The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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DOL Issues Final Regulation on Qualified Default Investment Alternatives

[21886]

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TO: PENSION MEMBERS No. 60-07
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 30-07
INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 33-07 RE: DOL ISSUES FINAL REGULATION ON QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

The Department of Labor has released a final regulation on qualified default investment alternatives (QDIAs) in participant-directed individual account plans for situations where the participant fails to provide investment direction. [1] The final regulation largely follows the proposed regulation, but includes various modifications requested by the Institute and other interested parties. [2] Despite several comments from insurers requesting that the Department include stable value funds on equal footing in the list of QDIAs, the Department retained the three general types of investments described in its proposal – target date funds or portfolios, balanced funds or portfolios, and managed accounts. The Department diverged from the proposal by allowing capital preservation products such as money market and stable value funds to be used for the first 120 days after a participant's first elective contribution. The Department also provided limited grandfather treatment to assets already invested by default in stable value products prior to the effective date of the final regulation. The regulation is effective December 24, 2007.

Guidance on default investment arrangements is required under section 404(c)(5) of ERISA, as amended by the Pension Protection Act of 2006. Section 404(c)(5) provides fiduciary protection for plan sponsors who, in the absence of an investment election by the participant, invest assets in accordance with the Department's regulation. Although the regulation is issued under section 404(c), the guidance extends to plans that do not meet the requirements of the Department's pre-existing 404(c) regulation. In addition, the fiduciary relief is not limited to the investment of assets pursuant to an automatic enrollment program. Like the proposal, the final rule provides that QDIAs may be used in situations such as the elimination of an investment option, change of service provider, rollover from another plan, or any other time when the participant has an opportunity to

direct the investment of assets in his or her account, but fails to do so. The final regulation clarifies that the fiduciary relief applies without regard to which type of QDIA the employer selects – any one of the general types of QDIAs would be appropriate and the employer does not need to evaluate which of the QDIAs would be most appropriate. [3]

In addition to the limited QDIA status for capital preservation products and grandfathering for prior investment in stable value funds, other notable changes from the proposed regulation include:

- Expanding QDIA status to investments managed by a plan trustee or a plan sponsor who is a named fiduciary;
- Allowing the advance notice requirement to be satisfied by providing notice on or before plan eligibility for participants who are permitted to make permissible withdrawals under Code section 414(w);
- Broadening the financial penalty restriction to preclude imposition of any fee or restriction upon movement out of the QDIA within the first 90 days;
- Clarification that ERISA preemption of state laws that would otherwise prevent automatic enrollment still applies if the plan sponsor chooses a default investment that is not a QDIA.

Conditions for Fiduciary Relief

The final regulation contains generally the same conditions for obtaining fiduciary relief under section 404(c)(1) as the proposal.

1. Assets must be invested in a "qualified default investment alternative" as described below.

2. The participant [4] must have had the opportunity to direct the investment of the assets in his or her account, but did not do so.

3. The participant must be furnished a notice at least 30 days in advance of the date of planeligibility or at least 30 days in advance of any first investment in a QDIA. As an alternative, and in response to comments from the Institute and others regarding the difficulty of providing 30-day advance notice in plans with immediate eligibility, the Department provided a special rule for participants able to take a permissible withdrawal within 90 days of being automatically enrolled – in that case, the notice may be furnished on or before the date of plan eligibility. Like the proposal, annual notice must be provided at least 30 days in advance of each subsequent plan year. The Department clarified that, for plans that, prior to the regulations, invested assets on behalf of participants in a default investment that would constitute a QDIA, fiduciary relief would be available beginning with the first investment to which relief is intended to apply (provided the advance notice requirement is satisfied and regardless of whether the participant was defaulted into that option or affirmatively elected to invest in that option). [5]

4. Material relating to a participant's investment in a QDIA and required to be provided under 29 C.F.R. 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix) and 29 C.F.R. 2550.404c–1(b)(2)(i)(B)(2) must be provided to the participant. [6] This is a modification of the proposal, which generally required furnishing any material provided to the plan relating to a participant's investment in a QDIA, such as account statements, prospectuses, and proxy voting material. In the final rule, the Department

also eliminated the confusing phrase “under the terms of the plan,” noting that many comments suggested a misinterpretation that the disclosure requirements had to be included in the terms of the plan document.

5. The participant must be able to transfer assets invested in a QDIA to any other investment option available under the plan, without financial penalty and with a frequency consistent with that afforded to a participant who affirmatively elected to invest in the default option, but not less frequently than once every three-month period. The Department rejected comments from the Institute and others requesting clarification that investment-level fees and restrictions, such as redemption fees, sales loads, market timing restrictions, surrender charges, and equity wash restrictions, would not be impermissible because these restrictions and charges are imposed independent of the plan sponsor and apply to any participant. Instead, the final regulation prohibits any restrictions, fees or expenses on the transfer or withdrawal of assets out of the QDIA during the 90-day period beginning on the date of the participant’s first elective contribution or other first investment in the QDIA. [7] After the expiration of the 90-day period, otherwise applicable fees and restrictions are permissible. [8]

6. The plan must offer a "broad range of investment alternatives" within the meaning of 29 C.F.R. 2550.404c-1(b)(3), the standard in the existing section 404(c) regulations. [9]

Qualified Default Investment Alternative

The final regulation defines a QDIA as an investment that:

1. Does not hold or permit the acquisition of employer securities (except employer securities held by a mutual fund or other pooled investment vehicle regulated by a federal or state agency and with respect to which the investment is made in accordance with the stated investment objectives of the vehicle and independent of the plan sponsor or its affiliate and employer securities held in a managed account and acquired as a matching contribution or prior to management of the account by the investment manager);

2. Satisfies the prohibition against financial penalties or other restrictions on the ability of a participant to transfer his or her assets from the QDIA to any other investment option under the plan, as described above under Conditions for Fiduciary Relief;

3. Is either (1) managed by an investment manager (as defined under ERISA section 3(38)), a plan trustee meeting the requirements of ERISA section 3(38)(A), (B), and (C), or a plan sponsor who is a named fiduciary, or (2) an investment company registered under the Investment Company Act of 1940. In addition, certain capital preservation products qualify for QDIA status on a limited basis as described below. The Institute urged the Department to include investments managed by plan sponsors, so that model portfolios or asset allocation models developed by plan sponsors (either with or without help from an adviser or consultant) could serve as QDIAs. The Department noted in the preamble that plan sponsors who are named fiduciaries may engage consultants or use allocation models (computer-based or otherwise) to carry out their investment management responsibilities.

4. Constitutes one of the following types of investment products:

- An investment fund product or model portfolio that is diversified so as to minimize the risk of large losses and 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 (such as normal retirement date under the plan), or life expectancy. The product's investment allocation will change over time to become more conservative with increasing age. The product is not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of this type of QDIA is a lifecycle or target-retirement date fund.

- An investment fund product or model portfolio that is diversified so as to minimize the risk of large losses and 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 participants in the plan as a whole. The product is not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of this type of QDIA is a balanced fund. [10] Despite the Institute's recommendation to eliminate the requirement to monitor participant demographics in connection with maintaining a balanced fund default, the Department reiterated its view that plan fiduciaries must monitor a balanced fund QDIA in light of plan demographics (i.e., the age of the participant population). [11]

- An investment management service with respect to which either an investment manager (under ERISA section 3(38)), a plan trustee, or a plan sponsor who is a named fiduciary, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment options available under the plan, based on the participant's age, target retirement date, or life expectancy. The portfolio must be diversified so as to minimize the risk of large losses and its investment allocation will change over time to become more conservative with increasing age. The asset allocation decisions are not required to take into account risk tolerances, investments, or other preferences of an individual participant.

- For the first 120 days after the date of a participant's first elective contribution only, [12] an investment product or fund offered by a State or federally regulated financial institution, that is designed to preserve principal and provide a reasonable rate of return consistent with liquidity and that seeks to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product. The Department noted that the description and standards for this type of investment are similar to the standards adopted for purposes of automatic rollovers of mandatory distributions at 29 C.F.R. 2550.404a-2.

- For assets invested prior to the effective date of the final regulation only, a stable value fund – described as an investment fund or product designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, while providing liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives. The product may not have fees or surrender charges imposed in connection with withdrawals initiated by a participant or beneficiary and the principal and rates of return must be guaranteed by a State or federally regulated financial institution. This provides limited grandfather treatment to assets already invested in a stable value default prior

to the regulation. For contributions made after the effective date, one of the other QDIAs must be used in order to get the fiduciary relief provided by the regulation.

In response to comments, the Department confirmed that QDIAs can include products offered through annuity contracts, common and collective trust funds or other pooled investment funds, assuming that the other QDIA criteria are met. The availability of annuity purchase rights, death benefit guarantees, investment guarantees or other common features of variable annuity contracts do not by themselves affect the QDIA status of a product.

As in the proposed regulation, the Department specified that the rule is not intended to imply that use of an investment alternative not identified as a QDIA would be imprudent for a given participant. [13] In addition, the Department confirmed that capital preservation vehicles can play a role in comprising the mix of equity and fixed income exposures within a QDIA.

Notice Requirement

The notice required under the final regulation must be written in a manner calculated to be understood by the average plan participant and must contain the following information:

1. A description of the circumstances under which the participant's assets may be invested on behalf of the participant in a QDIA; and if applicable, an explanation of the circumstances under which elective deferrals will be made on behalf of the participant, the applicable percentage, and the right to opt out or elect a different percentage.
2. An explanation of the right of participants to direct the investment of assets in their individual accounts.
3. A description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative.
4. A description of the participant's right to direct investment of the assets out of a QDIA to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer.
5. An explanation of where participants can obtain investment information concerning the other investment alternatives available under the plan.

Unlike the proposed rule, the final regulation does not permit the notice to be provided as part of a summary plan description or summary of material modification, so as to minimize the chances that a participant will overlook information regarding default investments. On the other hand, the preamble to the final regulation clarifies that the initial and annual QDIA notices may be distributed along with other materials being furnished to participants and beneficiaries. The final rule continues to allow the QDIA notice and the Pension Protection Act’s automatic enrollment safe harbor notice to be satisfied in a single document. [14] The final rule also is designed to satisfy the notice requirements under the preemption provision of ERISA section 514. Significantly, the Department stated in the preamble to the final rule that until further guidance is released, plans may satisfy the notice requirement electronically by relying on either the Department’s regulation at 29 C.F.R. 2520.104b-1(c) or the Treasury Regulation at 26 C.F.R. 1.401(a)-21.

Other Issues

The Department stated in the preamble that investment direction by a participant with respect to a portion of his or her account balance may be treated as an affirmative decision to retain the remainder of the account balance as currently invested, which would allow the plan to treat the participant's entire account balance as directed by the participant and no longer invested by default.

After requesting comments on whether regulation would be helpful in addressing the preemption provision added by section 902 of the Pension Protection Act [15] relating to automatic contribution arrangements, the Department specified in the final regulation that the preemption afforded under this provision is available for any plan that includes an automatic contribution arrangement, regardless of whether the plan complies with the QDIA regulation.

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endnotes

[1] The final regulation is available at http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf. A fact sheet is available at http://www.dol.gov/ebsa/newsroom/fsQDIA.html.

[2] See Memorandum to Pension Members No. 60-06 [20422], dated September 28, 2006; Memorandum to Pension Members No. 67-06 [20574], dated November 14, 2006.

[3] Like the proposal, however, the final regulation does not provide relief from the general fiduciary duties associated with selecting and monitoring a default investment alternative, or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. The preamble to the final regulation states that, as with other investment alternatives available under the plan, fiduciaries must carefully consider fees and expenses when choosing a default investment.

[4] The rules also would apply to default investments made on behalf of a beneficiary. For ease of reference, this memorandum generally refers only to participants.

[5] Notice provided prior to the effective date of the final regulation would satisfy the notice requirement, provided that the notice otherwise complies with the final regulation.

[6] By incorporating these provisions by reference, any future changes made to the disclosure requirements under the section 404(c) regulation will extend to this regulation automatically.

[7] The rule provides that this prohibition does not extend to ongoing fees charged for the operation of the investment itself, such as investment management fees, distribution and/or service fees, 12b-1 fees, or legal, accounting, transfer agent and similar administrative expenses, so long as the fees do not vary based on the participant's decision to transfer or withdraw assets out of the QDIA.

[8] According to the preamble, for a transfer or withdrawal election made within the 90-day

period, the prohibition remains in effect even if the actual transfer or withdrawal is delayed due to administrative or other delay.

[9] Under section 2550.404c-1(b)(3), in relevant part, "[a] plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to: (A) Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; (B) Choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics; (3) which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio …"

[10] The Department noted in the preamble that a lifestyle fund could possibly fall into the balanced fund category.

[11] In the preamble's discussion of balanced funds, the Department stated that fiduciaries would take into account the diversification of the portfolio, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to funding objectives of the plan, and the fees and expenses attendant to the investment.

[12] The Department stated in the preamble that in order to avail itself of the relief afforded by the regulation, the plan fiduciary must redirect the participant's investment in the capital preservation product to another qualified default investment alternative prior to the end of the 120-day period.

[13] The Department recognized that under certain circumstances, money market funds, stable value products, and the like may be a prudent investment.

[14] The Department did not include a model notice, but stated that it will explore the concept of model language in the future in coordination with the Department of Treasury concerning the automatic enrollment safe harbor notice.

[15] ERISA section 514(e) provides that title I of ERISA shall supersede any State law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement.