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Management Alert

New Regulations Provide Safe Harbor for Default Investment Options

Plan Sponsors Should Issue Notices before November 24, 2007 for Maximum Fiduciary Protection Under Final Qualified Default Investment Alternatives Regulations

The Department of Labor has issued final regulations providing fiduciary relief for plan fiduciaries who have selected default investment options for their 401(k) plans (or other plans in which participants have the opportunity to direct investments). These final regulations implement a safe harbor for default investment elections enacted as part of the Pension Protection Act of 2006, which applies for plan years after 2006.

We strongly recommend that all plans that include a default investment fund be revised to comply with the new safe harbor, in order to protect plan fiduciaries from potential personal liability. In addition, a plan that already uses a qualified default investment fund, or can switch to one by year end, can maximize the protection of its fiduciaries by issuing a notice to participants by November 24, 2007.

The highlights of the final regulations include:

- Only life cycle and balanced funds (or individually managed accounts) can qualify as safe harbor investment options. Stable value funds can only be used for the first 120 days after a participant is enrolled in the plan—after that the account must be transferred to a life cycle or balanced fund.
- Although stable value funds generally don't qualify, the regulations include an exception for default investments in certain types of stable value funds prior to December 24, 2007. This means that fiduciaries can get the benefit of the safe harbor for old investments in qualified stable value funds without transferring the accounts.
- A notice must be given to each employee, along with a copy of the default fund prospectus, when he or she first becomes a participant. An annual notice to all participants is also required. *For existing employees, the safe harbor will not begin to apply until 30 days after they receive their first notice.*
- The regulations 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, may be the subject of additional guidance.

The regulations provide that a participant who provided no investment direction and whose account is invested in a "qualified default investment alternative" is deemed to have exercised control over his or her plan assets. This means that plan fiduciaries who comply with these final regulations will not be liable to the participant for any investment loss the participant may experience due to investment in the default fund. This fiduciary relief is not limited to plans with automatic enrollment features. Any plan for which plan fiduciaries have established default investment alternatives for situations in which a participant fails to provide investment instruction (for example, a profit-sharing or similar plan that provides for automatic employer contributions) can benefit from this relief. Plan fiduciaries are, of course, still responsible for the prudent selection of the qualified default investment alternative.

Requirements of the Safe Harbor

The regulations provide six conditions that must be met in order for the plan fiduciary to benefit from the safe harbor.

Must have a qualified default investment alternative

The regulations generally permit different types of safe harbor default investments, technically known as "qualified default investment alternatives" or "QDIAs". The plan fiduciary is not required to evaluate which safe harbor option is the most prudent for its plan. Any safe harbor option will meet the fiduciary's obligation if the other regulation requirements are met. (However, the fiduciary must act prudently in selecting and monitoring the specific fund used as a safe harbor.)

The following types of safe harbor funds are permitted:

- "Life-cycle" or "target retirement" funds which provide a different mix of debt and equity investments depending upon the age of the participant, and become 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 balance fund chosen remains appropriate.
- An individually managed account.

The final regulations generally do not include stable value funds as a safe harbor. The regulations do provide, however, that default investments made to certain types of stable value funds before December 24, 2007 may be considered "grandfathered" and fiduciaries who selected those default funds may be eligible for the relief from liability.

The regulations also provide for a limited-time exception for capital preservation funds (including stable value and money market funds). These funds may be considered a safe harbor *for only the first 120 days* after the participant's account balance is invested in them. This exception is intended to help reduce the risk of loss in situations where participants are automatically enrolled, but are permitted to opt out and withdraw their deferrals within 90 days. In order for the fiduciary relief to apply, these funds must be reinvested after 120 days in a safe harbor.

Participant failed to make an investment election

This condition simply requires that the participant had the opportunity to direct the investment of his or her plan account, but did not do so. The Labor Department recognizes that many plans will not have sufficient records to tell which participants were defaulted into a particular fund and which affirmatively elected that fund. Accordingly, once the initial notice described below is given, all existing participants who are invested in the default fund will be treated as having been defaulted into the fund.

Advance notice and annual notice requirement

Initial Notice. This notice must be provided at least 30 days before the participant becomes eligible to participate in the plan or at least 30 days before the date of the first investment in a safe harbor. If the plan is designed to enroll eligible participants immediately upon employment and provide them with the opportunity to opt out and take a distribution of their automatic deferrals without tax consequence, the initial notice may be provided on or before the date the individual becomes eligible to participate in the plan.

If the plan already has selected a safe harbor and participants' assets have already been invested in the safe harbor by default, a notice that otherwise meets these regulation requirements and is given at least 30 days before the effective date of the final regulations, December 24, 2007, will still constitute an initial notice for these purposes (and will also meet the annual notice requirement described below for calendar year plans).

Annual Notice. Another notice must be provided to all participants at least 30 days in advance of each plan year. In the case of a 401(k) plan that uses automatic enrollment, this

notice may be combined with other annual notices required as described below.

Contents and Distribution of Notice. The notice must be written in a manner that would be understood by the average plan participant and generally must contain:

- A description of when a participant's account will be invested in a safe harbor. If the plan has an automatic enrollment feature, the notice should also include a description of when automatic deferrals will be taken, the percentage of these contributions, and the participant's right to opt out or change the percentage;
- An explanation of the participant's right to direct the investment of their accounts;
- A description of the safe harbor investment fund (including investment objectives, risk and return characteristics (if applicable) and applicable fees and expenses);
- A description of the participant's right to change to other investment alternatives and any applicable restrictions, fees or expenses in connection with such a change; and
- An explanation of where the participant can obtain investment information about the other investment alternatives.

The Labor Department did not provide a model notice.

Method of Giving Notice. Unlike the proposed regulations, the final regulations provide that these notice requirements are *not* met by including these notices in a summary of material modification or in a summary plan description. Rather, this information should be provided in a separate notice (although it can be included with distributions of other notices). The regulations provide that the Labor Department is reviewing its rules related to electronic disclosures. In the meantime, however, plans may distribute these notices electronically under either the DOL or IRS rules regarding electronic distribution.

The Pension Protection Act required all plans that include an automatic enrollment feature to provide an annual notice to all participants in order for the plan to be exempt from state payroll laws that might otherwise prohibit withholding from employee paychecks. In addition, 401(k) plans that use a safe harbor method of satisfying the nondiscrimination tests are required to provide an annual notice. The new safe harbor default investment notice can be combined with either of these other annual notices.

Participants receive investment alternative materials

If a mutual fund is used as the safe harbor investment fund, the plan or third party administrator must automatically provide all participants with a copy of the most recent prospectus at the same time they receive their initial notice. In addition, participants have the same right to request additional materials with respect to the safe harbor investment fund that they have with respect to other funds under the §404(c) regulations. To the extent rights such as voting rights are passed through to participants, materials related to the exercise of these rights should also be provided. The Labor Department indicated it is reviewing the disclosure requirements under a separate initiative which may determine that simply making the prospectus available rather than automatically distributing it would meet this requirement. At this point, however, automatic distribution is required.

Participants have same rights to change investment elections – limits on fees, expenses and restrictions for the first 90 days

Participants invested in the safe harbor must have the right to change investment options as often as other plan participants can, but at least once every three months. No restrictions, fees, or expenses (including surrender charges, liquidation or exchange fees, redemption fees) may be imposed on participants defaulted into the safe harbor fund for the first 90 days after the participant's account is initially invested in the safe harbor fund. Fees and expenses charged on an ongoing basis

for the operation of the investment itself (such as investment management fees) may still be charged in this initial 90-day period. After the initial 90-day period, restrictions, fees or expenses can be charged to participants defaulted into the safe harbor, if these provisions apply to all plan participants invested in that investment option.

Broad range of investment alternatives

The plan must offer a broad range of investment alternatives that satisfies the requirements of ERISA §404(c). The plan is not required, however, to actually comply with all the procedural requirements of §404(c) to be eligible for the safe harbor safe harbor relief.

Transitional Rules

The manner in which a plan transitions to the new safe harbor rules will depend on what type of default investment fund it is currently using:

- If the plan is currently using a qualified default investment alternative *(i.e.,* balanced or life cycle funds), it only needs to provide the initial notice to all current participants. This should be done not later than November 24, 2007, in order to obtain maximum protection. Thereafter, the plan will need to provide the initial notice to new participants and the annual notice to all participants.
- If the plan is currently using a stable value fund that meets the requirements for the grandfather rule, it should switch to a qualified default investment alternative as soon as it can prudently do so. If a qualified safe harbor option is already included in the plan's investment options, this should be done for new contributions made beginning December 24, 2007, and the initial notice should be given by November 24, 2007. The plan fiduciaries can then decide whether it is desirable to transfer funds previously invested in the old default fund into the new fund.
- If the plan is currently using a default fund that doesn't meet either the new safe harbor rules or the grandfather rule—i.e., a stable value fund in which the principal and minimum return are not guaranteed by a regulated financial institution—both old and new contributions should be transferred to a new qualified default investment alternative as soon as this can prudently be done.

The notice given by November 24, 2007, should include a copy of the prospectus for the safe harbor default option unless the plan previously provided a copy of the prospectus to those participants who are invested in the default fund at the time of their first investment in accordance with the §404(c) regulations. The §404(c) regulations require that the prospectus actually be delivered to the participant, and not merely furnished on request or otherwise made available.

If you have questions about whether your default investment fund constitutes a safe harbor, or need assistance in preparing the safe harbor notice to plan participants, please contact your Seyfarth Shaw Employee Benefits attorney or any Employee Benefits attorney on our website, www.seyfarth.com.

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