

Legal Alert: DOL Proposes Default Investment Regulations under ERISA

September 27, 2006

On September 27, 2006, the Department of Labor (“DOL”) [proposed regulations](#) to provide ERISA relief to fiduciaries of participant-directed defined contribution plans that invest participant accounts in certain types of default investment alternatives in the absence of participant investment directions. This proposal is the first regulation issued under and implements certain provisions of the [Pension Protection Act of 2006](#) (“PPA”), enacted on August 17. For a discussion of the default investment provisions of the statute, click [here](#). This relief will be of considerable utility to plans with automatic enrollment procedures; however, it is also available to plans with voluntary enrollment procedures.

Pursuant to ERISA §404(c)(5) as added by the PPA, the regulation would relieve fiduciaries of liability for loss or ERISA fiduciary breach that is the direct and necessary result of investing all or part of a participant’s account in a “qualified default investment alternative” or “QDIA” or of the investment decisions of the manager of the QDIA. In scope, this relief is intended to be the same as that provided under an ERISA §404(c) plan, although plans that do not qualify under §404(c)(1) may nonetheless take advantage of the default investment relief. (Plan fiduciaries would remain responsible under §404(a) for the selection and monitoring of the QDIA, as well as for any prohibited transaction violations.)

To qualify for this relief, the proposed regulation would require that the plan make available investment alternatives satisfying the “broad range” requirement applicable to §404(c) plans, even if the plan does not intend to take advantage of §404(c). The investment alternative or alternatives utilized as the QDIA must be, in terms of structure, either:

- A mutual fund registered under the Investment Company Act of 1940; or
- Managed by an ERISA “investment manager,” i.e., a registered investment adviser under the Investment Advisers Act of 1940, a state registered investment adviser meeting certain requirements, a bank or an insurance company, that is exercising discretionary investment authority and has acknowledged in writing that it is a plan fiduciary. (ERISA already provides a mechanism for relieving other fiduciaries of responsibility for the investment decisions of investment managers; the preamble reflects that DOL included investment managers in the default investment structure to avoid ambiguities.)

In terms of investment characteristics, the QDIA must be either:

- An investment fund product or model portfolio that provides “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 (which may be the plan’s normal retirement date) or life expectancy, e.g., a life-cycle or target retirement approach.¹ Asset allocation decisions may be based only on age and need not take into account any other participant-specific characteristics. The investment fund product or model portfolio may be a “fund of funds” or a stand-alone vehicle; or
- An investment fund product or model portfolio (again, a fund of funds or stand-alone vehicle) of diversified exposures with a target level of risk exposure appropriate for the participant population as a whole, e.g., a balanced fund approach. Asset allocation decisions may be based on the demographics of the participant population as a whole (which may change over time, leading the plan fiduciary to change or add to its selection of the QDIA), and need not take into account any participant-specific characteristics; or
- An investment management service under which the investment manager allocates the participant’s account among diversified exposures based on the participant’s age, target retirement date or life expectancy, e.g., an age-based managed account approach. Again, asset allocation decisions may be based solely on age and need not take into account of any other participant-specific characteristics.

The proposed regulation expressly contemplates that a QDIA, other than under the balanced fund approach, will change asset allocations and risk levels over time with the objective of becoming more conservative with the participant’s increasing age.

The proposed regulation does **not** authorize the use of money market, stable value, or similar products alone as a fourth type of QDIA. The preamble recites DOL’s reasons for not including these investments as a fourth type of QDIA, but expressly states that:

- These types of products may well be included in the investment mix under a QDIA;
- These types of products may qualify as a QDIA for certain participants. It seems conceivable that a plan could conclude, for example, that in an array of age-based

¹ This relief is also available as to beneficiaries who direct account investments; for convenience, in the text we refer only to participants.

QDIAs, a near risk-free fixed income investment may provide the appropriate risk exposure at advanced ages; and

- Plans may continue to use these products as default options in accordance with pre-PPA law (i.e., without the benefit of the fiduciary relief provided by the new §404(c)(5)).

The QDIA may not be nor include employer securities unless held in a mutual fund or other regulated pooled investment vehicle pursuant to stated investment objectives and independent of the plan sponsor. In addition, if the QDIA is a managed account, it may include employer securities acquired as a matching contribution or acquired prior to management of the account by the investment management service.

This relief would also be subject to the following procedural conditions, which appear to apply on a participant-by-participant basis:

- The participant is provided a notice at least 30 days in advance of the first default investment for his or her account, and at least 30 days in advance of each subsequent plan year, describing:
 - The circumstances in which default investments may be made;
 - The QDIA, including investment objectives, risk and return characteristics, and fees and expenses;
 - The participant's opportunity to transfer his or her account out of the QDIA to other investment alternatives; and
 - Where the participant may obtain information about the other investment alternatives.

For plans that are already utilizing default investments, the initial notice may be given in respect of the effective date of this regulation as adopted.

- The participant had the opportunity but did not direct the investment of his or her account. (That is, if the participant provides affirmative directions, the default investment relief is unavailable.)
- At the time the plan otherwise provides to direct investments but at least once within every three-month period, the participant has the opportunity to transfer all or part of

his or her account invested in the QDIA to any other investment alternatives available under the plan without financial penalty.

- The plan by its terms must provide that any material provided to the plan and relating to the QDIA – e.g., a prospectus, proxy voting materials or account statements – is provided to the participant.

The PPA requires the DOL to adopt these regulations by February 17, 2007. Comments on the proposed regulations are due on or before November 13, 2006. The regulations will take effect 60 days after adoption and publication in final form in the Federal Register.



Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

George H. Bostick	202.383.0127	george.bostick@sablaw.com
Daniel M. Buchner	202.383.0869	daniel.buchner@sablaw.com
Adam B. Cohen	202.383.0167	adam.cohen@sablaw.com
Ian A. Herbert	202.383.0644	ian.herbert@sablaw.com
Alice Murto	404.853.8410	alice.murtos@sablaw.com
Robert J. Neis	404.853.8270	robert.neis@sablaw.com
W. Mark Smith	202.383.0221	mark.smith@sablaw.com
William J. Walderman	202.383.0243	william.walderman@sablaw.com
Carol A. Weiser	202.383.0728	carol.weiser@sablaw.com