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DOL Issues Default Investment Rules

The Department of Labor ("DOL") has issued proposed regulations implementing the default investment provisions of the Pension Protection Act of 2006, Public Law 109-280 ("PPA"). 71 Fed. Reg. 56806 (Sept. 27, 2006). The regulations, when finalized, would provide fiduciary relief to plan sponsors and other fiduciaries who invest participant account balances in certain "qualified default investment alternatives" – including most lifecycle and balanced funds – and meet other conditions described in the regulations. Importantly, the fiduciary relief available under the regulation applies to individual account plans whether or not they meet the requirements of ERISA section 404(c) regulations. The regulations should encourage plans to offer so-called "automatic enrollment features" that automatically effect 401(k) payroll deductions for employees, unless they affirmatively opt out of participation. The regulations would also pave the way for fiduciaries to use default investment options and obtain relief in plan transitions, such as a change in the plan's administrative services provider. Comments are due by November 13. The regulations will be final 60 days following the publication of the final regulation.

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 other reasons, have not provided 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. The statute requires the DOL to issue final regulations by February of 2007. ERISA section 404(c)(5) is effective beginning with 2007 plan years.

Scope of Relief

According to DOL, the proposed regulation is potentially available where participant directions are lacking due to auto-enrollment as well as "any other failure of a participant or beneficiary to provide investment instructions." 71 Fed. Reg. at 56806 n.5. This would include the participant's failure to provide instructions following the elimination of an investment alternative or a change in service provider (a "conversion") or following a rollover from another plan. (To the extent that a fiduciary wishes instead to "map" to "reasonably similar" investment alternatives in the case of a conversion, new section 404(c)(4) of ERISA should provide relief.)

Fiduciaries that meet the requirements of the regulation would not be liable for losses that result from the investment of the participant's account balance in a qualified default investment alternative or for investment decisions made by the manager of the investment alternative. Nonetheless, like any other investment option, fiduciaries would 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 that manage qualified default investment options would remain subject to applicable fiduciary standards. DOL did note that, in choosing a default option, a plan fiduciary would be required to "carefully consider investment fees and expenses" and that relative fees and expenses of possible options should be "an important consideration" in selecting among them. 71 Fed. Reg. at 56808.

Importantly, the DOL interprets ERISA section 404(c)(5) as providing relief regardless of whether the plan meets all of the detailed requirements of section 404(c) regulations. As a result, fiduciaries of non-404(c) plans may qualify for 404(c)-like fiduciary relief in connection with default investments, but not with respect to investment decisions affirmatively made by plan participants (although a recent 7th Circuit case suggests that 404(c)-like relief in connection with affirmative participant instructions may be available without meeting the strict requirements of 404(c) regulations). See Jenkins v. Yager, 2006 WL 956944 (7th Cir. Apr. 14, 2006).

Qualified Investment Products and Services

Plan fiduciaries must meet a number of conditions in order to qualify for relief. Chief among them, plan assets must be invested in a "qualified default investment alternative." A qualified default investment alternative:

- May not hold employer securities, except if the investment alternative is a registered investment company, 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 and the manager has authority to dispose of the securities;

- May not impose penalties or restrict the ability of a participant to transfer out of the investment alternative;

- Must be (1) a registered investment company under the Investment Company Act of 1940, or (2) managed by an investment manager meeting the requirements of ERISA section 3(38);

- Must be diversified so as to minimize the risk of large losses; and

- Must qualify as a one of the three type of investment products or services as described in the regulation, summarized below.

The relief provided by the regulation is conditioned on the use of one of three types of investment products or services. With regard to choosing an appropriate default option, the DOL acknowledged that the only relevant information that plan fiduciaries may have regarding a participant who fails to provide investment instructions is the participant's age. 71 Fed. Reg. at 56810. Accordingly, none of the permissible default investments require the plan or manager to take into account other factors that could affect retirement asset allocations such as risk tolerance, other assets, level of income, or lifestyle preferences.

The first type of "qualified" default option is a fund or portfolio designed to provide varying degrees of long-term capital appreciation and capital preservation based on a participant's age, retirement date or life expectancy. This could be a stand-alone product or a "fund of funds" comprised of various investment options available under the plan. Examples include "life cycle" or "retirement date" funds. A participant's account would be invested in the appropriate fund or portfolio based solely on the participant's age, life expectancy or retirement date.

The second type of "qualified" default option is a single default option for all plan participants. This option is described as an investment fund or model portfolio 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 plan as a whole. According to DOL, an example of such an option may be a balanced fund. Like the first option, it could be a stand-alone investment product or a fund of funds utilizing other options otherwise available under the plan.

Finally, a plan could select an investment management service through which a professional investment manager allocates the assets of a participant's account among equity and fixed income investments based solely on the participant's age, life expectancy or target retirement date.

Significantly, DOL specifically rejected the use of capital preservation investment products such as stable value and money market funds as qualified default investment options, stating that those investments would be unlikely to generate a sufficient rate of return to provide adequate retirement savings for participants. Interestingly, the Department has specifically blessed the use of these investment products in other contexts, such as for automatic rollovers and for investing certain missing participant account balances. See 29 C.F.R. § 2550.404a-2; Field Assistance Bulletin 2004-02 (Sept. 30, 2004). The omission of stable value products is surprising since many plans currently use them as default options.

Proposed Additional Conditions for Relief

- A fiduciary may invest a participant's assets in a default option only after the participant has been given the opportunity to direct the investment of the assets in his or her account and fails to do so.

- Plan terms must provide that any material provided to the plan relating to a participant's investment in a qualified default investment alternative (e.g., prospectuses, proxies, account statements) will be provided to the participant or beneficiary. (It is unclear why the plan document itself should have to address such matters.)

- A participant must be able to transfer out of the default investment option without financial penalty on the same terms as any other investment option, and at least as frequently as once within any three-month period.

- The plan must offer a broad range of investment options consistent with the requirements of ERISA section 404(c) regulations.

- The plan must provide a notice to participants at least 30 days before the first plan investment under the regulation and before the beginning of each subsequent plan year. The notice must describe the default option, the circumstances under which plan accounts will be invested in the default option, and the participant's rights with respect to directing assets to other options under the plan. (These notice requirements and the requirements of Code section 401(k)(13)(E), relating to auto-enrollment, could likely be met in a single notice.)

Observations

The DOL proposal goes a long way to filling a major gap in ERISA's fiduciary framework for defined contribution plans. An accompanying DOL fact sheet estimates that aggregate 401(k) plan account balances will measure between $45 billion and $90 billion (over what period is not stated). Other steps the DOL – or plan sponsors – can take to remedy participant inertia in managing their plan accounts remain to be developed.