AUTOMATING YOUR PLAN: GIVE YOUR PLAN A 404(C), QDIA AND AUTOMATIC ENROLLMENT CHECK-UP

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I. Introduction

The introduction of various provisions of the Pension Protection Act of 2006 ("PPA") makes it much easier for even large companies to attempt a turn key approach to the maintenance of their retirement plans. This is a result of the enactment of such provisions allowing automatic enrollment, automatic default investments along with the basic ERISA Section 404(c) provisions.

The purpose of this Outline is to both review the applicable rules and to explore issues that should be reviewed in attempting to ensure that plans satisfy the various provisions designed to automate otherwise fiduciary provisions.

II. QDIA

A. Introduction

Although Section 404(c) of the Employee Retirement Income Security Act of 1974 ("ERISA") provides fiduciary relief where a participant in an individual account plan directs the investment of his/her account and the plan satisfies the requirements under the regulations, no relief was explicitly provided where the participant failed to exercise this authority. This meant, for example, that in the event the participant's account was invested in accordance with the plan's default investment options, because the participant failed to make an affirmative election, arguments could be made that the fiduciary, and not the participant, remained responsible for the direct and necessary results that flowed from that investment decision.

The Pension Protection Act of 2006 (PPA") extended, for the first time, the fiduciary relief accorded by ERISA Section 404(c)(1) to fiduciaries that invest participant accounts in certain types of default investment alternatives in the absence of participant investment direction. [PPA Section 624(a); ERISA Section 404(c)(5)(A)]

B. Statutory Provision

Effective for plan years beginning after December 31, 2006, PPA provides that a participant in an individual account plan meeting the notice requirement of the statute will be treated as exercising control over the investment of his individual account if the account is invested in a default arrangement in accordance with Department of Labor regulations. [ERISA Section 404(c)(5)(A)]

Eligibility for this relief requires that participants receive a notice, within a reasonable period of time prior to each plan year, explaining the employee's right under the plan to direct the investment of his/her account and explaining how the account will be invested in the absence of an affirmative election. After issuance of the notice, a participant must have a reasonable period of time before the beginning of the plan year to make an election. [ERISA Section 404(c)(5)(B)]

The Department of Labor ("DOL") was directed to issue regulations providing guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. [ERISA Section 404(c)(5)(A)]

C. Regulatory Guidance

1. Issuance of Regulatory Guidance

In response, the DOL issued proposed regulations on September 27, 2006. [Prop. Labor Reg. Section 2550.404c-5, Fed. Reg. Vol. 71, No. 187, p. 56805] The regulations were subsequently finalized with some modifications. [Labor Reg. Section 2550.404c-5; Fed. Reg. 72, No. 205, p. 60452]

2. Effective Date

The final regulation is effective on December 24, 2007.

3. Scope of Relief

General Rule

The scope of the relief remains primarily unchanged from that which was set forth in the proposed regulations. Specifically, the final regulations continue to provide that a fiduciary of an individual account plan that permits participants or beneficiaries to direct the investment of their accounts and that meets the requirements of the regulations will not be liable for any loss by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of:

(i) investing all or part of a participant's or beneficiary's account in any QDIA, or

(ii) investment decisions made by an entity described in paragraph (e)(3) of the regulatory section in connection with the management of a QDIA.

[Labor Reg. Section 2550-404c-5(b)(1)]

The entities described in (ii) are:

(i) (a) an investment manager, within the meaning of Section 3(38) of ERISA; (b) a trustee of the plan that meets the requirements of Section 3(38)(A), (B) and (C) of ERISA; or (c) the plan sponsor, or a committee comprised primarily of employees of the plan sponsor which is a named fiduciary within the meaning of Section 402(a)(2) of ERISA;

(ii) an investment company registered under the Investment Company Act of 1940, or

(iii) an investment product or fund meeting the special rules for limited relief for either certain capital preservation funds or stable value funds under Labor Reg. Section 2550.404c-5(e)(4)(iv) & (v)—see the special rules discussed with respect to the QDIA requirements below]

The Preamble notes that the use of the phrase "any qualified default investment alternative" in the final regulations is intended to make it clear that a fiduciary will be afforded relief without regard to which type of qualified default investment alternative the fiduciary selects provided that the fiduciary prudently selects the particular investment or service and satisfies the other requirements of the regulations. [Preamble Final Regulations, Section B. Overview of Final Rule; Scope of Relief]

Note, however, that according to the DOL Field Assistance Bulletin No. 2008-03, April 29, 2008, in responding to the question as to the extent of relief available to a plan sponsor who chooses to create and manage a QDIA itself using a mix of the plan's available investment alternatives, the DOL states that a plan sponsor that chooses to create and manage a QDIA itself may be relived of liability for decisions to invest all or part of a participant's or beneficiary's account in a QDIA only if the plan sponsor is a named fiduciary [citing Labor Reg. Section 2550.404c-5(e)(3)(i)(C))} The sponsor would not be relieved of liability for the management of the QDIA [citing Labor Reg. Section 2550.404c-5(b)(1)(ii)] or the prudent selection and monitoring of the QDIA [citing Labor Reg. Section 2550.404c-5(b)(3)]

Expansion of Who can Manage a QDIA

Note that, as originally proposed, the category of persons who could manage the assets of a QDIA was limited to investment managers. The final regulations extend this to permit plan sponsors that are named fiduciaries to manage QDIAs as well as trustees of a plan, i.e., banks that both serve as a plan trustee and can also qualify as an investment manager under ERISA. In addition, as a result of the amendment of the final regulations, those who can manage a QDIA also include a committee comprised primarily of employees of the plan sponsor, which is a named fiduciary with the meaning of Section 402(a)(2) of ERISA. [Labor Reg. Section 2550.404c-5(e)(3)(i)(C)]

Section 404c Status Not Required

The scope of the relief is the same as that extended to plan fiduciaries under ERISA Section 404(c)(1)(B) in connection with carrying out investment directions of plan participants and beneficiaries in an ERISA Section 404(c) plan as described in Labor Reg. Section 2550.404c-1(a) although it is not necessary for a plan to be an ERISA Section 404(c) plan in order to gain the fiduciary relief under the proposed regulations. [Preamble to Final Regulations, Section B. Overview of Proposal, Application of General Fiduciary Standard]

No Relief From General Fiduciary Requirements including Prudent Man Rule

However, the final regulations do not provide any relief from the general fiduciary rules applicable to the selection and monitoring of a particular QDIA or from any liability which results from a failure to satisfy these duties, including liability for any resulting losses. [Labor Reg. Section 2550.404c-5(b)(2)]

Similarly, nothing in the final regulations provide relief to an investment manager, plan trustee or plan sponsor that is a named fiduciary from its general fiduciary duties or from any liabilities that result from a failure to satisfy these duties, including liability for any resulting losses. [Labor Reg. Section 2550.404c-5(b)(3)]

Nothing in the regulations is to be interpreted as providing relief from the prohibited transaction provisions of ERISA or from any liability which results from a violation of those provisions. [Labor Reg. Section 2550.404c-5(b)(4)]

Not the Exclusive Means of Satisfying Default Obligations

The standards contained in the regulation apply solely for purposes of determining whether a fiduciary meets the requirements of the regulation. The standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under ERISA with respect to a participant who fails to make an affirmative investment election. [Preamble to Final Regulations, Section B. Overview of Final Rule; Scope of Fiduciary Relief]

Relief Available Beyond Mere Automatic Enrollment

The relief is not limited to only those situations involving automatic enrollment, but rather can be used whenever a participant or beneficiary has the right to invest his/her acco0unt but fails to make an affirmative election so long as all of the conditions of the regulations are satisfied. [Preamble to Final Regulations, Section B. Overview of Final Rule; Application of Final Rule to Circumstances Other than Automatic Enrollment]

4. Conditions for Relief

In order for the relief to be available, six conditions must be met:

(i) the assets must be invested in a QDIA;

(ii) the participant or beneficiary must have had an opportunity to direct the investment of his/her account but did not do so;

This means that no relief is available when a participant or beneficiary has provided an affirmative investment direction.

(iii) the participant or beneficiary must be furnished both an initial notice and an annual notice;

Timing of Initial Notice

With respect to the initial notice, the final regulations have been modified to require that the notice be provided at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the date of any first investment in a QDIA, or on or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal (as defined in IRC Section 414(w). [Labor Reg. Section 2550.404c-5(c)(3)(i)]

The final regulations peg the issuance of the initial notice from the date of plan eligibility to better coordinate the notice requirement with the Code provisions governing permissible withdrawals. Moreover, according to the Preamble, the use of the phrase "or at least 30 days in advance of the first investment" in a QDIA is intended to accommodate circumstances other than elective contributions, for example, the investment of a participant's rollover account.

The DOL further states that the phrase "in advance of the date of plan eligibility…or any first investment alternative" is not intended to foreclose the availability of the relief to fiduciaries that, prior to the adoption of the final regulation, invested assets on behalf of participants and beneficiaries in a default investment alternative that would constitute a QDIA under the regulation. In such case, the phrase should be read to mean the first investment with respect to which relief under the final regulation is intended to apply after the effective date of the regulation.

[Preamble to Final Regulations, Section B. Overview of Final Rule; Conditions for the Fiduciary Relief]

Timing of Annual Notice

The annual notice is required to be provided within a reasonable period of time of at least 30 days in advance of each subsequent plan year. [Labor Reg. Section 2550.404c-5(c)(3)(ii)]

No Satisfaction by SPD

Significantly, the final regulations remove the provision of the proposed regulations that had allowed the notice requirement to be satisfied by inclusion in a summary plan description or summary of material modification. However, the final regulations continue to anticipate that this notice requirement and the notice requirements of Sections 401(k)(13)(E) and 414(w)(4) could be satisfied in a single disclosure document. [Preamble to Final Regulations; Section B. Overview of Final Rule; Conditions for the Fiduciary Relief]

(iv) a fiduciary must provide to a participant or beneficiary, any material set forth in Labor Reg. Section 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix) and Labor Reg. Section 2550.404c-1(b)(2)(i)(B)(2) relating to a participant's or beneficiary's investment in a QDIA;

Note that the final regulations remove from the above requirement the phrase "under the terms of the plan" as some were concerned that this could be interpreted to require plan amendments to explicitly incorporate the proposed rule's disclosure provisions. [Preamble to Final Regulations, Section B. Overview of Final Rule; Conditions for the Fiduciary Relief]

Note also that the items required to be distributed are less broad than had been the case under the proposed regulations with the final regulations opting to ensure that the same items required to be disclosed to participants in Section 404(c) plan who have made an affirmative election are also provided to those whose accounts are subject to investment in a QDIA.

(v) any participant or beneficiary whose account is invested in a QDIA 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 invest in the QDIA, but not less frequently than once within any three month period;

Manner of Issuance of Notice and Additional Pass Through Material

The Preamble to the regulations authorizes the use of electronic means to provide the QDIA notice. Specifically, the Preamble states that, in the absence of guidance to the contrary, it is the view of the Department that plans that wish to use electronic means by which to satisfy their notice requirements may rely on either guidance issued by the Department of Labor at 29 CFR 2520.104b-1(c) or the guidance issued by the Department of the Treasury and Internal Revenue Service at 26 CFR 1.401(a)-21 relating to the use of electronic media.

However, this does not extend to the provision of the information required to be passed through. Specifically, the DOL states that, in the absence of further guidance, the DOL's view on this issue extends only to the QDIA regulation's notice requirement and not currently to the pass through investment materials. However, the DOL notes that it is working on a separate regulatory initiative concerning the broader application of disclosure by electronic means. [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-7]

Restrictions on Fees and Expenses

The final regulations also contain restrictions on the application of fees and expenses to such accounts at least for a limited period of time. Specifically, any such transfer or permissible withdrawal under Section 414(w)(2) by a participant or beneficiary invested in a QDIA, 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 as determined under Section 414(w)(2)(B) or other first investment in a QDIA on behalf of a participant or beneficiary may 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. [Labor Reg. Section 2550.404c-5(c)(5)(ii))(A)]

There is, however, an exception for fees and expenses that are charged on an ongoing basis for the operation of the investment itself (such as investment management fees, distribution and/or service fees, 12b-1 fees, or legal, accounting, transfer agent and similar administrative expenses) and are not imposed, or do not vary based upon a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the QDIA. Labor Reg. Section 2550.404c-5(c)(5)(ii))(B)]

Moreover, the final regulations were amended to provide that this restriction does not, in and of itself, prohibit so called "round-trip" restrictions. However, to the extent that a round-trip restriction would affect a participant's or beneficiary's ability to liquidate or transfer from a QDIA or restrict a participant's or beneficiary's ability to invest in any other investment alternative available under the plan, it would be impermissible for purposes of this section. [EBSA Federal

Register Notice, vol. 73, No. 84, page 23349-23350, April 30, 2008, Amendment of Supplementary Information Text]

Note, however, that the 90 day fee restriction does not apply to participants or beneficiaries who have "existing" assets invested in the plan as of the effective date of the QDIA regulation. However, in accordance with Labor Reg. Section 2550.404c-5(c)(5)(iii), assets invested in a QDIA cannot be subject to any restrictions, fees or expenses that are not otherwise applicable to participants and beneficiaries who elected to invest in the QDIA. However, if a new participant is enrolled in the plan on or after the effective date of the QDIA regulation, the 90 day fee restriction will apply with respect to the first elective contribution or other investment that is made into the plan's QDIA on behalf of that participant. [Field Assistance Bulletin No 2008-03, April 29, 2008, Q & A-12]

Plans that planned to use the 120 day capital preservation fund as a parking fund should note that the DOL takes the view that the 120 day capital preservation fund can only be used as a QDIA in the case of a plan with an EACA that allows the 90 day permissible withdrawal. [see the discussion below] However, plan sponsors would be permitted, according to the DOL, to pay any such fees however, the DOL cannot specify how such amounts would be treated for purposes of the Internal Revenue Code. [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-11] For example, it is certainly likely that such payments would be treated under the Code as annual additions for purposes of Section 415.

(vi) the plan must offer a "broad range of investment alternatives" within the meaning of Labor Reg. Section 2550.404c-1(b)(3).

[Labor Reg. Section 2550.404c-5(c)]

5. Contents of the Notice

The notice must be written in a manner calculated to be understood by the average plan participant and must contain the following:

(i) a description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant and beneficiary in a QDIA; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);

(ii) an explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts;

(iii) a description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative;

In the absence of further guidance, the DOL believes that for this purpose, participants should generally be furnished with information concerning: (1) the amount and a description of any shareholder-type fees such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees, and (2) for investments with respect to which performance may vary over the term of the investment, the total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio).

With regard to the form of disclosure, the DOL notes that there is nothing in the QDIA regulation that would preclude the use of separate, but simultaneously furnished, documents to satisfy the notice requirement such as a prospectus or profile prospectus. [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-6]

(iv) a description of the right of the participants and beneficiaries on whose behalf assets are invested in a QDIA to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and

(v) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

[Labor Reg. Section 2550.404c-5(d)]

The notice requirements have been broadened such that it, as modified, the notice will not only satisfy the notice requirements of Section 404(c)(5)(B), but also the notice requirement under the preemption provisions of ERISA

Section 514 applicable to automatic contribution arrangements within the meaning of ERISA Section 514(e)(2)] [Preamble to Final Regulations, Section B. Scope of Final Rule; Notices]

6. Qualified Default Investment Alternatives

Requirements to constitute a QDIA

Under the final regulations, a QDIA means an investment alternative available to participants and beneficiaries that:

1. subject to two exceptions [the first for employer securities held or acquired by a registered investment company or a similar pooled regulated investment regulated by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof and the second for employer securities acquired as a matching contribution from the employer, plan sponsor or at the direction of the participant or beneficiary or acquired prior to management by an investment management service to the extent the investment management service has discretionary authority over the disposition of such employer securities], generally must not hold or permit the acquisition of employer securities;

2. satisfies the regulations requirements regarding the ability of a participant or beneficiary to transfer, in whole or in part, his or her investment from a QDIA to any other investment alternative available under the plan;

3. is

   (i) managed by: (a) an investment manager within the meaning of Section 3(38) of ERISA; (b) a trustee of the plan that meets the requirements of Section 3(38)(A), (B) and (C) of ERISA, (c) the plan sponsor who is a named fiduciary, within the meaning of Section 402(a)(2) of ERISA, or a committee comprised primarily of employees of the plan sponsor, which is a named fiduciary within the meaning of Section 402(a)(2) of ERISA; or

(ii) an investment company registered under the Investment Company Act of 1940, or

(iii) an investment product or fund described in paragraph (e)(4)(iv) or (v) of this provision and

The reference to paragraphs (e)(4)(iv) and (v) refers to the special limited relief for certain capital preservation and stable value funds.

4. constitutes one of the following:

a. an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative with increasing age. For purposes of this paragraph, asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a life-cycle or targeted-retirement date fund.

b. an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this paragraph, asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a balanced fund, or

Note that, unlike the first alternative which focuses on the age, target retirement date or life expectancy of an individual participant, the second alternative requires a fiduciary to take into account the demographics of the plan's participants as a whole, similar to the considerations a fiduciary must take into account in managing an individual account plan that does not provide for participant direction.

The use of the phrase "investment fund product or model portfolio" in both the first and second alternatives is designed to indicate that the alternative can be provided through use of a single fund or by creation of a portfolio of funds available under the plan. [Preamble to Final Regulations, B. Overview of Final Rule; Qualified Default Investment Alternatives]

Variable Annuities

Finally, under a special rule added by the final regulations, an investment fund product or model portfolio that otherwise meets the requirements to constitute a QDIA will not fail to constitute a product or portfolio for purposes of the first two classes of QDIAs solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio. [Labor Reg. Section 2550.404c-5(e)(4)(vi)]

c. an investment management service with respect to which a fiduciary, within the meaning of Labor Reg. Section 2550.404c-5(e)(3)(i), applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative with increasing age. For purposes of this paragraph, asset allocation decisions are not required to take into account risk

> tolerances, investments or other preferences of an individual participant. An example of such a service may be a managed account.

[Labor Reg. Section 2550.404c-5(e)]

Do Lifecycle and Target Date Funds Pose Particular Concerns in Regards to Conflicts and Similar Issues?

Certainly, it appears that a significant number of plans opting for use of the QDIA approach have chosen as their QDIA target date or lifecycle funds. This may be due in large part to the basic requirement applicable to the balanced fund serving as the QDIA with respect to the plan's need to select a balanced fund that would be appropriate for the plan's population as a whole.

Concerns have been raised as to whether funds that are themselves funds of funds, as would be the case in lifecycle or target date funds are inherently subject to conflict due to the possible desire of the funds' manager to select subfunds that produce higher fees and not necessarily those that are most appropriate for the target group. This concern has been heightened as plans have become more familiar with the wide variance of portfolio construction sold in funds targeted for the same age groups.

The conflict issue was raised in comments to the DOL as set forth below:

> "The Department received one comment regarding the proposed regulation's potential effect on small entities. The commenter believes that certain types of mutual funds that would be qualified default investment alternatives under paragraph (e)(4)(i) (e.g., life-cycle or target-retirement date funds) sometimes invest in other types of mutual funds. According to the commenter, the investment advisers for the life-cycle or target-retirement-date funds may have an incentive to skew the fund's allocation toward sub funds that generate higher fees than to funds that would be most appropriate for the age or expected retirement date of the affected participants. The commenter stated that fiduciaries of small plans wishing to use the safe harbor would need to expend disproportionately more resources than large plan fiduciaries in making sure that the asset allocations (and thus, the corresponding fee structures) are not tainted by conflicts of interest. Specifically, the commenter was concerned that unlike larger plans which could conduct analyses of the neutrality of asset allocations in-house, small plans would have to expend resources on using

> outside consultants to conduct such analyses or face potential liability for a failure to do so. The commenter mentioned that some funds are willing to indemnify fiduciaries of large plans from any liability associated with choosing such funds. The commenter suggested that the Department add measures to mitigate the likelihood of conflicts, such as requiring that such funds allocate assets pursuant to independent algorithms and require equal treatment for small plan fiduciaries with regard to indemnification."

The DOL responded as follows:

> "Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not. This obligation flows from the fiduciary duties of prudence and loyalty to the participants set out in ERISA section 404(a)(1). The regulation imposes no new requirements for selecting qualified default investment alternatives. For large or small plans, the duty to evaluate a plan investment option exists regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary is seeking to comply with this regulation. Thus, the Department continues to believe that this regulation would not have a significant effect on a substantial number of small entities."

Thus, the DOL offers no blanket exemption and no relief from such concerns.

In the event of litigation over the use of such funds, it is certainly likely that participants will sue the named fiduciary responsible for selecting the particular fund of funds. Funds themselves argue that the fact that they effectively allocate a participant's account among the various subfunds will not make them ERISA fiduciaries. The managers argue that the exemption of ERISA Section 401(b) applies. Some practitioners have argued that this exemption is not applicable in the case of funds of funds. In all events, the language quoted above suggest that the DOL in all events believes that the named fiduciaries themselves must take such issues into consideration when selecting specific QDIAs.

Other issues of consideration include not only the varying percentages of equities owned by various target or lifecycle funds at the same given ages, but also the path at which those funds decrease their percentage of the equities and the assumptions being made as to post-target age life expectancies.

Further, plans must be aware of over promising with these funds. The concern is to not raise expectations that the target funds will actually produce sufficient assets at retirement for any individual participant. This is particularly a concern if the plan also follows a recent trend used by some plans administratively of giving participants various tools to determine their needs and assess where they are on that road to the ultimate assessed goal.

Limited Relief for Certain Capital Preservation and Stable Value Funds

While the DOL declined to include stable value funds as a long-term qualified default investment alternative, the final regulations include two special transition rules with one available for stable value funds.

First, the regulations add a limited capital preservation option that would constitute a QDIA for purposes of contributions made on behalf of a participant for a 120-day period following the date of the participant's first elective contribution. This limited relief is available provided that the fund or product:

1. seeks to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product, and

2. is offered by a State or federally regulated financial institution.

[Labor Reg. Section 2550.404c-5(e)(4)(iv)(A) & (B)]

According to the DOL's Field Assistance Bulletin, however, the 120 day capital preservation QDIA is available only for plan that include an Eligible Automatic Contribution Arrangement.

> "Accordingly, a plan fiduciary that uses the 120-day capital preservation QDIA for the investment of assets other than assets contributed pursuant to an EACA will not obtain fiduciary relief under the regulation. For example, use of the 120-day capital preservation QDIA for a rollover from an IRA or other plan would not relieve a plan sponsor from liability under the QDIA regulations (unless the rollover was made during the 120 day period following a participant's EACA contribution)." [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-18]

Moreover, generally a sponsor may not manage the 120-day capital preservation QDIA as the investment fund or product must be offered by a State or federally regulated financial institution as required by Labor Reg. Section 2550.404c-5(e)(4)(iv)(A)(2). [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-19]

In addition, the final regulations include a limited grandfather rule for stable value funds. According to the Preamble, this exception is intended to be limited to stable value products and funds with respect to which plan sponsors are typically limited by the terms of the investment contracts from unilaterally reinvesting assets on behalf of participants who fail to give investment direction without triggering a surrender charge or other fees that could directly and adversely affect participant account balances. Under this exception, stable value funds and products will be treated as a QDIA solely for purposes of investment in such products or funds made prior to the effective date of this regulation (i.e., before December 24, 2007).

Specifically, in order for this grandfather provision to apply, the following requirements must be an investment product or fund designed to preserve principal; provide a rate of return generally consistent with that earned on intermediate investment grade bonds; and provide liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives; such investment product or fund shall, meet the following requirements:

1. there are no fees or surrender charges imposed in connection with withdrawals initiated by a participant or beneficiary, and

2. such investment product or fund invests primarily in investment products that are backed by State or federally regulated financial institutions.

[Labor Reg. Section 2550.404c-5(e)(4)(v)]

This second requirement means that the product or fund may either be issued directly by a State or federal regulated financial institution or the principal and accrued interest on the product or fund may be backed by contracts issued by such institutions.

While sponsors were not required to issue the notice 30 days before the effective date of the regulations in order to gain relief under the grandfather provision for prior stable value fund investments, relief will not take effect until thirty days after the initial notice required by Labor Reg. Section 2550.404c-5(c)(3). For example, if a plan sponsor distributes the initial notice on January 1, 2008 to participants who were previously defaulted into the stable value fund prior to the effective date of the QDIA regulations, assuming all other requirements of the regulations are satisfied, the fiduciary relief provided by the regulation would be available on January 31, 2008. However, in all events, the relief would extend only to assets that were invested in the stable value product or fund on or before the effective date of the final regulations. [Field Assistance Bulletin No. 2008-03, April 29, 2008, Q & A-21]

7. Transition Guidance

In response to questions raised with respect to how plans should ensure compliance both where defaulted participants accounts have previously been invested in assets that will qualify as QDIAs under the final regulations and situations where defaulted participants accounts have invested default options that will not satisfy these requirements, practitioners questioned how to comply. This is particularly the case given that plans may no longer have records necessary to distinguish participants who were defaulted into a default investment from those who affirmatively elected to invest in that alternative.

Under either alternative, to ensure that a new or an existing default investment constitutes a QDIA with respect to both existing assets and new contributions, the DOL advises that fiduciaries must comply with the new notice requirements. It is the DOL's view that any participant or beneficiary, following receipt of a notice may be treated as failing to give investment direction for purposes of paragraph (c)(2) of Labor Reg. Section 2550.404c-5, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle of the plan. Under such circumstances, and assuming all other requirements are satisfied, the DOL states its view that a fiduciary would obtain relief with respect to investments on behalf of those participants and beneficiaries in existing or new default investments that constitute qualified default investment alternatives.

If moving from a previous default investment to one that qualifies as a QDIA will cause a participant's account to incur penalties or market value adjustments or similar financial penalties, the fiduciary must exercise general prudence. The DOL states that such decisions cannot be based solely on a fiduciary's desire to take advantage of the limited liability afforded by this regulation without regard to the financial consequences to the plan's participants and beneficiaries.

[Preamble to Final Regulations, Section C. Miscellaneous Issues; Transition Issues]

With respect to prior default decisions, the fiduciary will have the benefit of the regulatory relief for fiduciary decisions made on or after the date that all requirements of the QDIA regulations have been satisfied. However, relief is not available for fiduciary decisions made prior to the effective date of the QDIA regulations, such as decisions by a fiduciary to invest assets in a default investment. [Field Assistance Bulletin No 2008-03, April 29, 2008, Q & A-2]

> Example: Assume that a plan sponsor had previously used as its default investment Fund 1 which does not qualify as a QDIA. Following publication of the QDIA regulations, plan sponsor decides to change its default investment option to Fund 2, a fund that does qualify as a QDIA However, the records of the plan are such that it cannot determine who has invested in Fund 1 via default or by affirmative election. If the sponsor distributes a new investment election form to all participants invested in Fund 1, relief under the QDIA regulations would be available to the plan sponsor with respect to assets that are moved into Fund 2 for those participants who failed to respond and make an investment election if all of the requirements of the QDIA regulations are otherwise satisfied.
>
> If, in the Example, Fund 1 is an investment that would qualify as a QDIA and plan sponsor complies with the notice and other requirements necessary to establish Fund 1 as a QDIA, the plan sponsor would be relieved of liability in accordance with the regulations with respect to all assets invested in Fund 1 without regard to whether the assets were the result of a default investment.

III. <u>Automatic Enrollment Provisions</u>

A. Overview

Background

Given the undeniable movement away from traditional defined benefit plans and towards Section 401(k) plans, coupled with the increasing concern that the rate of savings in such plans will not be sufficient to provide for retirement, Congress, as part of PPA, codified rules allowing for automatic enrollment.

Types of Automatic Enrollment Provisions

As a result of the changes brought by PPA, we now recognize three types of automatic enrollment provisions: (1) Automatic Contribution Arrangements; (2) Eligible Automatic Contribution Arrangements, and (3) Qualified Automatic Contribution Arrangements.

The essential benefits of each are as follows:

1. an arrangement that satisfies the requirements to constitute an Automatic Contribution Arrangement gains the benefits of general preemption of state laws;

2. an Eligible Automatic Contribution Arrangement has

    a. the ability to allow participants to make Permissible Withdrawals, and

    b. the employer will have up to 6 months (rather than merely up to 2 ½) following the close of the plan year to correct any excess contribution or excess aggregate contribution without the imposition of an excise tax. [IRC Section 4979(f)(1)]

3. a Qualified Automatic Contribution Arrangement provides a safe harbor method to satisfy the otherwise applicable ADP and ACP nondiscrimination tests.

B. Automatic Contribution Arrangement

1. Preemption

Previously, where a Section 401(k) plan wanted to provide for automatic enrollment such that an eligible employee who fails to make an affirmative election is deemed to have elected <u>to</u> participate in the plan rather than being treated as having defaulted out of participation, and thus have amounts withheld from his paycheck and contributed to the plan, issues arose as to whether state laws imposing restrictions on when amounts can be withheld from a participant's wages, might interfere.

Specifically, since most states have laws precluding an employer from withholding amounts from a participant's paycheck absent either an affirmative election by the employee or a specific state statutory authorization, questions arose as whether such state laws were preempted by ERISA.

PPA alleviated those concerns. Specifically, PPA amended ERISA to explicitly provide that it preempts any state law that would directly or indirectly prohibit or restrict the ability of a plan to contain an automatic contribution arrangement. [ERISA Section 514(e)(1)]

2. Requirements to constitute an Automatic Contribution Arrangement

An automatic contribution arrangement means, for this purpose, a cash or deferred arrangement under which:

1. a participant may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant or to the participant directly in cash;

2. a participant is treated as having elected to have the plan sponsor make contributions in an amount equal to a <u>uniform</u> <u>percentage</u> of compensation provided under the terms of the plan until the participant makes an affirmative election; and

3. contributions are invested in accordance with the regulations prescribed by the DOL under ERISA Section 404(c)(5).

[ERISA Section 514(e)(2)]

This third requirement necessitates that the contributions be invested in a Qualified Default Investment Alternative ("QDIA") in accordance with DOL regulations at Labor Reg. Section 2550.404c-5(c).

The regulations also provide that nothing in the regulations governing automatic contribution arrangements precludes a pension plan from including an automatic contribution arrangement that does not meet the requirements Labor Reg. Section 2550.404c-5(a) through (e). [Labor Reg. Section 2550.404c-5(f)(4)]

3. Regulatory Expansion of Preemption

DOL regulations expand the application of the preemption provision by providing for the preemption of any State law that would directly or indirectly prohibit or restrict the inclusion in any pension plan of an automatic contribution arrangement regardless as to whether the plan includes an automatic contribution arrangement as defined in the regulations, that is, including satisfaction of the requirements under Labor Reg. Section 2550.404c-5(a) through (e). [Labor Reg. Section 2550.404c-5(f)(2)] This means that an arrangement may constitute an automatic contribution arrangement even though the amounts are not invested in accordance with Labor Reg. Section 2550.404c-5(a) through (e).

Moreover, unlike the basic preemption provision of ERISA which supersedes State laws only "insofar" as they satisfy the "relates to" standard set forth in ERISA Section 514, this provision supersedes a State law that would directly or indirectly prohibit or restrict the inclusion in any pension plan of an automatic contribution arrangement. [Labor Reg. Section 2550.404c-5(f)(2)]

4. Notice Requirement

In addition to the three requirements necessary to constitute an Automatic Contribution Arrangement, the statute also includes a notice requirement.

Specifically, the plan administrator must, within a reasonable period before each plan year, provide to each employee eligible to participate in the arrangement a written notice of the employee's rights and obligations under the arrangement which: (1) is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and (2) is written in a manner calculated to be understood by the average employee to whom the arrangement applies. [ERISA Section 514(e)(3)(A)]

A notice will not be treated as satisfying these requirements unless the notice:

1. includes an explanation of the employee's rights under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage);

2. ensures that the employee has a reasonable period of time after receipt of the notice and before the first elective contribution is made to make such an election, and

3. explains how contributions made under the arrangement will be invested in the absence of any investment election by the employee.

[ERISA Section 514(e)(3)(B)]

If the plan administrator fails to provide the notice, the DOL may assess a penalty of not more than $1,000 a day for each violation. [ERISA Section 502(c)(4)]

The plan administrator of an Automatic Contribution Arrangement will be considered to have satisfied the notice requirement if notices are furnished in accordance with Labor Regulation Sections 2550.404c-5(c)(3) and (d), i.e., the notice required with respect to a QDIA. [Labor Reg. Section 2550.404c-5(f)(3)] This reference would also peg the "reasonable period of time" requirement as at least 30 days in advance of the date of plan eligibility, and generally at least 30 days in advance of subsequent plan year. [Labor Reg. Section 2550.404c-5(f)(3)(i) and (ii)]

5. Civil Penalties

Overview

PPA provided for a civil penalty of not more than $1,000 a day for each violation of the notice requirement of Section 514(e)(3). [ERISA Section 502(c)(4)]

The DOL has now finalized its regulations [74 Fed. Reg. No. 1, January 2, 2009] establishing procedures for the calculation and assessment of various civil penalties including those arising under Section 514(e)(3).

To What Type of Arrangements does the Penalty Apply?

In the Preamble to the proposed regulations, the DOL had taken the position that the notice of automatic contribution arrangement had to be provided not only before the beginning of each plan year, but also, before the participant becomes eligible to participate. Specifically, the Preamble to the Proposed Regulations contained the following:

> “Notice under section 514(e)(3) of ERISA must be furnished within such time period prescribed in section 2550.404c-5(c)(3), generally at least 30 days in advance of a participant's date of plan eligibility and within a reasonable period of time of at least 30 days in advance of each subsequent plan year.”

This approach did not appear to be supported by the statutory language which provides that the notice must be provided within a reasonable period of time before each plan year. [ERISA Section 514(e)(3)(A)]

This sentence is simply omitted from the Preamble to the final regulations without explanation. However, the Preamble to the final regulations does make it clear that both the notice requirement of Section 514(e)(3) as well as the related civil penalty provision of ERISA Section 502(c)(4) apply only to an automatic contribution arrangement described in Labor Reg. Section 2550.404c-5(f)91). [Preamble to Final Regulations, Section A. Background]

Determining the Amount of the Penalty

The regulations provide that the amount to be assessed for each separate violation is to be determined by the DOL, taking into consideration the degree or willfulness of the failure or refusal to furnish the notice. However, the amount assessed for each violation shall not exceed $1000 a day (or such other maximum amount as may be established by regulation pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended) computed from the date of the administrator’s failure. [Labor Reg. Section 2560.502c-4(b)(1)]

For purposes of calculating the penalty, each failure or refusal to provide the required information with respect to any person entitled to receive it is to be treated as a separate violation. [Labor Reg. Section 2560.502c-4(b)(2)]

Prior to assessing the penalty, the DOL is to provide the administrator with a written notice indicating the DOL’s intent to assess a penalty, the amount of such penalty, the number of individuals on which the penalty is based, the period to which the penalty applies and the reason for the penalty. [Labor Reg. Section 2560.502c-4(c)]

The DOL may determine that part or all of the penalty in the notice of intent to assess a penalty will not be assessed on a showing that the plan administrator did in fact comply or on a showing of mitigating circumstances regarding the degree or willfulness of the noncompliance. [Labor Reg. Section 2560.502c-4(d)]

Upon issuance of a notice of intent to assess the penalty, the administrator will have 30 days from the date of service of the notice to file a written statement of reasonable cause why the penalty should not be assessed or should be reduced. The statement must contain a declaration by the administrator that the statement is made under penalties of perjury. [Labor Reg. Section 2560.502c-4(e)]

6. What Kinds of Plans are eligible for Automatic Contribution Arrangements?

The statute provides that Section 514(e) supersedes any state law which would directly or indirectly prohibit or restrict the inclusion in <u>any plan</u> of an automatic contribution arrangement. However, the DOL is interpreting its application in a narrower context.

In Advisory Opinion 2008-02A, February 8, 2008, the DOL concluded that a Kentucky wage withholding law, which only allowed for withholding from a participant's wages either where Federal or State law required or where the participant had consented in writing, was preempted. As a result, a company could continue to allow for automatic enrollment under its cafeteria plan.

What is significant here is that, although the Advisory Opinion was issued long after the enactment of Section 514(e), the DOL analyzed the provision in the context of Section 514(a) instead. In doing so, the DOL states in a footnote that "the Department views the PPA provisions as addressing only individual account pension plans."

7. Why Choose an Automatic Contribution Arrangement rather than QACA?

Notwithstanding the ability of obtain safe harbor status, some employers find the matching component associated with the QACA as prohibitively expensive given the likely expansion of participants eligible to share in the match.

Particularly given the state of the economy, some employers may look to arrangements without a match, hoping that the use of automatic enrollment will allows participation to remain high while using the potential match to satisfy other needs such as helping with the cost of health care benefits or to pay for the plan's administrative costs.

8. Can you have an Automatic Contribution Arrangement that applies to less than all of the eligible Employees?

According to an informal response from IRS personnel the answer is yes. Specifically, the facts involved an Automatic Contribution Arrangement, not intended to be a QACA, applied, presumably under the terms of the plan, to Group A employees with an automatic contribution amount of 3%. The Automatic Contribution Arrangement did not apply to Group B employees, all of whom were highly compensated. Both of the Groups could, however, affirmatively elect to make contributions of up to 100% of compensation, subject to the limits of Section 402(g). The questioner asked whether the arrangement satisfied the benefits, rights and features requirements of Section 401(a)(4)?

The IRS personnel, in its unofficial response, agreed with the proposed answer. The officials stated that the arrangement would indeed satisfy the benefits, rights and features test of Section 401(a)(4) stating that it is permissible to have an automatic enrollment feature that is not available for one group of employees without violating the benefits, rights and features test of Section 401(a)(4). [summarized from Q & A 8 of the American Bar Association, Section of Taxation, May Meeting 2008; Committee on Employee Benefits, Joint Committee on Employee Benefits, Internal Revenue Service, May 8-10, 2008]

C. Eligible Automatic Contribution Arrangement

1. Defined

An Eligible Automatic Contribution Arrangement (EACA) means an automatic contribution arrangement under an applicable employer plan (i.e., Section 401(k), 403(b) and Section 457(b) arrangement maintained by a governmental entity) under which, for the plan year:

1. a participant may elect to have the employer make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash;

2. the participant is treated as having elected to have the employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage);

3. prior to repeal by the Worker, Retiree, Employer Recovery Act of 2008, in the absence of an investment election by the participant, contributions described in (2) are invested in accordance with regulations prescribed by the Secretary of Labor under ERISA Section 404(c)(5), [note, the regulations make it clear that this requirement only applies to plans otherwise subject to title I of ERISA], and

4. the plan satisfies a notice requirement.

[Section 414(w)(3)]

It should be noted that the provision of the Worker, Retiree, Employer Recovery Act of 2008 repealing the requirement that, in the absence of an affirmative election, such contributions must be invested in a QDIA was effective as if originally contained in the PPA and therefore, was effective for plan years beginning after December 31, 2007. This change means that, in order to constitute an EACA and thus be drafted to allow permissible withdrawals, an arrangement will no longer be required to invest contributions, in the absence of an affirmative election, in a QDIA.

While the PPA restricted the EACA to Section 401(k), 403(b) and Section 457(b) arrangement maintained by a governmental employer, the Worker, Retiree, Employer Recovery Act of 2008 expanded the definition of "applicable employer plan to also include SARSEPs and SIMPLE IRAs under Section 408(p). [IRC Section 414(w)(5) as amended by the Worker, Retiree, Employer Recovery Act of 2008]

An automatic contribution arrangement for this purpose means an arrangement that provides for a cash or deferred election that provides that in the absence of an eligible employee's affirmative election, a default applies under which the employee is treated as having elected to have default elective contributions made on his or her behalf under the plan. The default election ceases to apply with respect to an employee if the employee makes an affirmative election (that remains in effect) to: (1) not have any default elective contributions made on his or her behalf, or (2) have default elective contributions made in a different amount or percentage of compensation. [Prop. Treas. Reg. Section 1.414(w)-1(e)(2)]

The uniformity requirement is not violated merely because the percentage varies in a manner permitted for Qualified Automatic Contribution Arrangements under Prop. Treas. Reg. Section 1.401(k)-3(j)(2)(iii) except that the rules are applied without regard to whether the arrangement is intended to be a Qualified Automatic Contribution Arrangement. [Prop. Treas. Reg. Section 1.414(w)-1(b)(2)]

2. Notice Requirement

Under the Proposed Regulations, the notice requirement will be deemed satisfied if each eligible employee is given notice of the employee's rights and obligations under the arrangement. The notice must be sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and be written in a manner calculated to be understood by the average employee to whom the arrangement applies. [Prop. Treas. Reg. Section 1.414(w)-1(b)(3)(i)]

The notice must include the provisions found in Treas. Reg. Section 1.401(k)-3(d)(2)(ii) to the extent those provisions apply to the arrangement. However, a notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes:

1. the level of elective contributions which will be made on the employee's behalf if the employee does not make an affirmative election;

2. the employee's rights to elect not to have default elective contributions made to the plan on his or her behalf or to have a different percentage of compensation or amount of elective contributions made to the plan on his or her behalf;

3. how contributions made under the arrangement will be invested in the absence of any investment election by the employee, and

4. the employee's rights to make a permissible withdrawal, if applicable, and the procedures to elect such a withdrawal.

[Prop. Treas. Reg. Section 1.414(w)-1(b)(3)(ii)]

The notice must be provided within a reasonable period before the beginning of each plan year (or, in the year an employee becomes an eligible employee, within a reasonable period before the employee becomes an eligible employee). A notice satisfies the timing requirements only if it is provided sufficiently early so that the employee has a reasonable period of time after receipt of the notice and before the first elective contribution is made under the arrangement to make the election. [Prop. Treas. Reg. Section 1.414(w)-1(b)(iii)(A)]

The timing requirement is deemed satisfied if at least 30 days (and no more than 90 days) before the beginning of each plan year, the notice is given to each eligible employee for the plan year. In the case of an employee who does not receive the notice within the period because the employee becomes an eligible employee after the 90^{th} day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the employee becomes an eligible employee (and no later than the date the employee becomes an eligible employee). [Prop. Treas. Reg. Section 1.414(w)-1(b)(iii)(B)]

3. Permissible Withdrawals

If the plan so provides, an employee who has default elective contributions made under an Eligible Automatic Contribution Arrangement may elect to make a "permissible withdrawal" of such contributions (and attributable earnings). If done in accordance with the statute, then:

1. the amount of the withdrawal is includible in gross income for the taxable year of the employee in which the distribution is made;

2. no tax is imposed under Section 72(t) with respect to the distribution, and

3. the arrangement shall not be treated as violating any restriction on distributions solely by reason of allowing the withdrawal.

Where the employee elects to make such a withdrawal, any employer matching contribution shall be forfeited or subject to such other treatment as the Secretary of the Treasury may prescribe.

[IRC Section 414(w)(1)]

The Preamble provides that a plan that decides to include a permissible withdrawal provision is not required to make it available to all employees eligible under the EACA. This means, for example, that the employer may decide to make it available only to employees for whom no elective contributions have been made under the CODA (or a predecessor CODA) before the EACA is effective. However, under a Section 401(k) or a Section 403(b) plan, the employer would be precluded from conditioning the right to take the withdrawal on the employee making an election to have no future elective contributions made on the employee's behalf. However, the employer could provide in the withdrawal election form a default election under which elective contributions would cease unless the employee makes an affirmative election.

An applicable employer plan that includes an Eligible Automatic Contribution Arrangement will not fail to satisfy the prohibition on in-service withdrawals under Section 401(k)(2)(B), 403(b)(7), 403(b)(11) or 457(d)(1) merely because it permits withdrawals that satisfy the requirements for a permissible withdrawal. [Prop. Treas. Reg. Section1.414(w)-1(c)(2)]

A "permissible withdrawal" means any withdrawal made from an "eligible automatic contribution arrangement which meets the requirements of Section 414 and which: (1) is made pursuant to an election by the employee, and (2) consists of elective contributions made pursuant to a deemed election in an amount that is a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made as a different percentage) and the earnings thereon. [IRC Section 414(w)(2)]

In order to be treated as a permissible withdrawal, the election to withdraw must be made no later than 90 days after the date of the first default elective contribution under the Eligible Automatic Contribution Arrangement. The date of the first default elective contribution is the date that the compensation that is subject to the cash or deferred election would otherwise have been included in gross income. The effective date of an election cannot be later than the last day of the payroll period that begins after the election is made. [Prop. Treas. Reg. Section 1.414(w)-1(c)(2)]

Note that it is the election to withdraw that must occur during the 90 day window and not the withdrawal itself.

Must the plan honor a permissible withdrawal if the employee makes an affirmative election during the 90 day election period particularly if the affirmative election is for more than the uniform percentage imposed by the plan? Likely, the answer is yes in the absence of any specific guidance to the contrary.

The amount of the distribution must be equal to the amount of default elective contributions made under the Eligible Automatic Contribution Arrangement through the effective date of the election (adjusted for allocable gains and losses to the date of distribution). If default elective contributions are separately accounted for in the participant's account, then the amount of the distribution will be the total amount in that account. However, if not separately accounted for then the amount of the allocable gains and losses will be determined under rules similar to those provided under Treas. Reg. Section 1.401(k)-2(b)(2)(iv) for the distribution of excess contributions. [Prop. Treas. Reg. Section 1.414(w)-1(c)(3)(i)]

The distribution amount may be reduced by any generally applicable fees. However, the plan may not charge a different fee for a distribution under Section 414(w) than applies to other distributions. [Prop. Treas. Reg. Section 1.414(w)-1(c)(3)(ii)]

Given the special rules applicable to permissible withdrawals and the likely small amounts involved, third party administrative firms may well charge a lesser amounts attributable to permissible withdrawals than other distributions. It is unclear whether such a lesser fee would be deemed to run afoul of this "no different fee" requirement.

What if there is no special rule and the fee actually exceeds the amount of the permissible withdrawal?

An employer matching contribution with respect to the default elective contribution distributed pursuant to Section 414(w) must be forfeited. The forfeiture is required to remain in the plan. [Preamble to Prop. Regs. 11/8/2007. Fed. Reg. vol. 72, No. 216, p. 63144, Explanation of Provisions, 2. Eligible Automatic Contribution Arrangement Under Section 414(w)] It is unclear whether the forfeited match is to be adjusted for gains and losses.

It is unclear what the effect will be on previously distributed amounts in the event that the plan should ultimately be determined not to be an EACA for example, because the investment option the plan treated as a QDIA was determined not to satisfy the requirements of a QDIA.

4. Tax and Reporting Treatment of Permissible Withdrawals

The amount of the withdrawal, other than any Roth contributions, is includible in the employee's gross income for the taxable year in which the distribution is made. [Prop. Treas. Reg. Section 1.414(w)-1(d)(1)(i)] The distribution is not subject to the early distributions tax of Section 72(t). [Prop. Treas. Reg. Section 1.414(w)-1(d)(1)(ii)]

The amount of the withdrawal is reported on Form 1099-R. [Prop. Treas. Reg. Section 1.414(w)-1(d)(1)(iii)]

5. Corrective Distributions from Eligible Automatic Contribution Arrangement

The time for making corrective distributions of excess contributions or excess aggregate contributions from an eligible automatic contribution arrangement (as defined in Section 414(w)(3)) is increased from the prior 2 ½ month period previously applicable to all Section 401(k) plans to 6 months. [IRC Section 4979(f)(1)] Further, any amount distributed will be treated as earned and received in the recipient's tax year in which the distributions are made. [IRC Section 4979(f)(1)]

Does the 6 month extension apply automatically to a QACA? No, while most QACAs will likely also be constructed to constitute an EACA, it is not necessarily the case. First, in order to be an EACA, but not a QACA, a plan subject to title I of ERISA must provide that, in the absence of an investment election by the participant, a participant's default contributions must be invested in accordance with regulations prescribed by the Secretary of Labor under ERISA Section 404(c)(5), i.e., in a QDIA. In addition, there may be circumstances in which an otherwise eligible QACA is ineligible for full safe harbor treatment, that is, some portion of the plan is subject to testing. This could occur, for example, if the plan also includes employee contributions subject to Section 401(m). The Preamble to the proposed regulations provide that, to the extent the requirements to be a QACA are the same as those for the pre-PPA safe harbor, the proposed regulations would apply the existing rules of Treas. Reg. Section 1.401(k)-3 and 1.401(m)-3 to the QACA. [See Preamble to proposed regulations, Explanation of Provisions—1. Qualified Automatic Contribution Arrangement Under Section 401(k)(13)] The regulations under Section 1.401(m)-3(j)(6) provides for separate ACP testing for employee contributions. The question is whether in such case in an otherwise applicable QACA, the 6 month rule would apply.

6. Can an EACA be added to a Section 401(k) Plan After the First Day of the Plan Year?

While governing regulations require that the QACA be in place and operated for a full twelve month plan year, whether a similar rule applies in the case of an EACA is not clear.

The regulations do not speak directly to this point. However, there are provisions of the regulations that seem to suggest that the IRS would impose a similar rule on EACA. For example, the requirement that the notice must be provided in advance of each plan year might be read as an indication that the EACA must be adopted before the beginning of the plan year.

At best, the issue needs clarification.

D. Qualified Automatic Contribution Arrangement--QACA

1. Background

In order to encourage Section 401(k) plans to adopt an automatic enrollment feature, PPA created the new "qualified automatic contribution arrangement." A plan that adopts a qualified automatic contribution arrangement ("QACA") is treated as satisfying the special ADP nondiscrimination requirements (i.e., the ADP test) [IRC Section 401(k)(13)(A)] and is also treated as meeting the top heavy requirements. [IRC Section 416(g)(4)(H)] The plan will also be treated as meeting the requirements of the ACP test if the plan constitutes a qualified automatic contribution arrangements and the contributions satisfy the requirements for the matching contribution safe harbor test under Section 401(m)(11)(B). [IRC Section 401(m)(12)]

The Service has issued proposed regulations. The Proposed Regulations are proposed to be effective for plan years beginning on or after January 1, 2008. However, plans and sponsors may rely on the proposed regulations pending the issuance of final regulations. In the event the final regulations are more restrictive, the more restrictive provisions of the final regulations will be applied without retroactive effect.

2. 12 Month Requirement

The proposed regulations provide that generally in order to satisfy the safe harbor requirements, the plan provisions satisfying the requirements of the safe harbor must be adopted before the first day of the plan year and must remain for an entire 12-month plan year. [Prop. Treas. Reg. Section 1.401(k)-3(e)(1)]

3. Fill Gaps Using Prior Safe Harbor Rules

To the extent that the requirements to be a Qualified Automatic Contribution Arrangement (QACA) are the same as those for the safe harbor described in Section 401(k)(12) and 401(m)(11), the Preamble provides that these proposed regulations would apply the existing rules currently in Treas. Reg. Sections 1.401(k)-3 and 1.401(m)-3 to a QACA.

4. Application of the Default Election

Under the proposed regulations, an automatic contribution arrangement for this purpose is a cash or deferred arrangement that provides that in the absence of an eligible employee's affirmative election, a default applies under which the employee is treated as having made an election to have a specified contribution made on his or her behalf under the plan. The default election ceases to apply with respect to an eligible employee if the employee makes an affirmative election to: (1) have elective contributions made in a different amount on his or her behalf (in a specified amount or percentage of compensation); or (2) not have any elective contributions made on his or her behalf. [Prop. Treas. Reg. Section 1.401(k)-3(j)(1)(ii)]

An automatic contribution arrangement will not fail to be a QACA merely because the default election is not applied to an employee who was an eligible employee under the cash or deferred arrangement (or a predecessor plan) immediately prior to the effective date of the QACA and on that effective date had an affirmative election in effect (that remains in effect to): (1) have an elective contribution made on his/her behalf (in a specified amount or percentage), or (2) not have elective contributions made on his/her behalf. [Prop. Treas. Reg. Section 1.401(k)-3(j)(1)(iii)] The Preamble states that generally this would require that the employee have completed an election form and chosen an amount or percentage (including zero) of his compensation to be deferred.

5. Requirements to constitute a QACA

To constitute a qualified automatic contribution arrangement (QACA): (1) the elective contribution must satisfy the "qualified percentage"; (2) the match or nonelective contribution must be made in accordance with the statute; (3) the match or nonelective contribution must vest in accordance with the statutory requirements and be subject to the restrictions on withdrawal that apply to Section 401(k) contributions, and (4) the plan must issue a notice.

Qualified Percentage

With respect to the qualified percentage, this requirement will be met if the percentage is applied uniformly and does not exceed 10 percent and, for the applicable year is at least:

1. 3% during the period ending on the last day of the first plan year which begins after the date on which the first elective contribution is made with respect to the employee;

2. 4% during the first plan year following the plan year described in (1);

3. 5% during the second plan year following the plan year described in (1), and

4. 6% during any subsequent plan year.

[IRC Section 401(k)(13)(C)(iii)]

The proposed regulations make it clear that an eligible employee's initial year of default participation to which the 3% minimum contribution applies may last as long as two plan years. That is, the period begins when the employee first participates in the automatic contribution arrangement that is a QACA and ends on the last day of the <u>following</u> plan year. [Prop. Treas. Reg. Section 1.401(k)-3(j)(2)(ii)] Thereafter the qualified percentage increases 1% for each subsequent plan year. The proposed regulations clarify that the qualified percentage is a minimum and that a QACA can provide a greater qualified percentage but not to exceed 10%.

While the qualified percentage must be a uniform percentage, the proposed regulations recognize some exceptions including that the plan will not run afoul of the uniformity requirement merely because the qualified percentage varies based upon the number of years the employee has participated in the plan. Further, the uniformity requirement is not violated because the plan suspends employees from making an elective contribution for six months following a hardship withdrawal. The uniformity requirement is similarly not violated because the rate of elective contributions under a cash or deferred election that is in effect immediately prior to the effective date of the default percentage under the QACA is not reduced. Finally, the uniformity requirement is not violated merely because the rate of elective contributions is limited so as not to exceed the limits of Section 401(a)(17), 402(g) (determined with or without catch-up contributions and Section 415. [Prop. Treas. Reg. Section 1.401(k)-3(j)(2)(iii)]

Employer Contribution

With respect to the employer contribution, the employer must either make a dollar-for-dollar match of the first 1% plus 50% of the elective contribution that exceeds 1% but does not exceed 6% of compensation for each non-highly compensated employee, or a nonelective contribution equal to at least 3% for each non-highly compensated employee. [IRC Section 401(k)(13)(D)(i)]

In the event that the plan satisfies its contribution requirement by virtue of use of the 3% nonelective contribution, such contributions may not be taken into account for purposes of permitted disparity (including the imputation of permitted disparity under Treas. Reg. Section 1.401(a)(4)-7). [Prop. Treas. Reg. Section 1.401(k)-3(h)(2)] However, under the general rule applying the same rules as applied to the pre-PPA safe harbor, nonelective contributions could be used to satisfy the top heavy minimum as well as counted for purposes of Section 401(a)(4).

Vesting Requirement for Employer Contributions

In all events, employer contributions must be fully vested with respect to any employee who has at least 2 years of service and must be subject to the general withdrawal restrictions that apply to elective contributions. [IRC Section 401(k)(13)(D)(iii)]

While not entirely clear, presumably, an employer that converts from the pre-PPA safe harbor 401(k) plan to a QACA would be able to subject to the new QACA employer match to the two year vesting requirement. This seems to be a logical conclusion although not specifically addressed under the proposed regulations.

Notice Requirement

The notice requirement is satisfied if, within a reasonable period before each plan year, each employee eligible to participate in the arrangement receives written notice of the employee's rights and obligations under the arrangement which: (1) is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and (2) is written in a manner calculated to be understood by the average employee to whom the arrangement applies. [IRC Section 401(k)(13)(E)(i)] Further, the notice:

1. must explain the employee's rights under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage);

2. in the case of an arrangement under which the employee may elect among 2 or more investment options, the notice explains how contributions made under the arrangement will be invested in the absence of any investment election by the employee, and

3. must ensure that the employee has a reasonable period of time after receipt of the notice and before the first elective contribution is made to make either such election.

[IRC Section 401(k)(13)(E)(ii)]

The additional requirements required by Section 401(k)(13)(E) (i.e., the employee's rights to elect to not have contributions made or to have contributions made in a different amount, and information as to how contributions made under the automatic contribution arrangement will be invested in the absence of affirmative directions) cannot be satisfied by reference to the plan's summary plan description. Further, the proposed regulations provide that in order to satisfy the notice requirement that the employee have a reasonable period of time after receipt of the notice before the first elective contribution is to be made to make an election with respect to contributions and investments. The proposed regulations interpret the requirement to provide a notice within a reasonable period before each plan year by applying the rules of Treas. Reg. Section 1.401(k)-3(d)(3). Thus, the proposed regulations would provide that the general determination of whether the timing requirement is satisfied is based on all of the relevant facts and circumstances, and the deemed timing rule of Section 1.401(k)-3(d)(3)(ii) applies.

Under the deemed timing rule, the timing requirement is satisfied if the notice is given to eligible employees at least 30 days and no more than 90 days before the beginning of each plan year. In the case of an employee who does not receive the notice within that period because the employee becomes eligible after the 90^{th} day before the beginning of the plan year, the timing requirement is deemed satisfied

If the notice is provided no more than 90 days before the employee becomes eligible (and no later than the date the employee becomes eligible.

In the case of a plan with immediate eligibility upon hire, the deemed timing rule would be satisfied if the employee is provided the notice on the first day of employment.

[Preamble to Prop. Treas. Reg. 11/08/2007, Fed. Reg. vol. 72, No. 216, p. 63144, Explanation of Provisions, 1. Qualified Automatic Contribution Arrangement Under Section 401(k)(13)]

IRS and DOL Sample Notice

The Service, in conjunction with the DOL, has issued a Sample, but not a Model Notice that can be used to satisfy the notice obligations for EACAs, QACAs and QDIAs. [see IRS Employee Plans News, Special Edition, 11/15/2007)]

Note, however, that plans are free to issue separate stand alone notices and are not required to combine them.

Because of the potential variance in plan provisions, the Service found it impossible to issue a Model Notice and thus the notice is issued as a Sample Notice. Plans will need to conform the provisions of the Notice to the actual plan provisions. For example, the notice assumes a calendar year plan that allows employees to participate as of their date of hire and to make changes in their contribution and investment elections at any time without restriction. In addition, the notice assumes that the plan allows for permissible withdrawals of automatic contributions.

Who Must Receive the Notice

Note also that IRS personnel have stated that the notice should be distributed to all eligible employees and not just to those for whom a default election is deemed to apply.

IV. <u>ERISA Section 404(c)</u>

A. Overview

Despite the general fiduciary requirements, if a plan that provides for individual accounts permits a participant or beneficiary to exercise control over assets in the participant’s or beneficiary’s account and the participant or beneficiary in fact exercises such control, then

(i) the participant or beneficiary will not be deemed a fiduciary under ERISA by reason of such exercise However, this relief is not complete as the participant will still be deemed a fiduciary for purposes of the Code's provisions governing prohibited transactions, and, as a result, a fiduciary may nevertheless have violated the prohibited transaction provisions of the Code by following a participant’s investment directions, and the fiduciary or others may thus be liable for the excise tax and the attendant requirements, [See, for example, Flahertys Arden Bowl v. Comm’r, 115 T.C. 19 (2000)], and

(ii) no person who is otherwise a fiduciary shall be liable for any loss, or by reason of any breach, resulting from such participant’s or beneficiary’s exercise of control.

[ERISA § 404(c)]

DOL regulations set forth the conditions that must be satisfied if a plan fiduciary is to gain this measure of relief from the general fiduciary liability for the investment decisions of plan participants. Compliance by a plan is discretionary. Thus, a plan may nevertheless offer participant direction of the investment of their accounts without complying with these provisions.

DOL’s view of Fiduciary’s Liability When Plan Does Not Comply

The DOL’s view is that absent strict compliance with its regulations, plan fiduciaries remain responsible for the results flowing from plan investment decisions including those made by the participant. In its amicus brief filed in the Enron case, the DOl states that “[t]he only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan.” [Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motion to Dismiss, Tittle v. Enron Corp.] The DOL, in its amicus brief, goes on to support the plaintiffs’ assertion that the plan failed to constitute a Section 404(c) status because participants were not informed that it was intended to be a Section 404(c) plan.

While this is the view of the DOL, courts may or may not accept this view. For example, in Jenkins v. Yager, 2006 WL 956944 (7^{th} Cir. 2006), the court found that even though participants could only change their investment options once every six months and therefore, the plan did not adhere to the requirements of Section 404(c), the court did not find the fiduciaries liable for significant investment losses. Instead, the court concluded that Section 404(c) is a safe harbor, but not the only means of shifting responsibility for investment decisions. Rather, the court concluded that, when the statute and regulations are read together as a whole, there is an implied exception to ERISA Sections 403 and 405 allowing participants to direct the investment of their accounts. Therefore, contrary to the plaintiff's claim, the court concluded that allowing participants to direct the investment of their accounts outside the purview of ERISA Section 404(c) did not run afoul of ERISA. The court went on to conclude that the fiduciary had not breached his fiduciary duty with respect to the investment of funds in the Section 401(k) plan even though he kept the same funds for twelve years concluding that losses are not proof of fiduciary breaches. The court concluded that annual meetings were sufficient to communicate material facts to participants.

B. Individual Account Plans

The relief from the fiduciary responsibility provisions provided by ERISA Section 404(c) applies only to individual transactions that meet the criteria established by Section 404(c), i.e., the transaction must be executed pursuant to a Section 404(c) plan and the participant must actually have exercised control with respect to the transaction.

An ERISA Section 404(c) plan is an individual account plan described in Section 3(34) of ERISA that provides:

(i) an opportunity for participants to exercise independent control over all or a specified portion of his account balance, and

(ii) an opportunity to choose from a broad range of investment alternatives.

[Labor Reg.§2550.404c-1(b)(1)]

C. Opportunity to Exercise Control

In order to obtain Section 404(c) relief, a participant must have a reasonable opportunity to exercise control over the assets in the participant's account. This means that the participant:

(i) must be provided with a reasonable opportunity to give investment instructions, (in writing or otherwise with an opportunity to obtain written confirmation of the instructions) to an identified plan fiduciary who, subject to limited exceptions, is obligated to comply with the instructions, and

(ii) must be provided or have the opportunity to obtain sufficient information to make informed decisions with regard to the alternatives available under the plan, and with regard to related incidents of ownership.

[Labor Reg. §2550.404c-1(b)(2)]

What Exactly Does the "Opportunity to Give Instructions and Receive Confirmation" Component Require?

One often overlooked requirement, and one that seems to have little place in the current environment of trading by internet and voice recognition, is the requirement that a participant or beneficiary "*under the terms of the plan,…ha[ve] a reasonable opportunity to give instructions (in writing or otherwise, with an opportunity to obtain written* *confirmation of such instructions)* <u>*to an identified plan fiduciary*</u> *who is obligated to comply….*

Certainly, if the plan's service provider is also a plan fiduciary and instructions are provided directly to that service provider, then, assuming the opportunity exist to obtain confirmation, this requirement would be deemed satisfied. However, this is rarely the case in practice. While some of the disclosure requirements explicitly provide that they can be satisfied either by an independent plan fiduciary ("or a person or persons designated by the plan fiduciary" [see for example, Labor Reg. Section 2550.404c-1(b)(2)(B)(1)], no such delegation is expressly allowed in the instant provision.

Here is how the DOL explains this requirement in the Preamble to the regulations:

> "Paragraph (b)(2)(i) of the 1991 proposal provided that a plan affords a participant or beneficiary with an opportunity to exercise control over assets in his account if, under the terms of the plan, the participant or beneficiary has a reasonable opportunity to give written investment instructions, or oral instructions followed by a written confirmation, to an identified plan fiduciary who is obligated to comply with such instructions.
>
> A number of commentators requested that the regulation be clarified so as not to preclude the use of electronic or telephonic communications of investment instructions. It was not the intention of the Department to preclude the use of such communications. Accordingly, paragraph (b)(2)(i)(A) of the final regulation requires only that the participant or beneficiary be afforded a *reasonable opportunity* (emphasis added) to provide investment instructions (written or otherwise) and an opportunity to obtain a written confirmation of such instructions.
>
> The Department believes that the ability of a participant or beneficiary to obtain a written confirmation of his investment instructions is considerably more important than the means by which investment instruction is communicated. In this regard, the Department notes that, unlike the 1991 proposal, the final regulation requires that the *opportunity* (emphasis added) to obtain written confirmation of investment instructions be extended to all participants and beneficiaries who give investment instructions….
>
> Other commentators requested that the Department clarify that the plan fiduciary responsible for receiving and acting on investment instructions may be identified in the plan by position rather than name inasmuch as responsible individuals often change and frequent plan amendments would be required to reflect such changes. It is the view of the Department that the identification of a fiduciary by position or function (e.g., plan administrator, investment committee, etc.) would satisfy the

> requirements of the regulation for an identified plan fiduciary under paragraphs (b)(2)(i)(A) and (b)(2)(i)(B)(1), and for a designated plan fiduciary for purposes of paragraph (d)(2)(ii)(E)(4)(viii). In this regard, the Department notes that the requirement for an identified plan fiduciary who is obligated to comply with participant and beneficiary instructions is applicable to all ERISA section 404(c) plans, including those which do not designate investment alternatives, i.e., those plans which permit investments in any asset which it is administratively feasible for the plan to hold and do not specifically describe any investment alternative.

On the one hand, the DOL is telling us that the regulations do not preclude the use of electronic means, something that is normally conducted without the use of an intermediary. However, it is also telling us that there must still be a designated fiduciary who is responsible for ensuring that those instructions are carried out and further, there must be the "reasonable opportunity" for the participant to provide the instructions to the identified fiduciary, who may be identified by position rather than by name, and a reasonable opportunity to obtain confirmation from such fiduciary.

It should also be noted that it may well have been this requirement that resulted in the fiduciary's problems in the recent Supreme Court case of LaRue v. DeWolff, Boberg & Associates, Inc., --U.S.---128 S. Ct. 1020 (2008) has now made it much easier for individual participants in defined contribution plans to sue plan fiduciaries for alleged fiduciary breaches that impair a participant's individual account, rather than the plan as a whole.

The plaintiff in LaRue claimed that in 2001 and 2002, he directed DeWolff to make certain changes in the investments in his account under the plan but that the changes were never implemented and, as a consequence, his account had been "depleted" by approximately $150,000.

Given the DOL's insistence on technical adherence to each of the requirements in order to obtain Section 404(c) relief, how does a plan, in the context of today's marketplace, comply with this requirement.

While there does not appear to be a perfect solution, some possible options to attempt to try and come within the purview of this requirement may include:

(1) drafting the plan to provide that, for purposes of Section 404(c), providing investment instructions to a third-party designee of the trustee shall be deemed, solely for this purpose, as the provision of the instructions to the trustee; the language may further provide that confirmation will be provided by that designee, in the form appropriate to the medium used, for example, in the case of internet trades, by the printing of the confirmation; in all events, the language should likely include disclaimers about the inability to respond or comply in the event of equipment breakdowns, acts of God etc.;

(2) draft the plan and disclosure documents to specifically provide that trades may be executed either through an actual plan fiduciary or by the participant him/herself via internet or voice response system or other methods used by the plan with the likelihood that, although the <u>reasonable opportunity</u> has in fact been provided, in all likelihood, the vast majority of participants will likely seek to execute their transactions directly.

D. Disclosure Requirements

With respect to the information required to be furnished to participants automatically, the participant or beneficiary must be provided, by an identified plan fiduciary, or by a person(s) designated by the plan fiduciary, with:

(i) an explanation that the plan is intended to constitute a plan described in ERISA Section 404(c) plan and Title 29 of the Code of Federal Regulations Section 2550.404c-1, and that the plan fiduciaries may be relieved of liability for any losses which are a direct and necessary result of investment instructions given by the participant or beneficiary;

(ii) a description of the investment alternatives available under the plan and, with respect to each designated investment alternative, a general description of the investment objectives and risk and return characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designated investment alternative;

(iii) identification of any designated investment managers;

(iv) an explanation of the circumstances under which participants and beneficiaries may give investment instructions and an explanation of any limitations on such instructions under the plan including any restrictions on transfers to or from designated investment alternatives, and any restrictions on the exercise of voting rights or similar rights;

(v) a description of any transaction fees including commissions, sales loads etc.;

(vi) the name, address and telephone number of the plan fiduciary, or the fiduciary's designee, responsible for providing the information which must be supplied upon request of any participant and a description of such information which may be obtained upon request, as discussed below;

(vii) if applicable to the plan, a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale of employer securities and the exercise of voting, tender and similar rights, by participants and beneficiaries, and the name, address and telephone number of the plan fiduciary responsible for monitoring compliance with the procedures;

(viii) in the case of an investment subject to the Securities Act of 1933, immediately following the participant's initial investment, a copy of the most recent prospectus provided to the plan; this requirement is deemed satisfied if such a prospectus was provided immediately prior to the participant's initial investment; [the DOL has okayed the use of the "profile" , see Advisory Opinion 2003-11A, September 8, 2003]

(ix) subsequent to an investment, any materials provided to the plan relating to the exercise of voting, tender or similar rights to the extent that such rights are passed through to the participants under the terms of the plan, as well as a description of or reference to plan provisions relating to the exercise of voting, tender or similar rights.

[Labor Reg. § 2550.404c-1(b)(2)]

In addition to the above information that must be provided automatically, the following information must be made available to participants or beneficiaries upon request. This information must be based upon the latest available information to the plan. Again, as is the case with the information which must be provided automatically, the participant or beneficiary must receive such information from the identified plan fiduciary, or by persons designated by the plan fiduciary with:

(i) a description of the annual operating expenses of each designated investment alternative, for example, investment management fees, administrative fees, transaction costs, which reduce the rate of return and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative;

(ii) copies of any prospectuses, financial statements and reports, and any other such information if provided to the plan;

(iii) a list of the assets comprising the portfolio of each designated investment alternative which constitutes plan assets, the value of each such asset, or the proportion of the investment alternative which it comprises; in the case of fixed rate investment contract issued by a bank, savings and loan association or insurance company, the name of the issuer of the contract, the term of the contract and the rate of return;

(iv) information concerning the value of shares or units in designated investment alternatives available to participants and beneficiaries under the plan, as well as the past and current investment performance of such alternatives, determined, net of expenses, on a reasonable and consistent basis, and

(v) information concerning the value of the shares or units in designated investment alternatives held in the account of the participant or beneficiary.

[Labor Reg. §2550.404c-1(b)(2)(i)(B)(2)]

Notice That Plan is Intended to be a Section 404(c) Plan

Perhaps the most overlooked disclosure obligation necessary to ensure Section 404(c) status is the requirement that participants and beneficiaries be notified that the plan is intended to constitute a Section 404(c) plan and that fiduciaries will be relieved of liability for investment results.

It can not be overstated that it was this failure that was asserted by the plaintiffs and supported by the DOL in its amicus brief as allegedly causing the Enron Section 401(k) plan to not constitute an ERISA Section 404(c) plan. [Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motion to Dismiss, <u>Tittle v. Enron Corp</u>.]

It should be also noted that there are two additional disclosure requirements related to this disclosure.

First, the regulations governing the contents of a summary plan description now require that the plan specify in the summary if it is attempting to comply with Section 404(c). [Labor Reg. §2520.102-3(d)]

Further, the Form 5500 requires that the plan indicate if it is attempting to comply with ERISA Section 404(c). Failure to properly complete the 5500 on this point may be used against the plan in the event of subsequent participant complaints and/or litigation where the plan claims Section 404(c) status and protection.

Changes Proposed By DOL Fee Proposed Regulations

Published in the Federal Register on July 23, 2008 are proposed regulations governing fiduciary disclosure obligations with respect to fees and expenses applicable to individual accounts under plans allowing participant investment direction. [[vol. 73 FR, No. 142 (July 23, 2008), pages 43013-43044] The regulations are proposed to be effective for plan years beginning on or after January 1, 2009]

The proposed regulations would amend the existing disclosure obligations under Labor Reg. Section 2550.404c-1 thereby ensuring that the new disclosure obligations extend to all individual account plans allowing participant investment direction and not just those attempting to satisfy Section 404(c).

The proposed regulations would be effective for plan years beginning on or after January 1, 2009.

The proposed regulations would require that fiduciaries take steps to ensure that participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of their accounts. This requirement necessitates that participants and beneficiaries be provided with sufficient information regarding the plan and the plan's designated investment alternatives, including with respect to both, fees and expenses, to make informed decisions. Under the proposed regulation, this requirement could be satisfied by disclosure of both "Plan-Related Information" and "Investment-Related Information".

<u>Plan-Related Information</u>

The Plan-Related Information that would be required to be disclosed under the proposed regulations would fall into the following categories: (a) eligibility information; (b) administrative expenses, and (c) individual expenses.

A. Eligibility Information

The proposed regulations would require that, on or before the date of plan eligibility and at least annually thereafter, participants be provided with:

> 1 an explanation of the circumstances under which participants and beneficiaries may give investment instructions;
>
> 2. an explanation of any specified limitations on such instructions including any restrictions on transfer to or from a designated investment alternative;
>
> 3. a description of or reference to plan provisions relating to the exercise of voting, tender and similar rights appurtenant to an investment in a designated investment alternative as well as any restrictions on such rights;
>
> 4. an identification of any designated investment alternatives offered under the plan, and
>
> 5. an identification of any designated investment managers; not later than 30 days after the date of adoption of any material change to the information described above, each participant and beneficiary must be provided with a description of such change.

[Prop. Labor Reg. Section 2550.404a-5(c)(1)]

B. Administrative Expenses

1. on or before the date of plan eligibility and at least annually thereafter, an explanation of any fees and expenses for plan administrative services (for example, legal, accounting recordkeeping) that, to the extent not otherwise included in investment-related fees and expenses, may be charged to the plan and the basis on which such changes will be allocated (for example, pro rata, per capita) to, or affect the balance of, each individual account, and

2. at least quarterly, a statement that includes:

a. the dollar amount actually charged during the preceding quarter to the participant's or beneficiary's account for administrative services, and

b. a description of the services provided to the participant or beneficiary for such amount (for example, recordkeeping);

[Prop. Labor Reg. Section 2550.404a-5(c)(2)]

C. Individual Expenses

1. on or before the date of eligibility and at least annually thereafter, an explanation of any fees and expenses that may be charged against the individual account for services provided on an individual, rather than plan, basis (e.g., fees attendant to processing plan loans or qualified domestic relations orders, fees for investment advice or similar services charged on an individual basis), and

2. at least quarterly, a statement that includes:

a. the dollar amount actually charged during the preceding quarter to the participant's or beneficiary's account for individual services, and

b. a description of the services provided to the participant or beneficiary for such amount (e.g., fees attendant to processing plan loans).

[Prop. Labor Reg. Section 2550.404a-5(c)(2)]

D. Investment-Related Information

The proposed regulations would mandate that a fiduciary (or a person or persons designated by the fiduciary to act on its behalf), satisfy the following requirements:

1. Information to be provided automatically. Provide to each participant or beneficiary, on or before the date of plan eligibility and at least annually thereafter, the following information with respect to each designated investment alternative offered under the plan--

   i. Identifying information—to include:

      a. the name of the designated investment alternative;

      b. an Internet Web site address that is sufficiently specific to lead participants and beneficiaries to supplemental information regarding the designated investment alternative, including the name of the investment's issuer or provider, the investment's principal strategies and attendant risks, the assets comprising the investment's portfolio, the investment's portfolio turnover, the investment's performance and related fees and expenses;

      c. the type or category of the investment (e.g., money market fund, balanced (stocks and bonds) fund, large-cap fund); and,

      d. the type of management utilized by the investment (e.g., actively managed, passively managed);

2. Performance data--for designated investment alternatives with respect to which the return is not fixed, the average annual total return (percentage) of the investment for the following periods, if available: 1-year, 5-year, and 10-year, measured as of the end of the applicable calendar year; as well as a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future. In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, both the fixed rate of return and the term of the investment;

3. Benchmarks--for designated investment alternatives with respect to which the return is not fixed, the name and returns of an appropriate broad-based securities market index over the 1-year, 5-year, and 10-year periods comparable to the performance data periods provided above and which is not administered by an affiliate of the

investment provider, its investment adviser, or a principal underwriter, unless the index is widely recognized and used;

4. Fee and expense information--for designated investment alternatives with respect to which the return is not fixed:

   a. the amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's or beneficiary's investment), such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees;

   b. the total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and

   c. a statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions. In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, the amount and a description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part;

The proposed regulations contain rules for providing the information regarding investment-related information in an acceptable comparative format.

<u>Additional Information and Changes</u>

In addition, the proposed regulations require that certain information be provided to participants and beneficiaries subsequent to investment as well as information to be provided upon request.

E. Broad Range of Investment Alternatives

If a plan is to obtain the limited relief provided by Section 404(c), the plan must offer a broad range of investment alternatives. [Labor Reg. §2550.404c-1(b)(3)]. This requirement is satisfied only if the investment alternatives made available under the plan, when taken together, provide each participant an opportunity to:

(i) materially affect the potential return on amounts in the participant's account and the degree of risk to which they are subject;

(ii) choose from at least <u>three</u> investment alternatives, each of which is diversified and has materially different risk and return characteristics, and which taken together, allow the participant, by choosing among them, to achieve a portfolio whose risk and return characteristics are within the range of risk and return normally appropriate for the participant; and each of which, when combined with investments in the other available investment alternatives, tends to minimize the overall risk of the participant's portfolio through diversification.

[Labor Reg. §2550.404c-1(b)(3)(i)(B)]

Because of this requirement, most Section 401(k) plans will find it necessary to have more than three core investment options.

(iii) the participant must have the opportunity to diversify that portion of his account which constitutes a participant-directed portion. In making this determination, both the nature of the investment alternatives offered as well as the size of the portion of an individual's account over which the participant is permitted to exercise control must be taken into account. If the portion over which any participant has control is so small that the opportunity to invest in pooled investment vehicles is the only prudent means to assure the opportunity to diversify, relief is available with respect to such participant only if the plan offers "look-through vehicles" as investment alternatives. [Labor Reg. §2550.404c-1(b)(3)(i)(C)].

A "look-through investment vehicle" means:

(i) an investment company or series investment company as defined in Section 3(a) or 18(f) of the Investment Company Act of 1940 or any of the segregated portfolios of such company;

(ii) a common or collective trust fund or a pooled investment fund maintained by a bank or similar institution, a deposit in a bank or similar institution, or a fixed rate investment contract of a bank or similar institution;

(iii) a pooled separate account or a fixed rate investment contract of an insurance company qualified to do business in a state, or and any entity whose assets include plan assets by reason of a plan's investment in the entity.

[Labor Reg. §2550.404c-1(e)(1)]

F. Actual Exercise of Independent Control

In order for Section 404(c) relief to be available, the participant must have actually exercised independent control with respect to the transaction.

The determination as to whether a participant has exercised the requisite control is to be determined based upon the facts and circumstances involved. However, the following will cause the exercise not to be deemed to constitute the exercise of independent control:

(i) the participant is subjected to improper influence by a plan fiduciary or plan sponsor;

(ii) the plan fiduciary has concealed material non-public facts regarding the investment from the participant, unless disclosure of such information to the participant would violate any provision of federal law or any provision of state law not preempted by ERISA, or

(iii) the plan fiduciary accepts instructions from a participant knowing the participant to be legally incompetent.

[Labor Reg. §2550.404c-1(c)(2)]

The regulations set forth additional restrictions and limitations with respect to transactions involving plan fiduciaries. [See Labor Reg. §2550.404c-1(c)(3)]

When Does The failure to Relay Sufficient Information Nullify the Exercise of Independent Control?

Certainly, one of the allegations made by the plaintiffs in the Enron case was that the defendants' concealment of material non-public facts about the company's financial condition effectively took away their ability to exercise independent control and judgment over their accounts. As such, they argued that ERISA Section 404(c) could not possibly apply to limit the defendants' liability. Plaintiffs have made similar claims in other stock drop cases. [See, for example, In re Dynergy, Inc. ERISA Litigation, 309 F. Supp. 2d 861 (S.D. Tex. 2004).

G. Limiting the Frequency of Investment Changes

A plan will not be deemed to lose Section 404(c) relief merely because it imposes reasonable restrictions on the frequency with which a participant may give investment directions. However, no restrictions will be deemed reasonable unless:

(i) the frequency is appropriate with respect to the volatility expected of the available investment options;

(ii) at least three "core options" permit instructions to be given at least once in any 3 month period, and

(iii) in the case of the more volatile investments, i.e., those that require transfers more frequently than once in any 3 month period, at least one core option allows transfers in at least as frequently as any more volatile option allows transfers out, or an income producing, low-risk liquid fund, subfund or account is provided as a "parking fund" to which transfers from a more volatile investment may be made at any time permitted by the more volatile investment and from which transfers may be made to at least as frequently as the core option generally permits transfers.

H. Charging for Costs

Direct charges, such as the commissions and other trading costs, may be charged to the participant's account without losing Section 404(c) relief. However, the ability to charge other more indirect cost, i.e., those not directly related to the trade, for example increased accounting or bookkeeping costs, is not quite as clear.

The regulations do provide that a plan may charge participants' and beneficiaries' accounts for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform participants and beneficiaries of actual expenses incurred with respect to their individual accounts. [Labor Reg. Section 2550.404c-1(b)(2)(ii)(A)]

I. Protecting the Plan and other Plan Participants

A fiduciary may decline to implement certain instructions. Specifically, a fiduciary may decline to implement instructions that would have the following consequences without losing Section 404(c) status:

(i) would not be in accordance with the plan documents;

(ii) would cause the fiduciary to maintain plan assets outside the jurisdiction of the district courts of the United States except as permitted by ERISA § 404(b) and Labor Reg. §2550.404b-1;

(iii) would jeopardize the plan's tax qualified status;

(iv) could result in a loss in excess of the participant's or beneficiary's account balance;

(v) would result in certain transactions between the plan and the plan sponsor set forth in the regulations;

[Labor Reg. §2550.404c-1(d)(2); §2550.404c-1(b)(2)(ii)(B)]

In addition, the fiduciary may decline to implement instructions specified in the plan including instructions which would result in a prohibited transaction under ERISA §406 or I.R.C. §4975 not otherwise exempt under the regulations or which would generate taxable income to the plan. [Labor Reg. §2550.404c-1(b)(2)(ii)(B)]

Plans will want to make sure that whatever restrictions on investments will be adopted in practice are also restrictions that are disclosed in the plan document and summary plan description or at the very least, are not subject to contradiction by those documents.

J. Mapping

When a plan that allows participants to direct their own investments changes the investment options offered, this will sometimes result in a blackout as defined in ERISA. In order to minimize the period of time during which plan assets are uninvested, plans will often make the change to the new investments by “mapping” the old investments into the most similar new investment option. After the change to the new investment options is complete, participants are then given the right to make affirmative elections to change any of their investment options.

Effective generally for plan years beginning after December 31, 2007 (subject to a later effective date for collectively bargained plans), a participant or beneficiary who has exercised control over the investment of his/her account prior to an investment change will continue to be treated as exercising the requisite control if certain requirements are met. For this purpose, a qualified change in investment options means a change in the investment options offered under the plan under which: (1) the participant’s account is reallocated among one or more new investment options offered instead of one or more investment options that were offered immediately before the effective date of the change; and (2) the characteristics of the new investment options, including characteristics relating to risk and return, are, immediately after the change, reasonably similar to the characteristics of the investment options offered immediately before the change. In addition, the plan administrator must furnish a written notice to participants at least 30 and no more than 60 days before the effective date of the change. The Act directs the Secretary of Labor to issue regulations providing guidance on how plan sponsors and other fiduciaries can satisfy their fiduciary responsibilities during any blackout period. [ERISA Section 404(c)(4)]

K. Responsibilities Retained by Plan Fiduciaries

Even where Section 404(c) relief is available, plan fiduciaries will still be responsible for the following:

(i) selection and retention of investment alternatives;

(ii) voting and tender decisions unless passed through to the participants;

(iii) selection and retention of investment managers made available under the plan.

With respect to the selection of investment options, the case of Mutual Funds Investment Litigation v. Amvescap PLC, No. 06-2003, 06-2176, 06-2177 (4th Cir. 2008) should be noted. The case was essentially a question of whether casehd out participants had standing to bring suit. The court held that post LaRue v. DeWolff, Boberg & Associates, Inc., --U.S.---, 128 S. Ct. 1020 (2008), they did. However, what is most interesting is the basis of their claim which results from the fall out of the mutual fund trading scandals of a few years ago. The former employees claimed a fiduciary breach based upon the alleged mismanagement of knowingly investing in mutual funds allowing investors to market time.

L. Special Concerns for Brokerage Accounts and Mutual Fund Windows

Use of individual Brokerage Accounts whereby a participant can invest in anything available through the brokerage or Mutual Fund Window options, pursuant to which, a participant can do the same but limited to mutual funds, would certainly seem to ensure compliance with the "broad range of investments" requirement component of the regulations. However, compliance with some of the disclosure obligations can prove problematic.

Although DOL officials have, informally on occasion stated that the intent was not to have the disclosure obligations impose an impediment to these types of arrangements, the DOL has not issued any additional formal guidance as to whether unlimited investment options can ever comply with the disclosure requirements applicable to a plan attempting to satisfy ERISA Section 404(c).

For example, the regulations provide that a participant or beneficiary will not be considered to have sufficient investment information unless, along with other requirements:

> " a description of the investment alternatives available under the plan and, with respect to each designated investment alternative, a general description of the investment objectives and risk and return characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designated investment alternative;" [Labor Reg. §404c-1(b)(2)(B)(1)(ii)]

While the regulations contemplate significantly more information being provided with respect to each "designated" investment alternative under the plan (that is, a specific investment identified by a plan fiduciary as an available investment alternative under the plan), the regulations appear to contemplate that the plan must, at a minimum, provide a description of each investment alternative under the plan without regard to whether that investment is a designated investment.

A statement to the effect that a participant may invest in any investment made available through the brokerage, (or any mutual fund) may well prove sufficient, but we do not have formal guidance on the point.

Other disclosure requirements under the regulations which are not specifically limited to "designated investments" include the requirement to provide:

> "a description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales loads, deferred sales charges, redemption or exchange fees);"
>
> "in the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant's or beneficiary's initial investment, a copy of the most recent prospectus provided to the plan;"
>
> "subsequent to an investment in an investment alternative, any materials provided to the plan relating to the exercise of voting, tender or similar rights which are incidental to the holding in the account of the participant or beneficiary of an ownership interest in such alternative to the extent that such rights are passed through to participants and beneficiaries under the terms of the plan, as well as a description of or reference to plan provisions relating to the exercise of voting, tender or similar rights;"

In all such cases, the fiduciary will need to rely heavily upon the individual brokerage house or mutual fund company to satisfy these requirements although the fiduciary will remain responsible for compliance.

In all events, plans may wish to impose some restrictions on the ability of a participant to invest including some or all of the following:

1. only <u>publicly traded</u> investments (this may prove essential particularly since a participant exercising discretion will be treated as a fiduciary for purposes of the Code's prohibited transaction provisions and therefore, investments by that fiduciary in any disqualified investment, such as an entity that the participant has a significant ownership interest in, will result in a prohibited transaction);

2. no investments where the potential loss could exceed the participant's account (this can be used to exclude many actual real property investments because of the unforeseen potential of tort lawsuits, environmental issues etc);

3. no investments that could result in taxable income to the plan;

4. no investments other than through <u>(specified brokerage house)</u> brokerage;

5. no investments that would result in a prohibited transaction;

6. no investments in collectibles;

7. no investments that would cause plan fiduciaries to maintain an indicia of ownership of any plan assets outside the jurisdiction of the district courts of the United States, and/or

8. no investments that would jeopardize the plan's tax qualified status;

"The plan may also want to prohibit trading in things that may be considered particularly risky such as futures or commodities, derivatives or similar types of investments.