

Client Alert

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for clients
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Department of Labor Issues Final Regulations on Qualified Default Investment Alternatives

On October 24, 2007, the Department of Labor (“DOL”) issued final regulations on the use of qualified default investment alternatives (“QDIA”) in defined contribution plans that allow for participant directed investments. The final regulations implement Section 404(c)(5) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), which was added under the Pension Protection Act of 2006 (the “PPA”) by providing “safe harbor” relief under ERISA for plan fiduciaries in situations in which participants fail to provide investment directions.

The final regulations relieve plan fiduciaries for liability from any loss that occurs as a result of investment in a QDIA, provided that the plan fiduciaries remain responsible for the prudent selection and monitoring of the QDIA. The relief is intended to be the same as that otherwise provided under an ERISA 404(c) plan, and is generally available where a participant has the opportunity, but fails, to direct the investment of his or her account. While the final regulations set forth the guidelines by which a fiduciary may invest such assets and qualify for the QDIA safe harbor relief, it is not intended for these guidelines to be the exclusive means by which fiduciaries might satisfy their responsibilities under ERISA with respect to the investment of plan assets of participants who fail to give direction on how to invest their assets.

The final regulations generally follow the proposed regulations, which were described in the Proskauer Rose LLP Client Alert issued in October 2006 (which can be found at http://www.proskauer.com/news_publications/client_alerts/content/2006_10_05/res/id=sa_PDF/13220-100306-Department%20of%20Labor%20

Proposed%20Regulations-v2-ca.pdf), with a few notable clarifications. These clarifications include: (i) expanding the list of permitted managers for a QDIA to include certain plan trustees (such as bank trustees of collective investment funds) and plan sponsors that are denominated as named fiduciaries; (ii) confirming that there is no obligation to select the most prudent QDIA (as opposed to a QDIA) available for the applicable plan as long as the alternative is prudently selected; (iii) expanding the notice and disclosure requirements that must be followed (e.g., the final regulations eliminated the provision allowing certain notices to be provided through the SPD); and (iv) providing more detail on the requirement that participants be able to transfer out of the QDIA without financial penalty.

Importantly, the final regulations also reaffirm the provision in the proposed regulations that capital preservation and stable value investments do not qualify as a QDIA, although they may comprise a component of a QDIA investment portfolio or represent a prudent investment or default choice in certain situations (without the benefit of safe harbor status under Section 404(c)(5)). The final regulations however, provide a limited exception to this rule by expanding the definition of the term QDIA to include: (i) an investment in a capital preservation product or stable value fund for not more than 120 days after the date of the participant’s first elective contribution and (ii) for purposes of investments made prior to December 24, 2007, a stable value fund that a plan may have utilized as a default investment.

Definition of a QDIA

The final regulations provide that a QDIA includes three categories of diversified investment funds or alternatives, as set forth below:

- *Target Retirement Date or Lifestyle Fund*, an investment fund, product or model portfolio that 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. These types of investments may be “life-

cycle” or “targeted-retirement-date” funds, and may be a “stand alone” product or a “fund of funds” comprised of various investment options otherwise available under the plan for participant investments (with the attendant risk levels changing to become more conservative with the increasing age of the participant);

- *Balanced Fund*, an investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a targeted level of risk appropriate for participants of the plan as a whole. Relevant considerations may change over time, which could engender the need to change the QDIA. This type of investment could be accomplished through a balanced fund, and may be a “stand alone” product or “fund of funds” comprised of various investment options otherwise available under the plan. This alternative requires a fiduciary to take into account the demographics of the plan’s participants, which must include the age of the participant population (and which may, but need not, consider other factors relevant to the participant population);
- *Professionally Managed Account*, an investment management service where 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 alternatives available under the plan, based on the participant’s age, target retirement date or life expectancy. Such portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative with increasing age. An example of such a service may be a “managed account.”

While the final regulations reaffirm the controversial provision in the proposed regulations, that a capital preservation or stable value fund cannot serve as a QDIA, a new provision permits the use of a capital preservation or stable value option (meeting certain requirements) as a QDIA with respect to investments made in such products or funds prior to the effective date of the final regulations (December 24, 2007). In addition, the final regulations provide that a money market or stable value fund qualifies as a QDIA for the first 120 days in which it holds plan assets invested by fiduciaries on a participant’s behalf.

Generally, a QDIA may not include employer securities unless held in a mutual fund or a similar pooled investment vehicle where the securities are made in accordance with prescribed investment objectives and independent of the plan sponsor.

Notice Requirements

In order for a fiduciary to receive the benefit of fiduciary relief, the plan must provide both an initial notice and an annual notice.

The information to be included in the notices including, among other things: (i) a description of the QDIA; (ii) the circumstances under which a participant’s account assets may be invested in a QDIA; (iii) the participant’s right to direct the investment of assets from the QDIA to any other investment alternative under the plan, including a description of any restrictions, fees, or expenses in connection with such transfer; (iv) where the participant may obtain information about the other investment alternatives; and (v) an explanation of the right of participants to direct the investment of assets in their individual accounts. A participant must be provided with notice at least 30 days prior to the date on which the participant is eligible to participate in the plan or the first investment in a QDIA and at least 30 days prior to each subsequent plan year.

Other Considerations

A few other important provisions in the final regulations include:

- The participants must have the opportunity to transfer any or all of their account assets to any other investment alternatives under the plan with a frequency consistent with that generally provided to plan participants, but no less frequently than once in any 3 month period.
- A plan may not impose any restrictions, fees or expenses (other than operational fees such as investment management and 12b-1, accounting and legal fees) during the first 90 days of a participant’s investment in the QDIA. Thus, during this 90-day period, the plan is precluded from imposing any surrender charge, liquidation or exchange fee, redemption fee, market value adjustment or “round-trip” restriction. However, once the 90-day period has expired, defaulted participants may be subject to the same restrictions, fee and expenses as other plan participants.
- A plan must offer a “broad range of investment alternatives” that is no more expansive than what is required under Section 404(c).
- Not all materials received by a plan relating to a participant’s QDIA investment, must be forwarded to the participant. Instead, the plan is required to forward such materials as is consistent with the pass-through requirements of Section 404(c).
- The required disclosures must be delivered through a separate notice, that for administrative purposes, may be included with other materials being furnished to participants. It is not sufficient, to include the disclosure solely in a summary plan description or summary of material modification.
- There are two additional optional notice delivery dates. A plan may now also provide a notice to a participant either (i) 30 days prior to his or her first investment in a QDIA or (ii)

on a participant's eligibility date, provided that the participant has the opportunity to make a permissible withdrawal within the 90-day period, beginning on the date of the participant's first elective contribution or other first investment in a QDIA.

Transitional Issues

The final regulations provide relief after the effective date for assets that were invested before the effective date in a default investment that qualifies as a QDIA, provided that the notice requirements of the final regulations are satisfied with respect to a plan participant on whose behalf the investment was made. In such a case, a participant is then treated as having failed to provide investment direction and fiduciary relief will apply prospectively to the investment.

Effective Date

While the final regulations are not effective until December 24, 2007, plan sponsors that comply with its annual notice requirement by December 1, 2007, can obtain fiduciary relief with respect to a QDIA investment made on a participant's behalf, on or after January 1, 2008.

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Client Alert

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