Q & A on Qualified Default Investment Alternatives

The federal government recently changed the law and regulations governing employee benefit plans, such as a 401(k) plan, to encourage greater participation in such retirement plans. These changes also affect the potential liability faced by plan sponsors and fiduciaries. If your retirement plan has a default investment, such as a money market account, the Department of Labor (DoL) regulations as of December 24, 2007, no longer afford plan sponsors protection when this type of investment is chosen. To afford yourself maximum protection, you may want to make sure those defaults satisfy the DoL's Qualified Default Investment Alternatives (QDIA) regulatory guidelines. A question and answer discussion follows that we trust will explain these changes.

Q: What are Default Investments?

A. When a retirement plan (such as a 401(k) plan) requires participants to direct their investments, and they fail to do so, plan fiduciaries are required to exercise judgment and select an appropriate investment for the employee.

Prior to these recent changes in the law, plan sponsors and fiduciaries were potentially liable for a plan participant's losses unless the participant exercised control over the investment of his or her account. Consequently, in the absence of a participant's investment directions, plan sponsors and fiduciaries would be required to direct where the funds should be invested. Typically, plan sponsors and fiduciaries seeking to avoid potential liability would direct that such defaulted investments be invested in a conservative investment, such as a money market, fixed income, or stable value fund.

The recent changes to the law provide that a plan participant will be deemed to have exercised control over assets in his or her account if, in the absent of investment directions from the participant, the plan invests the assets in a QDIA. If, however, a plan sponsor or fiduciary directs the investment into an investment that is not a QDIA, the plan sponsor or fiduciary continues to face potential liability for any investment losses.

Many plan sponsors in our 401(k) program, exercising their fiduciary duty, chose our money market fund. Why? The money market fund offered a conservative solution with a low probability of loss to the participant.

Q. What are QDIAS?

A. There are several limitations under the QDIA regulations (e.g., a QDIA generally may not hold or permit the acquisition of the employer's securities); however, there are several types of investment vehicles that may qualify as a QDIA, including the following

A life-cycle or targeted retirement date fund applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and 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.*

A balanced fund applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and 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.

A *managed account* is an investment management service whereby the fiduciary applies generally accepted investment theories and allocates the assets to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income exposures, offered through the investment alternatives available under the plan, based on the participant's age, target retirement date, or life expectancy.

As a result of final regulations issued October 15, 2007, by the DoL plan sponsors now may receive protection from employee lawsuits (in the event of investment losses or breach of responsibility) if they invest a participant's assets in QDIAs. In fact, a sponsor is exposed to potential participant litigation if it maintains the existing money market account as the default.

Q. Why Are Money Market Accounts No Longer Acceptable As A Default Investment?

A. In a footnote to previously proposed DoL regulations, the DoL outlined its thought process in restricting these accounts as QDIAs: "Investments in capital preservation vehicles deprive investors of the opportunity to benefit from the returns generated by equity securities that have historically generated higher returns than fixed-income investments". As noted above, either money market funds or stable value funds may serve as a QDIA for up to 120 days following the participant's first elective contribution.

Q. What Other Conditions Must Be Satisfied In Order To Take Advantage Of The Relief From Potential Liability?

- The assets must be invested in one of the three QDIAs described above.
- The participant had the opportunity to direct the investment, but did not.
- The participant must be provided a timely notice, which in general is 30 days in advance of plan eligibility or the first investment and 30 days in advance of each subsequent calendar plan year.

- The notice also must let participants know under which circumstances the QDIA kicks in, and how to elect out. Participants must be reminded that they have the right to direct their investments at any time.
- The participant must receive information regarding the default investment, such as a description of the fund, its investment characteristics, risk and return objectives, fees, expenses, etc.

Q. Who Benefits from QDIA?

A. Regulations on QDIA benefit both plan sponsors and plan participants:

- When a plan sponsor uses a QDIA, the Plan sponsor receives the same fiduciary relief (protection from lawsuits) under ERISA Section 404(c) as when participants choose their own investments.
- The plan sponsor has 404(c) protection for the QDIA portion of the plan, regardless of whether or not the entire plan qualifies for 404 (c) protections.
- QDIA could be an investment discipline that has the potential to offer more meaningful accumulation of retirement savings than money market or stable value funds, which typically were used by plan sponsors as default investments.

Q. How Are Participants In Default Accounts Affected Once A Plan Implements QDIA?

- A participant who has defaulted into a QDIA has the same rights, such as transferring to another fund, as a participant who directly chose the fund.
- During the first 90 days following initial default of elective contributions, the participant may withdraw from the QDIA fund and receive a refund

- adjusted for gains or losses. Only fees and expenses charged on an ongoing basis for operation of the investment itself, such as distribution fees, 12b-1 fees, and management fees, may be assessed. No surrender charges or expenses charged in connection with liquidation are permitted.

- Class A front-end sales charges may be applied and not refunded.

- At the end of the 90-day period, the default fund behaves as any other investment.

- Assuming a plan sponsor selects a QDIA, participants whose contributions are 100 percent invested in a money market fund, as a result of prior defaults, must be notified (via a 30-day notice) that, unless they elect to have their investments remain in the money market fund, the entire account balance will be transferred to the plan's QDIA. This also is permitted if you cannot tell whether the participant defaulted into the money market account or elected it outright. You only need to be concerned about participants who are 100 percent money market investors.

Q. Are There Any Guidelines A Plan Sponsor Should Follow When Selecting QDIA?

A. The DoL, in the preamble to the final regulation referenced above, notes: "The Department understands that the only information a plan fiduciary may have about its participant population is age. Thus, when determining the target level risk appropriate for participants of the plan as a whole, the fiduciary is required to consider the age of the participant population." Thus, a plan sponsor should select a QDIA that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and 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 (unless a managed account is used, in which case the plan sponsor must take into account a particular participant's age).

A stable value fund (limited capital preservation option) is designed to preserve principal and provide a reasonable rate of return, whether or not

such return is guaranteed, and seeks to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product. This option constitutes a QDIA for no more than 120 days following the participant's first elective contribution (this is the period of time when employees are most likely to opt out of plan participation; the stable value fund provides for a new risk-free investment alternative without loss of principal during such time period).

A grandfathered stable value fund is a stable value fund used as a default prior to December 24, 2007, and will be a QDIA for investments made prior to that date. In order for the stable value fund to qualify as a grandfathered QDIA, it has to provide a guarantee (by a state or federally regulated financial institution) of the principal and rates of return consistent with that earned by intermediate investment-grade bonds, while providing liquidity for withdrawals. In addition, there can be no fees or surrender charges imposed in connection with withdrawals initiated by the participant.