

One Minute Memo™



Labor Department Proposes Rules for Automatic 401(k) Investment Elections

The Department of Labor has issued its eagerly-awaited proposed regulations telling 401(k) plan fiduciaries how to invest the accounts of employees who don't make their own investment elections. The proposed regulations implement a default investment safe harbor enacted this summer as part of the Pension Protection Act of 2006, which takes effect for plan years beginning in 2007.

The safe harbor provides that plan fiduciaries will not be liable to a participant who does not affirmatively make an investment election on the grounds that the participant's account could have received a better investment return in one of the plan's other investments, as long as his or her account is invested in a "qualified default investment alternative" and the procedural requirements of the regulations are met. Plan fiduciaries will, of course, still be responsible for the prudent selection of the qualified default investment alternative.

The heart of the proposed regulations is the definition of qualified default investment alternative. The regulations

permit 3 different alternatives:

- "Life-cycle funds" which provide a different mix of debt and equity investments depending upon the age of the participant, becoming more conservative for older participants.
- A single balanced fund that provides a prudent overall mix of debt and equity. A single balanced fund can be used for all participants, regardless of age, but the fiduciary will be responsible for monitoring workforce demographics to insure that the balanced fund chosen remains appropriate.
- An individually managed account. This will not be a practical alternative for larger plans.

Note that fixed income, stable value and money market funds are not qualified alternatives, regardless of the size of the account. Plans that use such funds as a default investment will need to change to one of the permitted alternatives in order to take advantage of the new default investment safe harbor.

Other highlights of the proposed regulations include:

- Although the regulations are intended to complement the rules providing for automatic enrollment in 401(k) plans, a plan is not required to provide for automatic enrollment in order to utilize the default investment safe harbor. It can also be used for employees who for any reason never make an investment election.
- The plan must provide a menu of investment alternatives that satisfies the requirements of ERISA §404(c), but a plan is not required to comply with the procedural requirements of §404(c) in order to be eligible for the default investment safe harbor.
- The plan must provide a notice to all participants 30 days before the first default investment is made, and then must repeat the notice 30 days before the beginning of each plan year. It isn't clear how this will work in the case of automatic enrollment plans that begin enrollment fewer than 30 days after employment. *Even if the regulations are not finalized, all plan sponsors should give this notice within 30 days prior to the beginning of the 2007 plan year.*
- Unlike the current §404(c) fiduciary safe harbor, the plan must actually distribute to participants copies of all materials received from the default investment fund, including annual reports, proxy materials, etc. However, the regulations do not require a pass-through of voting rights. This apparently will require that the materials be furnished automatically, which

may impose a significant burden on some plans. Hopefully the Labor Department will relax the burden in the final rules by requiring that these materials be made available rather than automatically distributed, which is the requirement under the §404(c) fiduciary safe harbor.

The proposed regulations only apply to a participant who has never made an investment election. They do not address issues that arise when investments are "mapped" from one set of investment options to another. Issues raised by mapping, which was also addressed by the Pension Protection Act, are expected to be the subject of additional guidance.

If you have any questions concerning the new default election rules, please contact the Seyfarth Shaw LLP attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.

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