

DOL Issues Final QDIA Guidance

The Department of Labor issued its Final Rule on Default Investments Alternatives under Participant Directed Individual Account Plans on October 24, 2007. The regulation reflects section 624 of The Pension Protection Act of 2006 that creates a new ERISA section 404(c)(5) that provides that a participant or beneficiary in an individual account plan will be treated as exercising control over their investment for purposes of section 404(c)(1) for default investments that meet DOL regulations and if certain notice requirements are met. **The regulation is effective on December 24, 2007.**

Overview

The DOL issued a proposed rule in September 2006 and the final rule generally follows the proposed rule, with some notable exceptions. It includes very limited relief for non-diversified conservative investments. Many of PSCA's suggested changes under the proposed rule are adopted in the final rule, including relief for "refaults" when it cannot be determined who defaulted into and who elected into the existing default arrangement, relief under the 30-day advance notice rule for automatic enrollment, permitting plan sponsor fiduciaries to manage a QDIA, clarification of the fees assessed in a transfer or withdrawal from a QDIA, and application of the new preemption provision to all types of automatic enrollment arrangements.

The Rule

Under the rule, a fiduciary of an individual account plan will not be liable under the ERISA fiduciary requirements for any loss resulting from the investment in a Qualified Default Investment Alternative (QDIA) or for any investment decisions of the QDIA manager if the following six conditions are met:

1. The assets must be invested in a "qualified default investment alternative."

A QDIA is an investment that does not hold or permit the acquisition of employer securities, except securities held in a mutual fund or similar regulated independent pooled investment vehicle, and with respect to which investment in employer securities is made in accordance with the stated investment objectives of the investment vehicle. Additionally, a QDIA may include employer securities acquired in matching contributions or previously obtained employer securities that are held by an investment management service to the extent the investment management service has discretionary authority over the disposition of such employer securities. An investment management service cannot exercise its discretion to acquire additional employer securities on behalf of an individual account except as part of a mutual fund or similar pooled investment vehicle. The QDIA does not include employer securities that do not meet these requirements.

A QDIA must meet certain requirements regarding the ability of a participant or beneficiary to transfer, in whole or in part, the investment in the QDIA to any

other investment alternative under the plan. See #5 below for additional information.

A QDIA must be managed by an investment manager within the meaning of ERISA section (3)(38); a trustee of the plan that meets the requirements of section 3(38) (A), (B), and (C); the plan sponsor who is a named fiduciary within the meaning of ERISA section 402(a)(2); or it may be a mutual fund registered under the Investment Company Act of 1940.

A QDIA must constitute one of the following:

"Life Cycle" or "targeted retirement date" - 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 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. 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.

"Balanced fund" - 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 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. 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.

"Managed account" - An investment management service with respect to which a fiduciary, 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. Asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant.

All QDIAs should provide for some level of capital preservation through fixed income investments. This function may be served by a money market, stable value, and similar investment vehicles.

A QDIA is also 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. The product shall seek to maintain the dollar value equal to the amount invested in the product and be offered by a State or regulated financial institution. **This product shall constitute a QDIA for not more than 120 days after the date of a participant's first elective contribution as determined under IRC section 414(w)(2)(B).**

A QDIA is also a product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, while providing liquidity for withdrawals, including transfers to other plan investment alternatives. No fees or surrender charges may be imposed in connection with withdrawals initiated by a participant or beneficiary. Principal and rates of return must be guaranteed by a State or federally regulated financial institution. This investment is intended to be limited to stable value products. **This particular product is a QDIA only if it holds only assets invested in such product before December 24, 2007.**

No fund product or model portfolio that is otherwise a QDIA will fail to be a QDIA solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees, or other features ancillary to the investment fund product or model portfolio.

2. The participant or beneficiary must have been provided the opportunity to direct the investment of assets in their account but did not do so. A participant or beneficiary who directs the investment of part of their account may be treated as a deciding to retain the remainder of the account balance as currently invested; thus permitting the fiduciary to consider the entire account balance participant-directed.
3. The participant or beneficiary must be furnished a written notice containing the following:

A description of the circumstances under which assets may be invested on behalf of the participant or beneficiary in a QDIA, and, if applicable, an explanation of the circumstances under which elective contributions will be made, the percentage of such contributions, and the right to elect not have such contributions made or to elect such contributions at a different rate.

A description of the right to direct investments in their individual account.

A description of the QDIA, including investment objectives, risk and return characteristics, and fees and expenses.

A description of the right to direct QDIA investments to other plan investment alternatives, including any fees or expenses in connection with such transfer.

An explanation of where to find information about other plan investment alternatives.

Such notice must be provided at least 30 days in advance of the plan eligibility date, or at least 30 days in advance of any first investment in a QDIA made on behalf of a participant or beneficiary,
or,
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.

Such notice shall also be provided within a reasonable period of time of at least 30 days in advance of each plan year.

If a fiduciary fails to meet the requirements of this rule due to a failure to meet the notice requirements, such as the 30-day rule, relief may be obtained for later contributions to which the notice requirement is met.

For existing automatic enrollment arrangements that include a default investment that would constitute a QDIA, the term "in advance of the plan eligibility date" does not foreclose the availability of relief under this rule. In this case "in advance of the date of plan eligibility ... or any first investment" means the first investment to which the rule applies after the effective date.

The notice must be furnished through a separate notice, but the DOL anticipates that this notice requirement and the pending Treasury notice requirements for the automatic enrollment safe harbor and permissible withdrawals could be satisfied in a single disclosure document. Also the rule should not be construed to preclude the distribution of the notice with other materials being furnished to participants and beneficiaries.

Notices may be delivered electronically under either existing DOL or Treasury rules.

4. A fiduciary must provide any material provided to the plan under 29 CFR 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix) and 29 CFR 404(c)-1(b)(2)(i)(B)(2) relating to a participant's or beneficiary's investment in a QDIA.

These regulations require the provision of a mutual fund prospectus (or fund profile) immediately following a new investment in a mutual fund and the provision of any materials provided to the plan relating to voting, tender, and similar rights resulting from an investment in an investment alternative to the extent such rights are passed through to participants and beneficiaries under the plan.

Either directly or upon request, a fiduciary must provide, for the designated QDIA, the latest available information relating to annual operating expenses that reduce the rate of return; copies of any prospectuses, financial statements, and reports and any other material relating to the investment to the extent provided to the plan; a list of the assets comprising the portfolio in the investment which constitute plan assets and their value; if applicable, the name of the issuer of a fixed rate investment, the term of the contract, and the rate of return on the contract; and information about the value of shares or units in the QDIA held by the participant or beneficiary.

5. A participant or beneficiary subject to a default investment may transfer all or a portion of QDIA assets to any other plan investment alternative with a frequency consistent with that afforded a participant or beneficiary who elected to invest in the QDIA, but not less frequently than once in any three month period.

Within 90 days of the first elective deferral resulting from a default investment, any participant-directed transfer from a QDIA to another investment alternative or a permissible withdrawal under IRC section 414(w) is not subject to any restrictions, fees, or expenses (including surrender charges, liquidation or exchange fees, redemption fees, etc.) charged in connection with the transfer or withdrawal. Ongoing fees such as investment management fees, administrative fees, etc., not based on the decision to transfer or withdraw from the QDIA may be charged.

Following the 90 day period, any fees connected to a transfer or permissible withdrawal from a QDIA must be the same as those for a participant or beneficiary who elected to invest in that QDIA.

6. The plan must offer a "road range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).

Preemption of State law

The final rule includes guidance related to ERISA section 514(e), created in the Pension Protection Act of 2006, which provides that ERISA supersedes any State law that directly or indirectly prohibits or restrains an automatic contribution arrangement. The final rule defines an automatic contribution arrangement, for purposes of preemption, as an arrangement under which a participant may elect to have a plan sponsor make contributions upon his or her behalf or receive such payments in cash and the participant is treated as having elected to have such contributions made in an amount provided under

the plan until the participant elects otherwise. Such contributions must be made pursuant to this final rule.

The rule then states that preemption also applies to any state law that would directly or indirectly prohibit or restrict the inclusion in a pension plan of an automatic contribution arrangement, regardless of whether such plan includes an arrangement that meets the requirements described in the preceding paragraph.

An administrator of an automatic contribution arrangement who satisfies the notice requirements of this final rule will be considered to satisfy the notice requirements in section 514(e)(3).

Nothing in this section precludes a pension plan from including an automatic contribution arrangement that does not meet the conditions of this final rule.

Fiduciary issues

The rule is not intended to be the exclusive means for fiduciaries to satisfy their responsibilities with respect to investments in individual account plans on behalf of a participant or beneficiary who fails to give investment directions. Other investments that do not constitute a QDIA may nonetheless be a prudent default investment, but they will not obtain the relief provided under this rule. The rule does not require a fiduciary to undertake an evaluation as to which QDIA is most prudent for a participant or the plan. However, the fiduciary must prudently select and monitor the fund or portfolio or investment management service within any category of QDIA. Despite these statements, the preamble also states that the rule provides no relief from the general fiduciary rules applicable to the selection and monitoring of a particular QDIA. Except for offering a "broad range of investment options" a plan does not need to meet the "normal" requirements of section 404(c) in order to obtain the fiduciary relief under this proposal.

Circumstances other than automatic enrollment

Nothing in the rule limits the application of the relief for a QDIA to automatic enrollment arrangements. Other examples include the failure to designate an investment after enrolling, after the elimination of an investment arrangement, and following a rollover to the plan.

Transition issues

Any participant or beneficiary, following receipt of a notice in accordance with this rule, may be treated as failing to give investment direction for purposes of the rule, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle in the plan. This provision is expected to provide significant relief because many plans have reported that they do not have the records needed to determine which participants and beneficiaries in the existing default investment elected to invest in the investment and which participants and beneficiaries were defaulted.

The rule only provides relief for investments in a QDIA made when a participant and beneficiary do not give investment directions after the effective date of the regulation (December 24, 2007). However, compliance with the notice requirements may be achieved in accordance with rule before the effective date.

This provision is separate from the "mapping provisions" in section 404(c)(4) of ERISA (effective for plan years after 12/31/07). The mapping provision relief only applies when a participant chose to be in the eliminated fund and the new investment is reasonably similar to the eliminated investment. When changing investment alternatives, a plan has the flexibility to utilize a mapping or QDIA strategy to receive section 404(c)-type fiduciary relief.

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