MEMO# 20423

September 28, 2006

# Department of Labor Proposes Regulation on Default Investment Alternatives; Conference Call Scheduled for October 10, 2006

 URGENT/ACTION REQUESTED [20423] September 28, 2006 TO: PENSION COMMITTEE No. 32-06 PENSION OPERATIONS ADVISORY COMMITTEE No. 31-06 RE: DEPARTMENT OF LABOR PROPOSES REGULATION ON DEFAULT INVESTMENT ALTERNATIVES; CONFERENCE CALL SCHEDULED FOR OCTOBER 10, 2006 The Department of Labor has issued a proposed regulation regarding appropriate default investments in participant-directed individual account plans for situations where the participant fails to give investment direction.1 The regulation is proposed to be effective 60 days after the date of publication of the final rule in the Federal Register. Comments on the proposed regulation are due by November 13, 2006 – only 45 days after publication of the proposal. We have scheduled a conference call for Tuesday, October 10, 2006 at 2:00 pm ET to discuss the proposed guidance and the Institute's comment letter. If you would like to participate in this call, please complete the attached response form and fax it to Brenda Turner at 202/326-5841 or e-mail it to bturner@ici.org by noon Tuesday, October 10. To participate in the call, please dial 1-800-369-1120 and enter passcode 30323. The proposed guidance comes on the heels of the Pension Protection Act of 2006, which amended ERISA section 404(c) to provide relief under section 404(c)(1) to fiduciaries that invest individual account plan assets in certain default investment alternatives.2 Under new section 404(c)(5) of ERISA, a participant is treated as exercising control over the assets in his or her account with respect to assets invested in a default investment alternative in accordance with regulations prescribed by the 1 The proposed regulation is available at http://www.dol.gov/ebsa/regs/fedreg/proposed/2006008282.pdf. A fact sheet is available at http://www.dol.gov/ebsa/newsroom/fsdefaultoptionproposalrevision.html. 2 See Memorandum to Pension Members No. 48-06, Federal Legislation Members No. 5-06, and 529 Plan Members No. 13- 06 [20250], dated August 4, 2006. The Pension Protection Act requires the Department to issue final regulations under section 404(c)(5)(A) within six months of the date of enactment. Although the Department began work on the guidance well before passage of the Pension Protection Act, the proposed regulation is designed to meet the requirements of the Act. 2 Department.3 Importantly, the Department noted that the Pension Protection Act provision does not condition its relief on compliance with the existing 404(c) regulation. Therefore, although issued under section 404(c), the proposed guidance would extend to plans that do not meet the requirements of the Department's regulation under section 404(c). The proposal takes into account several Institute recommendations made to the Department over the past year.4 Significantly, the guidance is not limited to the investment of assets pursuant to an automatic enrollment program. According to the proposal, other circumstances where default investments nay be used in the absence of participant direction include elimination of an investment option, change of service provider, rollover from another plan, or when a participant simply neglects to provide investment direction after enrolling in the plan. Conditions for Fiduciary Relief The proposed rule contains six conditions for obtaining fiduciary relief under section 404(c)(1). 1. Assets must be invested in a "qualified default investment alternative" ("QDIA"), as described below. 2. The participant5 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, as described below, at least 30 days in advance of the first investment in a QDIA and at least 30 days in advance of each subsequent plan year. 4. Any material provided to the plan relating to a participant's investment in a QDIA, such as account statements, prospectuses, and proxy voting material, must be provided to the participant or beneficiary. 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, consistent with the terms of the plan, but not less frequently than once per any three-month period. The proposal states that this condition is not intended to confer greater rights on participants whose accounts are invested by default in a QDIA than are otherwise available under the plan with respect to the timing of investment directions. This provision appears to be consistent with the Institute’s 3 The proposed rule would 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. 4 See, e.g., Memorandum to Pension Members No. 37-05 [19138], dated September 7, 2005. 5 The rules also would apply to default investments made on behalf of a beneficiary. 3 recommendation that participants whose accounts are invested under a plan’s default investment provision should be permitted to change their investment allocation pursuant to normally applicable plan and investment-level rules. 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.6 Qualified Default Investment Alternative The proposed 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. Does not impose financial penalties or otherwise restrict the ability of a participant to transfer his or her assets from the QDIA to any other investment option under the plan; 3. Is either managed by an investment manager (as defined under ERISA section 3(38)) or an investment company registered under the Investment Company Act of 1940. 4. Is diversified so as to minimize the risk of large losses; and 5. Constitutes one of the following types of investment products: • A "life-cycle" or "targeted-retirement date" fund or account that is a fund or model portfolio 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. 6 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…” 4 • A "balanced" fund that is a 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 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. The Department’s proposal with respect to balanced funds is largely consistent with the Institute’s recommendations. • A “managed account” that is an investment management service with respect to which an investment manager 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's 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. Although model portfolios are specifically mentioned in the proposed regulation, the requirement that a non-mutual fund QDIA be managed by an investment manager who is a fiduciary under ERISA would exclude situations where a model portfolio is created by an adviser who is registered under the Investment Advisers Act of 1940 but is not a plan fiduciary. The Institute had recommended to the Department alternatives for addressing its concerns in this area that would maintain competitive equality among asset managers and provide flexibility for plan sponsors. As recommended by the Institute, 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.7 Notice Requirement The notice required under the proposed 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. 2. 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. 7 The Department recognized that under certain circumstances, money market funds, stable value products, and the like may be a prudent investment. 5 3. 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, without financial penalty. 4. An explanation of where the participants can obtain investment information concerning the other investment alternatives available under the plan. The notice may be provided as part of a summary plan description, summary of material modification, or other notice. The Department also noted that this notice requirement and the notice requirement under the Pension Protection Act’s automatic enrollment safe harbor rule could be satisfied in a single notice. Elena Barone Assistant Counsel Attachment (in .pdf format)