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"Following the issuance of the QDIA regulations, a number of issues arose. To address those issues and provide guidance with respect to the application of the final regulations, the Department of Labor recently issued Field Assistance Bulletin 2008-03."

THE DEPARTMENT OF LABOR'S FINAL RULES AND SUPPLEMENTAL GUIDANCE FOR QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

by
Gregory B. Kuhn
Utz, Miller, Kuhn & Eickman, LLC
gkuhn@utzmiller.com

Among the numerous changes included in the Pension Protection Act of 2006 (the "PPA") was the addition of the qualified default investment alternative (the "QDIA") rule to Section 404(c) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Under ERISA Section 404(c), fiduciaries of 401(k) and other ERISA-governed retirement plans that permit participants to direct the investment of their plan accounts are not responsible for losses resulting from the participants' investment elections. Before the addition of the QDIA rule, this relief was only available if a participant made an affirmative investment election. Now, the relief is also available when a participant fails to make an investment election if the participant's plan account is invested in a QDIA.

The QDIA rule in ERISA Section 404(c)(5) does not contain specific requirements. Rather, it directs the Department of Labor to issue regulations setting the QDIA requirements. In accordance with that direction, the Department of Labor issued final regulations establishing the detailed QDIA requirements. Those regulations first went into effect on December 24, 2007.

Following the issuance of the QDIA regulations, a number of issues arose. To address those issues and provide guidance with respect to the application of the final regulations, the Department of Labor recently issued Field Assistance Bulletin 2008-03 (the "Bulletin"). At the same time, the Department of Labor made some minor clarifications to the final regulations.

The Bulletin is written in question and answer format and is intended to address the most frequently asked questions about the final QDIA regulations. After a brief outline of the final regulations' QDIA requirements, this newsletter highlights the helpful and practical guidance provided by the Department of Labor in the Bulletin.

OUTLINE OF THE QDIA REGULATIONS' REQUIREMENTS. The QDIA regulations contain the following nine requirements that must be satisfied if a plan fiduciary wants investment responsibility relief for participants[1] who don't make investment elections:

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[1] Although the term "participants" is used throughout this newsletter, the QDIA regulations and ERISA Section 404(c)(5) fiduciary relief can also apply to beneficiaries of deceased participants and alternate payees under a qualified domestic relations order if those persons have the ability to direct the investment of their plan accounts.

"The QDIA regulations do not identify specific investments that are qualified."

Utz, Miller, Kuhn & Eickman, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

www.utzmiller.com

1. Broad Range of Investment Options. The plan must provide a broad range of investment options under ERISA Section 404(c).

2. Approved Default Investment Mechanisms. The QDIA regulations do not identify specific investments that are qualified. Rather, the regulations describe what a Department of Labor press release refers to as three acceptable investment "mechanisms," each of which is intended to individually meet a participant's long-term retirement savings needs. There is also a short-term mechanism that is intended to assist plans with an automatic 401(k) enrollment feature that permits automatically enrolled participants to opt-out of the plan and withdraw their deferrals. The following briefly describes each approved mechanism:

   - An investment product with a mix of investments that takes into account an individual participant's age or anticipated retirement date (for example, a life-cycle or target retirement date fund).

   - An investment product with a mix of investments that takes into account the ages or anticipated retirement dates of the group of plan participants as a whole, rather than each individual participant (for example, a balanced fund).

   - A professional investment management service where the investment manager (which is an ERISA "investment manager" of the plan)[2] invests the participant's account among the plan's investment options to provide a mix of investments that takes into account the participant's age or anticipated retirement date.

   - A capital preservation product limited to the first 120 days that a participant is first automatically enrolled in a 401(k) plan. To continue relief under the QDIA rule, the participant's account and future contributions would need to be invested in one of the above QDIA options after the 120-day period.

   In addition to the above QDIA options, certain stable value funds that served as a plan's default fund prior to the regulations' December 24, 2007 effective date remain a qualified option for amounts that were invested in that fund on December 24, 2007. Acceptable stable value funds are any investment fund or product that is designed to preserve principal and provides a rate of return generally consistent with that earned on immediate investment grade bonds. The fund or investment product cannot impose fees or surrender charges on withdrawals and the fund or product must hold investments that are backed by a State or federally regulated financial institution.

3. QDIA Manager. A QDIA may be managed by an investment company registered under the Investment Company Act of 1940

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[2] ERISA investment managers are limited to registered investment advisers under federal securities law, federally regulated banks and certain qualifying insurance companies. The manager must also acknowledge in writing that it is a plan fiduciary.

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(that is, a mutual fund). Alternatively, it can be a different type of investment product (including an "in-house" arrangement structured using a mix of plan investment options), so long as it is managed by one of the following: (i) an ERISA investment manager; (ii) the plan trustee if the trustee is also an ERISA investment manager; or (iii) a named fiduciary of the plan which is either the plan sponsor or a committee comprised primarily of employees of the plan sponsor.

4. <u>No Investment Election</u>. Each participant whose account is invested in the QDIA must have been able to direct the investment of his or her plan account but failed to do so.

5. <u>Notices</u>. An initial notice containing certain investment and fee information about the QDIA, and the right to direct investments under the plan, must be provided to the participant before the participant's account is first invested in the QDIA. Before the start of each following plan year, a similar notice must be given for so long as the participant's account is invested in the QDIA.

6. <u>Investment Materials</u>. All investment materials, such as mutual fund prospectuses and proxies, that are received by the plan for the QDIA must be passed through to participants invested in the QDIA.

7. <u>Investment Changes</u>. Participants must be able to transfer their accounts from the QDIA to other plan investments with the same frequency as other investment changes are permitted under the plan (and in no event less frequently than quarterly).

8. <u>Limitations on Fees and Restrictions</u>. For the 90-day period following a participant's first investment in a QDIA, no surrender, liquidation, redemption or similar fees or restrictions can be imposed if the participant elects to transfer funds from the QDIA to another plan investment option. This limitation does not prohibit "round-trip" type restrictions that impose waiting periods or other conditions on reinvestment in the QDIA after a transfer. Further, after the 90-day protected period, any surrender, redemption and similar fees and restrictions that apply to plan participants who direct investments into the QDIA are permitted.

9. <u>QDIA Selection and Monitoring</u>. The plan fiduciary must prudently select the QDIA and frequently monitor its investment performance and fees using an appropriate benchmark. If performance is poor, the plan fiduciary may need to select a replacement QDIA.

<u>HIGHLIGHTS OF THE BULLETIN</u>. Immediately following the issuance of the final QDIA regulations, questions arose about their application to various but common situations. The Bulletin is intended to address those questions. The Bulletin's questions and answers are organized into six categories. The following highlights the guidance provided in each category.

Scope of the QDIA Regulation.

- <u>Effective date of fiduciary relief</u>. There is no QDIA fiduciary relief until December 24, 2007, which is the effective date of the final Department of Labor regulations. Amounts that were invested in a plan's QDIA before December 24, 2007 are nonetheless eligible for the relief starting on the regulations' December 24, 2007 effective date. However, due to the initial QDIA notice requirement, QDIA relief does not begin until 30 days after participants have been give the notice. A plan fiduciary wanting QDIA relief for participants invested in the default fund starting on December 24, 2007 must therefore have provided the initial QDIA notice (which would have also satisfied the annual QDIA notice for 2008) to those participants no later than November 24, 2007.

- Transition relief for non-defaulted participants. If a plan fiduciary replaces a non-qualifying default investment (like a money market fund) with a QDIA, the QDIA fiduciary relief can apply to all participants whose accounts are transferred from the non-qualifying default investment to the QDIA, including those participants who elected before December 24, 2007 to invest in the non-qualifying default fund. It is therefore not necessary to limit the transfer to just those participants who were defaulted into the fund. It is also unnecessary to distinguish between participants who were defaulted into the fund and those who elected to invest in it where the default fund is already a qualifying fund so that no replacement default fund is needed.

- Contribution types. Nonelective contributions, like profit sharing contributions or QNECs that are made to satisfy 401(k) plan ADP testing, and even proceeds received by the plan from litigation or a settlement involving a plan investment option, can qualify for QDIA fiduciary relief. However, the participants receiving those contributions or proceeds must have the ability to invest those amounts in the plan's other investment options in order for the relief to apply.

- 403(b) plans. In addition to qualified retirement plans, QDIA relief is available for plan fiduciaries of 403(b) tax-sheltered annuity plans that are subject to ERISA.

Notice Requirements

- Fees and expense information. The initial and annual QDIA notice must disclose two categories of fee and expense information. First, it must include the amount and description of any shareholder-type fees, such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges and exchange fees. Second, it must include the QDIA's expense ratio, if applicable. If this information is included in a prospectus or profile prospectus, this disclosure requirement can be met by providing a copy of the prospectus or profile prospectus along with the initial and annual QDIA notices.

- Electronic delivery. The initial and annual QDIA notices can be provided electronically under either the Department of Labor or IRS rules for electronic delivery of documents to plan participants.

- Coordination with 401(k) plan notices. 401(k) plans with automatic enrollment features, and 401(k) plans with safe harbor provisions that eliminate the need for annual ADP testing, are also subject to initial and annual notice requirements under the Internal Revenue Code. In either case, the plan fiduciary may,

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7285 West 132nd St.
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www.utzmiller.com

but is not required to, combine these 401(k) plan notices with the QDIA notice. The Department of Labor and the IRS have developed a model combined notice for 401(k) plans with an automatic enrollment feature.[3] The model notice is available at http://www.irs.gov/pub/irs-tege/sample_notice.pdf.

- Timing. The timing requirements for the QDIA and 401(k) plan automatic enrollment notices are compatible. For a new participant, providing each notice (or, if the plan fiduciary prefers, the combined notice mentioned above) on or within 90 days before the participant's date of plan eligibility satisfies both the QDIA and automatic enrollment initial notice timing requirements. Meanwhile, providing the annual notice (either individually or in combination) at least 30 days and not more than 90 days prior to the start of each plan year satisfies each rule's annual notice timing requirement.

90-Day Limit on Fees

- Payment by plan sponsor/service provider. Redemption and other transfer or exchange fees and expenses can be imposed on a QDIA during the 90-day protected period if those fees and expenses are paid by the plan sponsor or by a plan service provider (like a recordkeeper or third party administrator). The IRS has not indicated how it would treat such a payment for tax purposes (that is, as a deductible business expense, a plan contribution, or something else).

- Effective date of limit. The 90-day protected period only applies to participants who are first invested in the QDIA on or after the regulations' December 24, 2007 effective date. As a result, if a plan's default fund met the QDIA requirements prior to December 24, 2007, participants who were invested in the fund before December 24, 2007 can remain subject to any redemption and other transfer fees and expenses that normally apply to transfers out of the QDIA.

Management and Asset Allocations

- Mix of equity and fixed income. Although the QDIA regulations do not set a minimum level of fixed income and equity allocations within the QDIA, a default fund with no fixed income or no equity allocation does not meet the QDIA requirements.

- ERISA Section 404(c) disclosures. The same investment disclosure rules under ERISA Section 404(c) apply to the QDIA. As a result, a copy of certain investment materials must automatically be provided to the participant, like a copy of the most recent prospectus or profile prospectus, if applicable, as well as all materials relating to voting, tender and similar rights that are received by the plan. On the other hand, information about the plan's other investment options need only be provided to the participant upon request.

[3] Under the Internal Revenue Code, a 401(k) plan that intends to comply with the new rules for automatic enrollment *must* satisfy the QDIA regulations' requirements for automatically enrolled participants who fail to direct the investment of their plan accounts.

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- Multiple QDIAs. A plan can have more than one QDIA. For example, one type of QDIA can be used for automatic deferrals (like a combination of the 120-day capital preservation fund option followed by the transfer to a target date fund) and another type of QDIA (like a balanced fund) can be used for rollover and other contributions.

120-Day Capital Preservation QDIA

- Limited to EACAs. The special short-term 120-day capital preservation QDIA option is only intended to provide administrative flexibility for those plans with a 401(k) eligible automatic contribution arrangement (an "EACA") under Internal Revenue Code Section 414(w) that permits participants to withdraw their 401(k) deferrals during the first 90 days following automatic enrollment. As a result, this QDIA option is not available for plans without the EACA withdrawal feature or for non-EACA contributions (such as a rollover into the plan from an IRA or another qualified plan, unless a participant for whom EACA contributions are made completes the rollover within 120 days of when the EACA contributions began).

- State or federal regulation. The special short-term QDIA must be offered by a State or federally regulated financial institution. As a result, it cannot be managed in-house by a named fiduciary of the plan or by an ERISA investment manager that is not a financial institution.

Grandfather Relief for Stable Value Funds

- Limited scope. Only participant accounts that were invested in a qualifying stable value fund on the QDIA regulations' December 24, 2007 effective date are eligible for the special grandfather relief. That relief does not begin until 30 days after the initial QDIA notice is given to those participants. Further, the relief only applies to assets that were invested in the stable value fund on December 24, 2007. Therefore, additional stable value fund investments after December 24, 2007 by participants receiving the stable value fund QDIA notice are not eligible for QDIA relief.

CONCLUSION. The Bulletin provides helpful guidance for plan fiduciaries that want ERISA Section 404(c) relief for plan assets invested in a default fund. Plan fiduciaries that are in the process of implementing a QDIA, as well as plan fiduciaries that have already implemented a QDIA, should carefully review the QDIA and the manner in which it is administered to ensure that the QDIA is consistent with the above highlights from the Bulletin. Further, the Department of Labor is about to issue proposed regulations containing new rules requiring specific fee and expense disclosures to participants for each plan investment option. Those new rules, when finalized, may require changes to the QDIA initial and annual notices.

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