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Employee Benefits

A Littler Mendelson Newsletter

Department of Labor Releases Final Regulations on Defined Contribution Plan Default Investment Vehicles

By Susan Katz Hoffman

The Department of Labor has issued final regulations that provide a safe harbor to qualified plan fiduciaries in connection with their provision of default investment alternatives to plan participants. Default investment alternatives are investments that are automatically provided by plan sponsor fiduciaries when participants who are given the opportunity to direct the investment of their defined contribution plan accounts do not make an affirmative investment election. This regulation will be applicable to 401(k) plans that use automatic enrollment for newly-eligible employees, as well as plans that do not receive an affirmative election from participants in situations such as a plan merger or transfer, elimination of an investment alternative, or replacement of a service provider. The final regulations are effective December 24, 2007.

General Rule

The fiduciaries of a defined contribution plan must comply with ERISA's general prudence standards in selecting and monitoring a particular qualified default investment alternative, just as they must in selecting and monitoring other investment options made available under the plan. The Department has made clear in these final regulations that, in connection with default investment vehicles, fiduciaries "must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate" and "must carefully consider investment fees and expenses when choosing a qualified default investment alternative." For more on fiduciaries' prudence obliga-

tions, see 401(k) Plan Fees Litigation: Is The Dam Breaking? A Slew of Class Action Lawsuits Alleging Shady Fee Practices Roils 401(k) Sponsors.

Requirements for Qualified Default Investment Alternative

If prudent default investment alternatives are in place and the rules set forth in the regulations are followed, plan fiduciaries will be able to afford themselves of the protections afforded by ERISA section 404(c) with respect to these investments. The regulation sets forth specific categories of investment alternatives that can be used for the default investments:

- Investment funds, products, or model portfolios that offer a mix of equity and fixed income exposure based on the participant's age, target retirement date, or life expectancy (a "lifecycle" fund).
- Investment funds, products, or model portfolios that offer a mix of equity and fixed income exposure appropriate for the plan population as a whole (a "balanced" fund). In determining whether a fund is "appropriate," the fiduciary must recognize the average age of the population and is not precluded from considering other factors as well.
- An investment management service that allocates the assets of each participant's individual account through a mix of equity and fixed income exposures offered as investment alternatives under the plan, based on the participant's age, target retirement date, or life expect-

tancy.

- Stable value or money market funds, but this category can be used only for the first 120 days following the date of the participant's first elective contribution under an automatic enrollment plan (as defined in Code section 414(w)). This category is also available for default investments before the effective date of the regulation.

The default investment must be managed by a registered investment manager, a mutual fund family or bank trust department (or similar institution acting as a fiduciary) or a named fiduciary under the plan. The "named fiduciary" alternative is designed for larger plan sponsors with in-house investment management, and it is anticipated that such named fiduciaries may well use asset allocation models, investment advisors, and other tools to enhance their ability to exercise their fiduciary functions. The regulation also recognizes that default investments may be made available under variable annuity contracts as well as other pooled investment vehicles.

The other investment alternatives available under the plan must include a broad range of investment options, sufficient to satisfy the requirements of the regulations under ERISA section 404(c).

Participants defaulted into the default alternative must have the same options to change their investments as other participants. These participants must have the right to change their investments, including a default investment, no less frequently than once within any three month period. For the first 90 days after the participant's initial investment into the default alternative, no restrictions, fees, or expenses may be imposed on the account if the participant elects to change investments, other than investment management and similar types of fees and expenses. This will preclude the assessment of market value adjustments, redemption fees, or surrender charges during this 90-day period. After the initial 90-day period, no fees can be charged to defaulted investments that are not otherwise charged to other participants who make an affirmative election to invest in the same alternative.

Once a participant makes an affirmative election to change any of the default investments to

another investment option available under the plan, the participant is deemed to have made an affirmative election to leave the remainder of the account invested in the default alternative. Accordingly, that participant is no longer considered invested in a default investment under the regulation.

Employer Securities

Generally, investment in employer securities will not be an acceptable default alternative. But a regulated pooled investment vehicle (such as a common or collective trust fund) or a mutual fund can hold employer securities as part of its diversified portfolio. In addition, an investment management service can serve as the default alternative manager even if that service manages employer security accounts acquired as matching contributions, or through an earlier affirmative election by the participant to invest in employer securities. While such a manager cannot acquire more employer securities (other than through matching contributions) without an affirmative participant election, the manager can exercise its discretion to reduce the amount of employer securities held on behalf of the participant.

Notice Requirement

Each participant whose account will be invested in the default alternative must receive an initial notice at least 30 days in advance of the first investment in the default alternative or 30 days in advance of the participant's first date of plan eligibility. If the notice is provided late, the safe harbor is still available for investments made 30 days or more after the provision of the notice, even if the safe harbor is not available for earlier investments. In the case of a plan with automatic enrollment and a right to make a permissible withdrawal under Code section 414(w), the notice can be provided at any time on or before the date of plan eligibility. The annual notice cannot simply be included in a summary plan description, but can be included with other plan informational materials such as enrollment forms.

In addition to the initial notice, the plan administrator must provide an annual notice at least 30 days in advance of each plan year. The annual notice cannot simply be included in a summary plan description or summary of material modifications, but can be included

with quarterly statements or other materials being furnished to plan participants and beneficiaries.

Participants whose accounts are invested in a default alternative must be provided with the same information about their investments as is required for other plan investment alternatives.

Immediate Action Required

Plan fiduciaries must immediately identify whether their defined contribution plans will have contributions going into default investments after the effective date of the regulation (pre-effective date contributions in default investments generally will be covered by the regulation if the investments are in stable value or money market funds, or other investment alternatives covered by the three regulatory categories). If so, one or more default investment alternatives must be selected by December 24, 2007 in compliance with the final regulation.

If any default investments are maintained under the plan (either old or new contributions), the fiduciaries must ensure compliance with the notice requirements of the final regulation.

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