ALERT

IMPORTANT EMPLOYEE BENEFIT DEVELOPMENTS

Part 2

July 25, 2008

This is the second in a series of Alerts. As we stated in Part 1 of this series, the employee benefit world has been very active and many of the legislative and regulatory changes could have a **significant impact on your benefit plans**. We have prepared this ALERT in order to continue to highlight some of the more important developments.

This Alert is one page long. It contains a short list of topics we have chosen to highlight, along with a very brief explanation of each topic. We know you are very busy and the last thing you need is a long, drawn out legal analysis of complex topics that may not affect you. This Alert is intended to highlight important new developments so you can quickly decide what may or may not apply to you.

Also enclosed with this Alert is a Memorandum that provides more detail on each topic. It will allow you to read a little more about the issues that affect you. It is also for those of you who are interested in understanding, in more detail, recent IRS and Department of Labor directives.

Here are some of the latest IRS and DOL developments that we feel employers should be aware of:

- **Qualified Default Investment Alternatives ("QDIAs").** Final QDIA regulations recently became effective. These regulations apply to qualified plans, such as 401(k) plans. They provide liability protection for qualified plan fiduciaries against participant challenges to the selection and/or performance of a qualified plan's default investments. Find out what qualifies as a QDIA in the enclosed Memorandum.

- **Automatic Enrollment in 401(k) Plans.** For several years, the government has been encouraging employers to adopt automatic enrollment features for their 401(k) plans to help deal with employees who neglect to return enrollment forms. The IRS issued proposed regulations on this topic late last year. Automatic enrollment provisions assist employees in saving for retirement. At the same time, they can help your plan pass required nondiscrimination testing. There are three different types of these automatic enrollment arrangements, all of which are discussed in the enclosed Memorandum.

- **Participant Benefit Statements.** The Pension Protection Act of 2006 added many new notice requirements for qualified retirement plans. Among the new notices required is a participant benefit statement. There are significant penalties for failing to provide this notice. The enclosed Memorandum discusses what is required to comply with the new benefit statement requirement.

For those of you who would like to know more about these developments, we hope the enclosed Memorandum is useful to you. If you have questions about these developments or would like to discuss any of these topics in further detail, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.

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July 25, 2008

MEMORANDUM

Important Employee Benefit Developments to Consider in 2008: Part 2

The employee benefits world has been very active over the past year. There have been numerous legislative and regulatory changes that have a significant impact on many employee benefit plans. This Memorandum is the second of a three part series intended to address what we view as some of the more important developments affecting our clients. It is certainly not intended to be a comprehensive analysis. What we have tried to do is pick out and highlight the changes that are most likely to directly affect the majority of our clients. We hope this is useful to you.

I. QUALIFIED DEFAULT INVESTMENT ALTERNATIVES ("QDIAs")

As part of the Pension Protection Act of 2006 ("PPA"), Congress directed the Department of Labor ("DOL") to issue regulations protecting plan fiduciaries from potential liability when employee retirement plan contributions are invested in certain types of default investments in the absence of specific investment direction by the employee. The DOL recently issued final regulations on these qualified default investment alternatives, which became effective on December 24, 2007. The rules apply to both conventional 401(k) and profit sharing plans, as well as to automatic enrollment in 401(k) plans (see Part II of this Memorandum for information on automatic enrollment).

QDIAs are welcome news for plan sponsors and fiduciaries who have struggled to deal with plan participants who neglect to provide direction on how their plan accounts should be invested. Prior to the PPA, plan fiduciaries risked being held liable to participants who were upset with the selection and/or performance of the default investments into which their participant contributions had been placed when the participant failed to provide investment direction. This potential liability was particularly problematic because it discouraged many plan sponsors from adopting automatic enrollment features in their 401(k) plans, which have been proven to substantially increase retirement savings by employees. Fiduciaries also found themselves vulnerable to liability when they allowed rollover contributions or switched investment providers because, like automatic enrollment, both scenarios often led to participants failing to designate how the new funds in their account should be invested. Now that Congress and the DOL have stepped in, however, a great deal of otherwise legitimate employer anxiety has been reduced.

The DOL regulations provide fiduciary protection for funds invested in any one of three primary types of QDIAs: life cycle funds, balanced funds, and managed accounts. Each type of QDIA must meet all of the following requirements:

- The QDIA must apply generally accepted investment theories;
- The QDIA must be diversified to avoid the risk of large losses; and

- The QDIA must be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

In addition, the regulations impose a number of other requirements that fiduciaries must satisfy before they may receive liability protection. These include mandatory periodic notices to participants about their investment rights, the provision of investment information (e.g., prospectuses) to the participants, a restriction on the fees that may be charged to participants who wish to transfer out of the default investments, and a "broad range of investment alternatives" in the event the participant wishes to specifically direct his/her investments rather than relying on the default investments.

Any employer that is currently maintaining, or considering adopting, a qualified retirement plan would be well served by including QDIAs as part of the plan. In fact, in today's highly litigious environment where wild stock market fluctuations are triggering waves of securities-related lawsuits, not including a QDIA as part of the plan may be an invitation for trouble.

II. AUTOMATIC ENROLLMENT IN 401(K) PLANS

Under an automatic contribution arrangement ("ACA"), often referred to as an "automatic enrollment" plan or "negative election" plan, an employer automatically withholds a percentage of its employee's paycheck and then contributes that amount to the employer's retirement plan on the employee's behalf. The paycheck deduction is characterized as an "elective 401(k) deferral," and the deferrals continue unless and until the employee affirmatively opts out. Automatic contribution arrangements have been authorized by the IRS since 2000 and are permitted in 401(k), 403(b), and 457(b) plans.

In the past, many employers subject to ERISA have been reluctant to adopt automatic enrollment features because of concerns that non-consensual payroll deductions may violate state laws. In addition, the benefits of standard ACAs to employers are relatively minimal. Indeed, the standard ACA is subject to all applicable non-discrimination rules (e.g., ACP and ADP tests) to the same extent as a plan with exclusively voluntary contributions. Although many employers have adopted ACA arrangements to correct ADP and ACP testing problems or simply to encourage greater retirement savings by its rank and file employees, the allure of this plan feature has been somewhat lacking. Until now.

The Pension Protection Act of 2006, however, amended ERISA to preempt any state law that would prevent an employer from adopting an automatic enrollment feature in its plan. In addition, as discussed below, the IRS released proposed regulations late last year – effective as of January 1, 2008 – that make automatic enrollment arrangements more attractive than ever to employers. Recognizing that having employees automatically defer (in the absence of an affirmative election to the contrary) a percentage of their compensation into a qualified plan tends to encourage greater retirement savings, Congress decided to up the ante in the PPA by enacting various advantageous administrative provisions designed to encourage more employers to adopt such arrangements. In particular, Congress created two new automatic enrollment features: the Eligible Automatic Contribution Arrangement ("EACA") and the Qualified Automatic Contribution Arrangement ("QACA"). Both are summarized as follows:

- **Eligible Automatic Contribution Arrangements ("EACA").** An EACA is an automatic contribution arrangement in which a uniform percentage of an employee's compensation is deducted from his/her paycheck unless and until the employee specifically elects not to defer any compensation or elects to defer a different percentage. An EACA has rigorous notice requirements, and any automatic deferrals must be invested in accordance with the QDIA regulations (see Part I of this Memorandum for information on QDIAs). The EACA has two major virtues:

    1. *Withdrawal Opportunity*. The plan may include a provision permitting any participant for whom the plan has been making automatic contributions to withdraw all of his/her default deferrals (and any attributable earnings) within 90 days after the date of the first deferral; and

    2. *Increased Compliance Time*. The plan has six months – rather than the usual 2½ months – to make any corrective distributions of excess contributions (which cause the plan to violate the ADP test) and/or excess aggregate contributions (which cause the plan to violate the ACP test) before the IRS will impose a 10% excise tax on the employer.

- **Qualified Automatic Contribution Arrangements ("QACA").** Very similar to an EACA, a QACA is an automatic contribution arrangement in which the percentage of compensation that an employer defers from the employee's paycheck increases each year according to a set schedule. (The figure starts at 3% for years one and two and continues up to 6% by the fifth year.)

    Under a QACA, the employer is required to make a contribution to the plan for the employee. The employer has two choices for this required contribution to the employee's plan account. The required contribution can be *either*:

    1. A matching contribution equal to 100% of a participant's deferrals that do not exceed 1% of compensation, plus 50% of the participant's deferrals that exceed 1% of compensation but do not exceed 6% (thus, the amount of the QACA match will total 3.5% of compensation if the participant defers at least 6% of compensation); *or*

    2. A 3% non-elective contribution.

    As with an EACA, the automatic contributions continue until such time as the employee affirmatively elects to terminate his/her deferrals and/or to specify a different deferral percentage. Also, as with EACAs, a QACA has detailed notice requirements, and any automatic deferrals must be invested in accordance with the QDIA regulations.

    Why would an employer undertake such an obligation? Because the carrot the IRS offers employers to adopt a QACA as part of their qualified retirement plan is extremely alluring. In particular:

    1. *Avoidance of ADP Test*. A plan that satisfies the QACA requirement automatically satisfies the ADP test;

    2. *Potential Avoidance of ACP Test*. A QACA can also avoid the ACP test if the plan satisfies the same limitations on matching contributions that enable a traditional 401(k) plan to meet the ACP safe harbor regulations; and

    3. *Potential Avoidance of Top-Heavy Rules*. If the plan satisfies the QACA requirements and offers only elective deferrals and employer contributions (including matching contributions), the plan is not subject to the ERISA top-heavy rules.

III. PARTICIPANT BENEFIT STATEMENTS

The Pension Protection Act of 2006 added an array of notice and disclosure requirements for qualified retirement plans that will increase the amount of information that pension plan participants receive about their plans. Although plan participants are fast approaching "information overload," Congress seems to feel they need more information. One of the most important new notices applicable to all qualified plans is the participant benefit statement. Substantial penalties, up to $100 per day per participant, may be assessed for non-compliance with the written statement requirement.

The benefit statement requirement went into effect for plan years beginning in 2007. Benefit statements now must be given:

- Quarterly to participants and beneficiaries in participant-directed individual account plans;
- Annually to participants and beneficiaries in individual account plans that do not allow participant-directed investments;
- Upon written request to a beneficiary who does not have his/her own individual account, self-directed or otherwise;
- At least once every three years to a defined benefit plan participant with a vested accrued benefit who is employed by the employer maintaining the plan; and
- No more than once a year upon the written request of a participant or beneficiary of a defined benefit plan.

The statement must be written so that the average plan participant can understand it, and it must be delivered in written, electronic, or some other appropriate form that is reasonably accessible to the participant. It may be provided through multiple documents if certain rules are followed. The statement(s) must include the following:

- Benefits information - the total accrued benefits of the participant (account balance for defined contribution plans) and the vested amount of such accrued benefits;
- If applicable, information on permitted disparity or floor offset arrangements that may be applied in determining accrued benefits;
- The value of each investment to which assets in the individual account have been allocated;
- An explanation of any limitations or restrictions on self-direction;
- An explanation of the importance of diversification using model language developed by the DOL; and
- A reference to the DOL website for sources of information on individual investing and diversification.

Your plan should already be complying with the participant benefit statement rules. However, it has come to our attention that some plan investment providers and administrators may not be doing this yet. We thought it would be useful to briefly summarize the rules just in case you have not heard about them.

IV. CONCLUSION

The world of employee benefits is constantly in a state of flux. The purpose of this Memorandum is to provide you with a very brief synopsis of some of the more important changes to employee benefit rules that may be of interest to you. It is not a comprehensive analysis or a list of every change that has taken place. Of course, you are always welcome to contact us at any time to discuss the design of your plan and whether any changes are appropriate in order to take advantage of new rules.

If you have questions about anything discussed in this Memorandum, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.