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Pension ANALYST

Important Information   Plan Administration and Operation   November 2007

DOL Issues Long-Awaited Final Rules on Default Investments

WHO'S AFFECTED   These rules affect plan sponsors of and participants in participant-directed defined contribution plans, including 401(k) plans, ERISA 403(b) plans, and multiemployer plans. These rules do not apply to governmental plans, non-electing church plans, or non-ERISA 403(b) arrangements.

BACKGROUND AND SUMMARY   Under ERISA, fiduciaries of participant-directed defined contribution plans are not liable for losses when participants or beneficiaries exercise control of the investment of their accounts, if the plan satisfies the requirements of ERISA section 404(c). In general, plan fiduciaries retain fiduciary liability for any loss or breach that results from investing assets in a participant's account when a participant does not exercise control over investments.

Under the Pension Protection Act of 2006 (PPA), plan fiduciaries of participant-directed defined contribution plans will receive relief from their fiduciary liability for default investments, as long as they comply with the Department of Labor (DOL) safe harbor rules for these investments. On October 24, 2007, the DOL issued final rules regarding safe harbor default investments for participant-directed defined contribution plans subject to ERISA. These rules:

- Require certain conditions to be met to obtain the safe harbor relief, including the default investment of assets in a qualified default investment alternative (QDIA);
- Authorize certain types of investment products as QDIAs; and
- Require plans to provide both an initial notice and an annual notice to participants and beneficiaries whose assets are being invested in a QDIA.

This additional fiduciary relief is available beginning December 24, 2007.

ACTION AND NEXT STEPS   Plan sponsors should review these rules to determine whether a change to the plan's default investment is prudent. Plan sponsors are not required to comply with these rules, but may choose to comply to receive the additional fiduciary protection offered by the safe harbor.

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Overview

The fiduciary relief provided in the final rules applies to situations where participants or beneficiaries have not exercised control over the investments in their accounts. Examples of these situations include:

- Automatic enrollment;
- The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider;
- The failure of a participant or beneficiary to provide investment instruction following a rollover from another plan; and
- Any other failure of a participant or beneficiary to provide investment instructions.

The relief provided by these rules is similar to the fiduciary relief that applies to participants or beneficiaries who exercise control over their investments in plans that comply with ERISA section 404(c). However, it is not necessary for a plan to comply with ERISA section 404(c) to receive the relief provided by these final rules.

Conditions for Fiduciary Relief

To obtain this additional fiduciary relief, the following conditions must be satisfied with respect to participants and beneficiaries whose assets are being invested in a default investment.

- Assets must be invested in a qualified default investment alternative (QDIA).
- The participant or beneficiary must have had the opportunity to make his own investment elections, but did not do so.
- The plan must provide an initial notice and ongoing annual notices to affected participants and beneficiaries. In general, the initial notice must be provided at least 30 days before a participant is first eligible to participate in the plan, or at least 30 days before contributions are first invested in the QDIA. However, if an "eligible automatic contribution arrangement" allows participants to make a withdrawal of accidental deferrals within 90 days (as permitted by PPA), the notice may be provided on or before the date of plan eligibility. The annual notice must be provided at least 30 days before the first day of each plan year.
- The plan must provide the same investment materials as those provided to participants who make affirmative elections.

- The plan must provide affected participants and beneficiaries with the opportunity to transfer any or all of their QDIA assets to any other investment option available under the plan at least as frequently as they can transfer assets out of other investments, but at least quarterly. In addition:
    - Within 90 days of the first investment in a QDIA, a participant's election to transfer out of a QDIA or withdraw accidental deferrals (as permitted by PPA) may not be subject to any restrictions, fees or expenses (i.e., surrender charges, liquidation or exchange fees, redemption fees and similar expenses) as a result of the transfer or withdrawal. *This fee restriction does not apply to fees and expenses that are charged for the ongoing operation of the investment itself, (such as investment management fees, distribution fees, accounting fees, and similar administrative expenses) as long as these fees are not imposed or do not vary based on the participant's decision to withdraw or transfer out of the QDIA.*
    - Following the end of the 90-day period, any restrictions, fees, or expenses related to a transfer or withdrawal of accidental deferrals may not be greater than those imposed on participants who affirmatively elected to invest in the QDIA.
- The plan must offer participants and beneficiaries the opportunity to invest in a broad range of investment alternatives, as defined by ERISA Section 404(c).

Although these rules provide fiduciary relief with respect to losses or breaches that occur as a result of these investments, plan fiduciaries still remain responsible for the prudent selection and monitoring of the investment fund, model portfolio, or investment management service within any type of qualified default investment alternative.

QDIA Requirements

A QDIA must meet five specific requirements. A QDIA:

- Cannot hold or permit the acquisition of employer securities, with two exceptions:
    - Employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 (a "registered investment company"), or a similar pooled investment vehicle regulated and subject to periodic examination by a State or federal agency (*such as an insurance company pooled separate account*); or
    - Certain employer securities acquired with matching contributions made by the plan sponsor;
- May not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer, in whole or in part, to another investment option available under the plan;
- Must be managed by an investment manager, as defined by ERISA, a plan sponsor that is a named fiduciary, a registered investment company, or plan trustees who meet certain requirements;
- Must be diversified to minimize the risk of large losses (this diversification requirement does not apply to capital preservation products described below); and
- Must be one of the permissible investment types described below.

Investment Types Permissible As QDIAs

The following types of investments are permissible as QDIAs:

- A product with a mix of investments that takes into account the individual's age, life expectancy, or target retirement date. *An example of such a fund or portfolio may be a "life-cycle" or "target-retirement-date" fund or account.*
- A product with a mix of investments that takes into account the characteristics of the employee group as a whole, rather than each individual. *An example of such a fund or portfolio may be a "balanced" fund.*

- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age, life expectancy, or target retirement date. *An example of such as service may be a "managed account" or asset allocation service.*
- A capital preservation product (*such as a money market account*) for just the first 120 days of an individual's plan participation. Before the end of the 120-day period, the plan must transfer the participant's assets into an acceptable QDIA, as described above, unless the participant redirected investments during this period or withdrew accidental deferrals during the first 90 days of participation.

Even though fiduciary relief is provided only if one of the investment alternatives described above is used as the default investment alternative, it is important to note that the DOL acknowledges that the use of other investment alternatives may still be prudent. *For example, investments in money market funds, stable value products and similarly performing investments may be prudent for some participants and beneficiaries, even though those investments are not QDIAs.*

Grandfather Protection for Stable Value Products

The final rules provide a "grandfather" provision for amounts invested in stable value products before December 24, 2007. Under this provision, these amounts may remain invested in these products after December 23, 2007, and will receive QDIA fiduciary protection. Contributions made on or after December 24, 2007, must be invested in a true QDIA to receive fiduciary protection. In addition, participants and beneficiaries who had been defaulted into the stable value product generally must receive a notice 30 days before the first contributions are invested by default in a true QDIA.

To assist plan sponsors that are interested in obtaining this grandfather protection, Prudential Retirement has drafted a sample notice that may be customized for distribution to participants and beneficiaries by November 24, 2007, to receive relief on the first day it is available. Your Prudential Retirement representative will be able to provide you a sample notice that may be customized to fit the needs of your plan.

Prudential's Investment Options as QDIAs

Prudential Retirement offers a number of investment options and investment models that could offer QDIA relief for plan fiduciaries, if prudently selected and monitored. Your Prudential Retirement representative will be able to help you determine if funds currently offered under your plan are QDIAs, as well as whether other QDIA funds may be available.

Notice Requirements

One of the requirements for obtaining this additional fiduciary relief is for plans to provide notices to participants and beneficiaries whose assets are being invested in a QDIA.

These notices must be written in a manner calculated to be understood by the average plan participant and must contain the following information:

- A description of the circumstances under which a participant's account will be invested in a QDIA. Plans that have an automatic enrollment provision must also include a description of when the automatic deferrals will be taken, the automatic deferral percentage, and the participant's right to elect not to make deferrals or to elect a different deferral percentage;

- An explanation of the right of participants and beneficiaries to direct the investment of their account assets;
- A description of the QDIA, including a description of the investment objectives, risk and return characteristics (if applicable), and the fees and expenses that apply to the investment alternative;
- A description of the right of the participants and beneficiaries whose assets are invested in a QDIA to direct the investment of those assets to any other investment alternative under the plan including a description of any applicable restrictions, fees or expenses in connection with the transfer; and
- An explanation of where participants and beneficiaries can obtain investment information concerning other investment alternatives under the plan.

This QDIA notice and the notice required for a "qualified automatic contribution arrangement" may be satisfied in a single notice. The notice may not be provided in a summary of material modification or summary plan description. The notice may be sent electronically using either the IRS or the DOL rules for electronic media. For more information regarding the electronic media rules, see the Prudential *Pension Analyst* chart comparing these rules.

The DOL did not provide a model QDIA notice. To assist plan sponsors, Prudential Retirement has developed a variety of sample notices that may be customized to fit plan sponsors' needs. Your Prudential Retirement representative will be able to provide you with a sample notice that most closely fits the needs of your plan.

ERISA Preemption of State Wage Withholding Laws

PPA added a provision to ERISA that immediately preempts *any* state law that would directly or indirectly prohibit or restrict the use of an automatic contribution arrangement. This includes state laws that prohibit involuntary wage withholding.

While PPA requires automatic contribution arrangements to use a QDIA in order to get this state law preemption, the final rules clarify that the ERISA preemption applies, regardless of whether the automatic contribution arrangement uses a QDIA as a default investment.

Impact on Automatic Enrollment Plans

Under PPA, "eligible automatic contribution arrangements" must use a QDIA for default investments in order to be able to:

- Refund (or "un-wind") accidental deferrals; and
- Make ADP and ACP test corrective distributions within six months of the plan year-end without the employer incurring the 10% excise tax.

A technical corrections bill making its way through Congress would eliminate the requirement for these plans to use a QDIA. However, it is unclear whether this bill will be enacted by year-end. As a result, plan sponsors adopting eligible automatic contribution arrangements as of January 1, 2008, may decide to wait until closer to November 30, 2007, to adopt QDIAs and distribute notices to affected participants and beneficiaries. Sponsors of eligible automatic contribution arrangements with non-calendar plan years that use a stable value product or another non-QDIA fund as their default investment may decide to refrain from changing their default investment choices as we follow the developments of this technical corrections bill. Prudential Retirement will continue to inform you of the developments of this technical corrections bill or any regulatory guidance that may provide similar relief.

Effective Date and Next Steps

This additional fiduciary relief is available beginning December 24, 2007. With the exception of certain automatic enrollment plans, plan sponsors are not required to comply with these rules. Plan sponsors that do not want this additional fiduciary protection do not need to take action at this time.

To receive the fiduciary protection as of December 24, 2007, a plan sponsor must comply with the new rules and distribute an initial notice to participants and beneficiaries invested in the plan's current default investment by November 24, 2007.

Prudential Retirement has developed a QDIA Decision Tree to assist you with this decision-making process. Your Prudential Retirement representative will contact you regarding your decision on your plan's default investment alternative.

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Editor: Mitzi Romano (860) 534-2768

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