Understanding the Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA) has paved the way for sweeping changes that can improve the retirement benefits of millions of American workers.

The Act's main focus is pension reform, but its provisions for improving defined contribution (DC) plans may have more far-reaching consequences. Here's a quick recap of the most important provisions for DC plans, including recent Department of Labor (DOL) rulings that clarify them.

Encouraging Automation

DC plans are rapidly becoming the primary retirement savings vehicle for most American workers, but many workers either contribute too little or don't participate at all. The PPA encourages employers to make participation as automatic as possible with key enhancements:

Eliminating state-law barriers. The Employee Retirement Income Security Act (ERISA), the law governing employer-offered retirement plans, preempts any state laws that require employees to give written consent for any payroll deductions in connection with a DC plan automatic enrollment program.

Providing fiduciary protection for default investments. If participants don't direct their investments, the Act extends "safe harbor" protection to fiduciaries who invest participants' contributions in a qualified default investment alternative (see QDIA on next page).

Bypassing nondiscrimination tests and top-heavy rules. Any plan with automatic enrollment will gain more time to correct violations of the Actual Deferred Percentage (ADP) and Actual Contribution Percentage (ACP) tests.

Plans can avoid these tests altogether if they comply with the following contribution requirements:

- Start default contributions at no less than 3% and increase them annually by at least 1%—to a maximum of 10%
- Either make matching contributions (100% of deferrals up to 1% of pay plus 50% of deferrals from 1%–6% of pay) or nonelective contributions (3% of pay to all employees whether contributing or not)
- Vest matching or nonelective contributions 100% after two years of service
- Provide employees with annual notices concerning automatic enrollment and their rights: opting out of the plan, changing their contribution level or choosing different investment allocations

Qualified Default Investment Alternatives (QDIA)

When plan sponsors use appropriate long-term investments as their plans' default options, the PPA protects fiduciaries from liability for employees' investment losses. Before the PPA, ERISA only provided this "safe harbor" when employees chose their investments—it didn't cover default options. This led many employers to use default options that were unlikely to lose money, money market funds, for example—even though participants rarely moved their assets out of these options.

The PPA addressed this problem by extending fiduciary safe harbor to default investments specified by the DOL that "include a mix of asset classes consistent with capital preservation or long-term capital appreciation or a blend of both."

Department of Labor Defines QDIAs

In regulations issued on October 24, 2007, the DOL specified three types of long-term QDIAs:

- A target-date retirement fund product or model portfolio
- A fund or model portfolio "with a target level of risk appropriate for participants of the plan as a whole"—such as a balanced fund
- An investment-management service in which a manager allocates the participant's account among the plan's investment alternatives based on the participant's age, target retirement date or life expectancy

Short-Term Exception for Capital-Preservation Products

The DOL also allows plans to use capital-preservation products like money market or stable value funds as a temporary QDIA—but only for the first 120 days after an employee begins contributing to the plan. The DOL included this default option as a convenience to plan sponsors during the time when employees are most likely to opt out of plan participation.

Also, for contributions made prior to December 24, 2007, the DOL "grandfathered" certain stable value products backed by state or federally regulated financial institutions. Even so, the legislation clearly protects plan sponsors when they move account balances from the plan's existing default options into a QDIA.

Requirements for QDIA Safe Harbor

Before plan sponsors can receive safe harbor treatment for a QDIA, they must give participants an opportunity to direct their investments, and the participants must fail to do so. Plans also have to:

- Notify participants at least 30 days before the first default investment and every year afterward
- Always provide any prospectuses for QDIAs, and certain other information when participants ask for it
- Allow participants to transfer out of the QDIA without penalty at least as frequently as other investments, but not less than once within any three-month period
- Offer a "broad range of investment alternatives" as defined in ERISA 404(c) regulations

Other Safe Harbor Default Situations

There are other situations beyond automatic enrollment that afford plan fiduciaries safe harbor protection by investing in QDIAs and complying with the other conditions of DOL regulations. Plan fiduciaries are protected if participants don't provide investment direction when the plan eliminates an investment option or if there's a change in service provider. The Act also extends safe harbor plan protection when a participant doesn't direct the investment of assets rolled over from another plan. Plan sponsors are also protected any other time a participant fails to provide investment instruction.

> The PPA provides plan sponsors with legislative "safe harbor" protection for default options that offer a balanced, diversified approach to long-term retirement saving.

Additional QDIA Highlights

The Act and the DOL's further guidance clarified several other important issues:

- **Plan sponsors can move existing non-QDIA defaults to QDIAs** after properly notifying participants.
- **All QDIAs must have some amount of fixed income**, although the DOL is not setting any minimum requirements. That decision has been left up to those who design and manage the QDIAs.
- **A company can have more than one QDIA**—for example, one for elective deferrals and another for rollovers.
- **A QDIA must be managed by** a fiduciary investment manager as defined by ERISA, the plan sponsor (if it's a named fiduciary), a plan trustee meeting ERISA requirements, or it must be a registered investment company (for example, a mutual fund).
- **QDIAs can have investment guarantees** or other features and can be offered through variable annuity or similar contracts.

Eliminating Barriers to Participant Investment Advice

When Congress was drafting the PPA legislation, it recognized that the dominance of defined contribution plans made helping participants manage their plan investments paramount.

But ERISA's prohibited transaction rules didn't allow certain service providers to give advice, so the PPA lifted the ban—as long as the advice program meets certain requirements:

Professional credentials. The fiduciary advisor must be a registered investment advisor, bank or similar financial institution, insurance company, broker-dealer—or employees, agents or representatives of these organizations.

The advice program. The advice arrangement must satisfy one of the following conditions:

- The advisor's fee doesn't vary based on the investment selected.
- The program uses a computer model that meets certain requirements, including certification by an independent expert.

The legislation also requires that an independent auditor audit the program annually for compliance and give a report to the plan fiduciary. Because Congress wants to help workers make better retirement savings decisions, participant advice must be easy to understand.

Only Participant Advice Is Exempt

The Act underscores that this exemption from ERISA's prohibited transaction rules only applies to investment advice that's delivered to the plan's participants—not investment advice that goes to the plan itself or its fiduciaries.

> The PPA will help plan participants receive advice that can help them manage their plan investments.

Additional Clarifications

The Department of Labor noted that the PPA doesn't invalidate advice programs that were already permitted. It clarified that the flat-fee condition relates only to the fees of the entity providing the advice—not to the fees of the advisor's affiliates. The DOL stressed also that plan sponsors retain fiduciary liability in selecting and monitoring advice providers—even though they aren't liable for the specific advice these providers give to participants.

More Guidance Needed

While the PPA's investment advice provisions are a great step in the right direction, many service providers and plan sponsors feel they need more guidance from the DOL. The DOL needs to iron out the investment advice details so that advisors can develop useful and acceptable programs for plan participants.

Additional DC Plan Issues Covered by PPA

Employer Stock Diversification Rights—The PPA also addresses the heightened risk when participants over concentrate their investments in a single industry or company—typically employer stock. To encourage better diversification, the Act requires plans to allow participants to diversify out of publicly traded employer stock immediately for elective deferrals or after three years of service for employer contributions.

Requirements for Quarterly Benefits Statements—The PPA requires DC plan administrators to provide quarterly statements. These statements must include the participant's balance in each account or fund. Just as important, the Act insists that these statements always include a notice emphasizing the importance of a well-balanced portfolio and the risk of holding more than 20% of a portfolio in the security of one entity—such as employer stock.

Fiduciary Relief for Asset Mapping and Plan Blackouts—The Act also extends protection when plan sponsors map assets to new or remaining investment options, as long as the mapping option has "reasonably similar" characteristics (including risk and return). But plan administrators must furnish written notice at least 30 days—and no more than 60 days—before the change, giving participants the option to select other investments.

If fiduciaries prudently authorize and implement a plan blackout, the Act protects them against liability for investment losses during the blackout period.

For More Information

To read the complete Pension Protection Act of 2006, go to www.dol.gov/ebsa. For their Final Rules on QDIAs and detailed Field Assistance Bulletins on investment advice and other issues, go to www.dol.gov/ebsa/compliance_assistance.html.

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