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DOL Issues Final Default Regulations: Many Questions Answered, Many Questions Remain

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The Department of Labor's ("DOL's") anxiously awaited final "Qualified Default Investment Alternative" ("QDIA") regulations were released on October 24 and become effective on December 24, 2007. 72 Fed. Reg. 60452. The regulations implement provisions of the Pension Protection Act of 2006 ("PPA") and will affect the ability of plan sponsors to invest "undirected" participant accounts in a variety of circumstances, including through automatic enrollment arrangements.

Scores of questions have been asked by our clients since the regulations were announced covering a variety of issues on how to apply the regulations to specific products and how to achieve relief in connection with default investment programs. In response, we have had a number of conversations with DOL staff who have advised us that the DOL intends to issue a list of Q&As in the near term that will provide further guidance in this area. This gives the benefits community a brief window of opportunity to work with the DOL to resolve some of the uncertainties created by the regulation.

This article sets forth a discussion of the PPA's provisions related to default investments, the basic framework of DOL's regulation, and a discussion of some of the more significant regulatory provisions and the problems identified by our clients.

A. Background

Prior to the PPA, some plan sponsors were reluctant to adopt automatic enrollment features because of concerns that they would be liable for investing participant account balances without affirmative investment instructions. Specifically, DOL had taken the position that protection under ERISA section 404(c)(1) is not available in the absence of affirmative participant investment elections. The PPA made significant changes to ERISA to encourage employers to adopt automatic enrollment programs, including adding provisions that make it easier for such plans to satisfy various tax qualification tests and clarifying the application of ERISA's preemption rules to state laws that restrict employers from wage withholding without an employee's consent. In addition, section 624 of the PPA added new ERISA section 404(c)(5) which generally extends the protection available under ERISA section 404(c) to fiduciaries who invest account balances of auto-enrolled participants or of participants who, for any other reason, have failed to provide investment directions.

ERISA section 404(c)(5) provides that a participant in an individual account plan that meets certain notice requirements will be treated as exercising control over the assets of his account which are invested by the plan fiduciary in accordance with regulations issued by the DOL. The statute requires a participant to receive prior notice of how contributions will be invested in the absence of instructions as well as his right to reallocate his investments.

Fiduciaries that meet the requirements of the QDIA regulation would not be liable for losses that result from the investment of the participant's account balance in a QDIA or for investment decisions made by the manager of the investment alternative (assuming the fiduciary does not himself manage the QDIA). Nonetheless, like any other investment option, fiduciaries remain responsible for prudently selecting and monitoring the default option (and any investment manager for that option), and would be liable for any losses that result from a failure to do so. Investment managers and others that manage QDIAs remain subject to applicable fiduciary standards in managing the assets or allocation of the QDIA.

The fundamental structure and conditions of the final regulations for QDIAs closely follow the proposed regulations released over a year ago. In addition, the final regulations continue to authorize the use of the three investment strategies that were described in the proposal – including managed accounts, life cycle or target retirement date funds, balanced funds and similar arrangements. The DOL also accommodated many of the requests made by commenters and relaxed several restrictive aspects of the proposal. Summarized below are the basic requirements of the regulation, some of the most significant changes made by the DOL in response to comments, and a discussion of the key features and issues created by the regulations.

A. Regulatory Conditions

The regulation provides specific conditions that a plan sponsor must meet in order to qualify for relief in connection with defaulted participant account balances. First, the undirected investment must meet a number of general conditions:

- Assets must be invested in a "qualified default investment alternative;"

- The participant on whose behalf the investment is made had the opportunity to provide investment instructions, but did not do so;

- The participant must be provided a notice concerning the plan's default investment at least 30 days before plan eligibility or the first investment in the QDIA, or as late as on the date of plan eligibility if the participant has a right to make a permissible withdrawal under section 414 of the Code; and at least 30 days prior to each subsequent plan year;

- The participant must receive certain disclosures concerning the plan's default investment that parallel the disclosure requirements of current section 404(c) regulations;

- The participant must have a right to transfer out of the QDIA at least as frequently as a participant who affirmatively elected the investment (but no less frequently than once within a 3-month period);

- No fees, restrictions or expenses may be imposed in connection with transfers out or withdrawals from a QDIA within the 90-day period beginning on the participant's first elective contribution or other first investment in a QDIA (certain ongoing fees are permitted); and

- The plan must offer a "broad range of investment options" within the meaning of existing 404(c) regulations.

Chief among these requirements, plan assets must be invested in a "qualified default investment alternative." A second set of regulatory conditions provides the rules a fund or allocation must meet in order to be deemed a "qualified default investment alternative:"

- It generally may not hold employer securities, except if the investment alternative is a registered investment company or similar regulated pooled vehicle, or, in the case of an investment management service, the securities were acquired as a result of a matching contribution or prior to management by the service provided the manager has authority to dispose of the securities;

- It meets the regulation's transferability and fee restriction provision (described above);

- It must be (1) managed by an investment manager meeting the requirements of ERISA section 3(38), a professional trustee, or the plan sponsor who is a named fiduciary, (2) a registered investment company under the Investment Company Act of 1940, or (3) one of the limited-purpose principal preservation vehicles described below.

- It must qualify as a (1) one of the three types of investment products or services described in the regulation that provide a mix of equity and fixed income exposures appropriate for the plan or the participant (such as a life cycle, target retirement date, or a balanced fund, or a managed account), or

(2) one of the limited-purpose principal preservation vehicles described below.

What follows is a discussion of some of more important changes and clarifications made by the DOL in response to public comments on the proposal and a discussion of some of the issues we have considered in applying the regulations to specific programs.

B. Principal Preservation Vehicles

Many commenters asked the DOL to extend unlimited QDIA status to principal preservation products, such as stable value and money market funds. DOL rejected this request, but did provide limited QDIA status to principal protection vehicles under two specific circumstances.

Grandfather Relief for Prior Default Investments – A number of commenters asked the DOL to provide "grandfather" relief for default investments that were made in principal protection vehicles prior to the effective date of final regulations. They pointed out that investments in stable value funds are frequently subject to market value adjustments or other fees in connection with withdrawals initiated by the employer, and that a large-scale sell-off of stable value investments over a short period of time could affect the market and hurt plan participants.

The final regulation contains a significant grandfather provision for investments made before the effective date of the regulation (December 24, 2007) into certain "guaranteed" investments. Importantly, this relief applies only to investments that guarantee principal and a rate of return generally consistent with that of intermediate investment grade and bond and meet other conditions - it does not apply to investments made to other types of principal protection vehicles that do not guarantee principal such as money market or bond funds. In addition, this relief 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 provides liquidity for participant-initiated withdrawals and transfers. The product must not impose fees or surrender charges in connection with participant-initiated withdrawals, and principal and rates of return must be guaranteed by a regulated financial institution. In order to utilize the grandfather rule and obtain relief for investments prior to December 24, 2007, all other conditions of the final regulation must be met.

We have received a number of comments from our clients who have asked whether certain stable value funds or products qualify for relief under the grandfather provision. These uncertainties are created at least in part by the fact that DOL's definition appears to require that the product guarantee both principal and a rate of return consistent with intermediate investment grade bonds. We are aware that there are many stable value products that provide a guarantee of principal and accrued interest, but do not guarantee a rate of return, unless they can be said to "guarantee" at least a 0% rate of return. In addition, DOL's definition requires the guarantee to be provided by "a state or federally regulated financial institution." We know of many stable value products whose guarantees are offered through multiple contracts that provide layered guarantees, and we have been asked whether these products may qualify for relief under DOL's grandfather provision. The DOL has made clear to us that they did not intend to offer relief under a provision for which very few or no products would qualify, but at this point they are unwilling to opine on whether various stable value fund features would cause a product to fail to qualify for the grandfather provision.

Short-Term Fund Relief – Although the DOL did not choose to extend unlimited QDIA status to principal preservation vehicles, these vehicles were given short-term QDIA status. The regulation provides that a participant's account may be defaulted into a principal preservation vehicle for not more than 120 days after the participant's first elective contribution (as determined under section 414 of the Code). However, assets defaulted into a principal preservation vehicle for this purpose must be moved into one of the other QDIA vehicles before the 120-day period ends in order to continue to qualify for relief. The DOL explained that this rule was intended to ease plan administration since the Code generally permits participants to opt out of automatic enrollment within 90 days and receive a return of their funds free of certain taxes. For this purpose, the principal preservation product must seek to maintain principal and provide a reasonable rate of return, whether or not guaranteed, and be offered by a regulated financial institution.

Based on conversations with the DOL, the DOL intended that this limited duration QDIA would be available only in the context of automatic enrollment and only where the plan offers participants the opportunity to make a permissible withdrawal from the plan. Accordingly, absent further guidance from the DOL, this short-term QDIA could not be used for plan transitions or for undirected IRA rollovers. Further, the DOL has told us that it purposefully used the same definition that was used in its automatic rollover regulations, and those regulations may provide additional guidance as to the types of investment products that may qualify.

C. Investment Manager or RIC Requirement

The proposed rule contained a requirement that a QDIA must either be (1) managed by an investment manager under section 3(38) of ERISA, or (2) a registered investment company. The DOL received a number of comments asking that this requirement be extended to other products. Plan sponsors requested that they be permitted to manage their own default asset allocations. Members of the banking industry asked for clarification that bank collective funds could qualify as QDIA vehicles notwithstanding the bank's status as a plan trustee. They argued this clarification was necessary because parenthetical language in section 3(38) provides that a fiduciary *other* *than a trustee* or named fiduciary may serve as an investment manager. In addition, the insurance industry asked for clarification that investments made in separate accounts under group annuity contracts, or in other pooled investment vehicles, could qualify for QDIA status as long as the conditions of the regulation were satisfied.

The final regulation significantly broadens the range of entities that may be responsible for the management of a QDIA. Specifically, the final regulation provides that a QDIA must be either (1) managed by an ERISA section 3(38) manager, a trustee of a plan that meets the requirements of section 3(38)(A), (B) and (C), or a plan sponsor who is a named fiduciary, (2) a registered investment company, or (3) one of the principal preservation vehicles entitled to limited QDIA status. In addition, 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 and management decisions affecting the vehicle is the entity that must meet the specified requirements.

One technical issue that arises from DOL's language is that a product managed by a named fiduciary may only qualify if the named fiduciary is a plan sponsor. We know that many plans name a committee or corporate officer, not the plan sponsor, as the plan's named fiduciary. Under the technical language of the final regulation, it appears that an investment allocation managed by a fiduciary committee could not qualify as a QDIA. Nonetheless, given the scope of relief available through the regulation, we question whether using a named fiduciary-managed QDIA would result in meaningful fiduciary relief for the named fiduciary.

D. <u>Preemption</u>

The PPA added a new preemption provision to ERISA for automatic enrollment arrangements. New section 514(e) of ERISA contains a preemption provision that broadly preempts any state laws that would directly or indirectly restrict a plan from offering an automatic contribution arrangement. On its face, section 514(e) requires that contributions are invested consistent with all conditions of DOL's default regulations in order for preemption to apply. In response to comments requesting clarification of the preemption rule, the regulation contains a specific preemption provision that is broader in scope than section 514(e)'s preemption rule. The regulation clarifies that any state laws that would inhibit automatic contribution arrangements under ERISA plans are preempted regardless of whether the plan's default investment fund qualifies as a QDIA or whether the other conditions of the default regulation are met. The preemption rule also clarifies that the notice requirement of section 514(e) will be satisfied by a notice that meets the requirements of the final default regulations.

E. Disclosure Requirement

The proposed regulation contained a broad disclosure rule that could have required participants whose accounts were invested by default to receive greater information than participants who provide affirmative investment instructions under section 404(c) plans. In addition, the proposed rule arguably would have required plans to be amended to describe the disclosure rights of defaulted participants.

The DOL relaxed the disclosure rule in the final regulations, making it clear that participants whose account balances are invested by default are entitled to the same disclosures that must be provided in connection with affirmative participant instructions under 404(c) plans. In addition, DOL has clarified to us orally that disclosures required to be provided to default investors must be provided in the same manner that 404(c) regulations require (meaning, certain disclosures must be provided automatically, such as prospectus', and other disclosure are required only upon request). DOL comments in the preamble make clear that these disclosures may be provided directly to the participant by the provider of the investment alternative or by a third party. In addition, the DOL eliminated the problematic language that appeared to require plan terms to describe the disclosure rights of defaulted participants.

F. Notice Requirement

Both the statute and the regulations require that participants be provided a notice that describes certain fundamental information about the plan's default investment option. The notice must describe the default investment, its fees and risk and return characteristics, the circumstances under which a participant's account will be invested in the default investment, an explanation of the circumstances under which elective contributions will be made on behalf of the participant and the percentage, an explanation of the right to direct the investment of account assets to any other investment alternative under the plan, and an explanation of where participants can obtain information about the plan's other investment alternatives.

The proposed regulation requires the notice to be provided at least 30 days before the participant's first investment in the QDIA and annually thereafter. A number of commenters asked the DOL to relax the notice-timing rule to accommodate immediate participation plans, or those plans that allow participation on the first day of employment. The DOL accommodated these requests by allowing the notice to be provided as late as on a participant's eligibility date for plans that allow participants to make a permissive withdrawal within the first 90 days of employment under tax Code rules. DOL has made clear to us that a plan that does not allow permissive withdrawals would not be able to provide notice as late on the eligibility date and obtain fiduciary relief in connection with investments made within 30 days of the participant's eligibility.

The preamble clarifies that the DOL does not view information provided in an SPD or SMM as satisfying the notice requirements of the regulation. Nonetheless, language in the preamble suggests that notices may be provided with other regularly provided disclosures as long as QDIA information is provided on a separate sheet.

G. Transition Issues

1. Availability of Relief in Transitions:

A number of commenters on the proposed regulation asked the DOL for guidance as to how to transition previously defaulted investments into investments that would meet the requirements of the regulation. They asked how to ensure that a plan's current default investment that meets the requirements of the regulation could be treated as a QDIA as soon as possible after the regulation becomes effective. They also asked what steps should be taken in transferring previously defaulted amounts from a non-QDIA to a QDIA vehicle once the regulations are in effect.

In this regard, a number of commenters pointed out that transitioning existing defaulted amounts into a QDIA would pose particular problems where plans are unable to distinguish defaulted participants in a particular investment fund from those participants who affirmatively elected the fund. The DOL gave significant help to plan sponsors faced with these issues when it stated that a participant or beneficiary can be treated as failing to give investment instructions without regard to whether the participant elected to be in plan's current default investment when he or she fails to respond to a QDIA notice. Nonetheless, the DOL made clear that in order for any investments in a QDIA to qualify for fiduciary relief, whether moved from a non-QDIA or those investments that are in a current qualifying default fund, a notice must be provided and the participant or beneficiary must fail to respond to the notice after the effective date of the regulations, or after December 24, 2007.

The grandfather rule for stable value funds is also a critically important transition rule. It permits a plan that previously defaulted participants into a stable value fund to leave contributions made prior to December 24, 2007 in the stable value fund, and receive relief in connection with those investments, as long as a participant is provided a notice that complies with the regulation and fails to respond after December 24, 2007. Importantly, as discussed above, the stable value fund must meet certain requirements in order for the grandfather rule to apply.

2. Timing of Relief in Transitions:

It is clear from our conversations with the DOL that, at least with respect to new contributions, DOL intended for relief under section 404(c)(5) to be available beginning 30 days after a notice is provided meeting the content requirements of the regulation. It is also clear that the DOL intended that the regulation could be used to achieve relief for existing assets, or assets already invested in the plan's default fund. However, with respect to relief for existing assets that are not moved as a result of designating a new default fund, it is not entirely clear how and when relief becomes effective. This is because notices are generally required to be provided at least 30 days in advance of a "first investment" in a QDIA, and a first investment in the case of existing assets would have been made in the past. Therefore, it is not entirely clear from DOL's final regulation exactly when relief is effective with respect to existing assets after a QDIA notice has been provided and, specifically, whether a plan fiduciary will have relief in the first 30 days after providing a notice. We understand from conversations with DOL staff members that the DOL will address this issue shortly in Q&As.

H. **Fee Restrictions**

The final regulation contains a broad prohibition on the imposition of transfer or withdrawal fees in connection with withdrawals from the QDIA. Specifically, it provides that no fees, restrictions or expenses may be imposed on any transfer or permissible withdrawal from a QDIA within the 90-day period beginning on the participant's first elective contribution as determined under section 414 of the Code or other first investment in a QDIA. The regulation specifically provides that this precludes the imposition of any surrender charges, liquidation, exchange or redemption fees or similar expenses in connection with the liquidation of or transfer from a QDIA. Certain ongoing management fees, or fees that are not triggered by transfers or withdrawals, may be charged against participants in the QDIA at any time, including investment management fees, distribution or services fees, 12b-1 fees, legal, accounting, transfer agent or other fees. Also, following the end of the 90-day period, transfer or withdrawal fees or restrictions may be imposed as long as they would be charged against participants who affirmatively chose to invest in the QDIA.

There are a number of ambiguities regarding the regulation's fee transfer or withdrawal fee restrictions. First, it is unclear whether and how these restrictions apply to a grandfathered stable value fund or other fund for which a sponsor seeks relief prospectively. Because the fee restrictions apply in the 90-day period following an investor's first investment or elective contribution under section 414 of the Code, it is unclear whether these restrictions apply to a grandfathered vehicle and, if so, how the restricted time period is measured. Second, it is unclear whether certain restrictions imposed by stable value funds, such as surrender charges for employer-initiated withdrawals or equity wash restrictions, could apply to a grandfathered vehicle. Thirdly, it is unclear whether any transfer or withdrawal fees could be paid by a third party, such as the employer or a service provider, during the 90-day restricted period.