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Re: New DOL Proposed Regulation – “Qualified Default Investment Alternatives”

Dear Clients and Other Friends:

The Department of Labor published a proposed regulation in the September 27, 2006 Federal Register defining “qualified default investment alternative” requirements for 401(k) plans and other participant-directed plans. Plan fiduciaries that comply with the proposed regulation (when finalized) will not be liable for any loss as a result of a participant’s investment in a qualified default investment alternative. Plan fiduciaries remain responsible for the prudent selection and monitoring of the default vehicle.

A qualified default investment alternative (“QDIA”) is a default vehicle for participant-directed plans such as 401(k) plans for use in cases where participants fail to direct how they want their accounts invested – for example, plans that provide for automatic enrollment.

DOL guidance addressing this subject is required by the Pension Protection Act of 2006 (“PPA”). The DOL expects this new rule to guide plan sponsors to select default investment vehicles that are “retirement-oriented” funds rather than the “cash-oriented” funds commonly used by many 401(k) plans currently. In the preamble of the proposed regulation, the DOL asserts:

Several studies note that the contributions of automatically enrolled participants are frequently invested in products that present little risk of capital loss, e.g., money market funds, stable value funds and similarly performing investment vehicles. It also appears that many plans without automatic enrollment provisions utilize similar capital preservation default investment products for those employees who enroll in the plan but fail to direct the investment of their contributions or their employer’s matching contributions. As a short-term investment, money market or stable value funds may not significantly affect retirement savings. Such investments can play a useful role as a component of a diversified portfolio. However, when such funds become the exclusive investment of participants or beneficiaries, it is unlikely that the rate of return generated by those funds over time will be sufficient to generate adequate retirement savings for most participants or beneficiaries [because equity securities have historically generated higher returns than investments oriented toward capital preservation].”

Qualified Default Investment Alternatives: The DOL's proposed regulation imposes the following five requirements for QDIAs:

1. One of the following investment alternatives must be used:
 - Life-Cycle or Target Date Retirement Fund--An investment fund (e.g. mutual fund or collective investment fund) or model portfolio of such funds that provides varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income investments based on the participant's age, target retirement date or life expectancy.
 - Balanced Fund--An investment fund or model portfolio that provides for long-term appreciation and capital preservation through a mix of equity and fixed income investments consistent with a target level of risk appropriate for participants of the plan as a whole, taking into account the demographics of the group.
 - Individually Managed Account--Have an investment manager allocate the assets of each participant's account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income investments, based on the participant's age, target retirement date or life expectancy.

Note that the money market funds or stable value funds that have been often used as default investments in the past are not on this list. Continuing to use such a fund as default investment may not necessarily be imprudent, but it does not qualify for the relief offered by the proposed regulation.

2. Employer securities generally may not be used as the default investment.¹
3. The QDIA may not impose financial penalties on or otherwise restrict a participant's transfer from a QDIA (except as otherwise provided in the proposed regulation).
4. The QDIA must be managed by an "investment manager" as defined in ERISA or a mutual fund.
5. The QDIA must be diversified so as to minimize the risk of large losses.

Relief from Fiduciary Liability: In addition to requiring that a QDIA be used as the default investment vehicle, the proposed regulations impose some additional requirements in order to qualify for fiduciary relief:

- Participants must receive at least 30 days advance notice prior to their first plan investment and at least 30 days advance notice prior to each subsequent plan year;²

¹ There are two exceptions: (i) if the default investment is a mutual fund that invests in the employer's stock as part of the fund's own investment strategy, or (ii) if the employer uses employer stock to fund contributions, and a designated independent investment manager is free to sell the stock at any time.

² The notice must be written in plain English and must include various information about the plan's investment procedures and the investment characteristics of the QDIA.

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- Participants must receive prospectuses, proxy voting material, account statements, etc. relating to their investment in a QDIA;
- Participants with QDIA balances must be permitted to transfer funds to any other plan investment alternative without financial penalty; and
- The plan must offer a “broad range of investment alternatives” within the meaning of the DOL’s 404(c) regulations.

This regulation is proposed to become effective 60 days after the date the final regulation is published in the Federal Register. Comments on the proposal can be submitted to the DOL by November 13, 2006. The PPA requires the DOL to issue regulations within six months of August 17, 2006 and is otherwise effective for plan years beginning after December 31, 2006.

Though this is a proposed regulation, it is our view that its requirements will likely remain materially intact as it is finalized, especially with respect to its focus on a longer-term balanced investment objective for a default fund. Therefore, plan sponsors should review their default investment arrangements in response to the new rules. As with other investment alternatives, fiduciaries must carefully consider investment fees and expenses in choosing a QDIA.

Please call us if you have any questions about this proposed regulation or other matters involving the Pension Protection Act of 2006.

Sincerely,

Theodore K. Rice

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