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Automatic enrollment – more choices, more decisions for Plan Sponsors.

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Automatic enrollment, frequently referred to as negative elections, has received the blessing of the IRS through a series of Announcements, Revenue Rulings, Bulletins and Information Letters. As a result of the Pension Protection Act of 2006 (PPA), automatic enrollment has been anointed by the IRS. We will discuss automatic enrollment in terms of pre-PPA and post-PPA. Keep in mind that other than state preemption, the post-PPA opportunities are effective for plan years beginning on or after January 1, 2008.

Automatic enrollment pre-PPA

Automatic enrollment, also referred to as negative elections, basically provides that eligible participants will be automatically enrolled in their company's 401(k) plan regardless of whether or not they elect to join the plan. The IRS through a series of pronouncements[i] issued guidance which provided among other things, that automatic enrollment was permissible as long as the eligible participant was given the opportunity to elect not to contribute and an initial and annual notice describing the participant's right to revoke the automatic salary deferral was provided.

Many plan sponsors had concerns implementing automatic enrollment with respect to investing automatically enrolled contributions absent participant investment direction and the impact of State law on "unauthorized" salary reductions. PPA has provided relief regarding these two issues as well as opportunities for adding automatic enrollment features to plans currently without it as well as enhancing existing automatic enrollment features.

Automatic enrollment post-PPA

PPA impacted automatic enrollment by:

- Addressing preemption of state law,
- Relieving plan fiduciaries of fiduciary responsibility with respect to participant deferrals invested in a qualified default investment alternative (QDIA) absent participant investment direction,
- Expanding the automatic enrollment concept by adding
  - Eligible automatic contribution arrangements, and a
  - Qualified automatic contribution arrangement safe harbor.

Preemption of state law

Before PPA, employers were concerned that automatically deducting salary deferrals would violate state wage and hour laws by withholding money from an employee's pay with employee authorization. Effective August 17, 2006, PPA preempted state law that would interfere with the implementation of an automatic enrollment feature in a 401(k) plan. PPA § 902(f) provides that "automatic contribution arrangements" are exempt from state law which "would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement". The automatic salary deferral must be invested in a "qualified default investment alternative". Participants must be provided with a notice which describes their right to revoke the election and explains how the salary deferrals will be invested in the absence of participant direction. The notice must be provided within a reasonable period of time before each plan year and provide the participant with a reasonable period of time to take action with respect to the automatic salary reduction.

Qualified default investment alternative (QDIA)

A fiduciary of a plan with an automatic contribution arrangement is relieved of fiduciary responsibility with respect to investing employee contributions where the employee fails to make an investment election if the employee contributions are invested in a QDIA. The DOL issued proposed QDIA regulations[ii] in September, 2006. The proposed regulations provide that plan fiduciaries remain responsible for the prudent selection and monitoring of the QDIA. The relief provided under the proposed regulations is not contingent on the plan being an ERISA 404(c) plan.

The proposed regulations provide six conditions for fiduciary relief:

- The assets invested on behalf of the participant must be invested in a QDIA.
- The participant or beneficiary on whose behalf assets are being invested must have the opportunity to direct the investments but did not.
- The participant or beneficiary must be provided with a notice at least 30 days in advance of the first investment and at least 30 days in advance of each subsequent plan year. The notice can be in the plan's SPD or SMM or a separate notification.
- The plan terms must provide that any material provided to the plan relating to a participant's or beneficiary's investment in a QDIA is provided to the participant or beneficiary.
- The participant or beneficiary on whose behalf assets are invested in a QDIA must have the opportunity consistent with plan terms to transfer to any other available investment alternative without penalty.
- The plan must offer participants and beneficiaries the opportunity to invest in a broad range of investment alternatives within the meaning of the 404(c) regulations.

There are five requirements for QDIAs; a QDIA:

- cannot invest in employer securities. The proposed regulations provide that the QDIA not hold or permit the acquisition of employer securities unless employer securities are held or acquired by an investment company registered under the Investment Company Act of 1940. What this means is that the QDIA cannot be an employer stock fund; however, employer stock could be contained in a fund offered by an investment company which includes that particular stock as part of its overall fund objective which is totally independent of the employer. Another exception to the "no employer stock" rule is in the situation where employer matching contributions are made in the form of employer stock; *however, if the matching contributions have transfer restrictions, the fiduciary relief provided by the proposed regulations would not be available until the restriction no longer applied.* The proposed regulations also clarify that if a participant or beneficiary had previously invested in employer stock, but failed to provide investment direction after an event, e.g., change in investment alternatives, and the terms of the plan so provide, the investment management service could continue to hold the assets in employer securities in the absence of participant or beneficiary election but could not acquire additional employer securities.

- can not impose financial penalties or restrict the availability of a participant or beneficiary to transfer from the QDIA.

- must be either managed by an investment manager as defined by ERISA §3(38) or an investment company registered under the Investment Company Act of 1940. The preamble to the proposed regulations indicate that "…when plan fiduciaries are relieved of liability for underlying investment management/asset allocation decisions, those responsible for the investment management/asset allocation decisions must be investment professionals who acknowledge their fiduciary responsibilities and liability under ERISA."

- must be diversified so as to minimize risk of large losses.

- must be one of three types of investments, namely funds with characteristics usually found in balanced funds, lifestyle or targeted funds or managed accounts.

Automatic enrollment enhancements

PPA contains three terms related to automatic enrollment features:

- Automatic contribution arrangement,
- Eligible automatic contribution arrangement and
- Qualified automatic contribution arrangement.

Automatic contribution arrangement

An automatic contribution arrangement is defined under PPA as an arrangement under which:

- a participant may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant or to the participant directly in cash,
- a participant is treated as having elected to have the plan sponsor make such contribution in an amount equal to a uniform percentage of compensation until the participant specifically elects not to have such contribution made or made at a different percentage,

- contributions are invested in accordance with regulations to be prescribed under §404(c)(5) and
- a notice described in §414(w)(3) to each participant to whom the arrangement applies within a reasonable period of time before the plan year provides.

Eligible automatic contribution arrangement

An eligible automatic contribution arrangement appears to include any plan which meets the definition of an automatic contribution arrangement. Additional features added by PPA include:

- Extended period for making corrective distributions for failed ADP/ACP tests from 2 ½ months after the end of the plan year to 6 months after the end of the plan year
- Provides for the distribution of "erroneous" deferrals within 90 days of the deferral. This is an optional provision and not required.

Qualified Automatic Contribution Arrangement

A qualified automatic contribution arrangement provides a safe harbor from satisfying the ADP/ACP and top heavy discrimination tests if certain requirements are met. Requirements include:

- A qualified percentage – an automatic deferral for eligible employees of at least 3% and not more than 10% increasing 1% per year so that after three years, assuming the starting percentage is 3%, eligible participants will be contributing 6%
- A matching employer contribution of 100% of the first 1% and 50% of the next 5% or a 3% non-elective to all eligible non-highly compensated employees.
- A notice requirement described in §401(k)(13)(E)(i).

Other provisions include:

- In determining "eligible employees" for purposes of the automatic deferral, plan sponsors with existing automatic enrollment features can exclude eligible employees who already participate or who have elected not to participate
- Employer contributions are 100% vested after 2 years of service
- The 401(k) withdrawal restrictions apply

Plan Sponsor Considerations

Should you add an automatic enrollment feature? Should you enhance your existing automatic enrollment feature? Should you convert to a Qualified Automatic Contribution Arrangement? Bottom line is that plan sponsors know their employee population, know what will work and what won't; that said, more and more plan sponsors are adopting basic automatic enrollment features and there is an increasing number of plan sponsors who are implementing automatic annual increases. The proposed QDIA regulations indicated that in 2002, about 5% of workers eligible for 401(k) plans were in plans that utilized automatic enrollment features; the government expects that number to grow to 25% and with the PPA changes estimates that up to 45% of eligible workers will be in 401(k) plans with automatic enrollment features.

Behavioral finance studies will argue that many human beings are subject to inertia and indecision; either an eligible employee will join the plan or not. If an eligible employee joins the plan at a particular salary deferral election, chances are they will stay at that percentage for a long time. Participants will keep their initial investment direction and make minimal adjustments, if any. Too many investment choices are too complicated for the average participant.

PPA has provided opportunities which will help participants save more for retirement, simplify the investment process and provide fiduciary relief to plan sponsors.

As noted in ErisaALERT 2007-2, you may want to focus on:

- The pros and cons of adding auto enrollment in your particular environment if you don't already have it
- Implementing an automatic increase feature if you already have auto enrollment
- Costing out the employer match requirements for the auto enrollment nondiscrimination safe harbor. At the same time, you may wish to cost out the existing nondiscrimination safe harbor.
- Reviewing our current default investment vs the proposed QDIA regulations if you already have automatic enrollment
- Analyzing you current investment line up vs the proposed QDIA regulations if you are contemplating adding auto enrollment
- Talking to your recordkeeper regarding the administrative requirements/implications of plan changes
- Developing an implementation plan including a communication campaign
- Obtaining necessary legal and investment advisory expertise

Note: This material is for the sole purpose of providing general information and does not under any circumstances constitute legal advice and should not be used as a substitute for legal advice. You should seek the advice of counsel when applying the requirements to your plans. For more information on this Article, contact us by phone at 610-524-5351 and ask for Mary Andersen or 973-994-7539 and ask for Theresa Borzelli.

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[i] IRS Announcements 2000-31, 2000-60
Revenue Rulings 2000-8, 2000-35
IRB 2000-7
Information Letter 2004 TNT 71-31

[ii] http://www.dol.gov/ebsa/regs/fedreg/proposed/2006008282.pdf