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A non-technical review of qualified retirement plan legislative and administrative issues December 2006

Participant Cruise Control: Automatic Enrollment

On August 17, President Bush signed the Pension Protection Act of 2006 (PPA) into law. The new law, heralded by many as the most important change to the rules governing retirement benefits since the passage of the Employee Retirement Income Security Act of 1974 (ERISA), aims to increase employee participation in 401(k) and other defined contribution plans by explicitly allowing for the automatic enrollment of employees. It also provides a safe harbor for plan sponsors and other fiduciaries who invest automatically enrolled participants' contributions in a qualified default investment alternative.

Introduction to Automatic Enrollment

Automatic enrollment is not a novel concept in the defined contribution plan world. Plans that currently have the feature deduct a specified percentage of an employee's wages without the employee's consent and then invest the money in the 401(k) plan's default investment option. Research has shown that companies with such an option see drastically increased participation.

Despite the benefits of automatic enrollment to both plans and participants, it has not been widely implemented because plan sponsors feared that withholding and investing employee wages without affirmative investment instructions from the participant could result in liability under ERISA. Moreover, there has been concern that automatic enrollment would run afoul of state laws that forbid withholding without employee consent. The PPA alleviates employer fears by explicitly authorizing automatic enrollment.

PPA Automatic Enrollment Provisions

The PPA allows a percentage of an employee's wages to be automatically withheld and contributed to a defined contribution plan. The basic rules are as follows:

- The employer may withhold a specified percentage of an employee's wages and invest them in the plan;
- The employee must have the option of opting out of the plan or changing the contribution level;
- Employees that have been swept into a plan without making an affirmative election to do so may make withdrawals of automatic defer-

rals within 90 days of the first contribution without a penalty. By doing so, they forfeit any employer-provided matching contributions;

- The plan must notify employees of automatic enrollment when they are hired, just before they become eligible and once a year thereafter. The notice has to inform the employee that he can opt out of the plan and/or change his contribution level; and
- A plan with automatic enrollment may avoid nondiscrimination testing if it enrolls all new employees at a deferral percentage of at least 3%, the plan automatically increases the employee contribution percentage by 1% each year until it reaches 6% and the employer makes certain matching contributions which are fully vested after two years of service.

Deferring employee wages because of automatic enrollment will not be subject to state prohibitions on withholding wages without consent.

By itself, the express authorization of automatic enrollment under the PPA would not necessarily be enough to make plan sponsors change their salary deferral plans because a question would still remain as to what type of investments should be used for those participants that were automatically enrolled. Fortunately, the PPA addressed this issue as well.

Default Investments

Generally, plan sponsors and other fiduciaries are not liable for the investment decisions of participants in defined contribution plans. The theory is that fiduciaries should only be liable in instances where they exercise discretion or control over plan assets. However, prior to the PPA, the U.S. Department of Labor (DOL) took the position that in situations like automatic enrollment, where there is no affirmative participant investment election, plan fiduciaries might be liable for losses resulting from the default investment.

Congress was aware of this impediment to automatic enrollment and, as a result, addressed this issue in the PPA. The PPA reverses the DOL's prior position and extends protection to fiduciaries that invest the account balances of auto-enrolled participants in a default investment, provided that the plan gives the participant notice of how contributions will be invested in the absence of instructions and the participant's right to reallocate the investments.

As required by the PPA, the DOL has issued proposed regulations that clarify the rules for default investments. Final regulations are expected by February at the latest.

DOL's Proposed Regulations

The DOL's proposed regulations provide protection from liability to plan sponsors and other fiduciaries that invest participant account balances in a way that meets the following conditions:

- A fiduciary may invest a participant's assets in a default option only after the participant has been given the opportunity to direct the investment of the assets in his account and fails to do so;
- Plan terms must provide that any material provided to the plan relating to a participant's investment (such as prospectuses, proxies, account statements) will be provided to the participant or beneficiary;
- A participant must be able to transfer out of the default investment option without financial penalty on the same terms as any other investment option and at least as frequently as once within any three-month period;
- The plan must provide a notice to participants at least 30 days before the first plan investment and at least 30 days before the beginning of each subsequent plan year. The notice must describe the default option, the circumstances under which plan accounts will be invested in the default option and the participant's rights

with respect to directing assets to other options under the plan. These notice requirements and the notice relating to auto enrollment could likely be met in a single notice;
- The plan must have a variety of different investment options; and
- Most importantly, the default investment must be invested in a "qualified default investment alternative."

Qualified Default Investment Alternative

The chief requirement for any default investment option is that it meets the requirements of a "qualified default investment alternative." The regulations explain that a qualified default investment alternative:

- May not generally hold employer securities, such as employer stock, except for employer securities held in certain types of "pooled" investment alternatives;
- May not impose penalties or restrict the ability of a participant to transfer out of the investment alternative;
- Must be a registered investment company under the Investment Company Act of 1940 or managed by an investment manager;
- Must be diversified so as to minimize the risk of large losses; and
- Must qualify as one of the three approved types of investment products or services.

Investment Products and Services Approved by the DOL

After surveying the various types of investment products and services available to plans and their relative merits, the DOL determined that only three types were suitable for use as a qualified default investment alternative:

- The first type of qualified default option is a fund or portfolio designed to provide varying degrees of long-term capital appreciation and capital preservation based on a participant's age, retirement date or life expectancy. This could be a stand-alone product or a "fund of funds" comprised of various investment options available under the plan. Examples include "life cycle" or "retirement date" funds. A participant's account would be invested in the appropriate fund or portfolio based solely on the participant's age, life expectancy or retirement date.
- The second type of "qualified" default option is a single default option for all plan participants. This option is described as an investment fund 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 for the plan as a whole. According to the DOL, an example of such an option may be a balanced fund. Like the first option, it could be a stand-alone investment product or a fund of funds utilizing other options otherwise available under the plan.
- Third, a plan could select an investment management service through which a professional investment manager allocates the assets of a participant's account among equity and fixed income investments based solely on the participant's age, life expectancy or target retirement date.

The DOL acknowledged that the only relevant information that plan fiduciaries may have regarding a participant who fails to provide investment instructions is the participant's age. Accordingly, none of the permissible default investments require the plan or manager to take into account other factors that could affect retirement asset allocations such as risk tolerance, other assets, level of income or lifestyle preferences.

Products That Do Not Qualify

Significantly, the DOL specifically rejected the use of capital preservation investment products, such as stable value and money market funds, as qualified default investment options, stating that those investments would be unlikely to generate a sufficient rate of return to provide adequate retirement savings for participants. The omission of stable value products is especially surprising since many plans currently use them as default options.

Plan Sponsor Liability

Fiduciaries that provide default investments meeting the requirements of the regulation would not be liable for losses that result from the investment of the participant's account balance in a qualified default investment alternative or for investment decisions made by the manager of the investment alternative.

Nonetheless, like any other investment option, fiduciaries could still be liable for decisions made concerning plan assets, including:

- Any losses that result from imprudently selecting and monitoring the default option;
- Improper management of the qualified default investment options by investment managers; and
- Excessive investment fees and expenses.

As a result, plan fiduciaries should continue to monitor and periodically reassess the prudence of their default investment and be aware of the relative fees and expenses when selecting among different options.

Conclusion

The PPA's automatic enrollment and default investment provisions will go a long way to encouraging 401(k) plan investment and shielding plan fiduciaries from liability. Plan sponsors thinking about making changes to their plans should carefully consult their advisors, consultants and counsel before taking any action.

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