QDIA Legislative Update

The U.S. Department of Labor (DOL) recently published the much anticipated final regulations on qualified default investment alternatives (QDIAs) in 401(k) and other defined contribution retirement plans that permit participants to direct the investment of their accounts.

The final regulations provide fiduciary relief, when a plan participant or beneficiary does not make an affirmative investment election, such as when a participant is automatically enrolled in a plan. If the terms of the regulations are satisfied, a participant is treated as having exercised control over the assets invested in the plan's QDIA and the plan fiduciary will not be responsible for any loss that results from investing a participant's account in such default investment alternative. However, the regulations do not provide any relief for a fiduciary that does not prudently select and monitor the particular default fund available under the plan. For example, if a fiduciary selects an imprudent balanced fund, the regulations do not provide any relief from liability for such breach.

The final regulations will be effective December 24, 2007. Highlights are listed below:

Transition Rules. The final regulations include two transition rules for amounts that were invested in a default fund prior to the effective date of the final regulations. First, the preamble to the final regulations provides that a plan that defaulted participants into a fund that is a QDIA under the final regulations may come within the ambit of the final regulations by providing participants with a notice that they have been defaulted into the QDIA, have the right to make an affirmative investment election and otherwise satisfies the regulations. Second, the final regulations explicitly provide that amounts that were invested in a fund "designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds" prior to the effective date of the final regulations will be treated as a QDIA if (i) there are no fees or surrender charges imposed on participant-initiated withdrawals and (ii) principal and rates of return are guaranteed. This relief is targeted to stable value funds and would not appear to be available to other capital preservation funds, such as money market funds. It also appears that participants who have been defaulted into stable value funds prior to the effective date will ordinarily need to be provided a notice reminding them of their opportunity to make an affirmative investment election in order to make use of the transition rule.

Stable Value Funds Not Included. The final regulations do not add stable value and other capital preservation funds as a fourth type of QDIA. Instead, the only permitted types of QDIAs are life-cycle or target-date retirement funds, managed account options, and balanced funds. The final regulations do, however, include a very limited exception for capital preservation funds that are used to hold default investments for a period not exceeding 120 days. After lapse of the "holding" period, the plan must transfer such amounts to another QDIA in order for the arrangement to be considered a QDIA.

Investment Manager Requirement. To be eligible for the relief from fiduciary liability, the proposed regulations provided that the default investment must be managed by an investment manager described in section 3(38) of ERISA or an investment company registered under the Investment Company Act of 1940. Generally, an investment manager under ERISA is a person who has the power to manage plan assets and who is a bank, insurance company, or registered investment advisor, and who agrees in writing that he or she is a fiduciary with respect to the plan. The final regulations modify the investment manager requirement to add the plan's named fiduciary as a permitted manager of a QDIA.

This modification was made in response to comments indicating that many large plans construct life-cycle, target-date, or managed account options out of a plan's existing investment menu, i.e., build portfolios constructed from the plan's core investment options. These plans ordinarily obtain professional advice regarding the construction of the portfolios but do not engage an investment manager and some argued that the investment manager requirement would significantly increase the cost to the plan. The final regulations provide relief by allowing the plan's named fiduciary (often the plan sponsor) to construct the default investment but the regulations emphasize that the named fiduciary would retain fiduciary liability for prudent construction of the investment.

Other commentators noted that the investment manager requirement under the proposed regulations could adversely affect managed account options that use computer-based investment programs that rely on the SunAmerica advisory opinion. These programs are often constructed by an entity that has no direct relationship with the plan, and it would be a significant change if these entities had to take on investment manager/fiduciary responsibility. The final regulations accommodate so-called SunAmerica programs as default options only where the advisor is an ERISA investment manager or the plan's named fiduciary takes on fiduciary responsibility for the program, which may make it difficult for some SunAmerica programs to qualify as default options.

Balanced Funds. Many commentators were critical of the proposed regulations because the balanced fund QDIA required an initial and ongoing determination by the plan fiduciary that the particular balanced fund is appropriate to the plan's participant population as a whole. The final regulations retain this requirement.

Financial Penalty Limitation. Like the proposed regulations, the final regulations provide that a QDIA may not impose a financial penalty on the sale of a default investment. However, the final regulations significantly rewrite the financial penalty rules. Specifically, the final regulations provide that a QDIA must not have any withdrawal restrictions (e.g., no surrender charges, loads, or redemption fees) during the first 90 days following the initial investments. Thereafter, the QDIA may have withdrawal restrictions provided that such restrictions also apply to participants that affirmatively elect to invest in the option.

Applicable Beyond Automatic Enrollment. The final regulations confirm that a plan may rely on the default investment rule in contexts beyond automatic enrollment, including, for example, where a plan moves from one financial institution to another or eliminates an investment option. Although not entirely clear, the final regulations appear to provide that the fiduciary relief is available where a participant has made a prior affirmative investment election and the investment remains an available option. Put differently, the final regulations appear to provide that its relief is available where the plan overrides a participant's prior investment election, if adequate notice is provided.

Notice. The final regulations generally require 30-days advance notice prior to eligibility to contribute or before initial investment under the plan. Commentators indicated that this would make it difficult for plans that provide for immediate eligibility to have an automatic-enrollment feature. To address this concern, the regulations provide that the notice must be provided prior to the initial investment if the plan includes an automatic enrollment feature and offers the 90-day "unwind" in-service withdrawal right under section 414(w) of the Internal Revenue Code. The notion is that the unwind will provide automatically enrolled participants an ongoing opportunity to reconsider whether they wish to make an affirmative investment election.

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