THE QDIA REGULATIONS: THE NEW CORNERSTONE OF DEFINED CONTRIBUTION PLAN DESIGN

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Introduction

Almost exactly a year ago we drafted a letter to clients about the proposed regulation clarifying the types of investments that qualify as a "qualified default investment alternative" (QDIA). As a reminder, default investment options are used within defined contribution programs for purposes of auto enrollment and in cases where the employee does not give investment instructions to the employer as to how to direct his or her defined contribution contributions. The final regulation was released by the U.S. Department of Labor (DoL) on October 24, 2007. It amends ERISA to include language about the types of default investments sponsors can use to avail themselves of a "safe harbor" or relief from liability for any loss, or by reason of any breach, that occurs as a result of investing employees/plan participants in such investments. While many of the proposed regulations remain unchanged, there are some differences between the proposed rule and final rule, as addressed in this letter. There are also some *immediate action items* for plan sponsors seeking the safe harbor for new contributions and/or existing balances invested historically in something other than a named QDIA, as the effective date of the regulation is just sixty days away, December 24, 2007.

The Three (or Three and a Half) Choices for a Safe Harbor QDIA

First of all, the headline news is that the final regulation maintains the proposed three QDIAs: lifecycle funds that take into account an individual's age or retirement date; professionally managed accounts that allocate an individual's contributions among investment alternatives available under the plan; or a balanced fund with a uniform mix of equity and fixed income exposures appropriate for the participants of the plan as a whole. Plan sponsors seeking the safe harbor have to select one of these choices as their plan's (long-term) default, and do so by December 24, 2007.

Plan sponsors also have the option of defaulting to a capital preservation type of vehicle as a short-term default, for use within the first 120-days of a participant's experience within the plan. The Department did not allow for these types of products to be used as long-term defaults, but did allow for this 120-day compromise. The 120-day timeframe is intended to provide plan sponsors sufficient time to effectuate a transfer of assets after the end of the 90-day permissible withdrawal period for employees to opt out of auto enrollment (meaning, if participants don't opt out of automatic enrollment or move the balance of their defaulted assets themselves, plan sponsors will have to re-direct them). This solution addresses any concerns plan sponsors might have about auto enrolling employees and having them experience losses in a QDIA. Prior to the end of the 120-days, plan sponsors must redirect *both* the deferral election and the defaulted balance of assets to the (long-term) QDIA.

THE HEADLINE NEWS IS THAT THE FINAL REGULATION MAINTAINS THE PROPOSED THREE QDIAS: LIFECYCLE FUNDS; PROFESSIONALLY MANAGED ACCOUNTS; OR A BALANCED FUND.

As an aside, NEPC has concerns about this solution, as administratively it is more complex, and from an investment perspective, the capital preservation vehicle cannot be a stable value fund, as plan sponsors will not be able to re-direct the assets without incurring book value/market value adjustments and possible withdrawal, surrender or transfer fees.

NO SAFE HARBOR RELIEF IS PROVIDED FOR NEW CONTRIBUTIONS MADE TO STABLE VALUE FUNDS AFTER DECEMBER 24, 2007.

Grandfather Provision for Stable Value (ONLY)

Plan sponsors currently using a *stable value* fund as a plan default are provided relief for existing balances and new contributions to these funds prior to December 24, 2007. No relief is provided for new contributions made to stable value funds after that date. This "grandfather" provision accommodates the historic use of stable value funds as plan default options, which was a nod to the insurance industry, which argued vigorously for stable value's inclusion as a QDIA.

Please be aware, no safe harbor relief appears to be provided for default investments made prior to, or following December 24th, in other types of capital preservation products. Practically speaking, stable value assets are participant-directed assets which may incur a market value adjustment, surrender charge or withdrawal penalty if unilaterally re-directed by the plan sponsor, whereas other types of capital preservation investments can be re-directed by the plan sponsor without penalty. In our view, plan sponsors who have defaulted participants to money market funds or other liquid non-QDIA investments in the past should begin down the path of identifying affected participants and their assets and unilaterally reinvesting them in the QDIA.

Requirements for Plan Sponsors Currently Using a QDIA

No significant requirements for plan sponsors already using a lifecycle fund or other QDIA appear to have been attached to the regulation. A large and growing proportion of defined contribution plans already direct default investments to a QDIA. Fiduciaries of these plans are not obligated to unilaterally reinvest assets directed to a non-QDIA in the past, so long as the prior default was a stable value fund or other type of non-liquid investment with surrender charges or other fees that could directly and adversely affect participant account balances. Nor are plans under any requirement to undertake a new evaluation as to which of the designated types of QDIAs is the *most* prudent for a participant or their population.

Please be mindful that the guidance for the selection of a QDIA relates back to ERISA's general fiduciary rules. For example, the selection of a particular qualified default investment alternative is a fiduciary act and therefore ERISA obligates fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries. A fiduciary must engage in an objective, thorough and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate. As with other investment alternatives made available under the plan, fiduciaries must carefully consider investment fees and expenses when choosing a qualified default investment alternative. Further language governs the selection of a managed account or single balanced fund as a QDIA For the balanced fund, fiduciaries need to take into account the diversification of the portfolio, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to funding objectives of the plan and the fees and expenses attendant to the investment. Language around managed accounts is more involved and we'll likely address it in later letters.

Management of the QDIA

Contrary to the original proposal, a QDIA does not have to be managed solely by an investment company registered under the Investment Company Act of 1940. Instead, under the final rule, a QDIA must either be managed by a named fiduciary[1] or by an investment company registered under the Investment Company Act of 1940.

[1] Under section 402(a)(2) of ERISA, a named fiduciary refers to a fiduciary appointed as a fiduciary by a person who is an employer and/or an employee organization with respect to the plan.

This last item is of particular significance to NEPC as we manage custom lifecycle/target retirement date products for some clients. If the proposed regulation had been finalized, custom lifecycle/target retirement date products would have been required to engage an outside investment manager to manage their asset mix. However, under the final regulation, as a named fiduciary, NEPC can continue to manage custom lifecycle/target retirement date products for our clients without jeopardizing their safe harbor eligibility.

The Effective Date

The final QDIA rule was released with an effective date of December 24, 2007. Please be advised that there is some ambiguity in the language

NO SIGNIFICANT REQUIREMENTS FOR PLAN SPONSORS ALREADY USING A LIFECYCLE FUND OR OTHER QDIA APPEAR TO HAVE BEEN ATTACHED TO THE REGULATION.

as to whether the effective date of December 24th is an implementation date deadline (i.e. your recordkeeper defaults employees differently as of that date) or a deadline for your decision. As the regulation is silent on it, we would conservatively interpret it as an implementation deadline – a very near-term one for those plan sponsors seeking the safe harbor. The near-term effective date most affects plan sponsors who:

- Currently default employees to something other than a designated QDIA,
- Currently or historically defaulted employees to something other than a designated QDIA or stable value.

These plan sponsors should select a QDIA from the three designated by the DoL: lifecycle/target retirement date funds, balanced funds, or managed accounts by the effective date. They also should carefully consider the language of the "Grandfather Provision" we summarized earlier in this letter. Depending on the circumstances of the particular plan, a unilateral redirection of historically defaulted balances may be appropriate.

Notwithstanding the above, NEPC does not view the rule as onerous for the vast majority of our clients. By and large NEPC's clients have already changed their default election to a QDIA, and the new rule does not appear to contain any significant requirements for them, so long as their prior QDIA was a stable value fund. Certainly there is language in the rule that deals with communication and notification requirements for participants, some of which may have changed from the original proposal. We will wait for record keepers and service providers' comments in this area.

Other Knock-On Effects

The QDIA rule is a comprehensive, thorough and surprisingly readable piece of regulation that is likely to shape best practices in areas other than the default and automatic enrollment decision, like mapping or re-enrollment to QDIAs, or the unilateral redirection of assets in a service provider conversion. The DoL acknowledges the regulations' effects will be cumulative and gradual, and their magnitude will depend on plan sponsor and participant choices. Accordingly the Department has developed low- and high-impact estimates to illustrate a range of potential effects, including predictions on how the QDIA is predicted to increase aggregate annual 401(k) plan contributions and balances. In the interest of getting the QDIA headline news out to plan sponsors quickly and effectively, we will cut off our comments here, while impressing upon our clients that the importance of this particular piece of regulation will play itself out for years to come.

Final Comments

Last week's publication of the Department of Labor's final regulations on qualified default investment alternatives (QDIAs) was eagerly anticipated. While the DoL held to its original proposal for three QDIAs: lifecycle/target date funds, balanced funds, and managed accounts, it did grant a couple of concessions to the insurance industry and other groups that lobbied for capital preservation products to be named QDIAs. In some instances, existing balances in these types of products are grandfathered indefinitely, and further, they may continue to be used both as non-default investment options and as short-term QDIAs (for up to 120-days).

An Appendix to this letter supplements the summary of items we laid out in this letter. We are also happy to provide a copy of the Federal Register upon request. We encourage our defined contribution clients to discuss this regulation with us in their upcoming meetings, particularly those clients who currently use a non-QDIA as a default, and clients who defaulted to something other than stable value historically. We thank you in advance for your time and attention to this important matter.

Since the publication of this paper in October 2007, NEPC has written additional papers detailing different components of the QDIA regulations. Topics include the implications of the QDIA on mapping practices and the appropriate use of a balanced fund as a QDIA. NEPC is happy to provide copies of these papers upon request.

Appendix

Default Investment Alternatives – Final Rule

The final regulations set forth conditions for fiduciary relief[2], clarify the notification requirements concerning default investment provisions and define the requirements for a QDIA.

i) Conditions for Fiduciary Relief

Like the proposal, the final rule sets forth six conditions for relief. The following are the six conditions set forth in the final rule:

- The investment of assets in the individual account of a participant or beneficiary must be invested in a "qualified default investment alternative" as defined in the final rule.
- The participant or beneficiary on whose behalf the investment is made must have been given the opportunity to direct the investment of his or her account but did not direct the investment of the assets.
- The participant or beneficiary on whose behalf an investment in a qualified default investment alternative may be made must be furnished a notice within a reasonable period of time of at least thirty days in advance of each subsequent plan year and:
    - a) at least thirty days in advance of the date of plan eligibility, or at least thirty days in advance of the date of any first investment in a qualified default investment alternative or
    - b) on or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal.
- A fiduciary must provide to a participant or beneficiary materials, as set forth in the 404(c) regulation, relating to a participant's or beneficiary's investment in a qualified default investment alternative.
- Any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative may transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elected to invested in the qualified default investment alternative, but not less frequently than once within any three month period. Any transfer or permissible withdrawal by a participant or beneficiary of assets invested in a qualified default investment alternative, in whole or in part, resulting from the participant's or beneficiary's election to make such a transfer or withdrawal during the 90-day period beginning on the date of the participant's first elective contribution or other first investment in a qualified default investment alternative on behalf of a participant or beneficiary shall not be subject to any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment.
- The plan must offer participants and beneficiaries the opportunity to invest in a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).

If the above conditions are met, according to the DoL, a fiduciary of an individual account plan that permits participants or beneficiaries to direct the investment of assets in their accounts shall not be liable for any loss, or by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of investing all or part of a participant's or beneficiary's account in any qualified default investment alternative.

ii) Notification Requirements

In order to qualify for relief under the final regulations, participants and beneficiaries must be given advance notification concerning the QDIA and it must be written in a manner calculated to be understood by the average plan participant and contain the following information:

- A description of the circumstances under which assets of the individual account of a participant or beneficiary may be invested on behalf of the

[2] Fiduciary relief, sometimes referred to as Section 404(c) relief, refers to limited liability protection from claims by participants and beneficiaries arising from investment losses.

participant and beneficiary in a qualified default investment alternative and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contribution and the right of the participant to elect not to have such contributions made on his or her behalf.

- An explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts.
- A description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics, and fees and expenses attendant to the investment alternative.
- A description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative, to direct the investment of those assets to any other investment alternative in the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer.
- An explanation of where the participants and beneficiaries can obtain information concerning the other investment alternatives available in the plan.

iii) Qualified Default Investment Alternatives

In order to be considered a QDIA, the following criteria must be met:

- The default cannot hold or permit the acquisition of employer securities (aside from where held within a 1940 Act mutual fund or pooled vehicle or received as a matching contribution from the employer/plan sponsor or at the direction of the participant or beneficiary).
- The default cannot impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer assets, in whole or in part, to another investment alternative in the plan.
- The default must *either* be managed by a named fiduciary[3] or by an investment company registered under the Investment Company Act of 1940.
- The default must constitute one of the following:
    - Lifecycle funds that take into account an individual's age or retirement date;
    - Professionally managed accounts that allocate an individual's contributions among investment alternatives available under the plan; or
    - A balanced fund with a uniform mix of equity and fixed income exposures appropriate for the participants of the plan as a whole
    - A capital preservation product may be used as a QDIA for the first 120-days following the date of a participant's initial elective contribution.

[3] Under section 402(a)(2) of ERISA, a named fiduciary refers to a fiduciary appointed as a fiduciary by a person who is an employer and/or an employee organization with respect to the plan.