

Investments That Qualify Under the Final QDIA Regulation

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This is the second in our series of bulletins on the final regulation on Qualified Default Investment Alternatives (“QDIAs”). Our first bulletin provided an outline of the regulation (<http://www.reish.com/publications/pdf/finalqdiareg.pdf>). This bulletin focuses on the types of investments that qualify as QDIAs.

Q1: What types of investments qualify as a QDIA under the regulation?

As discussed in the first bulletin, we divide the five types of investments that qualify as QDIAs into three categories—a short-term QDIA, a grandfathered QDIA and three long-term QDIAs.

Q2: What is a short-term QDIA?

The short-term QDIA is a default into a money market (or similar) account for not more than 120 days after the date of the first deferral for the defaulted participant. (Note that the regulation does not specifically use the term “money market account,” but the language in the regulation is the general definition of a money market account.) Before 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.

The regulation defines the short-term QDIA as follows:

“an investment product or fund designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. Such investment product shall for purposes of this paragraph (e)(4)(iv):

- (1) Seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product; and
- (2) Be offered by a State or federally regulated financial institution.

(B) An investment product described in this paragraph (e)(4)(iv) shall constitute a qualified default investment alternative for purposes of paragraph (e) of this section for not more than 120 days after the date of the participant’s first elective contribution (as determined under section 414(w)(2)(B) of the Code).”

COMMENT: Unlike the grandfathered QDIA (*see*, Question 5), there is no requirement that the short-term QDIA investment guarantee principal or interest, so it is different from a classic stable value investment. As mentioned above the definition in the regulation does not specifically use the term “money market account,” so to the extent another type of investment meets the short-term QDIA definition it qualifies.

For example, if a stable value investment satisfies the requirements, it qualifies as a short-term QDIA. But if there are transfer fees or restrictions imposed within the first 90 days this would pose a problem (remember that a condition for relief under the regulation is that no transfer restrictions or fees can be imposed at any point during the first 90 days). Additionally, if a stable value investment is used as a short-term QDIA and there are market value adjustments when the money is moved to the long-term QDIA between 90 to 120 days, this raises significant fiduciary issues.

Q3: Why would a plan sponsor use a short-term QDIA?

Under Internal Revenue Code section 414(w), automatically enrolled plans can allow employees to request a return of their contributions, adjusted for earnings or losses, within 90 days from their first deferral. (Note that the plan must be amended to allow for this.) For automatically enrolled plans, the short-term QDIA allows the plan sponsor to ensure that if an employee opts-out of participation within the first 90-days of enrollment that the employee’s account balance will be the same as his deferrals (plus interest). On the other hand, if the plan sponsor used a long-term QDIA and the market had a downturn, the participant’s contributions would suffer losses and only the diminished amount would be returned, possibly causing employee complaints.

In addition, if a plan has a long-term QDIA that has transfer fees or restrictions, a plan can couple that option with a money market fund to avoid the transfer fees or restrictions. That is, the plan can use the money market fund as a short-term QDIA for at least 90 days (but no more than 120 days) and then transfer the defaulted amounts to the long-term QDIA.

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Finally, a plan could also use a short-term QDIA where a participant-level investment manager wants to manage participant accounts, but the underlying funds have short-term redemption fees or, alternatively, where the plan uses an asset allocation model, but the underlying funds have redemption or other transfer fees. In other words, it might be used in a variety of situations where the imposition of transfer fees or restrictions on the underlying mutual funds or other investments would preclude QDIA status.

Q4: What is a grandfathered QDIA?

The grandfathered QDIA is a stable value investment. Defaults in this grandfathered option on the date the regulation was issued (October 24, 2007), plus any additional amounts that were deposited into the stable value option on or before December 23, 2007, can be grandfathered as a QDIA. However, to obtain fiduciary protection for deposits that are made after December 23, those amounts must be placed in a long-term QDIA. This means that even for participants who were defaulted prior to the effective date that their deposits of the December 23rd need to be placed in a long-term QDIA in order to get fiduciary protections for those deposits.

Q5: What investments qualify for grandfathering?

The QDIA regulation includes, as the preamble to the regulation states, “a ‘grandfather’-like provision pursuant to which stable value products and funds will constitute a qualified default investment alternative.” However, the definition of “stable value” in the regulation does not cover all of the types of investments that are called stable value in industry parlance. That is because the regulation requires that, to be a grandfathered QDIA, the investment must “guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds.” In many cases, the principal amounts are guaranteed; but the rate of return is not. In some cases, we have found that neither the principal nor the return is guaranteed. In both of those cases, the investment does not satisfy the definition in the regulation and, as a result, the retroactive fiduciary protections for the grandfathered QDIA are not available.

To make matters worse, some providers of non-eligible stable value products limit the ability of plan fiduciaries to transfer money from that investment. A number of people and organizations (ourselves included) have asked the DOL for further explanation and clarification about the definition of stable value in the regulation. For the moment, the best course of action for plans with non-eligible stable value products may be to wait until the DOL responds. We anticipate that the DOL will be giving soft, or informal, guidance in the next few months.

In situations where the protections for the grandfathered QDIA are not available, the fiduciaries have a difficult choice...do they switch the non-eligible stable value defaults to a long-term QDIA (and possibly incur market value adjustments or other charges) or do they run the risk of being sued for imprudently investing the participants’ money. In analyzing those alternatives, the fiduciaries should consider two DOL statements from the preamble:

“With regard to the possible assessment of market

value adjustments or similar withdrawal penalties that may result from a fiduciary’s decision to move assets to a qualified default investment alternative, the Department reminds fiduciaries that such decisions must be made in compliance with ERISA’s prudence and exclusive purpose requirements. These decisions cannot be based solely on a fiduciary’s desire to take advantage of the limited liability afforded by this regulation, without regard to the financial consequences to the plan’s participants and beneficiaries. In this regard, the Department notes that the final regulation does not change the status of an otherwise prudent default investment into an imprudent default investment.”

COMMENT: Thus, fiduciaries must follow ERISA’s prudence and exclusive purpose requirements in deciding whether or not to move assets from a current default investment that imposes a market value adjustment to a QDIA. This language in the preamble reminds fiduciaries that their decision (to move to a QDIA) cannot be based solely on their desire to take advantage of the relief provided by the regulation without regard to the financial consequences to participants.

“As a short-term investment, money market or stable value funds may not, in the Department’s view, significantly affect retirement savings. The Department recognizes, however, that such investments can, and in many instances will, play an important role as a component of a diversified portfolio that constitutes a qualified default investment alternative. 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.”

COMMENT: Since fiduciaries are charged with prudently selecting a default investment that is appropriate for participants in accumulating retirement benefits, this statement in the preamble is an indication that a 100% investment in a money market or stable value will often not, over the long-term, provide rates of return and, therefore, benefits as favorable as those that can be achieved through diversified portfolios including a number of asset classes.

Q6: How does the regulation describe the three types of long-term QDIAs?

For ease of discussion, we refer to the three long-term investment alternatives as age-based investments, balanced or risk-based investments, and managed accounts. However, the language of the regulation does not define the three investment alternatives by using those

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labels; instead, it provides detailed definitions of each type of QDIA and gives examples for each definition. While those examples are illustrative of an investment that meets the regulatory definition, the preamble to the regulation is careful to point out that each alternative is not limited to those particular investments:

“While the Department does provide examples of products, portfolios and services that would fall within the framework of the various definitions of products, portfolios and services set forth in the regulation, these examples are provided solely for the purpose of providing the benefits community with guidance as to what might be included within the defined categories and are not intended in any way to limit the application of the definitions to such vehicles.”

Q7: What are the three long-term QDIAs?

The long-term QDIAs are age-based funds or models (for example, lifecycle or target date funds), balanced or risk-based funds or models (including risk-based lifestyle funds) and managed accounts.

Q8: How does the regulation define the first alternative — the age-based QDIA?

The regulation provides that both a “targeted-retirement-date” or “lifecycle” fund are examples of the investments that fit within the first type of investment that qualifies as one of the long-term QDIAs. However, the definition in the regulation goes beyond that example:

“An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and 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 (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (*i.e.*, decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(i), asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant.”

While the most obvious examples are target maturity mutual funds and retirement date asset allocation model, the definition is broad enough to also include collective trusts, pooled funds, and other investments and services.

Q9: How does the regulation define the second alternative — the risk-based QDIA?

The example of the second type of long-term investment is commonly referred to as a balanced fund or model. The regulation defines the second alternative as follows:

“An investment fund product or model portfolio that applies generally accepted investment

theories is diversified so as to minimize the risk of large losses and that 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. For purposes of this paragraph (e)(4)(ii), asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant.”

Thus, an investment that targets a certain level of risk (e.g., moderate, conservative or aggressive), so long as it meets the other conditions in the regulation, would qualify as a long-term QDIA under this definition. That would include balanced funds and risk-based funds.

The regulation and the preamble are clear that, for the risk-based alternative, the plan must select a single QDIA investment as the default. And, the primary factor to be considered by the fiduciaries is the “level of risk appropriate for participants of the plan, as a whole.” While the fiduciaries may also take into account other factors, they are not required to do so. Specifically, the preamble to the regulation provides:

“The Department understands that the only information a plan fiduciary may know about its participant population is age. Thus, when determining a target level of risk appropriate for participants of a plan as a whole, a plan fiduciary is required to consider the age of the participant population. However, a plan fiduciary is not foreclosed from considering other factors relevant to the participant population, if the fiduciary so chooses.”

Q10: What is an “investment fund product” or a “model portfolio”?

The definitions of the first and second long-term investment alternatives use the language “investment fund product or model portfolio.” Although the regulation does not define the terms “investment fund product” or “model portfolio,” the preamble to the regulation provides some insight into the DOL’s use of that terminology: “the reference to ‘an investment fund product or model portfolio’ is intended to make clear that this alternative might be a ‘stand alone’ product or a ‘fund of funds’ comprised of various investment options otherwise available under the plan for participant investments.”

While this language clarifies that an investment fund product or model portfolio can be a stand alone product or fund of funds, it does little to clarify what the Department defines as a “product” or whether that term is used to limit the long-term investment alternatives to certain product types. The preamble to the regulation sheds some light, but falls short of providing a concrete definition, by stating:

“Consistent with providing flexibility and encouraging innovation in the development and offering of retirement products, model portfolios

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or services, the Department intends that the definition of “qualified default investment alternative” be construed to include products and portfolios offered through variable annuity and similar contracts, as well as through common and collective trust funds or other pooled investment funds, where the qualified default investment alternative satisfies all of the conditions of the regulation.”

COMMENT: We believe that any investment portfolio, made up of investments included in the plan, that otherwise satisfies the requirements in the regulation, would be a fund of funds. Because of the language in the preamble regarding flexibility, it is our belief that any investment portfolio that uses investments that are not otherwise available under the plan (regardless of whether it also includes some or all of the investments in the plan) would qualify as a stand alone fund. The DOL will be issuing additional guidance in the form of “Frequently Asked Questions” (FAQs) clarifying certain aspects of the QDIA regulation; we hope that the DOL FAQs will clarify this issue.

Q11: How does the regulation define the third alternative the managed account QDIA?

The example of the third type of long-term investment is a managed account. The regulation defines this alternative as follows:

“An investment management service with respect to which a fiduciary, within the meaning of (e)(3)(i) of this section, applying generally accepted investment theories, 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 (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (*i.e.*, decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(iii), asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant.”

COMMENT: The language in the regulation defines a “managed account” as one that allocates assets in participant accounts using “a mix of equity and fixed income exposures, offered through investment alternatives available under the plan.” Thus, the DOL limited the managed account option to use only those investment alternatives that are available under the plan. We are aware that some managed accounts do not limit themselves to the investment alternatives that are otherwise available under the plan. However, it appears that, in most cases, a managed account that includes investment options that are not otherwise available under the plan could satisfy

the definition of an age-based alternative, that is, the first long-term alternative (*see*, Questions 8 and 10).

Similar to the definition of the first long-term alternative, the managed account QDIA must be based on the participant’s age, target retirement date or life expectancy. In other words, a managed account alternative that was based only on a targeted level of risk would not qualify under this category unless it took into account the age of the participant by becoming more conservative over time. However, a managed account that is based on a targeted a level of risk could qualify under the second category as a risk-based QDIA (*see*, Question 9).

Q12: Does the fiduciary have to select the “best” QDIA?

The preamble to 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. 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, 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.”

COMMENT: Thus, 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. However, once the fiduciary selects a type of QDIA, the fiduciary must engage in a prudent process in selecting and monitoring the specific investment, model portfolio or managed account service.

Q13: Can employer securities be part of a QDIA?

Generally, no, a QDIA cannot invest directly in employer securities; however, there are two limited exceptions. The first exception is for employer securities acquired “passively” through mutual funds or similar pooled investment vehicles. The second exception is for managed account QDIAs and allows for employer securities that were acquired because of an employer matching contribution in employer securities or employer securities acquired, prior to management by the investment management service to the extent that the investment management service has discretionary authority over those assets.

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Q14: Does the QDIA have to be a mutual fund?

No, there is no requirement in the regulation that the QDIA be a mutual fund. But, if another type of investment or service (e.g., an asset allocation model or investment management) is used, it must either be managed by an investment manager (as defined under ERISA section 3(38)), a trustee of the plan that meets the requirements under ERISA section 3(38), or the plan sponsor who is a named fiduciary under ERISA section 402(a)(2).

Q15: Can a QDIA be offered through a variable annuity contract?

Yes. The regulation specifically provides that an investment fund or model portfolio that otherwise meets the requirement in either the first or second long-term alternatives is not precluded from being a QDIA if it is offered through other products. Specifically, the preamble to the regulation provides:

“The Department intends that the definition of “qualified default investment alternative” be construed to include products and portfolios offers through variable annuity and similar contracts, as well as through common and collective trust funds or other pooled investment funds, where the qualified default investment alternative satisfies all of the conditions of the regulation.”

Q16: Can a long-term QDIA be 100% invested in equities or fixed income?

No. The description of the all three alternatives similarly requires that each alternative apply “generally accepted investment theories” be diversified “so as to minimize the risk of large losses,” **and** provide “varying degrees of long-term appreciation and capital preservation **through a mix of equity and fixed income exposures.**” As such, any long-term QDIA cannot be 100% invested in equities nor can it be 100% invested in fixed income. The preamble states that the investment must have a fixed income component:

“One commenter inquired whether the Department intended to exclude funds that had no fixed income exposure, which, according to the commenter, might be appropriate for young individuals many years away from retirement. While the Department believes that such an investment option may be appropriate for individuals actively electing to direct their own investments,

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.”

COMMENT: The regulation does not define what is meant by “fixed income” nor does it provide what percentage of fixed income is sufficient to constitute a “mix of equity and fixed income.” For example, what if a QDIA had 95% of its investments in equities on 5% of its investments in stable value? Would that be adequate, both in terms of the form of the investment and the amount? We believe that it would, but the guidance does not explicitly say so. Hopefully this will be addressed in the DOL’s FAQs.

Prior to issuance of the final QDIA regulation, several mutual fund families had a 100% equity allocation in their longest term QDIAs (e.g., 2040 and 2045 funds). Because of this regulation, though, some fund families have decided to reduce the equity allocation to those target maturity mutual funds to ensure that they qualify. Those changes reflect the impact this regulation will have on 401(k) investments.

Conclusion

In most cases, it will be obvious whether an investment satisfies the definition of a QDIA. For example, with long-term QDIAs, it is clear that target maturity funds will qualify (if they have less than a 100% allocation to equities or to fixed income); for the risk-based alternative, it seems obvious that balanced and life-style mutual funds will qualify (if they have allocations that are appropriate for the participant population as a whole); and for the managed account alternative most participant-level managed accounts will qualify (if they are managed by an eligible fiduciary).

However, we have seen a number of investments and services that will also qualify — and that are not so obvious. Each case must be carefully analyzed, using the definitions and not the examples. And, providers and advisers, as well as their lawyers, should be open to innovative ways of developing and using QDIAs. ❖

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