

DOL Issues the Final QDIA Regulation

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The Pension Protection Act (PPA) added a new fiduciary protection to ERISA for default investments. Section 404(c)(5) provides that, in situations where participants have an opportunity to direct their investments but fail to do so, the fiduciaries will be entitled to a 404(c) defense if those participants are invested in a qualified default investment alternative (QDIA). This defense is being called a fiduciary “safe harbor.”

The PPA directed the Department of Labor (DOL) to issue regulations within six months defining the types of investments that will qualify as QDIAs. On October 24, 2007, over a year after a proposed regulation was published, the DOL issued the final regulation for QDIAs. This bulletin is the first in a series that analyze the regulation.

This bulletin provides an overview of the final regulation in a question-and-answer format. Our future bulletins will discuss specific issues related to the regulation, such as the notice requirements and the types of investments that qualify as QDIAs.

Q: Who does this regulation affect?

This regulation provides fiduciary protection for sponsors of participant-directed plans that default participants into investments when they fail to make an affirmative election. In addition, it benefits those participants by placing them in investments with appropriate mixes of equities and fixed income.

As stated in the preamble to the regulation: “This regulation will affect plan sponsors and fiduciaries of participant-directed individual account plans, the participants and beneficiaries in such plans, and the service-providers to such plans.”

Q: What does the final regulation do?

In effect, if the conditions of the regulation are satisfied, fiduciaries will not be liable for how defaulted participants are invested. As stated in the preamble to the final regulation: “A fiduciary of a plan that complies with this final regulation will not be liable for any loss, or by reason of any breach, that occurs as a result of such investments. ... Plan fiduciaries remain responsible for the prudent selection and monitoring of the qualified default investment alternative.”

Q: When is the regulation effective?

The preamble to the regulation provides that: “This final rule is effective on December 24, 2007.”

However, plan sponsors will feel the effect much sooner. For example, some QDIA notices must be provided as early as November 24th—a little over two weeks from now, in order to obtain the full protection offered by 404(c)(5) as of the effective date of the regulation.

Q: What is a default?

A default is where participants have an opportunity to direct their investments, but fail to do so.

The preamble to the regulation provides the following examples as situations where a participant might be defaulted, and further provides that, in any situation where a participant fails to provide investment instructions, fiduciaries may obtain the protections offered by the QDIA regulation: “The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant to provide investment instruction. Whenever a participant or beneficiary has the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation, so long as all of its conditions have been satisfied.”

Q: What is a default investment?

For participant-directed plans, fiduciaries are required to exercise independent discretion and judgment in investing the monies of those participants who do not direct their own investments. If the fiduciary selects a particular investment for that purpose — as they often do, it is commonly called the “default investment” or “default account.”

Fiduciaries have historically selected a single “default investment” for all of the defaulting participants in the plan. Stable value, money markets and balanced funds were frequently used as the default investment. However, since those were fiduciary selected—and not participant directed, the fiduciaries were legally responsible for prudently selecting and monitoring the use of the investment for the defaulted participant. (Having said that, though, we suspect that many of those fiduciaries were not aware that they were legally responsible at that level.)

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Some in the 401(k) and investment industries questioned whether money market funds and stable value vehicles were prudent investments, for long-term retirement purposes—particularly for young and mid-aged participants.

To improve investing for defaulted participants and to provide fiduciary protections for plan sponsors, Congress included the new 404(c)(5) defense in the PPA. In particular, this was motivated by concerns of plan sponsors that, if they adopted automatic enrollment, as many as 70%, 80% or more of their participants might default. However, the protections afforded by the QDIA fiduciary safe harbor are not limited to automatically enrolled plans.

Q: What is a qualified default investment alternative (QDIA)?

Generally, QDIA is a type of default investment that the regulation determines is appropriate for meeting a participant's needs for long-term retirement investing. However, the short-term QDIA and the grandfathered QDIA are exceptions to that general statement. (The five types of investments that “qualify” for QDIA status are discussed briefly later in this bulletin and more completely in a future bulletin.)

Q: What is the extent of the fiduciary protection?

A fiduciary that complies with the conditions in the regulation will not be liable for any loss or breach that occurs as a result of participants being defaulted in a QDIA. However, a fiduciary remains legally responsible for the prudent selection and monitoring of the QDIA. As the preamble to the regulation states: “However, the plan fiduciary must prudently select and monitor an investment fund, model portfolio, or investment service within any category of qualified default investment alternatives in accordance with ERISA’s general fiduciary rules.”

Q: Does the plan have to satisfy all the conditions under 404(c) to get the protections offered for a QDIA? In other words, does the plan have to comply with 404(c)?

No. The preamble to the final regulation specifically states that, “the relief afforded by section 404(c)(5), therefore, is not contingent on a plan being an ‘ERISA 404(c) plan’ or otherwise meeting the requirements of the Department’s regulations at section 2550.404(c)-1.” But, of course, the plan must satisfy the conditions in the 404(c)(5) regulation.

Q: What are the fiduciary’s duties for making a selection among the different types of QDIAs?

The regulation is clear that, when selecting among the available categories of investments that qualify as a QDIA, the fiduciary is free to select any of the categories. That is, the fiduciary gets a free pass on choosing the type of QDIA and does not have to evaluate which type would be best for participants. As the preamble to the regulation states, “The Department believes that each of these qualified default investment alternatives is appropriate for participants and beneficiaries who fail to provide investment direction; accordingly, the rule does not require a plan fiduciary

to undertake an evaluation as to which of the qualified default investment alternatives provided for in the regulation is the most prudent for a participant or the plan.”

However, as explained earlier, once a type of QDIA is chosen, the fiduciaries must engage in a prudent process to select the investments in that category to be used by the plan.

Q: What if a plan is already using a QDIA-type investment as a default, how does the plan get the protection after the effective date of the regulation?

If your plan is already using a QDIA-type investment as the default there is no need to change that investment; however, the plan will need to comply with the notice requirements in the final regulation. That means that notices that satisfy the conditions in the regulation must be provided to participants that are defaulted into that investment by November 24th. If notice is provided by November 24th or earlier, any existing amounts in the default accounts will become QDIAs on December 24th, and any amounts defaulted into that investment on December 24th or after will automatically be protected, so long as the other requirements of the regulation are met.

The preamble to the regulation addresses this situation and provides:

“A number of commenters raised issues concerning the status of existing default investments and transfers to default investments that would meet the requirements of the regulation. Specifically, commenters requested guidance on what steps should be taken to ensure that a plan’s current default investments, which also meet the requirements of the regulation, will be treated as qualified default investment alternatives after the effective date of the regulation...

“To ensure that an existing or a new default investment constitutes a qualified default investment alternative with respect to both existing assets and new contributions of participants or beneficiaries, plan fiduciaries must comply with the notice requirements of the regulation. It is the view of the Department that any participant or beneficiary, following receipt of a notice in accordance with the requirements of this regulation, may be treated as failing to give investment direction for purposes of paragraph (c)(2) of § 2550.404c-5, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle of the plan. Under such circumstances, and assuming all other conditions of the regulation are satisfied, fiduciaries would obtain relief with respect to investments on behalf of those participants and beneficiaries in existing or new default investments that constitute qualified default investment alternatives.”

Q: Is complying with this regulation the only way for fiduciaries to get the “safe harbor” protection?

In order to obtain the fiduciary safe harbor for default investments, plans must satisfy the conditions of the regulation. For example, if a fiduciary uses a QDIA-type investment, such as a suite of target maturity funds, as the plan default, but fails to give the notice

required by the regulation, the fiduciary will not receive the safe harbor protection. Nevertheless, in all likelihood that fiduciary would comply with his duties under 404(a), since it is likely that the target maturity funds will be prudent investments.

If another non-QDIA default investment is prudently used, fiduciaries may not have breached their duties. As the regulation states, “these standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under ERISA with respect to the investment of assets on behalf of a participant or beneficiary in an individual account plan who fails to give investment directions...The Department further notes that such investments, while not themselves qualified default investment alternatives for purposes of investments made following the effective date of this regulation, may nonetheless constitute part of the investment portfolio of a qualified default investment alternative.”

Of course, this means that the non-QDIA default investment must be prudent for investing for the accumulation of retirement benefits. If fiduciaries select a non-QDIA investment, they should document their decision-making process and be prepared to justify that decision. For example, in discussing stable value investments, the DOL stated: “It is the view of the Department that investments made on behalf of defaulted participants ought to and often will be long-term investments and that investment of defaulted participants’ contributions and earnings in money market and stable value funds will not over the long-term produce rates of return as favorable as those generated by products, portfolios and services included as qualified default investment alternatives, thereby decreasing the likelihood that participants invested in capital preservation products will have adequate retirement savings.”

Q: What are the conditions in the regulation for obtaining the fiduciary safe harbor?

The regulation conditions safe harbor relief on:

- Assets must be invested in a QDIA as defined in the regulation.
- Participants must have been given the opportunity to provide investment direction, but failed to do so.
- A notice must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. The notice must contain the information outlined in the regulation and must be given in advance of the investment in the QDIA. (The specific notice requirements, including content and timing, will be discussed in a separate bulletin.)
- Materials provided to the plan for the QDIA must be furnished to participants.
- Participants must have the opportunity to direct investments out of the QDIA as frequently as afforded to participants who affirmatively invested in the QDIA, but no less frequently than once in any three month period.
- Transfer fees or restrictions cannot be imposed upon a defaulted participant who opts out of the QDIA within 90 days of the first investment in the QDIA. This prohibition includes mutual fund redemption fees. (Note, a similar rule applies to withdrawals made within 90 days of the

first deferral under an automatically enrolled plan – where the plan allows for such withdrawals.) After the 90-day period, the default investment may be subject to the same transfer fees and restrictions that generally apply to all participants.

- The plan must offer a “broad range of investment alternatives” as that is defined in the existing regulation under section 404(c) of ERISA.

Q: What types of investments qualify as a QDIA under the regulation?

There are five types of investments that qualify as QDIAs. We have divided the five types of investments into three categories—long-term QDIAs, a short-term QDIA, and a grandfathered QDIA.

The short-term QDIA is a default into a money market account for not more than 120 days after the date of the first elective contribution for the defaulted participant. By the end of that 120-day period, the participant’s account must be transferred to one of the three long-term QDIAs in order to continue the fiduciary safe harbor. (Technically, the short-term QDIA is defined as an investment that seeks to maintain the dollar value that is equal to the amount invested, provides a reasonable rate of return, and is offered by a state or federally regulated financial institution. As a practical matter, we believe plans will use money market accounts or similar short-term vehicles for this purpose.)

The grandfathered QDIA is a stable value investment. The regulation defines it generally as a product “designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds.” (Note that there are additional limitations in the definition.) Defaults in this grandfathered option on the date the regulation was issued (October 24, 2007), plus any additional amounts that are deposited into the stable value option on or before December 23, 2007, will be grandfathered as a QDIA. However, to obtain fiduciary protection for deposits for those previously defaulted participants that are made after December 23, the new amounts must be placed in a long-term QDIA.

The long-term QDIAs are target maturity funds or models (*e.g.*, lifecycle or target date funds), balanced funds or models (including risk-based lifestyle funds) and managed accounts.

In a future bulletin, we will discuss each of these QDIAs in more detail.

Q: What must fiduciaries do after selecting a particular category or type of QDIA investment?

Once a fiduciary has identified the type of QDIA that will be used by the plan, the fiduciary must engage in a prudent process to select the particular investment fund, model portfolio or managed account service. In addition, the fiduciary must monitor that selection to ensure that it remains a prudent choice.

The preamble states the general rule regarding a fiduciary’s duties and provides an example to illustrate the application of those duties: “the plan fiduciary must prudently select and monitor an investment fund, model portfolio, or investment management service within any category of qualified default investment

alternatives in accordance with ERISA's general fiduciary rules. For example, a plan fiduciary that chooses an investment management service that is intended to comply with paragraph (e)(4)(iii) [the investment manager alternative] of the final regulation must undertake a careful evaluation to prudently select among different investment management services."

Similar standards would apply to other forms of QDIAs, for example, to the selection of a suite of target maturity funds.

Q: Were there any surprises in the regulation?

- **120-Day Short-Term Investment Option** – The money market QDIA – for the limited period of 120 days – was not in the proposed regulation. As a result, it was somewhat of a surprise. We assume it is primarily intended to coordinate with the provision in the Internal Revenue Code allowing automatically enrolled participants to request the withdrawal of their accounts within 90 days. However, it will also be helpful for avoiding transfer fees (*e.g.*, redemption fees) for withdrawals and transfers within the first 90 days.
- **Grandfathering for Stable Value** – The regulation provides for permanent QDIA protection for stable value defaults made before December 24, 2007. However, any defaults of deferrals, rollovers or company contributions for those previously defaulted participants after the effective date of the regulation must be put into a long-term QDIA to be protected. Undoubtedly, this is a concession to the insurance industry, which was concerned about the potential financial disruption that would be caused by large amounts of stable value investments being liquidated and moved to other QDIAs.
- **No Redemption Fees or Expenses** – The regulation provides that (a) any transfers or withdrawals within 90 days from the QDIA by a participant "shall not be subject to any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer, from the investment)...", but (b) that restriction "shall not apply to 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 expenses), and are not imposed, or do not vary, based on a participant's...decision to withdraw, sell or transfer assets out of the qualified default investment alternative..."

The proposed regulation had prohibited any penalties on transfers or withdrawals, without time limit. This limits any transfer fees or restrictions, but only for 90 days. As a result, plans need to determine whether their default investments impose redemption fees for short-term trading; if so, those investments will not be QDIAs and will not have the fiduciary safe harbor.

- **100% Equity Funds Are Not QDIAs** – The regulation provides "...the Department believes that when an investment is a default investment, the investment should provide for some level of capital preservation through fixed income investments. Accordingly, the final regulation, like the proposal, continues to require that the qualified default investment alternatives, defined in paragraph (e)(4)(i), (ii) and (iii), be designed to provide degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures." In other words, as we interpret it, for lifecycle, lifestyle or balanced funds, or managed accounts, to be QDIAs, they must have an allocation to fixed income. The unanswered question is whether a lifecycle, or target maturity, fund's "glidepath" to an allocation in fixed income satisfies this condition. This discussion also raises the issue of how much is enough? For example, is a 3% allocation to fixed income satisfactory for a 2050 fund? We have posed these questions to the DOL.
- **Asset Allocation Models** – The proposed regulation, in effect, required that asset allocation models be managed by a fiduciary investment manager. The final regulation changes that requirement and allows plan sponsors to manage the asset allocation models for participants, which is consistent with existing practices. This is a welcome "surprise." (As a disclosure, we commented to the DOL that this change should be made, as models are used successfully for many participants. Also, in large plans, the models incorporate the plans' low-cost funds – such as institutional shares and collective trusts, thereby substantially reducing the cost to the employees.)

Conclusion

The final regulation is a substantial improvement over the proposed regulation. However, many of the conditions are more complex than they initially appear to be and the notice requirements are both burdensome and a trap for the unwary.

Our future bulletins will delve into those issues more deeply.

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