PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

October 2006

Department of Labor Proposed Regulations on Qualified Default Investment Alternatives

On September 27, 2006, the Department of Labor ("DOL") issued proposed regulations regarding qualified default investment alternatives ("QDIA") in defined contribution plans that allow for participant-directed investments. The proposed regulations would implement new 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"). The proposed regulations provide a "safe harbor" for plan fiduciaries that allows them to direct the investment of a participant's account assets in the event that the participant does not otherwise do so, such as where participant directions are lacking due to auto-enrollment, and protects them from decisions made by investment managers in connection with investments in QDIA.

The proposed regulations state that the standards set forth therein apply solely for the purpose of determining whether a fiduciary meets the requirements of the proposed regulations and are not intended to be the exclusive means by which a plan fiduciary might satisfy their responsibilities under ERISA with respect to the investment of plan assets.

Fiduciary Relief

The proposed regulations provide that under new Section 404(c)(5) of ERISA a participant of an individual account plan that allows participants to direct the investment of their account assets will be treated as exercising control over their account assets, and a plan fiduciary will be relieved of any liability, including liability for any resulting loss or by reason of any breach of ERISA, where the following requirements are met:

- the participant's account assets are invested in a QDIA;
- the participant had the opportunity, but did not, direct the investment of their account assets;
- a notice is provided to the participant within a reasonable period of at least 30 days prior to the first investment in a QDIA and within a reasonable period of at least 30 days prior to each subsequent plan year, with the following information:
    - a description of the circumstances under which a participant's account assets may be invested in a QDIA,
    - a description of the QDIA,
    - a description of a participant's right to direct the investment of assets from the QDIA to any other investment alternative under the plan without financial penalty,
    - an explanation of where a participant can obtain investment information about other investment alternatives under the plan;
- the participant is provided with any material provided to the plan relating to the participant's investment in the QDIA;
- in accordance with the plan, but no less frequently than once in any 3-month period, the participant may transfer any or all of their account assets to any other investment alternative under the plan without financial penalty; and

- the plan offers a "broad range of investment alternatives." [1]

The proposed regulations do not provide fiduciaries relief from any liability (including liability for any resulting loss) resulting from:

- a failure to prudently select and monitor QDIA's; and

- prohibited transactions under Section 406 of ERISA.

In addition, the proposed regulations do not provide relief to investment managers from their fiduciary duties under ERISA or any liability that results from a failure to satisfy their ERISA duties, including liability for any resulting loss.

Definition of QDIA.

The proposed regulations define a QDIA as an investment alternative that:

- does not hold or permit the acquisition of employer securities except where,

  - the employer securities are held or acquired by a registered investment company or a similar state or federally regulated pooled investment vehicle, and the securities are invested in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or its affiliates, or

  - with respect to a QDIA constituting an investment management service (as described below), the employer securities are acquired as a matching contribution from the employer/plan sponsor or are acquired by the participant prior to management of the account by the investment management service;

- does not impose financial penalties or otherwise restrict the participant from transferring their account assets to another investment alternative under the plan;

- is either managed by an investment manager (as defined in Section 3(38) of ERISA), or is a registered investment company under the Investment Company Act of 1940;

- is diversified to minimize the risk of large losses; and

- constitutes either:

  - a life-cycle or targeted-retirement-date fund designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based only on the participant's age, target retirement date or life expectancy, with the fund's risk levels becoming more conservative over time (i.e., decreasing risk of losses),

  - a balanced fund 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 plan participants as a whole, or

  - an investment management service in which an investment manager allocates an individual participant's account assets to achieve varying degrees of long-term appreciation and capital preservation through a mix of the equity and fixed income exposures offered through investment alternatives available under the plan based only on the participant's age, target retirement date or life expectancy, with the allocations becoming more conservative over time (i.e., decreasing risk of losses).

Comments; Effective Date.

The PPA requires the DOL to issue final regulations on Section 404(c)(5) of ERISA no later than February 17, 2007, effective for plan years beginning after December 31, 2006. Comments on the proposed regulations should be submitted to the DOL on or before November 13, 2006. The regulations will be effective 60 days after the date of publication of the final regulations in the Federal Register.

[1] In general, Labor Regulation 2550.404c-1(b)(3) provides that a plan offers a "broad range of investment alternatives" if the plan's investment alternatives are sufficient to provide participants with a reasonable opportunity to materially affect their return and degree of risk, choose from at least 3 diverse investment alternatives with different risk and return characteristics, and allows them to diversify their accounts so as to minimize the risk of large losses.

NEW YORK • LOS ANGELES • WASHINGTON
BOSTON • BOCA RATON • NEWARK
NEW ORLEANS • PARIS

Client Alert

The Employee Benefits and Executive Compensation Law Practice Group at Proskauer Rose LLP counsels clients on the full spectrum of benefit and compensation issues, communicating technical and complex legal concepts in an intelligible, pragmatic manner.

The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you might have:

Jacob I. Friedman
212.969.3256 – jfriedman@proskauer.com

Ira G. Bogner
212.969.3947 – ibogner@proskauer.com

Stephen I. Brecher
212.969.3733 – sbrecher@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.