



New Law Facilitates Automatic Enrollment Arrangements For 401(k) Plans

The Problem of Inadequate 401(k) Contributions

Over the past two decades, the 401(k) plan has become the most common retirement plan among private sector employers. One unwelcome result of the growth of 401(k) plans – which, by definition, permit employees to choose whether and how much to contribute – is that many employees do not defer enough to ensure a comfortable retirement. Studies repeatedly have shown that too many employees never enroll in the plan, and that those who do participate don't contribute enough to build an adequate retirement fund. And because of the "ADP" and "ACP" discrimination tests that apply to 401(k) plans – which tie the maximum rate at which higher paid employees can contribute to the rate at which lower paid employees do – low contribution rates often prevent highly compensated employees from contributing as much as they would like.

In recent years, many 401(k) plan sponsors have begun to use "automatic enrollment" or "negative election" arrangements in order to increase employee enrollment and contribution rates. Under an automatic enrollment feature, new employees (or, sometimes, all plan participants) are automatically enrolled and assigned a default contribution rate – 3% of pay, for example – unless and until they affirmatively opt out of the plan or elect a different contribution rate. Numerous studies have shown that automatic enrollment can substantially increase employee participation and contribution rates and reduce ADP and ACP testing failures. One such study found that, on average, an automatic enrollment feature increased the employee participation rate from 68% to over 90%.

Until recently the legal basis for automatic enrollment arrangements was somewhat uncertain. The IRS did not formally approve such arrangements until 1998, and even then several unsettled issues remained. For example, most 401(k) plans permit participants to direct the investment of their accounts, and sponsors that permit participant investment direction generally try to comply with the fiduciary relief provisions of section 404(c) of ERISA. ERISA section 404(c) can protect plan fiduciaries from liability for participants' investment decisions if the detailed requirements of this law are complied with, such that participants have an effective opportunity to control the investment of their accounts. But plan fiduciaries were not eligible for section 404(c) relief for automatically enrolled participants who did not affirmatively elect investments for their accounts.

Furthermore, many States – including New York – have laws which prohibit deductions from employees' paychecks without their written consent. Automatic enrollment arrangements on their face appear to conflict with these laws. Although ERISA arguably preempted these State laws, the situation was never entirely clear.

The Pension Protection Act Addresses Automatic Enrollment Arrangements

The Pension Protection Act of 2006 (the Act) has addressed these issues and substantially improved the rules that govern automatic enrollment features. The Act:

- Establishes a discrimination test "safe harbor" for automatic enrollment arrangements under the Internal Revenue Code. Plans that meet the safe harbor requirements will be exempt from the ADP and ACP discrimination testing rules and from the "top heavy" rules.
- Provides that State laws that might otherwise prohibit an automatic enrollment arrangement are preempted by ERISA, as long as certain requirements are met.
- Provides rules under which a default investment fund can be used without affecting the plan fiduciaries' right to relief from liability under the ERISA section 404(c) rules.

The New Internal Revenue Code Discrimination Testing Safe Harbor

An automatic enrollment arrangement will qualify for the new discrimination testing safe harbor, and thereby exempt the plan from ADP and ACP testing, if it satisfies the following requirements:

- *Minimum automatic deferrals:* The arrangement must provide that contributions on behalf of automatically enrolled participants will be at least 3% of pay for the first year, 4% for the second year, 5% for the third year and 6% thereafter – unless, of course, the participant affirmatively elects a different contribution rate, or elects not to contribute at all. The automatic contribution rate cannot exceed 10% of pay.
- *Matching or profit sharing contributions:* The employer must make either matching contributions or profit sharing contributions at a minimum rate:
 - Matching contributions for all non-highly compensated employees must be at least 100% of the first 1% of compensation deferred, plus 50% of the next 5% of compensation deferred. So, if a participant contributed 6% of pay to the plan, the required matching contribution would be 3.5% (100% of the first 1% deferred, plus 50% of the next 5%).
 - A profit sharing contribution equal to 3% of compensation.

Note that the new requirements for employer contributions are slightly less onerous than those that apply under the existing 401(k) safe harbors. Under the existing safe harbor, a 401(k) plan (whether or not it has an automatic enrollment feature) is exempt from ADP and ACP testing if the employer makes a 3% profit sharing contribution, or a matching contribution of at least 100% of the first 3% of pay that is deferred plus 50% of the next 2% deferred. So, to comply with the current safe harbor, if a participant contributed 6% of pay, the required matching contribution would be 4%, rather than the 3.5% required under the new safe harbor.

- *Notices:* Notices must be provided to all participants, each year, that explain the automatic enrollment arrangement and the participant's right to elect out.

The new safe harbor is elective, not mandatory. Employers that already have an automatic enrollment arrangement in place do not have to amend it to comply with the new rules, although doing so would enable them to discontinue ADP/ACP discrimination testing. The new Internal Revenue Code safe harbor is effective January 1, 2008.

Requirements for ERISA Preemption of State Law

As mentioned earlier, the Act also amended ERISA to provide that State laws that might otherwise prohibit automatic enrollment arrangements are preempted if:

- *Investment of contributions:* Contributions for automatically enrolled participants are invested in a fund that is a "qualified default investment alternative" (QDIA). (This term has been defined in new proposed regulations; see below under "Requirements for Fiduciary Relief".)
- *Notices:* Participants are notified that they have the right to opt out of the arrangement or change their contribution rate, and that contributions will be invested in a QDIA if they don't provide different investment directions. Each participant must receive the required notice within a reasonable period of time before the participant is automatically enrolled. (Note that this notice is different from the one required under Internal Revenue Code safe harbor; however, it's possible that the two notices could be combined into a single notice.)

Automatic enrollment arrangements that don't comply with the QDIA requirements are arguably still exempt from State laws. However, employers that fail to send the required notices could be subject to a \$1,000 per day penalty, beginning in 2008.

Requirements for Fiduciary Relief

Plans that permit participants to direct the investment of their accounts – like most 401(k) plans – often do so in reliance on a fiduciary relief provision of ERISA – section 404(c) – which provides that the plan fiduciaries will not be liable for investment decisions made by participants if the participant has an effective opportunity to control the investment of his or her account. The Act amended ERISA section 404(c) to provide that the use of a default investment fund for automatically enrolled participants will not affect the availability of section 404(c) relief as long as:

- Participants are notified of the default investment feature, and
- The default fund complies with regulations to be issued by the Secretary of Labor.

The Department of Labor has proposed new regulations governing Qualified Default Investment Alternatives (QDIAs), and final regulations are expected to be issued later this year. The proposed regulations provide that a QDIA must be one of the following:

- A "life cycle" or "target retirement date" fund, or another fund or model portfolio, the investments of which are based on each participant's age, life expectancy or years to retirement,

- A balanced fund, or another fund or model portfolio that is appropriate, as to risk and return factors, for all plan participants, or
- An "investment management service" -- that is, a managed fund that determines an appropriate mix of investments for each affected participant based on that participant's age, life expectancy or target retirement date.

What 401(k) Plan Sponsors Need to Consider

The provisions of the Pension Protection Act and of the proposed regulations, in general, make automatic enrollment arrangements more useful and should be welcomed by 401(k) plan sponsors. The Internal Revenue Code safe harbor, if used, will allow highly compensated employees to "max out" their 401(k) contributions without worrying about the discrimination testing. The State law preemption and fiduciary relief provisions resolve ADP and ACP concerns about the legality of automatic enrollment arrangements under State law, and their effect on the availability of ERISA section 404(c) relief from fiduciary liability. However, plan sponsors should be aware of the new notice requirements, which are enforced by provisions that include hefty penalties.

401(k) plan sponsors should consider the following:

- 401(k) plan sponsors who don't already have an automatic enrollment feature should consider whether adopting such a feature would make sense. Sponsors who sometimes fail the ADP/ACP test, especially, should consider automatic enrollment.
- All 401(k) plan sponsors should consider whether to implement a safe harbor automatic enrollment arrangement, allowing them to forego ADP/ACP discrimination testing.
- 401(k) plan sponsors who use default investment funds should consider whether the default fund they have designated complies with the definition of a "QDIA" in proposed regulations and make any appropriate changes.
- All 401(k) plan sponsors should begin planning for the participant notices that will be required next year, or when the proposed regulations are finalized later this year.

If you have any questions or would like more information regarding the Pension Protection Act, or other Employee Benefits issues, please contact any member* of our Employee Benefits practice group:

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