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November 2007 Vol. 11

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Default Investments in Self-Directed 401(k) Plans –"Safe" is No Longer Safe

By: Edward F. Martin

A regulation published by the Department of Labor on October 24 will affect the way default investments are made under most 401(k) plans, as well as other defined-contribution plans. Prompt action is recommended to bring plans into compliance.

Most sponsors of defined-contribution plans allow participants to choose their own investments from a menu provided to them. In that way the participant, rather than the plan sponsor and the plan's fiduciaries, can be made responsible for any losses incurred by the participant.

If a participant fails to make an investment choice (a "passive participant"), then the plan has to have a default investment. In many plans the default has been a money market fund or some other fixed-income investment where there is little or no risk of loss of principal. Because the fiduciary, not the participant, is making the choice, that appeared to be a prudent choice.

Not so any longer. The Pension Protection Act of 2006 added Section 404(c)(5) to ERISA, providing that if a qualifying default investment arrangement (QDIA) is selected as the default investment for a passive participant, the participant will be deemed to have made the selection, thus freeing the plan's fiduciaries of responsibility. The new law seemed to require the QDIA to have some exposure to stocks. After a long internal debate, the Department of Labor has agreed that under the new regulations a QDIA must be either (1) a "life-cycle" type of investment that has substantial investment in stocks, with the degree of risk depending on the age of the participant, (2) a "balanced" type of investment fund, or (3) management of the account by a qualified investment manager.

Thus, the new law and the regulations require that a QDIA put the passive participant's account at risk. This actually makes sense, because a prudent manager of an investment account that has a long growth period should take risks in order to maximize return. Over any historical 20-year period a diversified portfolio including stocks has outperformed a money market type of investment.

The new law goes into effect December 24, 2007. The following are some important features of the transition to these new rules:

- The new rules apply to default investments made after December 24, 2007. Thus, 404(c)(5) does not, at least technically, apply to default investments made before December 24, 2007. However, it may be desirable to invest all of a passive participant's accounts uniformly.

- If a participant's account is invested in the current default investment fund and it is not possible to tell whether it got there by default or by selection, the plan can notify the participant of the intention to transfer the existing account to the

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new default, and be protected upon doing so when the participant fails to elect otherwise.

- The default investment can be a money market fund for the first 120 days of participation, switching to a QDIA no later than the 120th day, if the participant fails to act.

- It is necessary to notify participants of the default investment. The notice must be given at least 30 days prior to the first contribution for a participant, and 30 days before each plan year thereafter. *We recommend that plan sponsors begin working now to implement the new QDIA rules effective at the end of December, with notice to be given no later than 30 days prior to the year-end contribution.*

- If the plan has an automatic contribution feature, and the first contribution is made less than 30 days after becoming eligible, then the notice must be given no later than the date when eligible *and* the participant must be given a right to withdraw all such automatic contributions during the first 90 days of participation.

- The selection of one or more QDIA's for a plan must be made prudently. A single "balanced fund" may work, but the regulations seem to encourage the use of several different "life-cycle funds," with the age of the participant determining which QDIA will be used. For example, a life-cycle fund having a target year of 2050 would be the default for a new participant who is now about 22 years old. That fund will be invested heavily in stocks at first but will reduce its risk as the years go by. Many mutual fund companies offer life-cycle funds for participants at all ages. If individual management can be made available then that could work best of all, but most plans do not offer such a service.

Keep in mind that these new rules do not relieve a plan's fiduciaries from responsibility for prudently selecting the investment options that will be offered to plan participants and monitoring the performance of those investment options.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact any of the attorneys listed below.

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