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THE PENSION PROTECTION ACT OF 2006
DESIGNATING DEFAULT INVESTMENT OPTIONS

In response to concerns about the adequacy and diversification of retirement savings, the Pension Protection Act of 2006 includes two provisions: one expressly authorizes automatic compensation deferrals and the other suggests that default alternatives provide for investment in equity securities. On September 27, 2006, the Department of Labor issued proposed regulations about the designation of new default investment options; these regulations are summarized below.

General Requirements for Relief:

Under ERISA Section 404(c), plan fiduciaries may be relieved of liability for losses that result from a participant's exercise of investment control in the context of an individual account plan, commonly a 401(k) plan. Historically, this relief has not been available for amounts invested in "default" options, since these investments are not the result of the exercise of control by participants. Relief will now be available for default investment arrangements that satisfy six requirements:

- A participant or beneficiary must have been provided the opportunity to make investment decisions in accordance with the plan's terms and failed or declined to do so;
- The default investment option must be a qualified default investment alternative, or "QDIA";
- The participant or beneficiary must be furnished with timely notice of the default investment and other aspects of the plan's investment arrangement;
- The participant or beneficiary must be furnished with generally available information about the QDIA, such as a prospectus, proxy statement or similar material;
- The participant or beneficiary must have the opportunity to redirect investment from the QDIA to other available investment options with the same frequency as other plan investments (ordinarily on a daily basis); and
- Other available investment options must provide for a broad range of investment opportunities, usually through a "menu" of mutual funds.

Although the regulations are in proposed form, they can be relied upon and provide relief for compliant arrangements as of January 1, 2007.

Status as a QDIA:

As before, plan fiduciaries must select the QDIA, the decision is a fiduciary one, and the designated QDIA must be periodically monitored to ensure that it remains an appropriate investment alternative. The investment alternative must satisfy the following additional requirements:

- It cannot impose fees or other financial penalties or otherwise restrict transfers (effectively precluding the use of a stable value fund that requires an "equity wash" or a product that includes a back end load);
- It cannot be intended to invest in employer securities, although the incidental acquisition and holding of such securities in the context of a mutual fund may be acceptable;
- It must be a mutual fund or it must be managed by a registered investment adviser, a bank or an insurance company (necessitating the designation of a single, professionally managed trust or fund);
- It must provide for diversification between asset classes; and

- It must be structured as either a balanced fund or a targeted retirement date fund, commonly a "lifecycle" fund.

Notice Requirements:

A condition of the relief is that participants be furnished with notice not less than 30 days before the default investment is first implemented and therefore not later than 30 days before the beginning of each plan year. As a result, **calendar year plans that intend to obtain relief at the earliest possible time must distribute notice not later than December 1, 2006.**

The notice must be written in "plain English." It must include a description of the circumstances under which the QDIA will be applied; a description of the QDIA, including its investment objectives, risk and return characteristics and any fees or expenses charged; a description of the investment procedures applicable to the participant's account, including the time at which investment changes are permitted, how investment changes are made and the investments available under the plan; and a contact for information about alternative investments.

In addition, a prospectus or other generally available information describing the QDIA should be distributed at the time of the initial notice, but in no event later than the first date on which a participant's balance is invested in the QDIA.

Status of Existing Default Options:

Since there is no requirement that the investment structure of an individual account plan comply with the provisions of ERISA Section 404(c), there is correspondingly no requirement that a default investment option be a QDIA or otherwise structured to comply with the proposed regulations. Failure to comply means that protection from investment loss will not be available under ERISA Section 404(c). Similar protection may be available if the default option otherwise satisfies the fiduciary requirements of ERISA, primarily that it has been properly selected and monitored, that fees are reasonable, and that under the circumstances, failure to diversify investments is appropriate.

If a new default option is designated as a QDIA, care should be taken to liquidate all existing default investments and to reinvest the proceeds in the QDIA. This avoids the negative inference that existing default investments have has ceased to be prudent or that plan fiduciaries now believe that diversification is an important consideration for default investments.

This memorandum is for informational purposes only and is not intended as legal advice. For more information about the Pension Protection Act of 2006 or our executive compensation and employee benefits practice, please contact any of the following attorneys:

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