

# Qualified Default Investment Alternative (QDIA)

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The Pension Protection Act of 2006 (PPA) includes a provision which insulates plan fiduciaries from liability associated with an approved default investment option.

## QDIA

“Under the proposal, employers would be protected from suits about the default investment option’s market performance, US Secretary of Labor Elaine Chao and Assistant Secretary of Labor Ann Combs said during a news media briefing.”<sup>1</sup>

Many workers are overwhelmed by investment choices or paperwork which contributes to their failure to sign up for their employers’ defined contribution plan. “This regulation would boost retirement savings by establishing default investments for these workers...,” said Chao.

Even if plans follow the rule, Combs cautioned, plan sponsors are still liable for how the investment options were chosen and how they were later monitored.

## FIRST, SECOND, AND THIRD REQUIREMENTS

Paragraph (e) of § 2550.404c-5 sets forth five requirements for a qualified default investment alternative (QDIA).

The first requirement is intended to limit investment in employer securities, as part of an investment strategy. Except for two exceptions, a “qualified default investment alternative” (QDIA) cannot hold or permit the acquisition of employer securities. § 2550.404c-5(e)(1)(i).

The second requirement states that a QDIA cannot impose financial penalties or restrict the ability of a participant to transfer his or her investment from the QDIA to any other investment alternative available under the plan.

The third requirement states that a QDIA must be managed by 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)

Section 3(38) of ERISA defines the term investment manager to mean any fiduciary who (a) has the power to manage, acquire, or dispose of any asset of a plan; (b) (i) is registered as an investment adviser under the Investment Advisers Act of 1940 or is registered as an investment adviser under the laws of the



State in which it maintains its principal place of business; or (ii) is a bank; or (iii) is an insurance company and (c) has acknowledged, in writing, that he is a fiduciary with respect to the plan.

The Department believes that when plan fiduciaries are relieved of liability for underlying investment management and asset allocation decisions, those responsible must be “investment professionals” who “acknowledge their fiduciary responsibilities and liability” under ERISA.<sup>2</sup>

## FOURTH AND FIFTH REQUIREMENTS

The fourth requirement provides that a QDIA is diversified so as to minimize the risk of large losses.

The fifth requirement conditions relief on the use of one of three types of investment products, model portfolios, or management services.

## APPROVED PRODUCT, MODEL, OR SERVICE

The approved categories for a QDIA include: lifecycle or target-retirement date fund or model, balanced fund or model, and managed account.

In considering the category for a lifecycle/target-retirement date alternative, the DOL presumed that when a participant fails to direct the investment of assets, the only readily available and objective information relevant to making an investment decision is "age." When age is used as the criteria, the DOL does not require the advisor to take into account other factors; such as risk tolerances, other investments, or preferences of an individual participant.

#### **FIRST ALTERNATIVE TARGET-DATE FUND**

The first approved alternative is an investment fund product or model portfolio that 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 (such as normal retirement age) or life expectancy. This type of alternative will change its asset allocation and risk levels over time with the objective of becoming more conservative with increasing age. Target-retirement-date and lifecycle funds, as well as target-retirement-date model portfolios, qualify under this alternative.

#### **SECOND ALTERNATIVE BALANCED PORTFOLIO**

The second approved alternative is an investment product or model portfolio that 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.

This alternative does not require an advisor to take into consideration the age of an individual participant. Instead, the focus is on the "demographics" of the participant population, as a whole. A balanced fund or balanced model portfolio qualifies under this alternative.

#### **THIRD ALTERNATIVE MANAGED ACCOUNT**

The third approved alternative is an "investment management service" in which an investment manager allocates the assets of a participant's individual account to achieve 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.

As with the first alternative, asset allocation decisions would not require the manager to take into account risk tolerances, other investments, or other preferences of an individual participant and the portfolio would become more conservative with increasing age.

Within this alternative, ERISA provides that "a person who is a named fiduciary with respect to control or management of assets of a plan may appoint an investment manager to manage (including the power to acquire and dispose of) any assets of a plan."

The Department decided to include investment management services, within the scope of fiduciary relief, in order to avoid any ambiguity in connection with section 402(c)(3): "...no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager."

#### **FIDUCIARY RELIEF CONDITIONED ON ...**

In addition to the requirement that the assets be invested in a QDIA, fiduciary relief is also conditioned on: (i) participants must be furnished notice that explains the QDIA at least 30 days before the first investment and 30 days in advance each year, (ii) participants cannot hold employer securities, except under certain conditions, (iii) the plan cannot impose financial penalties or restrict the participant's ability to transfer to any other investment alternative available under the plan, (iv) all materials relating to investments in a QDIA must be furnished to participants (account statements and prospectuses), and (v) the plan must offer a broad range of investment alternatives.

A plan that allows participant direction of investments, may require a default alternative in the following circumstances: (i) enrollment, (ii) rollover, (iii) change in service providers, and (iv) change in investment options.<sup>3</sup>

Required notice can be furnished in the plan's summary plan description, summary of material modifications, or as a separate notification.

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<sup>1</sup> DOL Releases Default Investment Option Safe Harbor, PlanSponsor.com, 26 Sep. 2006

<sup>2</sup> DOL, Employee Benefits Security Administration, Federal Register, Vol. 71, No. 187, 27 Sep 2006

<sup>3</sup> Employee Benefits and Executive Compensation Practice, Winston & Strawn, LLP, Oct. 2006