

Qualified Default Investment Alternatives for Participant-Directed Individual Account Plans

November 20, 2007

The Pension Protection Act of 2006 (the PPA) added Section 404(c)(5) to the Employee Retirement Income Security Act of 1974, as amended (ERISA), effective for plan years beginning after December 31, 2006, which provides that a participant in a participant-directed individual account plan will be deemed to have exercised control over assets in his or her account if, in the absence of investment directions from the participant, the plan invests the assets in a qualified default investment alternative (QDIA). On October 24, 2007, the Department of Labor (DOL) issued final regulations that provide guidance with respect to QDIAs under such plans. A plan fiduciary that complies with the final regulations will not be liable for any loss, or by reason of any breach, that results from investments in a QDIA. The final regulations will be effective as of December 24, 2007.

The QDIA structure was introduced in large part to encourage automatic enrollment in 401(k)-type plans. According to a DOL Fact Sheet issued last month, approximately one-third of eligible employees do not participate in their employers' 401(k)-type plans, and studies suggest that automatic enrollment plans (in which employees "opt out" of plan participation rather than "opt in") could increase participation rates to more than 90%, significantly increasing retirement savings. By facilitating the adoption of automatic enrollment plans, and by encouraging investments appropriate for long-term retirement savings, the DOL estimates the provision will result in between \$70 billion and \$134 billion in additional retirement savings by 2034. While the regulations are not limited to automatic enrollment situations, the regulations provide greater certainty with respect to automatic enrollment programs and help alleviate employer fears about legal liability for market fluctuations.

General QDIA Requirements

Relief from fiduciary liability for investment outcomes in a QDIA under the final regulations is conditioned on the satisfaction of the following six conditions:

1. The assets must be invested in a QDIA.
2. The participant or beneficiary must have had the opportunity to direct the investment of the assets, but have not done so.
3. A notice must be provided to the participant or beneficiary (a) (i) at least 30 days in advance of the date of plan eligibility or at least 30 days in advance of the date of any first

investment in a QDIA; or (ii) on or before the date of plan eligibility, provided the participant has the opportunity to make a permissible withdrawal under section 414(w) of the Internal Revenue Code of 1986, as amended (the Code), and (b) within a reasonable period of time at least 30 days in advance of each subsequent plan year.

4. A plan fiduciary must provide the participant or beneficiary any material provided to the plan relating to a participant's or beneficiary's investment in a QDIA (e.g., account statements; prospectuses; voting rules, where applicable; descriptions of operating expenses, lists of assets comprising the portfolio of the QDIA).
5. (a) The participant or beneficiary must be allowed, with the same frequency that is applicable to other investment choices (but not less frequently than once every three months) to transfer, in whole or in part, his or her QDIA assets to another investment alternative available under the plan (e.g., if transfers are permitted daily, transfers under the QDIA must be allowed daily);

(b) During the 90-day period beginning on the date of the participant's first elective contribution or other first investment in a QDIA, the participant must not be subject to any restrictions, fees, or expenses (including surrender charges, liquidation or exchange fees, redemption fees, and similar expenses, but not including fees and expenses that are charged on an ongoing basis 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 agent expenses). Thereafter, such restrictions, fees, and expenses may be imposed to the extent imposed on participants who have affirmatively elected that investment alternative.
6. The plan must offer participants and beneficiaries the opportunity to invest outside the QDIA in a broad range of investment alternatives as defined in the DOL's regulation under section 404(c) of ERISA.

As mentioned above, the application of the final regulations is not limited to an automatic enrollment situation, but can apply in any situation in which a participant has the right to direct investment and does not do so, including changes in investment alternatives, changes in service providers, and rollovers where the participant does not provide investment direction. The fiduciary protection provided by the final regulations also extends to a plan that does not otherwise qualify as an ERISA section 404(c) plan (which provides fiduciary relief for participant-directed individual account plans if various conditions are met).

Types of Investment Alternatives

For purposes of the final regulations, a QDIA means an investment alternative that meets the following requirements:

- It does not hold or permit the acquisition of employer securities (except for two limited exceptions discussed below).

- It does not impose financial penalties (except as described in condition 5 above) or otherwise restrict the ability of a participant or beneficiary to transfer, in whole or in part, his or her investment from the QDIA to any other investment alternative under the plan
- It is:
 - managed by (i) an investment manager within the meaning of section 3(38) of ERISA; (ii) a trustee of the plan that meets the requirements of sections 3(38)(A), (B), and (C) of ERISA; or (iii) the plan sponsor who is a named fiduciary within the meaning of section 402(a)(2) of ERISA; or
 - an investment company registered under the Investment Company Act of 1940; or
 - an investment product or fund designed to preserve principal and provide a reasonable rate of return or to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds.
- It is one of the following:
 - *A life-cycle or targeted-retirement-date fund*—which applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and is 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, or life expectancy.
 - *A balanced fund*—which applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and is 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 of the plan as a whole.

Note: Balanced funds look at the plan’s entire population and do not provide for automatic adjustment as the plan population shifts. Thus balanced funds can require more monitoring by the plan fiduciaries than a life-cycle or targeted-retirement-date fund.
 - *A managed fund*—which is an investment management service where the fiduciary applies generally accepted investment theories and allocates the assets to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income exposures, offered through the investment alternatives available under the plan, based on the participant’s age, target retirement date, or life expectancy.
 - *A stable value fund (limited capital preservation option)*—which is designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, and which seeks to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product. This option constitutes a QDIA for no more than 120 days following the participant’s first elective contribution (this is

the period of time when employees are most likely to opt out of plan participation and the stable value fund provides for a new risk-free investment alternative without loss of principal during such time period).

- *A grandfathered stable value fund*—a stable value fund used as a default prior to December 24, 2007 will be a QDIA for investments made prior to that date.

Note: In order for the stable value fund to qualify as a grandfathered QDIA it has to provide a guarantee (by a state or federally regulated financial institution) of the principal and rates of return consistent with that earned by intermediate investment grade bonds while providing liquidity for withdrawals. In addition, there can be no fees or surrender charges imposed in connection with withdrawals initiated by the participant.

A plan is permitted to have more than one QDIA, and the plan fiduciaries are not required to determine which type of approved QDIA is the most prudent QDIA choice for the plan participants.

Notice Requirements

The final regulations provide detailed instructions on what must be included in the notice required to obtain fiduciary protection for the QDIA. In order to aid plan sponsors in meeting this notice requirement, the Internal Revenue Service issued a sample automatic enrollment and default investment notice that the DOL has specifically stated will satisfy the notice requirements of §404(c)(5) and the final regulations. (The sample notice can be found at http://www.irs.gov/pub/irs-tege/sample_notice.pdf.)

Pursuant to the final regulations, the notice required must be written in a manner to be understood by the average plan participant and must be separate from the plan's summary plan description and summary of material modifications, but it can be included with the notices required by Code section 401(k)(13)(E) and section 414(w)(4) (automatic contribution arrangements and permissive withdrawal notices). The DOL has stated, however, that the notice cannot be combined with the traditional safe harbor notice.

The notice must contain the following information:

- The circumstances under which assets of the participant may be invested in the QDIA
- An explanation of the participants' right to direct the investment of assets in their accounts
- A description of the QDIA, including investment objectives, risk and return characteristics, and fees and expenses
- A description of the participant's right to transfer amounts from the QDIA to other investment alternatives, including any restrictions, fees, and expenses associated with the transfer
- An explanation of where participants can obtain investment information concerning other investment alternatives

Satisfying the notice requirement under ERISA section 404(c)(5) will also satisfy the notice requirements of ERISA section 514, which provides that ERISA will preempt any state law that would directly or indirectly prohibit or restrict a plan's use of an automatic contribution arrangement.

Employer Stock

QDIAs are generally not allowed to hold or permit the acquisition of employer securities. However, a QDIA may permit employer securities held or acquired by an investment company registered under the Investment Company Act or a similar pooled investment if the investment in employer securities is made in accordance with the stated investment objectives of the QDIA and independent of the plan sponsor. In addition, a managed fund may hold employer securities acquired as a matching contribution or employer securities acquired prior to management by the investment management service to the extent the investment management service has discretionary authority over the disposition of the employer securities. If the matching contributions are subject to restrictions on transferability, relief under the final regulations with respect to the securities will not be available until the investment management service has an unrestricted right to transfer the securities. While the investment management service would have responsibility to decide whether and to what extent to continue to hold the employer securities, it can not, except as part of an investment company or similar pooled investment vehicle, exercise its discretion to acquire additional employer securities.

Transition Issues

There has been some question as to the status of existing default alternatives and how to transition into a QDIA from a noncompliant default investment.

The final regulations provide relief with respect to participants and beneficiaries who received notice in accordance with the final regulations and who did not give investment directions to the plan after the effective date of the regulations. However, the notice requirements may be met by providing notice before December 24, 2007. If notice is not provided by November 24, 2007 or is not provided at least 30 days before plan eligibility for a participant's first elective contribution, the fiduciary may receive relief under the final regulations once the notice has been provided for any contributions made after the requirements of the final regulations have been met. In addition, if a participant invested in the QDIA does not receive the required notice, the plan fiduciaries will not lose section 404(c) protection with respect to other participants in the plan; they would lose it only with respect to the participant who did not receive the notice until such time as the participant did receive the required notice.

The DOL has provided that existing or new default investments will constitute a QDIA with respect to both existing assets and new contributions if the plan fiduciaries meet the requirements of the final regulations including the notice requirements without regard to whether the participant was defaulted in the investment or elected to invest in the original default investment.

Note: The final regulations were not clear, however, on the extent of this relief. Addressing this question with respect to future changes to investment vehicles, a DOL spokesperson stated that a plan sponsor may always treat amounts in an account as defaulted into the investment vehicle (whether or not the participant previously elected the investment vehicle), if notice is provided to the investment participants that unless the plan sponsor hears back from the participant, the amounts held in the account will be placed in a new default investment.

The DOL is working on further guidance with respect to QDIAs in the form of Q&As. Stay tuned.

For further information about the issues raised in this Morgan Lewis LawFlash, please contact your Morgan Lewis attorney or any of the following:

Chicago

Brian D. Hector 312.324.1160 bhector@morganlewis.com

Dallas

Riva T. Johnson 214.466.4107 riva.johnson@morganlewis.com
Heath Miller 214.466.4118 hmillier@morganlewis.com

New York

Craig A. Bitman 212.309.7190 cbitman@morganlewis.com

Philadelphia

Robert L. Abramowitz 215.963.4811 rabramowitz@morganlewis.com
I. Lee Falk 215.963.5616 ilfalk@morganlewis.com
Vivian S. McCardell 215.963.5810 vmccardell@morganlewis.com
Mark J. Simons 215.963.5992 msimons@morganlewis.com
Steven D. Spencer 215.963.5714 sspencer@morganlewis.com
Marianne R. Yudes 215.963.5490 myudes@morganlewis.com
David B. Zelikoff 215.963.5360 dzelikoff@morganlewis.com

Pittsburgh

John G. Ferreira 412.560.3350 jferreira@morganlewis.com
Lauren Bradbury Licastro 412.560.3383 llicastro@morganlewis.com
R. Randall Tracht 412.560.3352 rtracht@morganlewis.com

San Francisco

Eva P. McComas 415.442.1249 emccomas@morganlewis.com

Washington, D.C.

Althea R. Day 202.739.5366 aday@morganlewis.com
Margery Sinder Friedman 202.739.5120 mfriedman@morganlewis.com
Stuart P. Kasiskie 202.739.6368 skasiskie@morganlewis.com
Daniel R. Kleinman 202.739.5143 dkleinman@morganlewis.com
Gregory L. Needles 202.739.5448 gneedles@morganlewis.com

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