law governing ERISA-covered retirement plans. Some of the most significant provisions in the PPA were aimed at encouraging employers to adopt automatic enrollment programs. The law made it easier for plans with automatic enrollment to satisfy various tax qualification tests and clarified the application of ERISA's preemption rules to state laws that restrict employers from wage withholding without an employee's consent.

In addition, the PPA added a new section to ERISA that extends the fiduciary relief for participant directed accounts to fiduciaries who invest participant account balances when the participant has not provided affirmative investment instructions. Although enacted to encourage automatic enrollment, the relief covers a variety of situations, including IRA rollovers for which no directions are given, mapping transactions where the plan terminates an investment option and transfers assets to a similar fund, and changes to investment or administrative providers and the plan's investment lineup. Plan sponsors, however, retain liability for the prudent selection and monitoring of the default fund. The statute requires that plans give participants notice that their account will be invested in a default investment, and the assets must be invested in accordance with DOL regulations in order to take advantage of the relief.

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The Final Default Investment Regulations

After keeping the benefits community on the edge of its seat for over a year, DOL finally released a final default investment regulation on October 24, 2007. The regulation establishes that relief is provided to fiduciaries of plans that offer a broad range of investment alternatives when a participant's account is defaulted into a Qualified Default Investment Alternative (QDIA) after the participant has been given the opportunity to direct his or her assets and fails to do so. Plan fiduciaries must meet certain notice and disclosure requirements to qualify under the regulation.

Qualified Default Investment Alternatives. The chief requirement under the regulation is that participant assets be invested in a QDIA. A QDIA must be managed by an investment manager, a plan sponsor that is a named fiduciary, a plan trustee that meets the ERISA definition of investment manager, a registered investment company, or one of the principal preservation vehicles entitled to limited QDIA status (*e.g.,* stable value and money market funds). The preamble language clearly states that the regulation is intended to permit investments made in separate accounts under group annuity contracts, as well as common and collective trust funds or other pooled investment funds that satisfy all of the conditions of the regulation. The preamble also clarifies that the entity responsible for asset allocation decisions affecting the vehicle is the entity that must meet the specified requirements.

Retaining language from the proposed regulation released in 2006, the final regulation authorizes the use of the following three investment strategies:

1) Funds/portfolios designed to provide varying risk/return based on participant's age with the objective of becoming more conservative over time (*e.g.,* life cycle or target retirement date funds).
2) Single fund/portfolio providing long-term appreciation and capital preservation through a mix of equity and fixed income with a level of risk appropriate for the plan as a whole (*e.g.,* a balanced fund).
3) An investment management service under which a fiduciary manages the participant's account based on participant's age or target retirement date ("managed account").

In response to numerous comments, DOL extended limited QDIA status to certain principal preservation products, such as stable value and money market funds. The regulation contains a significant grandfather provision that applies only to stable value fund investments. Specifically, investments made before the effective date of the regulation (*i.e.,* prior to December 24, 2007) into stable value products may qualify for QDIA status. This provision does not apply to contributions made after the effective date of final regulations. For purposes of this rule, investments must have been made into a product that is designed to guarantee principal and provide a rate of return consistent with bond funds, while providing liquidity for participant-initiated withdrawals and transfers. This grandfather rule does not apply to bond or money market funds.

DOL extended limited QDIA status to certain principal preservation products, such as stable value and money market funds.

Although the Department generally did not extend QDIA status to principal protection vehicles, these vehicles are given short-term QDIA status. The regulation provides that a participant's account may be defaulted into capital preservation vehicles offered by regulated financial institutions — including stable value funds and money market funds — for up to 120 days after the participant's first elective contribution. However, assets defaulted into such a capital preservation vehicle for this

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purpose must be moved into one of the other QDIA vehicles after the 120-day period ends. The Department explained that this rule should ease plan administration since the tax code generally allows participants to opt out of automatic enrollment within 90 days and receive their funds back.

The regulation also places limits on the transfer fees and restrictions that can be placed on a QDIA and, with limited exceptions, prohibits the holding of employer securities.

Notices and Disclosures. DOL has long required plan fiduciaries of defined contribution plans to distribute information about plan investments to participants, so it came as no surprise that the new regulation contained notice and disclosure requirements. In particular, participants must be given notice that their account assets will be invested in the QDIA at least 30 days before plan eligibility or a first investment, or, if the participant has the right to transfer out, on or before date of plan eligibility, and at least 30 days in advance of each new year. Additionally, participants who have their account balances invested by default are entitled to the same disclosures that must be provided in connection with affirmative participant instructions. These disclosures include prospectuses and risk and return information, and they may be provided directly to the participant by the provider of the investment alternative or by a third party.

Preemption. Prior to the PPA, many plan sponsors were reluctant to institute automatic enrollment for fear of violating state law prohibitions on wage withholding. The PPA amended ERISA's broad preemption provision to specifically preempt any state laws that would directly or indirectly restrict a plan from offering an automatic contribution arrangement. The final regulation clarifies that any state laws that would inhibit automatic contribution arrangements in ERISA pension plans are preempted, regardless of whether the investment chosen as the plan's default investment qualifies as a QDIA. The provision provides significant relief to plans that have automatic enrollment but do not meet all of the technical requirements of the regulation.

Going Forward

Overall, the default investment regulation makes important strides toward clarifying the requirements that fiduciaries must meet in order to obtain relief from liability for investment losses suffered by plan participants whose accounts are invested in a default investment. The regulation is especially important to plans with automatic enrollment features and for plans making changes to their investment options. Although there are a variety of technical issues that were not clear from the regulation (*e.g.,* whether certain stable value products generally qualify as "guaranteed products" under the grandfather provisions), DOL appears to be preparing to release additional guidance in the form of a Question & Answer list that should provide further assistance to plan fiduciaries.

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