THE WAGNER LAW GROUP
A PROFESSIONAL CORPORATION

DEFAULT INVESTMENTS AND INVESTMENT ADVICE UNDER PPA

I. Default Investments.

Fiduciary Relief. Plan sponsors are not responsible for the specific investment decisions made by participants if the plan complies with ERISA Section 404(c). For years beginning after December 31, 2006, the Pension Protection Act of 2006 ("PPA") extends this protection to situations where the participants do not make an investment choice, and the plan fiduciary makes a default investment consistent with regulations which the PPA authorizes the DOL to issue. On September 27, 2006, the DOL issued proposed regulations that stipulated the conditions for such relief.

The proposed regulations relieve plan fiduciaries of liability for loss or for an ERISA fiduciary breach that is the direct and necessary result of investing part or all of a participant's account in a "qualified default investment alternative" ("QDIA"). Notwithstanding this relief, the fiduciaries would remain responsible under Section 404(a) of ERISA for the prudent selection and monitoring of a QDIA. The Wagner Law Group submitted comments to DOL that focus on the difficulty that small and medium sized plan sponsors will have in fulfilling this responsibility, particularly when the QDIA consists of a fund of funds and there may be little transparency as to the fees charged by underlying funds.

Definition of a QDIA. A QDIA consists of one of the following three types of investment products or services:

- An investment fund product or model portfolio 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 (e.g., a life-cycle or target retirement approach), although asset allocation decisions may be based only on age without taking other participant characteristics into account. The investment fund product may be a stand-alone product or a fund of funds and is thus intended to cover life-cycle funds offered by mutual fund houses;

- An investment fund product or model portfolio 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 to participants in the plan as a whole (e.g., a balanced fund approach). Asset allocation decisions under this alternative may be based on the demographics of the participant population as a whole as it evolves over time and need not consider individual participant characteristics;

- An investment management service in which the investment manager allocates the assets of a participant's individual account to achieve long-term appreciation and capital preservation through a mix of equity and fixed income exposures offered through investment alternatives based on the participant's age, target retirement date, or life expectancy (e.g., an aged-based managed account approach), although as with the first alternative, asset allocation decisions may be based on considerations limited to the participant's age.

Stable Value Fund Controversy. The most controversial aspect of the proposed regulations is their failure to include a stable value fund in the mix of QDIA alternatives. The politicization of this issue has caused the DOL to miss the PPA mandated target date (February 17, 2007) for issuing final regulations, and it is not clear when the final rules will be published. Nevertheless, because of the DOL's policy objective of enabling participants to accumulate benefits at a rate that exceeds inflation, it is likely that the three alternatives already included as QDIAs will, because of their significant equity component, continue to be included in the list of QDIA products even if a stable value fund is added. In the meantime, there is also a discernible trend among employers, motivated by the same concerns that influenced the DOL, or perhaps pushed by their mutual fund providers, in the direction of establishing default funds based on a mutual fund provider's life-cycle funds, i.e., the first category of QDIA specified in the proposed regulations.

Notwithstanding the failure to include a stable value fund as a stand-alone QDIA, the preamble to the proposed regulations anticipates that money market and stable value funds will be part of the investment mix under the first two QDIA alternatives, that is the life cycle/target retirement approach and the balanced fund approach. Further, plans may continue to use money market and stable value products as default options in accordance with pre-PPA law, although this will not ensure the relief from fiduciary liability provided by the PPA. Employers wishing to take advantage of the protection for default investments need to select qualifying investment products and amend their plans to require appropriate disclosure to participants, and, if necessary, remove any provision that would prevent the use of a QDIA as a default investment.

Special Considerations Applicable to Balanced Funds. It should be noted that the balanced fund approach to meeting the QDIA definition requires a plan fiduciary to take into account the demographics of the plan participants as a whole, rather than focus on the age, retirement date or life expectancy of an individual participant. As pointed out in the preamble to the proposed regulations, this is similar to the considerations that the fiduciary would take into account in managing an individual account plan that did not provide for participant investment direction, and thus would require constant monitoring of the investments within the balanced fund investment product to ensure that they remain consistent with the character of the current workforce. From time to time, as the demographics of the workforce evolve, the fiduciary may need to replace the current investment product or buy a new one. Many plan sponsors will want to participate in the process of selecting new investments and will therefore require advice from sources independent of the provider of the investment product.

Investment Manager Requirement. The proposed regulations include a requirement that a QDIA must be managed by either an investment manager, as defined in Section 3(38) of ERISA, or an investment company registered under the Investment Company Act of 1940. Section 3(38) generally defines an investment manager as a fiduciary who is a registered investment adviser, a bank, or an insurance company that has the power to manage, acquire, or dispose of plan assets and has acknowledged its fiduciary status in writing. This definition would have the effect of prohibiting any trustee or named fiduciary of a plan, including the plan sponsor, from managing a QDIA for that plan.

The investment manager requirement, which is part of the definition of a QDIA, has been attacked in several comments to the DOL which have suggested that a plan sponsor or plan investment committee consisting of individuals employed by the plan sponsor should be allowed to manage a QDIA. The advocates of such a change argue that the proposed rule, as it now stands, will disrupt the historic relationship between plan sponsors and independent investment consultants. The latter are unwed to proprietary investment products and are therefore more likely to recommend the use of non-mutual fund investment vehicles or non-proprietary mutual funds which arguably could lead to economies of scale and the reduction of fees as well as superior investment results. An expanded definition of a QDIA would be required to enable a plan sponsor or plan investment committee, working with an investment consultant, to structure and operate one or more QDIA asset allocation strategies (for a series of target retirement dates) consisting of multiple separately managed accounts that may or may not include mutual funds but that would include the use of best in class investments not available in the mutual fund context. If the investment manager rule is relaxed, small and medium sized employers that wish to operate a QDIA may continue to rely on the expert advice of outside investment consultants in establishing and managing one or more QDIAs.

Availability of Alternatives to a QDIA. A QDIA may not restrict the ability of a plan participant or beneficiary to transfer his account from the QDIA to other investment alternatives available under the plan. This definitional requirement also prohibits the imposition of financial penalties resulting from such a transfer. In addition, as a condition of qualifying for relief from fiduciary liability, the plan must allow the participant to transfer out of a QDIA at least once every three months and on terms that that are no less favorable than transfers from any other plan investment. Relief from fiduciary liability is further conditioned on the plan's making available the "broad range" of alternative investments applicable to Section 404(c) plans even if the plan does not intend to take advantage of the Section 404(c) safe harbor.

Diversification and Restrictions on Holding Employer Stock. All QDIAs must be diversified so as to minimize the risk of large losses. Presumably with the same objective, the proposed regulations, with two exceptions, prohibit QDIAs from holding or acquiring employer securities. The first exception allows, although it does not encourage, employer securities to be held within a mutual fund or similar pooled investment vehicle, provided that such an investment is made in accordance with the fund's stated investment objectives. The second exception would allow the acquisition of employer securities as an employer matching contribution or at the direction of a participant or beneficiary. The second exception is apparently intended to enable an account managed by an investment management service hired to create a managed account type of QDIA to hold employer securities acquired as matching contributions or as the result of prior participant direction. However, the investment management service must have the authority to dispose of the employer securities.

Notice Requirement. For the default investment fiduciary protections to apply, the proposed regulations require that a default investment notice must be provided to participants at least 30 days in advance of the first default investment, and at least 30 days in advance of each subsequent year. The notice must describe how, among other things, contributions will be invested in the absence of any investment election by the participant.

The 30-day requirement has been subjected to severe criticism on the grounds that many automatic enrollment plans provide for salary deferrals to be deducted from an individual's pay starting with the first paycheck following his or her date of hire. Moreover, a plan without an automatic enrollment feature may permit new hires to begin immediate salary deferrals, and will cause such deferrals to be allocated to a default investment if the new participants do not provide effective investment instructions. It has been suggested that it would be sufficient if the notice were provided within a certain period, say five days, after the date of hire. If the 30-day rule is carried over in the final regulations, employers should be advised that new participant default elections should not be implemented until the first payroll period after an employee has been a participant for 30 days.

Pass-Through of Information Requirement. A further condition on the applicability of fiduciary protection for default investments is that the plan, by its terms, must provide that any material provided to the plan and relating to a QDIA (e.g., a prospectus, proxy voting materials or account statements) will be provided to the participant. It has been observed that this disclosure exceeds the disclosure required under the DOL's Section 404(c) regulations. For instance, those regulations do not require the pass-through of proxy materials unless a participant has the right to vote proxies under the terms of the plan. The DOL has been asked to narrow this requirement to the pass-through of materials required under the 404(c) regulations. The Department has also been requested to clarify whether disclosure is required for those who may affirmatively elect to invest their account in a QDIA, as opposed to those who are defaulted into the QDIA. Finally, the DOL has been requested to withdraw the requirement that plan documents be amended to reflect the disclosure requirement.

Conclusion. The proposed QDIA regulations are an ambitious attempt to provide guidance on an important issue that will have a significant effect on the level of retirement plan savings and that is likely to determine whether the PPA's automatic enrollment provisions are successfully implemented. However, the proposed rules raise a number of controversial issues that the DOL must resolve and that, whatever the outcome, will result in substantial changes to the proposal.

II. Investment Advice.

The PPA encourages plan sponsors to provide investment advice to participants by allowing a "fiduciary advisor" to provide investment advice (including advice with respect to the fiduciary advisor's own investment products) to participants in plans with participant-directed accounts without violating prohibited transaction rules, provided that certain conditions are met. These conditions include the following safeguards:

- The investment advice must either be based on a computer model that is certified by an "eligible investment expert" or the fiduciary advisor's fees cannot vary based on the investment options selected;

- Before the initial provision of investment advice and annually thereafter, the fiduciary advisor must provide the participant with information on the investment advice program, including fees, historical rates of return, and the role of other parties with a material role in developing the program;

- Transactions may occur only at the participant's direction;

- The fiduciary advisor's compensation must be reasonable and all transactions must be at least as favorable to the plan as "arm's length" transactions;

- The investment advice program must be authorized by a fiduciary other than the fiduciary providing the advice or any person providing investment options under the plan;

- The investment advice program must be subject to an independent annual audit regarding compliance with these new standards for which a written report is prepared; and

- The fiduciary advisor must retain compliance records for at least six years.

A fiduciary advisor is broadly defined to include banks, insurance companies, broker dealers and registered investment advisors, as well as their affiliates, employees, representatives and agents.

The plan sponsor must use prudence in selecting and monitoring a fiduciary advisor, and is required to periodically monitor its performance, but does not have the responsibility of monitoring the specific investment advice provided to any particular participants.

These investment advice rules are effective for advice provided after December 31, 2006.

Comment: Plan sponsors wishing to take advantage of the new investment advice rules should establish procedures to ensure that fiduciaries comply with ERISA's fiduciary prudence requirements with respect to the selection and periodic review of the fiduciary advisor. The plan sponsor should be able to demonstrate compliance with ERISA standards in the event of a DOL audit.