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Department of Labor Issues Final Regulations on Qualified Default Investment Alternatives ("QDIAs")

On October 24, 2007, the Employee Benefits Security Administration of the U.S. Department of Labor ("DoL") published final regulations on the use of default investment alternatives. The final regulations, which take effect December 24, 2007, provide much-needed guidance to employers on fiduciary liability relief extended to investments in qualified default investment alternatives.

Plan sponsors will want to review the impact of the final regulations and determine what action needs to be taken in order to take full advantage of the relief offered under the final regulations.

Background

Generally, under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), anyone exercising discretionary control over the investment of plan assets is considered a fiduciary and subject to fiduciary liability. Section 404(c) of ERISA, however, limits fiduciary liability in participant-directed individual account plans (e.g., 401(k) and 403(b)) if the requirements of ERISA Section 404(c) are met. In such a case, plan fiduciaries are protected from fiduciary liability for losses resulting from the participant's investment decisions. Until the final regulations were issued, fiduciary protection under Section 404(c) did not extend to default investments because the participant did not direct the investments. That is, default investments were selected by the employer, and the DoL did not accept the argument that the default investment option was a "negative election" by the participant.

The Pension Protection Act of 2006 (the "Act"), signed into law by President Bush on August 17, 2006, includes a provision amending ERISA Section 404(c) to extend fiduciary liability protection to default investments if plan

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assets are invested in specific types of default investment alternatives. The Act directed the DoL to issue guidance, by way of regulations, on the different types of default investment alternatives and conditions that must be satisfied in order for fiduciary liability relief to apply. On September 27, 2006, the DoL published proposed regulations, which generated more than 120 public comments. The final regulations adopted in significant part the proposed regulations, but also included modifications reflecting commenters' suggestions.

Final Regulations: Six Conditions for Fiduciary Relief

The final regulations establish six conditions that must be met for the plan fiduciary to be protected under ERISA Section 404(c) from claims related to losses incurred in default investments. The six conditions are as follows:

First, assets must be invested in a "qualified default investment alternative" ("QDIA"). To meet the DoL's qualified status, the default investment must satisfy the following requirements:

- Subject to two exceptions, the default investment alternative may not hold employer stock. The first exception applies to employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle, which could occur where the plan sponsor is publicly traded and the mutual fund happened to acquire the shares as part of its investment policy, and the fact that the employer has selected the funds as a QDIA is a coincidence. The second exception applies to employer securities acquired as a matching contribution from the employer or from prior direction by the participant, so long as the managed account alternative (discussed below) has been selected and the investment manager has the authority to dispose of the securities;
- The default investment alternative must be managed by an investment manager, a trustee, or a plan sponsor who is a named fiduciary. Alternatively, it can be managed by an investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund company), or one of the capital preservation funds or products entitled to limited QDIA status (discussed below); and
- One of the following four types of investment vehicles

is used as the default investment alternative:

i. A life cycle fund, target retirement-date fund or a similar fund or model portfolio that is designed to provide varying degrees of long-term appreciation and principal preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date or life expectancy. Such funds change their asset allocation and associated risk levels over time with the objective of becoming more conservative with the participant's increasing age;

ii. A balanced fund or a similar fund or model portfolio that is designed to provide long-term appreciation and principal preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for the participants of the plan as whole;

iii. A managed account or a similar investment management service where an investment advisor allocates the assets of a participant's account to achieve varying degrees of long-term appreciation and principal preservation through a mix of equity and fixed income exposures offered through investment alternatives under the plan and based on the participant's age, target retirement date or life expectancy; or

iv. A stable value fund or money market fund, which is designed to preserve capital and provide a reasonable rate of return. Such fund or investment product will only meet the requirement of a QDIA for the first 120 days from the participant's first elective contribution to the plan.

The final regulations include a "grandfather" provision pursuant to which a default investment in certain capital preservation products prior to December 24, 2007 will receive ERISA Section 404(c) protection if it provides liquidity and a guaranteed rate of return consistent with that earned on an intermediate investment grade bond, while also providing liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives. Additionally, no fees or surrender charges may

be imposed in connection with withdrawals initiated by a participant or beneficiary.

Second, the participant or beneficiary must have had the opportunity to direct the investments in his or her account, but did not. Thus, a default investment that overrides a participant's investment election is not protected under the safe harbor.

Third, notice must generally be provided to the participant or beneficiary at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of any first investment in a QDIA. However, if the plan allows for penalty-free withdrawals under Internal Revenue Code Section 414(w), the initial notice may be provided on the day the participant makes his or her first investment in the QDIA. In the case where a fiduciary fails to meet the notice requirement by not providing the notice at least 30 days in advance of the date of plan eligibility or the plan does not provide for a penalty-free withdrawal, the fiduciary may still qualify for ERISA Section 404(c) protection for later contributions that meet the notice requirement. In addition to the initial notice, an annual notice must also be provided at least 30 days in advance of each subsequent year.

Notices must be written in a manner calculated to be understood by the average plan participant and must describe the following:

- The circumstances in which the participant's or beneficiary's plan account may be invested in a QDIA;
- The circumstances in which elective contributions will be made on behalf of the participant, the contribution percentage, and the right of the participant to opt-out of participation, or elect a different percentage (if applicable);
- An explanation of the participant's and beneficiary's right to direct investments in his or her account;
- The type of QDIA, including objective, risk and return characteristics (if applicable), and fees and expenses;
- The right of the participant or beneficiary to direct the investment to any other investment alternative under the plan, including a description of any restrictions, fees or expenses in connection with such transfers; and
- The person and address where the participant or

beneficiary should direct his or her request for investment information concerning the other investment alternatives offered under the plan.

As to distribution of the notice, the final regulations provide that to limit the chance of participants overlooking or ignoring the information relating to their participation and the investment of their contributions, the notice may not be included in the summary plan description or a summary of material modifications. However, the regulations allow the initial and the annual notice to be distributed with other notices (e.g., the 401(k) safe harbor notice, automatic enrollment notice, and quarterly statements) in a single mailing or other transmittals. The final regulations also clarify that electronic delivery of the notice is permissible if it conforms to other guidance provided on the use of electronic media.

Fourth, the plan or third party administrator must also send participants and beneficiaries investment materials relating to the QDIA. Some of the investment materials include: prospectuses, proxy voting material, and annual operating expenses.

Fifth, the participant or beneficiary must have the ability to transfer the default investment alternative to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who voluntarily elected to invest in the QDIA, but no less frequently than once within any three-month period. Thus, if a plan permits daily investment direction, participants in a default investment alternative must be permitted to direct their investment daily. Additionally, in response to numerous comments, the final regulations were modified to preclude restrictions, fees or expenses (other than investment management and similar types of fees and expenses such as 12b-1 fees and transfer agent expenses), e.g., surrender charges and redemption fees, on such transfers during the first 90 days of an investment in a QDIA. Thereafter, restrictions, fees, and expenses may be imposed in the same amount as those charged to other participants who elect to invest in the QDIA.

Finally, the plan must offer participants and beneficiaries the opportunity to invest in a "broad range of investment alternatives." A "broad range of investment alternatives" is defined as a minimum of three investment alternatives with materially different risk and return characteristics allowing any participant or beneficiary to create a risk and return investment portfolio in their appropriate range. The DoL

expects virtually all 401(k) and 403(b) plans that allow participants or beneficiaries to direct their own investments in an arrangement that satisfies the ERISA Section 404(c) requirements will meet the “broad range of investment alternative” standard without having to make significant changes in available investment alternatives.

What Should Employers Do Now?

Employers who have already amended their 401(k) or 403(b) plans for automatic enrollment should update their administrative processes and review their current default investments for compliance with the final regulations. For example, as quickly as possible, employers will want to review the content of the initial notice for compliance with the final regulations, and then distribute the notice to participants and beneficiaries. Employers who have not amended their plans for automatic enrollment should give careful consideration to making such amendments in light of the new fiduciary liability protection extended to QDIAs.

If you have any questions regarding the final regulations on QDIAs or more general questions on automatic enrollment, please contact either [Drake Frazier](#) or [Luke Bailey](#).

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