

Employee Benefits Attorneys

Donald J. Christl
Thomas E. Funk
Jeffrey R. Fuller
Mary A. Brauer
Steven D. Huff
Anne W. Reed
Kristin M. Bergstrom
Denise P. Goergen
Bennett E. Choice
John E. Mossberg
Gail M. Olsen
William H. Tobin
Philip R. O'Brien
Gregory A. Storm
Keith L. Johnson
Todd W. Martin
Susan U. Ladwig
Erin E. Margerie
Sarah A. Huck
Lucas J. Pagels
Rebecca E. Greene
Carolyn M. McAllister
Daniel R. Peterson
Alicia R. Mohn

Paralegals

Ellen L. Heib
Colleen McGuire Schmitz
Donna L. Paulsen
Mary Ellen Raney
Jeanne Scherkenbach
Laurie Matthews
Tammy Taddey
Pamela Lyons
Jennifer Tatarek

1000 North Water Street
P.O. Box 2965
Milwaukee, WI 53201-2965
414-298-1000
800-553-6215

22 East Mifflin Street
P.O. Box 2018
Madison, WI 53701-2018
608-229-2200
800-728-6239

N16W23250 Stone Ridge Drive
Waukesha, WI 53188
262-951-4500
800-928-5529

2215 Perrygreen Way
Rockford, IL 61107
815-633-5300
800-840-5420

www.reinhartlaw.com

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DOL Issues Regulations on Fiduciary Safe Harbor for Qualified Default Investment Alternatives

The Department of Labor ("DOL") issued its final regulations implementing the fiduciary safe harbor for default investments, which was added to ERISA by the Pension Protection Act of 2006. The final regulations, published on October 24, 2007, finalize the proposed regulations released September 27, 2006 and consider the more than 120 public comments sent to the DOL.

BACKGROUND

ERISA section 404(c) provides plan fiduciaries protection from liability for investment decisions made by a qualified plan participant who "exercises control" over his or her account. No protection was available when an employer invested an account in a default fund because a participant failed to make an investment decision. Typically, plan fiduciaries utilized a default fund with very low risk, resulting in a minimal return on investment. The new regulations aim to encourage plan fiduciaries to choose a default fund that is a more profitable investment alternative by releasing them from liability if the fund satisfies the regulation's requirements for a Qualified Default Investment Alternative ("QDIA"). The QDIA rules are also intended to promote automatic enrollment in 401(k) plans.

SUMMARY OF THE FINAL REGULATIONS

In order to qualify for fiduciary relief, plans must meet six conditions that are detailed in the final regulations.

1. **Assets Must Be Invested in a QDIA.** First, any default investments must be allocated on behalf of participants or beneficiaries to a QDIA. A QDIA must be one of four specific categories of investment alternatives:

- An investment fund or product with a mix of equity and fixed income exposure that takes into account the individual's age, retirement date or life expectancy (for example, a life-cycle or target-retirement fund);
- An investment fund or product that allocates individual participant accounts between a mix of equity and fixed income exposures offered as plan options to provide an asset mix that also takes into account the individual's age and retirement date in making that allocation, such as a professionally managed account;
- An investment product with a mix of equity or fixed income investments that takes into account the characteristics of a group of employees as a whole, such as a balanced fund; or
- A capital preservation product, such as a money market fund, but only for the first 120 days following the date of an employee's first elective contribution under a plan. Prior to the end of the 120-day period, the participant's investment must be directed to one of the other three QDIA categories. In addition, stable value funds are "grandfathered" for all default investments made prior to December 24, 2007. This provision is intended to assist plan fiduciaries who are limited by the terms of an investment contract from unilaterally reinvesting assets on behalf of defaulted participants.

A QDIA must be managed by a registered investment manager, a mutual fund family or bank trust department or a named fiduciary under the plan, in the case of large plan sponsors with an in-house investment management service. A QDIA may also be available under variable annuity contracts and other pooled investment vehicles. Generally, an investment in employer securities will not be an acceptable QDIA, but a regulated pooled investment vehicle or a mutual fund can hold employer securities as part of a diversified portfolio.

2. Participants Must Have Had Opportunity to Direct the Investment. A second condition required by the regulations is that the participant or beneficiary must have had the opportunity to direct how to invest the funds but failed to do so. Upon this failure to direct, the fiduciary may utilize the QDIA process.

3. Transfers Out of QDIA Must be Available at Least Quarterly Without Financial Penalty. Participants and beneficiaries in a QDIA must be allowed to transfer QDIA funds (in whole or in part) to any other available investment alternative with the same frequency provided to elected investments. Transfers must be permitted at least quarterly. No restrictions, fees or expenses (other than fees charged on an ongoing basis, such as investment management, 12b-1 fees and administrative-type fees) may be imposed on transferring assets from the QDIA for the first 90 days of a participant's investment in the QDIA. For instance, this precludes the assessment of a surrender charge, liquidation or exchange fee, any market value adjustment or "round trip" restriction on the ability of the participant to reinvest within a specified period of time.

Fees and expenses charged after 90 days cannot be any greater for QDIA participants than those applied to participants who make affirmative investment elections. Once a participant makes an affirmative election to transfer any assets in a QDIA to another investment vehicle, the participant is considered to have made an affirmative election to leave the remainder of the assets in the QDIA. The participant is then no longer deemed to be invested in a QDIA.

4. Initial and Annual Notice Must be Provided. Participants or beneficiaries must receive notice of the QDIA at designated times. An initial notice must be provided at least 30 days before the date of plan eligibility or before the first QDIA investment. It can be provided on or before the date of plan eligibility as long as plan participants are allowed 90 days to make a "permitted withdrawal" from the default account (in accordance with Internal Revenue Code § 414(w)). Subsequent annual notices must be sent within a reasonable period of time of at least 30 days in advance of each subsequent plan year.

The final regulations do not permit the notice to be included within a summary plan description or a summary of material modification. However, notices can be sent in the same mailing as other documents, including quarterly statements or annual enrollment notices. In addition, plans that already have to provide automatic enrollment notices or 401(k) safe harbor notices can combine these notices with the annual QDIA notice. The notice can be provided electronically. The DOL is not publishing a model notice because each notice will need to be individualized, but it will explore doing so in the future.

The DOL imposes specific requirements on the content of the notice. The notice generally must describe: (a) the circumstances under which assets in the individual account may be invested in a QDIA; (b) the QDIA option and how it operates; (c) the right of the participants and beneficiaries whose assets are invested in a QDIA to direct the investment of those assets to any other investment alternative; and (d) how the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

5. Investment Materials (e.g., Prospectuses) for QDIA Must be Provided. The fiduciary must provide material relating to a participant's or beneficiary's investment in a QDIA (as specified in 404(c)). For example, a prospectus or proxy voting materials may be required

and can be sent directly from the provider to the participant.

6. A Broad Range of Investment Alternatives Must be Available. The final condition is that plan participants must be given the opportunity to invest in a broad range of investment alternatives. The standard of section 404(c) of ERISA satisfies this objective. This range should achieve a diverse portfolio with risk and return characteristics within the range typically appropriate for the participant or beneficiary.

SAFE HARBOR

The final regulations confirm that the QDIA rules are not intended to be the exclusive means for fiduciaries to satisfy their responsibilities under ERISA with respect to the investment of assets on behalf of a participant or beneficiary who fails to give investment directions. Plan fiduciaries "must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate" and "must carefully consider investment fees and expenses" when choosing a QDIA.

ACTION PLAN FOR PLAN SPONSORS

The final regulations are effective December 24, 2007. In order to take advantage of the fiduciary relief offered under the final regulations, plan sponsors may want to consider the following actions:

1. Review your plan's current investment alternatives and determine whether an existing alternative satisfies the requirements of a QDIA, or whether a new investment alternative will need to be offered. Document the process for the fiduciary choice of the QDIA, including the consideration of the quality of competing providers and investment products as well as the consideration of investment fees and expenses, as appropriate.
2. Draft the plan's QDIA notice. Reinhart can assist plan sponsors in preparing or reviewing notices.
3. Provide the notice as soon as possible. If plan assets are already held in an investment fund which satisfies the requirements for a QDIA, relief is available as of the December 24, 2007 effective date of the regulations if the notice is provided no later than November 24, 2007. If notice is provided after that date, relief will be available 30 days after the notice. In order to have the initial notice also qualify as the plan's annual notice for all of 2008, notice must be provided no later than December 1, 2007.
4. If necessary, transfer defaulted plan assets to the QDIA as soon as possible, but no later than December 24, 2007 to obtain immediate relief. If defaulted investments have been deposited into a stable value or money market fund that will no longer be the plan's default fund, direct any new defaulted investments into the QDIA as soon as possible.
5. If the plan will continue to deposit defaulted funds into a stable value or money market fund for the first 120 days of participation, determine the QDIA to which the funds will be transferred before the end of the 120 days if participants do not opt out of the plan or make an affirmative investment election.
6. Review the plan's annual notice procedures and possible default circumstances to be certain of compliance with the new rules. This may be an appropriate time for plan sponsors who have not previously incorporated automatic enrollment or default investment options into their plan structure to consider the use of these plan features. The QDIA rules are also a reminder to plan sponsors to periodically review the plan's overall compliance with ERISA 404(c).

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