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Automatic Enrollment Programs And Default Investments: The DOL and IRS Provide More Clarity

By William F. Sweetnam, Jr., Kendall W. Daines, Ellen M. Goodwin

I. Introduction

More Americans are funding their retirement benefits with their own savings by means of contributions to employer-provided retirement savings plans, such as plans established under Internal Revenue Code ("Code") sections 401(k), 403(b) and 457(b). Recognizing the importance of encouraging employees to save for retirement, policy makers and employers have wrestled with how to encourage employees, especially lower-paid and younger employees, to contribute to these plans. Even with the lure of "free money" in the form of an employer match, the unfortunate fact is that many employees do not sign up to become participants. This is often due to inertia on the part of the employee. The decision of how much to contribute to the employer's 401(k) plan, and how to invest the contributions, can be so intimidating that an employee may perpetually put off making the decision and, thereby, forego participation. In addition, saving for retirement may not be a priority for some employees, especially younger employees. Other employees, for example, lower paid employees, may believe that they cannot afford to save.

Before 2006, some employers were implementing an arrangement in their retirement savings plans whereby pre-tax contributions would be automatically deducted from an employee's paycheck and contributed to the savings plan unless the employee affirmatively elected otherwise. This arrangement typically became known as "automatic enrollment" or "auto-enrollment." The contributions were then invested in a default investment option selected by the employer until the employee filed an investment direction. The IRS first blessed this type of arrangement in 1998, as long as an employee was given an opportunity to "opt out" of the arrangement before contributions were deducted from his or her paycheck.[1]

Auto-enrollment arrangements proved to increase employee participation in retirement savings plans. As studies have shown, individuals are less likely to stop contributions once they begin than they are to affirmatively elect to make contributions. Therefore, auto-enrolled employees accumulate more retirement savings; their inertia results in increased retirement savings.

Building on the success of automatic enrollment, employers adopted a new design feature whereby the rate of contributions would automatically increase. Some employers timed the

[1] Revenue Rulings 98-30, 2000-8, and Revenue Ruling 2000-33.

increase to coordinate with annual pay raises so the pay raise would mask the effect of the additional contributions.

However, many employers hesitated to implement auto-enrollment. Even though the IRS had blessed auto-enrollment in several Revenue Rulings, issues remained that made it unclear whether an auto-enrollment arrangement was too risky to implement. One uncertainty was that some states had laws prohibiting an employer from deducting amounts from an employee's paycheck without the employee's affirmative written consent. It was unclear whether ERISA preempted this sort of law, or whether an employee could sue an employer for deducting pre-tax contributions from his or her paycheck without consent. In addition, employers worried that, even though an employee would be notified of the auto-enrollment and have an opportunity to opt-out before the contributions were deducted from his or her paycheck, the employee would only become aware of the auto-enrollment after the contributions had been deducted from his or her paycheck and contributed to the plan, where the qualification rules would prevent the amount from being repaid to the employee. Finally, employers worried about assuming fiduciary liability for the investment of automatic contributions in the absence of affirmative participant investment elections. Specifically, the Department of Labor ("DOL") had taken the position that protection under ERISA section 404(c)(1) is not available in the absence of affirmative participant investment elections.

In 2006, Congress gave a major boost to auto-enrollment when it passed the Pension Protection Act ("PPA"). The PPA addressed many of the issues that had been preventing employers from implementing auto-enrollment arrangements.[2] Proposed IRS regulations providing details of auto-enrollment under the PPA were published on November 8.[3] This article describes automatic enrollment under the PPA, focusing on the recently published proposed regulations.

In addition, the DOL published final regulations addressing the qualified default investment alternatives ("QDIA") and ERISA preemption on October 24, 2007.[4] The PPA added new ERISA section 404(c)(5) which generally extends the protection available under ERISA section 404(c) to fiduciaries who invest account balances of auto-enrolled participants or of participants who, for other reasons, have failed to provide investment directions.

The PPA automatic enrollment provisions are effective, and the proposed regulations are intended to be effective, for plan years beginning on or after January 1, 2008. The proposed regulations provide that, until the regulations are finalized, plan sponsors may rely on them. If the final regulations are more restrictive than the proposed regulations, the more restrictive provisions will be effect on a prospective basis only. On the other hand, the DOL regulations are final and effective December 24, 2007, but they do provide transition relief for default investments on principal preservation vehicles made before the effective date.

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[2] See section 902 of the PPA.

[3] 72 Fed. Reg. 63144 (Nov. 8, 2007).

[4] 72 Fed. Reg. 60452 (October 24, 2007).

II. Automatic Enrollment Under the PPA

The PPA contained a number of provisions intended to encourage the establishment of automatic enrollment arrangements in employer retirement savings plans. In addition to expressly preempting state laws that forbid deductions from employee paychecks without affirmative consent, the PPA provided additional incentives for establishing an auto-enrollment arrangement. First, it provided a special rule whereby an employee could request the distribution of automatic contributions within 90 days after the contributions were made to the plan. Second, it directed the DOL to develop regulations, now finalized, describing safe harbor default investment funds to allow employers to avoid fiduciary liability with respect to the investment of automatic contributions. Finally, it provided a safe harbor from the nondiscrimination rules and exclusion from the top-heavy requirements for certain auto-enrollment arrangements. These rules apply to automatic contributions arrangements for 401(k) plans and in some respects to, 403(b) plans and eligible 457(b) governmental plans.

The recently proposed IRS regulations describe the requirements that must be met in order for an auto-enrollment arrangement to be eligible for these special provisions (other than the ERISA preemption provision, which applies to any auto-enrollment arrangement). The proposed regulations distinguish two types of auto-enrollment arrangements: (a) an eligible automatic enrollment arrangement, referred to in the regulations as an "EACA", described in the proposed regulations under Code section 414(w); and (b) a qualified automatic contribution arrangement, referred to in the regulations as a "QACA," described in the proposed regulations under Code section 401(k)(13). The key distinction between the two is that the QACA automatically passes the ADP test on a design basis, similar to the safe harbor described in Code section 401(k)(12). The two types of auto-enrollment arrangements, as introduced in the proposed regulations, are described below.

Please note that while many employers will decide to convert their auto-enrollment arrangement into either an EACA or a QACA, or both, in order to take advantage of the special features associated with them, there is no requirement that an automatic enrollment arrangement be either an EACA or a QACA. In fact, the preemption of state laws prohibiting the deduction of amounts from an employee's paycheck without written consent applies to all auto-enrollment arrangements, without regard to whether the auto-enrollment arrangement is an EACA or a QACA or uses a default investment that is a QDIA. (However, such an auto-enrollment arrangement remains subject to the same notice requirement that applies to a QDIA.)

A. Eligible Automatic Contribution Arrangements ("EACA")

1. What is an EACA? An EACA is an auto-enrollment arrangement that meets certain requirements "for a plan year." An IRS representative has said informally that an EACA may be implemented mid-year, but, in light of the language quoted in the prior sentence, this does not seem to be clearly supported by the proposed regulations.

Uniform Contribution Percentage Requirement. The default contribution rate must be a uniform percentage of compensation, which may increase automatically as an employee performs additional years of service. There does not appear to be any restriction on the minimum or maximum contribution percentage, or on the timing of the increase. For example, it

appears that the automatic increase could be coordinated with the timing of annual raises. In addition, it appears that automatic contributions may consist of Roth contributions.

Notice Requirement. Each "eligible employee" must be given a notice that describes the auto-enrollment arrangement. There has been some confusion over whether the notice must be provided to all employees eligible for the employer's plan or only to those employees eligible for the auto-enrollment arrangement, i.e., those who have not affirmatively made a deferral election. Although the language of the proposed regulation itself is not entirely clear, the Preamble states that the EACA notice must be provided "to each employee to whom the EACA applies."

The notice must include the following information:

- the information required to be included in the Code section 401(k)(12) safe harbor notice, e.g., a description of the distribution rights, "to the extent these provisions apply to the arrangement." However, since an EACA is not an ADP testing "safe harbor," one might argue that the information required by the pre-PPA 401(k) testing safe harbor does not apply;
- the level of contributions that will be made on the employee's behalf if the employee does not act;
- the fact that the employee can elect not to have default elective contributions made to the plan or can elect to have a different amount contributed to the plan;
- a description of how the contributions to the plan will be invested in the absence of any investment election by the employee; and
- if the plan provides for the withdrawal of automatic contributions, as described below, a description of the employee's right to make a withdrawal of the amounts automatically contributed and the steps to take to make that withdrawal.

The Preamble provides that these requirements may not be met by reference to the SPD. It also provides that one notice may be used to meet the required EACA, QDIA, and preemption notice requirements. The regulations issued by the DOL regarding the notice required for the QDIA provides that this notice may not be provided with other notices, other than the preemption and EACA/QACA notices. Therefore, the combined notice should be provided as a separate document, although the document may be included with other notices, for example, in a year-end general mailing regarding the plan.

On November 15, 2007, the IRS posted on its website a sample notice that plan sponsors may use to meet these notice requirements. This notice is specifically for a QACA, described below, but can be modified for use with an EACA. In the preface to this sample notice, the IRS states that the DOL has agreed that this notice could be used to meet the QDIA and preemption notice requirements.

An annual notice must be provided within a reasonable time before the beginning of each plan year. A period of at least 30 days (and no more than 90 days) prior to the beginning of each

plan year is deemed to meet this requirement. In addition, the notice must be provided to newly eligible employees no more than 90 days before the employee is first eligible to make elective deferrals under the plan, but no later than the date he or she becomes eligible. For a plan with immediate eligibility, this means that the notice must be provided to a newly hired employee on his or her first day of employment. Eligible employees must have a reasonable period of time after receipt of the notice to make an affirmative election. The notice can be in writing or can be delivered electronically, as long as the electronic transmission of the notice meets the existing IRS guidance on the electronic transmission of information.[5]

Investment Requirement. An EACA must provide that, until an employee files an investment election, automatic contributions and associated employer contributions are invested in a QDIA. By investing the employee's contribution in a QDIA, a plan sponsor obtains significant relief from fiduciary liability.

2. What Are the Advantages of an EACA? There are two advantages to an EACA. First, if a plan includes an EACA, it may distribute automatic contributions to a participant upon request, provided certain requirements are met. Second, if a plan sponsor adopts an EACA, the time period for performing the annual ADP test is extended. These advantages are described below.

Permissible Withdrawals. In some cases, employees who have had automatic contributions made to the plan on their behalf may decide that they do not want to make contributions to the plan and request that the contributions be repaid to them. However, the qualification rules that apply to a section 401(k), 403(b), or 457(b) plan generally would not permit distributions merely because an employee did not want automatic contributions made to the plan on his or her behalf.

The PPA provides an exception from these rules to allow, but not require, an EACA to permit an employee to withdraw automatic contributions, adjusted for earnings (including losses), made to a plan on his or her behalf. A plan may charge a fee for such a withdrawal, provided the fee is the same fee charged for other distributions. An employee's election is not subject to any of the notice and consent rules that usually apply to distributions.

The Preamble to the proposed regulations states that a plan is not required to extend this option to all eligible employees. An employer may provide in the withdrawal election a default election whereby the employee elects to make no elective deferrals to the plan. Presumably, this would be considered an affirmative election. However, the Preamble states that an employer may not provide for a default election whereby an employee elects never to participate in the plan because this would violate the contingent benefit rule.

The withdrawal election must be made no later than 90 days after the date the contributions would have been included in gross income. Presumably, this is the date that the contributions otherwise would have been paid to the employee. For example, if an employer has a 2-week payroll cycle and an employee's paycheck is automatically reduced for EACA

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[5] Treas. Reg. §1.401(a)-21 details the rules regarding when notice can be given to participants electronically.

contributions for the payroll period ending April 30, the employee will have until 90 days after April 30 to elect to withdraw the automatic contributions. The withdrawal election will apply to all automatic contributions made through the last day of the payroll period that begins after the date the election is made; it appears that it is not permissible for an employee to elect to withdraw only a portion of the automatic contributions. The proposed regulations do not address the timing of the distribution. Presumably, it should be reasonable to make distributions within the plan's usual time period for making distributions.

The returned amount is not eligible for rollover treatment and will be subject to income tax in the taxable year in which the distribution is made, to the extent taxable. There is no early distribution tax on these returned amounts. Finally, the distribution is reported on Form 1099-R. Any related matching contributions are forfeited; they cannot be returned to the employer or paid to the employee.

Additional Time to Perform ADP/ACP Tests. The withdrawal feature makes it impossible for an employer to perform the ADP and ACP testing within the required 2½ month period following the end of a plan year. For example, if a plan uses a calendar year plan year, and if automatic contributions are first made on behalf of an employee in December, the employee may request the return of these contributions as late as March. Therefore, the regulations provide that distributions of contributions to highly compensated employees necessary in order to pass the ADP and/or ACP tests can be made up to 6 months after the close of the plan year. This allows plan sponsors to delay performing the ADP and ACP tests for their 401(k) plans after all withdrawals of automatic contributions for a plan year have been made. Although not entirely clear, it appears that this extension is available whether or not a plan provides for employee withdrawals of automatic contributions as described above. Of course, now that plans are no longer required to distribute "gap period" earnings along with excess contributions, highly compensated employees will be able to maintain up to 6 months of post-year end earnings in the plan on distributed contributions.

B. Qualified Automatic Contribution Arrangements ("QACA")

A QACA is an auto-enrollment arrangement that is treated as automatically meeting the ADP and ACP tests on a safe harbor basis. The rules that apply to a QACA are similar to the rules that apply to the current 401(k) safe harbor. For example, a plan must be amended to provide for the QACA before the plan year during which it will be effective, and it must be effective for a 12-month plan year. However, not all the same rules apply. For example, the special "early participation" rule that allows a plan to meet the section 401(k)(12) safe harbor by disregarding employees who have not met the minimum age and service requirements does not apply. In addition, the following requirements must be met:

Eligible Employees Covered. Any eligible employee who has not made an affirmative election as of the initial effective date of the QACA, and any employee first becoming eligible for the QACA after the initial effective date, must be subject to auto-enrollment unless he or she affirmatively elects not to participate. The Preamble describes an affirmative election as a completed election form on which the employee elects an amount or percentage (including zero) of his or her compensation to be paid to the plan as elective deferrals.

Percentage of Compensation to be Contributed. The contribution percentage must be uniform for all eligible employees. The minimum contribution percentage is 3%, and increases by 1% each plan year, up to 6%. However, a plan may provide for a higher annual percentage, up to 10%. The initial minimum contribution percentage of 3% must remain in effect until the end of the first plan year following the plan year during which automatic contributions were first made to the plan. This means that an eligible employee on whose behalf automatic contributions are first made to a calendar year plan in mid-January would make automatic contributions at the minimum 3% for almost two years. There are two special rules regarding the contribution percentage:

- If an employer has an auto-enrollment arrangement in effect before the effective date of a QACA, the automatic contribution percentages in effect upon the implementation of the QACA may continue to apply, provided they comply with the QACA minimum contribution percentages; and

- If elective deferrals have been suspended for 6 months due to a hardship distribution, the plan must provide that, at the end of the suspension period, the plan will automatically resume elective deferrals at the rate in effect before the suspension.

Interestingly, a QACA requires that the contribution percentage increase on a plan year basis. This will undermine the ability of employers to coordinate the timing of annual increases with annual raises.

Required Employer Contribution. Similar to the Code section 401(k)(12) safe harbor, an employer must make an employer contribution to the plan on behalf of all non-highly compensated employees in order for the auto-enrollment arrangement to be a QACA. However, the level of match and vesting required under a QACA are more favorable to employers than those required under the Code section 401(k)(12) safe harbor.

- The employer contribution may be either a nonelective contribution or a matching contribution. The nonelective contribution must equal at least 3% of eligible employee's compensation. The matching contributions must equal (i) 100% of the contributions that do not exceed 1% of the employee's compensation and (ii) at least 50% of the contributions exceeding 1%, but not 6%, of the employee's compensation. Matching contributions will satisfy the ACP test on a safe harbor basis in accordance with the same rules that apply to matching contributions used to meet the Code section 401(k)(12) safe harbor.

- The employer contribution must be fully vested after no more than 2 years of service.

The employer contribution is subject to the distribution restrictions that apply to elective deferral contributions (except that they may not be distributed on account of a hardship).

One unclear issue is whether the employer must make a match on automatic contributions that are withdrawn by the employee if the match has not been made by the time the contributions are withdrawn. An IRS representative stated informally that this question had not been resolved.

Notice Requirement. It appears that the notice requirements apply to both an EACA and a QACA. As stated earlier, the proposed regulations are not entirely clear with regard to whether the notice must be provided to all employees eligible under the plan, or only those who have not made an affirmative deferral election and are, therefore, eligible for the EACA or QACA. In the case of a QACA, there would appear to be a stronger basis for providing the notice to all employees eligible for the plan. First, the QACA is a "safe harbor" design, and the required notice for the section 401(k)(12) safe harbor must be provided to all employees. Second, all employees will receive the employer contribution and, therefore, the information in the notice would be relevant to all participants. However, at this time, it seems reasonable to provide the notice only to those eligible employees who have not made an affirmative elective deferral election.

Investment Requirements. In contrast to an EACA, automatic contributions under a QACA are not required to be invested in a QDIA. However, in light of the protection from fiduciary liability associated with use of a QDIA, it is likely that employers will invest automatic contributions and associated employer contributions in a QDIA. Implementing a QDIA will also enable the plan to provide for employee-elected withdrawals available under an EACA.

III. Qualified Default Investment Alternate

ERISA section 404(c)(5) added by the PPA provides that a participant in an individual account plan that meets certain notice requirements will be treated as exercising control over the assets of his account which are invested by the plan fiduciary in accordance with regulations issued by the DOL. The statute requires a participant to receive prior notice of how contributions will be invested in the absence of instructions as well as his right to reallocate his investments.

Fiduciaries that meet the requirements of the QDIA regulation would not be liable for losses that result from the investment of the participant's account balance in a QDIA or for investment decisions made by the manager of the investment alternative (assuming the fiduciary does not himself manage the QDIA). Nonetheless, like any other investment option, fiduciaries remain responsible for prudently selecting and monitoring the default option (and any investment manager for that option), and would be liable for any losses that result from a failure to do so. Investment managers and others that manage QDIAs remain subject to applicable fiduciary standards in managing the assets or allocation of the QDIA.

The fundamental structure and conditions of the final regulations for QDIAs closely follow the proposed regulations released over a year ago. In addition, the final regulations continue to authorize the use of the three investment strategies that were described in the proposal – including managed accounts, life cycle or target retirement date funds, balanced funds and similar arrangements. The DOL also accommodated many of the requests made by commenters and relaxed several restrictive aspects of the proposal. Summarized below are the

basic requirements of the regulation, some of the most significant changes made by the DOL in response to comments, and a discussion of the key features and issues created by the regulations.

A. Conditions for Fiduciary Relief

1. In General

The regulation provides specific conditions that a plan sponsor must meet in order to qualify for relief in connection with defaulted participant account balances. First, the undirected investment must meet a number of general conditions:

- Assets must be invested in a "qualified default investment alternative;"
- The participant on whose behalf the investment is made had the opportunity to provide investment instructions, but did not do so;
- The participant must be provided a notice concerning the plan's default investment at least 30 days before plan eligibility or the first investment in the QDIA, or as late as on the date of plan eligibility if the participant has a right to make a permissible withdrawal under section 414 of the Code; and at least 30 days prior to each subsequent plan year;
- The participant must receive certain disclosures concerning the plan's default investment that parallel the disclosure requirements of current section 404(c) regulations;
- The participant must have a right to transfer out of the QDIA at least as frequently as a participant who affirmatively elected the investment (but no less frequently than once within a 3-month period);
- No fees, restrictions or expenses may be imposed in connection with transfers out or withdrawals from a QDIA within the 90-day period beginning on the participant's first elective contribution or other first investment in a QDIA (certain ongoing fees are permitted); and
- The plan must offer a "broad range of investment options" within the meaning of existing 404(c) regulations.

2. Requirements to be a QDIA

Chief among these requirements, plan assets must be invested in a "qualified default investment alternative." A second set of regulatory conditions provides the rules a fund or allocation must meet in order to be deemed a "qualified default investment alternative:"

- It generally may not hold employer securities, except if the investment alternative is a registered investment company or similar regulated pooled vehicle, or, in the case of an investment management service, the securities were acquired as a result

of a matching contribution or prior to management by the service provided the manager has authority to dispose of the securities;

- It meets the regulation's transferability and fee restriction provision (described above);

- It must be (1) managed by an investment manager meeting the requirements of ERISA section 3(38), a professional trustee, or the plan sponsor who is a named fiduciary, (2) a registered investment company under the Investment Company Act of 1940, or (3) one of the limited-purpose principal preservation vehicles described below;

- It must qualify as a (1) one of the three types of investment products or services described in the regulation that provide a mix of equity and fixed income exposures appropriate for the plan or the participant (such as a life cycle, target retirement date, or a balanced fund, or a managed account), or (2) one of the limited-purpose principal preservation vehicles described below.

B. <u>Principal Preservation Vehicles</u>

Many commenters asked the DOL to extend unlimited QDIA status to principal preservation products, such as stable value and money market funds. DOL rejected this request, but did provide limited QDIA status to principal protection vehicles under two specific circumstances.

1. <u>Grandfather Relief for Prior Default Investments</u> – A number of commenters asked the DOL to provide "grandfather" relief for default investments that were made in principal protection vehicles prior to the effective date of final regulations. They pointed out that investments in stable value funds are frequently subject to market value adjustments or other fees in connection with withdrawals initiated by the employer, and that a large-scale sell-off of stable value investments over a short period of time could affect the market and hurt plan participants.

The final regulation contains a significant grandfather provision for investments made before the effective date of the regulation (December 24, 2007) into certain "guaranteed" investments. Importantly, this relief applies only to investments that guarantee principal and a rate of return generally consistent with that of intermediate investment grade bonds and meet other conditions - it does not apply to investments made to other types of principal protection vehicles that do not guarantee principal such as money market or bond funds. In addition, this relief does not apply to contributions made after the effective date of final regulations. For purposes of this rule, investments must have been made into a product that provides liquidity for participant-initiated withdrawals and transfers. The product must not impose fees or surrender charges in connection with participant-initiated withdrawals, and principal and rates of return must be guaranteed by a regulated financial institution. In order to utilize the grandfather rule and obtain relief for investments prior to December 24, 2007, all other conditions of the final regulation must be met.

Questions have arisen whether certain stable value funds or products qualify for relief under the grandfather provision. These uncertainties are created at least in part by the fact that DOL's definition appears to require that the product guarantee both principal and a rate of return consistent with intermediate investment grade bonds. There are many stable value products that provide a guarantee of principal and accrued interest, but do not guarantee a rate of return, unless they can be said to "guarantee" at least a 0% rate of return. In addition, DOL's definition requires the guarantee to be provided by "a state or federally regulated financial institution." There are many stable value products whose guarantees are offered through multiple contracts that provide layered guarantees, and some have asked whether these products may qualify for relief under DOL's grandfather provision. The DOL has made clear that they did not intend to offer relief under a provision for which very few or no products would qualify, but at this point they are unwilling to opine on whether various stable value fund features would cause a product to fail to qualify for the grandfather provision.

2. **Short-Term Fund Relief** – Although the DOL did not choose to extend unlimited QDIA status to principal preservation vehicles, these vehicles were given short-term QDIA status. The regulation provides that a participant's account may be defaulted into a principal preservation vehicle for not more than 120 days after the participant's first elective contribution (as determined under section 414 of the Code). However, assets defaulted into a principal preservation vehicle for this purpose must be moved into one of the other QDIA vehicles before the 120-day period ends in order to continue to qualify for relief. The DOL explained that this rule was intended to ease plan administration since the Code generally permits participants to opt out of automatic enrollment within 90 days and receive a return of their funds free of certain taxes. For this purpose, the principal preservation product must seek to maintain principal and provide a reasonable rate of return, whether or not guaranteed, and be offered by a regulated financial institution.

Based on conversations with the DOL, the DOL intended that this limited duration QDIA would be available only in the context of automatic enrollment and only where the plan offers participants the opportunity to make a permissible withdrawal from the plan. Accordingly, absent further guidance from the DOL, this short-term QDIA could not be used for plan transitions or for undirected IRA rollovers. Further, the DOL has said that it purposefully used the same definition that was used in its automatic rollover regulations, and those regulations may provide additional guidance as to the types of investment products that may qualify.

C. Investment Manager or RIC Requirement

The proposed rule contained a requirement that a QDIA must either be (1) managed by an investment manager under section 3(38) of ERISA, or (2) a registered investment company. The DOL received a number of comments asking that this requirement be extended to other products. Plan sponsors requested that they be permitted to manage their own default asset allocations. Members of the banking industry asked for clarification that bank collective funds could qualify as QDIA vehicles notwithstanding the bank's status as a plan trustee. They argued this clarification was necessary because parenthetical language in section 3(38) provides that a fiduciary *other than a trustee* or named fiduciary may serve as an investment manager. In addition, the insurance industry asked for clarification that investments made in separate

accounts under group annuity contracts, or in other pooled investment vehicles, could qualify for QDIA status as long as the conditions of the regulation were satisfied.

The final regulation significantly broadens the range of entities that may be responsible for the management of a QDIA. Specifically, the final regulation provides that a QDIA must be either (1) managed by an ERISA section 3(38) manager, a trustee of a plan that meets the requirements of section 3(38)(A), (B) and (C), or a plan sponsor who is a named fiduciary,[6] (2) a registered investment company, or (3) one of the principal preservation vehicles entitled to limited QDIA status. In addition, preamble language clearly states that the regulation is intended to permit investments made in separate accounts under group annuity contracts, as well as common and collective trust funds or other pooled investment funds, that satisfy all of the conditions of the regulation. The preamble also clarifies that the entity responsible for asset allocation and management decisions affecting the vehicle is the entity that must meet the specified requirements.

D. Disclosure Requirement

The proposed regulation contained a broad disclosure rule that could have required participants whose accounts were invested by default to receive greater information than participants who provide affirmative investment instructions under section 404(c) plans. In addition, the proposed rule arguably would have required plans to be amended to describe the disclosure rights of defaulted participants.

The DOL relaxed the disclosure rule in the final regulations, making it clear that participants whose account balances are invested by default are entitled to the same disclosures that must be provided in connection with affirmative participant instructions under 404(c) plans. In addition, DOL has stated that disclosures required to be provided to default investors must be provided in the same manner that 404(c) regulations require (meaning, certain disclosures must be provided automatically, such as prospectus', and other disclosure are required only upon request). DOL comments in the preamble make clear that these disclosures may be provided directly to the participant by the provider of the investment alternative or by a third party. In addition, the DOL eliminated the problematic language that appeared to require plan terms to describe the disclosure rights of defaulted participants.

E. Notice Requirement

Both the statute and the regulations require that participants be provided a notice that describes certain fundamental information about the plan's default investment option. The notice must describe the default investment, its fees and risk and return characteristics, the

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[6] One technical issue that arises from DOL's language is that a product managed by a named fiduciary may only qualify if the named fiduciary is a plan sponsor. We know that many plans name a committee or corporate officer, not the plan sponsor, as the plan's named fiduciary. Under the technical language of the final regulation, it appears that an investment allocation managed by a fiduciary committee could not qualify as a QDIA. Nonetheless, given the scope of relief available through the regulation, we question whether using a named fiduciary-managed QDIA would result in meaningful fiduciary relief for the named fiduciary.

circumstances under which a participant's account will be invested in the default investment, an explanation of the circumstances under which elective contributions will be made on behalf of the participant and the percentage, an explanation of the right to direct the investment of account assets to any other investment alternative under the plan, and an explanation of where participants can obtain information about the plan's other investment alternatives.

The proposed regulation requires the notice to be provided at least 30 days before the participant's first investment in the QDIA and annually thereafter. A number of commenters asked the DOL to relax the notice-timing rule to accommodate immediate participation plans, or those plans that allow participation on the first day of employment. The DOL accommodated these requests by allowing the notice to be provided as late as on a participant's eligibility date for plans that allow participants to make a permissive withdrawal within the first 90 days of employment under tax Code rules. DOL has stated that a plan that does not allow permissive withdrawals would not be able to provide notice as late as on the eligibility date and obtain fiduciary relief in connection with investments made within 30 days of the participant's eligibility.

The preamble clarifies that the DOL does not view information provided in a Summary Plan Description ("SPD") or Summary of Material Modifications ("SMM") as satisfying the notice requirements of the regulation. Nonetheless, language in the preamble suggests that notices may be provided with other regularly provided disclosures as long as QDIA information is provided on a separate sheet.

F. Transition Issues

1. Availability of Relief in Transitions

A number of commenters on the proposed regulation asked the DOL for guidance as to how to transition previously defaulted investments into investments that would meet the requirements of the regulation. They asked how to ensure that a plan's current default investment that meets the requirements of the regulation could be treated as a QDIA as soon as possible after the regulation becomes effective. They also asked what steps should be taken in transferring previously defaulted amounts from a non-QDIA to a QDIA vehicle once the regulations are in effect.

In this regard, a number of commenters pointed out that transitioning existing defaulted amounts into a QDIA would pose particular problems where plans are unable to distinguish defaulted participants in a particular investment fund from those participants who affirmatively elected the fund. The DOL gave significant help to plan sponsors faced with these issues when it stated that a participant or beneficiary can be treated as failing to give investment instructions without regard to whether the participant elected to be in plan's current default investment when he or she fails to respond to a QDIA notice. Nonetheless, the DOL made clear that in order for any investments in a QDIA to qualify for fiduciary relief, whether moved from a non-QDIA or those investments that are in a current qualifying default fund, a notice must be provided and the participant or beneficiary must fail to respond to the notice after the effective date of the regulations, or after December 24, 2007.

The grandfather rule for stable value funds is also a critically important transition rule. It permits a plan that previously defaulted participants into a stable value fund to leave contributions made prior to December 24, 2007 in the stable value fund, and receive relief in connection with those investments, as long as a participant is provided a notice that complies with the regulation and fails to respond after December 24, 2007. Importantly, as discussed above, the stable value fund must meet certain requirements in order for the grandfather rule to apply.

2. Timing of Relief in Transitions

With respect to new contributions, DOL intended for relief under section 404(c)(5) to be available beginning 30 days after a notice is provided meeting the content requirements of the regulation. It is also clear that the DOL intended that the regulation could be used to achieve relief for existing assets, or assets already invested in the plan's default fund. However, with respect to relief for existing assets that are not moved as a result of designating a new default fund, it is not entirely clear how and when relief becomes effective. This is because notices are generally required to be provided at least 30 days in advance of a "first investment" in a QDIA, and a first investment in the case of existing assets would have been made in the past. Therefore, it is not entirely clear from DOL's final regulation exactly when relief is effective with respect to existing assets after a QDIA notice has been provided and, specifically, whether a plan fiduciary will have relief in the first 30 days after providing a notice. We understand from conversations with DOL staff members that the DOL will address this issue shortly in Q&As.

G. Fee Restrictions

The final regulation contains a broad prohibition on the imposition of transfer or withdrawal fees in connection with withdrawals from the QDIA. Specifically, it provides that no fees, restrictions or expenses may be imposed on any transfer or permissible withdrawal from a QDIA within the 90-day period beginning on the participant's first elective contribution as determined under section 414 of the Code or other first investment in a QDIA. The regulation specifically provides that this precludes the imposition of any surrender charges, liquidation, exchange or redemption fees or similar expenses in connection with the liquidation of or transfer from a QDIA. Certain ongoing management fees, or fees that are not triggered by transfers or withdrawals, may be charged against participants in the QDIA at any time, including investment management fees, distribution or services fees, 12b-1 fees, legal, accounting, transfer agent or other fees. Also, following the end of the 90-day period, transfer or withdrawal fees or restrictions may be imposed as long as they would be charged against participants who affirmatively chose to invest in the QDIA.

There are a number of ambiguities regarding the regulation's fee transfer or withdrawal fee restrictions. First, it is unclear whether and how these restrictions apply to a grandfathered stable value fund or other fund for which a sponsor seeks relief prospectively. Because the fee restrictions apply in the 90-day period following an investor's first investment or elective contribution under section 414 of the Code, it is unclear whether these restrictions apply to a grandfathered vehicle and, if so, how the restricted time period is measured. Second, it is unclear whether certain restrictions imposed by stable value funds, such as surrender charges for employer-initiated withdrawals or equity wash restrictions, could apply to a grandfathered

vehicle. Thirdly, it is unclear whether any transfer or withdrawal fees could be paid by a third party, such as the employer or a service provider, during the 90-day restricted period.

IV. Preemption

The PPA added a new preemption provision to ERISA for automatic enrollment arrangements. New section 514(e) of ERISA contains a preemption provision that broadly preempts any state laws that would directly or indirectly restrict a plan from offering an automatic contribution arrangement. On its face, section 514(e) requires that contributions are invested consistent with all conditions of DOL's default regulations in order for preemption to apply. In response to comments requesting clarification of the preemption rule, the regulation contains a specific preemption provision that is broader in scope than section 514(e)'s preemption rule. The regulation clarifies that any state laws that would inhibit automatic contribution arrangements under ERISA plans are preempted regardless of whether the plan's default investment fund qualifies as a QDIA or whether the other conditions of the default regulation are met. The preemption rule also clarifies that the notice requirement of section 514(e) will be satisfied by a notice that meets the requirements of the final default regulations.