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Regulatory Update
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Introductory Comment: Spring provides the opportunity to see new beginnings and new life. The same can be said for regulation; there is always new beginnings and new life to the seasons of regulation. In this issue I present new guidance on existing items that will require your attention. The OCC provides guidance for conducting account reviews – something that we all need to doing on an annual basis. In light of the current discussions surrounding the need to properly value assets, I have included a summary on FASB 157 as well as thoughts from the SEC – proper valuation of all assets is a must. I have also included recent IRA guidance, as well as EBSA assistance for Qualified Default Investment Alternatives.

OCC – Annual Reviews of Fiduciary Accounts Pursuant to 12 CFR 9.6(c)

Background and Purpose
The Office of the Comptroller of the Currency (OCC) is providing guidance to national banks on the annual review requirement contained in OCC fiduciary regulation 12 CFR 9.6(c). The date of this issuance is March 27, 2008. Under the regulation, at least once during every calendar year, a national bank is required to conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account. These annual reviews are commonly referred to as "annual investment reviews."

The OCC has developed this guidance to clarify the agency's expectations for the depth and breadth of annual investment reviews. Specifically, the guidance will:

- Identify information that should be considered in a bank's annual investment review process;
- Address the importance of ensuring that all account assets, including unique and hard-to-value assets, are reviewed for appropriateness and consistency with account investment objectives;
- Provide information on the different types of reviews currently used by the industry, including an overview of their strengths and limitations; and
- Emphasize the need for thorough documentation of reviews and a strong "exception" tracking system.

Elements of an Effective Annual Investment Review Process
In addition to being a regulatory requirement, annual investment reviews are among the most useful tools bank fiduciaries have to ensure they meet their fiduciary responsibilities and properly administer their customers' accounts. An annual investment review is a point-in-time evaluation of both account assets and objectives. Regardless of the tools employed by a

particular institution, management supervision, information systems, and follow-up are all critical to an effective investment review process. An effective investment review process should be based upon policies and procedures that provide clear standards for scope, documentation, and exception reporting and tracking. The process should:

- Ensure that account investment objectives are current and appropriate, and that investments are consistent with those objectives.
- Ensure that the investment review provides for an annual assessment of the portfolio in its entirety. This is particularly important when unique assets make up a portion of the account.
- Include exception tracking that identifies and provides for follow up and resolution of exceptions such as securities not included on "approved" or "retention" lists, assets posing potential conflicts of interest, or asset concentrations.
- Include performance measurements and a process for handling performance outliers.
- Ensure that each asset is valued using an appropriate valuation process.

Exception tracking systems are essential to a strong investment review process. An effective tracking system should provide notification to management of items such as investment reviews coming due, identification of reviews that are past due, and realistic time frames for implementing corrective action. The bank should have a process for reporting and escalating issues/exceptions to appropriate management or committee levels. Exceptions should be properly addressed and corrective action should be implemented in a timely manner. Any waivers granted by administrators or portfolio managers should be based upon clearly defined parameters.

Unique or hard-to-value assets such as real estate, oil, gas and mineral interests, farms and ranches, timberland, closely held businesses, loans, and personal property should be included as part of the annual investment review. The review of these assets should:

- Be sufficiently detailed to document the bank's determination that the asset is appropriate for the investment objectives of the account and should be retained.
- Include a careful review of Asset Retention letters because these investment directions can require a bank to hold assets that may be inconsistent with the bank's investment strategies. A bank should accept Asset Retention letters only from authorized parties.
- Provide updated asset valuations appropriate for the type of asset and nature of account.[1]
- Ensure that proper insurance coverage is maintained on assets that warrant protection.

Various types of assets, including unique assets, held in a single account may be reviewed at different times. However, the investment review process must ensure that an assessment of the account as a whole is made at least annually. This is particularly important when unique assets make up a substantial portion of the account.

Appropriate document retention policies and procedures should be in place to ensure that the bank maintains adequate documentation of each annual investment review. This will provide evidence of the bank's review process in the event complaints are lodged against the fiduciary, or litigation issues arise.

Automated and Manual Investment Review Processes

The annual investment review process has evolved over time. In an effort to increase efficiencies, many banks are increasing their use of automation to facilitate investment reviews. Some banks have acquired investment review packages from vendors, while others have developed their own in-house systems. Some automated systems have the ability to screen an account's marketable securities on a daily basis. Many banks use hybrid processes that encompass features of both automated and traditional manual investment reviews.

A manual investment review process provides a more hands-on approach to investment reviews. Marketable securities and unique assets are usually reviewed at the same time, which can allow for more dialogue among administrators, portfolio managers, and unique asset managers. However, manual reviews can be more labor intensive, and some banks use a risk-based approach that relies upon a higher level of oversight (e.g., an asset review committee) for higher risk accounts and asset types, and for accounts with exceptions.

Factors to consider in using a manual review process:

- Manual investment reviews can be time consuming, particularly if the department has a large number of discretionary accounts with an array of unique assets.
- As the number of reviews becomes larger, the risk level becomes higher of a bank's review becoming a "rubber stamp," or of reviews not being completed in a timely manner.
- The quality of reviews may vary with the individual(s) performing the review.

Automated investment reviews can also be a useful investment management and compliance tool. Lower risk accounts, such as those invested in model portfolios comprised of mutual funds or collective investment funds, lend themselves well to an automated process. Automated systems allow marketable securities to be screened efficiently and frequently to identify assets not on an approved list, concentrations, own-bank securities, or accounts with allocations inconsistent with account objectives. While automation can provide efficient identification, reporting, escalation, and ongoing monitoring of many types of exceptions, an automated investment review is not a substitute for good portfolio management or committee oversight and accountability.

Factors to consider in using an automated review process:

- A wholly automated screening process may not provide for the independent perspective customarily provided by an effective committee review process.
- Automated systems may not address whether an account's investment objectives have, or need to be, changed over time.
- If account administrators are not included in the automated investment review process, key information such as account objectives, cash needs, grantor intent, and beneficiary requests may not be properly considered.
- Vendor systems may only identify exceptions to a limited number of pre-set parameters.

Supervisory Considerations

The OCC expects annual 12 CFR 9.6(c) investment reviews to be performed in a timely and comprehensive manner. Banks may use manual, automated, or a combination of tools to facilitate a review process that complies with the requirements of 12 CFR 9.6(c). During the normal course of the supervisory process, examiners will evaluate the adequacy of annual investment reviews to determine compliance with the requirements of the regulation and this interpretive guidance. Examiners will seek corrective action for significant weaknesses or unwarranted risks.

SEC/FASB – Fair Value Rules and Summary of Statement No. 157

Background
There is a tremendous amount of conversation surrounding the guidance that is to be provided regarding "fair value" rules. The new guidance, if it is to be issued, will more than likely stop short of full suspension of the "fair value" rules that require companies to mark assets to current market value. But it will highlight the SEC's interest in an issue that is crucial importance for financial groups, whose balance sheets and share prices have been rocked by the liquidity squeeze. However, until such guidance is issued, FASB Statement No. 157 is the standard to be used.

Outlined below is an overview and summary of FASB Statement No. 157. This statement was finalized and became effective in late 2007. I believe it is an important time to understand the need for a consistent process in valuing all assets, including those assets held in investment management and fiduciary accounts. The proper valuation of assets held in these accounts will assist in ensuring proper reporting, effective pricing, and accurate regulatory reporting.

Summary – Fair Value Measurements
This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

Reason for Issuing This Statement
Prior to this Statement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that require fair value measurements. Differences in that guidance created inconsistencies that added to the complexity in applying GAAP. In developing this Statement, the Board considered the need for increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements.

Differences between This Statement and Current Practice
The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

The definition of fair value retains the exchange price notion in earlier definitions of fair value. This Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

This Statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, this Statement establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

This Statement clarifies that market participant assumptions include assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine. Therefore, a measurement (for example, a "mark-to-model" measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

This Statement clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. That guidance applies for stock with restrictions on sale that terminate within one year that is measured at fair value under FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations.*

This Statement clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

This Statement affirms the requirement of other FASB Statements that the fair value of a position in a financial instrument (including a block) that trades in an active market should be measured as the product of the quoted price for the individual instrument times the quantity held (within Level 1 of the fair value hierarchy). The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). This Statement extends that requirement to broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

This Statement expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. This Statement encourages entities to combine the fair value information disclosed under this Statement with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* where practicable.

The guidance in this Statement applies for derivatives and other financial instruments measured at fair value under Statement 133 at initial recognition and in all subsequent periods. Therefore, this Statement nullifies the guidance in footnote 3 of EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."
This Statement also amends Statement 133 to remove the similar guidance to that in Issue 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments.*

How the Conclusions in This Statement Relate to the FASB's Conceptual Framework
The framework for measuring fair value considers the concepts in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* Concepts Statement 2 emphasizes that providing comparable information enables users of financial statements to identify similarities in and differences between two sets of economic events.

The definition of fair value considers the concepts relating to assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements,* in the context of market participants. A fair value measurement reflects current market participant assumptions about the future inflows associated with an asset (future economic benefits) and the future outflows associated with a liability (future sacrifices of economic benefits).
This Statement incorporates aspects of the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* as clarified and/or reconsidered in this Statement. This Statement does not revise Concepts Statement 7. The Board will consider the need to revise Concepts Statement 7 in its conceptual framework project.

The expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements (present and potential investors, creditors, and others) with information that is useful in making investment, credit, and similar decisions—the first objective of financial reporting in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises.*

How the Changes in This Statement Improve Financial Reporting
A single definition of fair value, together with a framework for measuring fair value, should result in increased consistency and comparability in fair value measurements.
The expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the extent to which fair value

is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period.

The amendments made by this Statement advance the Board's initiatives to simplify and codify the accounting literature, eliminating differences that have added to the complexity in GAAP.

Costs and Benefits of Applying This Statement

The framework for measuring fair value builds on current practice and requirements. However, some entities will need to make systems and other changes to comply with the requirements of this Statement. Some entities also might incur incremental costs in applying the requirements of this Statement. However, the benefits from increased consistency and comparability in fair value measurements and expanded disclosures about those measurements should be ongoing.

The Effective Date of This Statement
This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

The provisions of this Statement should be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. The provisions of this Statement should be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):

- A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement;
- A financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of Issue 02-3 prior to initial application of this Statement;
- A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in Statement 133 (added by Statement 155) prior to initial application of this Statement.

The transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date this Statement is initially applied, should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the fiscal year in which this Statement is initially applied.

EBSA - Proposed Regulation Relating To Service Provider Disclosures Under ERISA Section 408(b)(2)

Background
On December 13, 2007 the Employee Benefits Security Administration proposed regulations relating to service provider disclosures under ERISA. The final regulation has not yet been issued. In recent years, changes in the way services are provided to plans have resulted in complexities that make it difficult for plan fiduciaries to understand how service providers are compensated and whether they have possible conflicts of interest that may affect their performance.

Under ERISA, plan fiduciaries are obligated to act prudently in selecting service providers and ensure that no more than reasonable compensation is paid for services provided to plans, taking into account the direct and indirect compensation received by the service provider.

Thus, a plan fiduciary must have sufficient information regarding fees and compensation that the service provider receives and whether there are relationships or interests on the part of the service provider that may call into question the objectivity of the service provider in providing services to the plan.

The Labor Department's Employee Benefits Security Administration (EBSA) has proposed amending the regulation under section 408(b)(2) of the Employee Retirement Income Security (ERISA), which provides an exemption from the prohibited transaction rules, to clarify what constitutes a reasonable contract or arrangement and to require more comprehensive written disclosure concerning plan contracts with service providers.

Overview of Proposed Regulation
The proposed regulation focuses on disclosure of the direct and indirect compensation received by service providers and potential conflicts that may affect their objectivity.

The proposed regulation affects only certain service providers whose contracts or arrangements are most likely to raise concerns about the receipt of indirect compensation, the fiduciary nature of the services to be provided, or conflicts of interest that might affect the provision of services.

In addition, the Department is proposing a class exemption that would provide relief to a plan fiduciary who enters into a contract that is not "reasonable" because, unknown to the plan fiduciary, the service provider failed to comply with its disclosure obligations under the proposed regulation.

The Department believes the benefits will outweigh the costs of compliance with the proposal, which generally fall on service providers that must create and provide additional disclosures. The cost of the proposed regulation is estimated to be $52 million in the year of implementation, falls to approximately $36 million in the second year, and varies slightly with changes in market size thereafter. Benefits accrue due to possible lower fees paid by plans, possible increased efficiency in plan-service provider relationships and reduced costs incurred by plans to evaluate potential service providers.

The proposal applies to:

- fiduciary service providers;
- providers of banking, consulting, custodial, insurance, investment advisory or management, recordkeeping, securities brokerage, or third party administration services; or
- providers who receive indirect compensation for accounting, actuarial, appraisal, auditing, legal, or valuation services.

Disclosure Requirements
Disclosure of Services and Compensation - The terms of the contract must require that the service provider disclose information regarding all services to be performed and all compensation that will be received either directly from the plan or indirectly from parties other than the plan or plan sponsor. The proposal includes a definition of "compensation or fees" and rules for bundled service providers and for estimating the amount of prospective compensation.

Disclosure of Conflicts of Interest - Service providers also must disclose information about relationships or interests that may raise conflicts of interest for the service provider in performing plan services. Specifically, service providers must describe:

- any participation or interest of the service provider in transactions to be entered into by the plan pursuant to the contract;
- any material relationships with other parties that may create conflicts of interest;
- any compensation the service provider may receive that it can affect without prior approval by an independent fiduciary; and
- any policies or procedures in place to address potential conflicts of interest.

Ongoing Disclosure Obligations - The proposal includes ongoing disclosure obligations relating to:

- Material Changes: During the term of the contract, a service provider must disclose material changes to information previously furnished within 30 days of such changes.
- Reporting and Disclosure Requirements: Service providers must disclose compensation or other information related to the contract or arrangement that is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA's reporting and disclosure requirements.
- Actual Performance: The proposal also includes an explicit requirement that service providers actually make the required disclosures.

EBSA – Field Assistance Bulletin 2008-03 Guidance Regarding Qualified Default Investment Alternatives; and Technical Corrections to the Final Regulation

Background

On April 29, 2008 the U.S. Department of Labor's Employee Benefits Security Administration announced publication of technical corrections to the final regulation on qualified default investment alternatives along with guidance (Field Assistance Bulletin 2008-03) to clarify the scope and meaning of the final rule.

On October 24, 2007, the department published final rule to implement Pension Protection Act provisions providing a safe harbor from liability for fiduciaries of plans in which the contributions of workers who do not provide investment direction (such as automatically enrolled workers) are invested in "qualified default investment alternatives" or QDIAs. The QDIAs are designed to encourage the investment of employee assets in investment vehicles appropriate for long-term retirement savings.

The technical corrections affect three areas of the final regulation on QDIAs. These include changes clarifying the preamble example on "round-trip restrictions," expanding the scope of who can manage a QDIA to include a committee that is a named fiduciary of the plan, and correcting the "grandfather" relief for stable value funds.

Field Assistance Bulletin 2008-03 provides guidance on a series of frequently asked questions raised by the employee benefit community since publication of the final rule. The questions address issues relating to the scope of the regulation, the notice requirements, the 90-day limitation on fees and restrictions, management and asset allocation of QDIAs, the capital preservation investment option, and the grandfather relief for stable value funds.

Questions and Answers
Scope of QDIA Regulation
Q-1. To what extent does the QDIA regulation relieve a plan sponsor from fiduciary liability when the plan sponsor chooses to create and manage a qualified default investment alternative (QDIA) itself using a mix of the plan's available investment alternatives?
A plan sponsor that chooses to create and manage a QDIA itself may be relieved of liability for decisions to invest all or part of a participant's or beneficiary's account in a QDIA only if the plan sponsor is a named fiduciary (see § 2550.404c-5(e)(3)(i)(C)). The plan sponsor would not be relieved of liability for the management of the QDIA (see § 2550.404c-5(b)(1)(ii)) or the prudent selection and monitoring of the QDIA (see § 2550.404c-5(b)(3)).

Q-2. Is relief available under the QDIA regulation for assets invested in a default investment prior to the effective date of the regulation?
Yes, if all conditions of the QDIA regulation are satisfied with respect to such assets. The relief available under the QDIA regulation is not limited to assets that are invested in a QDIA on or after the effective date of the regulation. If the notice and other requirements for relief under the QDIA regulation are satisfied, the fiduciary will, except to the extent otherwise limited by the regulation, be relieved of liability with respect to all assets invested in the QDIA, without regard to whether the assets were contributed prior to the effective date of the regulation. The fiduciary will have the benefit of the relief under the QDIA regulation for fiduciary decisions made on or after the date that all requirements of the QDIA regulation have been satisfied. However, relief is not available for fiduciary decisions made prior to the effective date of the QDIA regulation, such as decisions by a fiduciary to invest assets in a default investment.

Q-3. Could a fiduciary obtain the relief referred to in Q-2, above, with respect to assets invested in a QDIA on behalf of participants and beneficiaries who elected to invest in a default investment prior to the effective date of the regulation?
Yes. The relief available under the QDIA regulation would extend to all assets invested in a QDIA on behalf of participants and beneficiaries who, on or after the effective date of the regulation, fail to give investment direction after being provided the required notice without regard to whether the participant or beneficiary made an earlier affirmative election to invest in the default investment. This result may be significant when plan records cannot establish that an investment was the direct and necessary result of a participant's or beneficiary's exercise of control for purposes of ERISA section 404(c)(1)(A) and 29 CFR § 2550.404c-1.

For example, assume that prior to the effective date of the QDIA regulation, plan sponsor (PS) used Default A as the default investment for its plan, an investment that would not qualify as a QDIA under the regulation. Following publication of the QDIA regulation, PS decides to change to Default B, an investment that would qualify as a QDIA under the regulation, but PS is unable to distinguish between those participants and beneficiaries who directed that their assets be invested in Default A and those participants and beneficiaries who were defaulted into Default A. If PS distributes a new investment election form to all participants and beneficiaries invested in Default A, relief under the QDIA regulation would be available to PS with respect to assets that are moved into Default B and held in the plan accounts of participants and beneficiaries who failed to respond to the investment election form, if all of the requirements of the regulation are otherwise satisfied with respect to such participants and beneficiaries. Alternatively, if Default A is an investment that would qualify as a QDIA under the regulation and PS complies with the notice and other requirements necessary to establish Default A as a QDIA, PS would be relieved of liability in accordance with the QDIA regulation with respect to all assets invested in Default A, without regard to whether the assets were the result of a default investment.

Q-4. Is fiduciary relief under the QDIA regulation available if non-elective contributions such as qualified non-elective contributions (QNECs), or the proceeds from litigation or settlements, are invested in a QDIA?

One of the conditions for fiduciary relief under the QDIA regulation is that the participant or beneficiary on whose behalf an investment in a QDIA is made must have had the opportunity to direct the investment of assets in his or her plan account, but did not direct such investment. See § 2550.404c-5(c)(2). Although the answer to this question may vary based on the particular facts and circumstances, if participants and beneficiaries are not provided the opportunity to direct the investment of plan assets that result from non-elective contributions such as QNECs, or the proceeds from litigation or other settlements, at least one of the conditions for fiduciary relief will not have been satisfied, and relief would not be available under the QDIA regulation. To the extent a participant or beneficiary is, in fact, given the opportunity to direct the investment of such contributions, or after such amounts are allocated to a participant's or beneficiary's plan account and the participant or beneficiary is subsequently provided the opportunity to direct the investment of those assets, the answer may be different.

Q-5. Does the QDIA regulation, including the preemption provisions, apply to plans under section 403(b) of the Internal Revenue Code (Code)?

The fiduciary relief provided under section 404(c)(5) of ERISA and the QDIA regulation is available to a Code section 403(b) plan, if the program is a "pension plan" within the meaning of section 3(2) of ERISA and covered by Title I pursuant to section 4(a) of ERISA. For more information regarding ERISA coverage of Code section 403(b) plans, see 29 CFR § 2510.3-2(f) and Field Assistance Bulletin 2007-02 (July 24, 2007).

Notice Requirements

Q-6. How much information regarding fees and expenses attendant to a QDIA must be provided in a notice? Can this information be provided by attaching other disclosure documents to the notice?

Paragraph (d) of § 2550.404c-5 sets forth the information required to be included in notices required by paragraph (c)(3) of § 2550.404c-5. Fees and expenses are addressed in paragraph (d)(3), which, among other things, requires that the notice include "a description of the qualified default investment alternative, including a description of the fees and expenses attendant to the investment alternative[.]" In the absence of further guidance, the Department believes that, for purposes of § 2550.404c-5(d)(3), participants and beneficiaries generally should be provided information concerning: (1) the amount and a description of any shareholder-type fees such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees and (2) for investments with respect to which performance may vary over the term of the investment, the total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio). In this regard, the Department notes that it is currently developing a proposed regulation that would establish disclosure requirements, including requirements applicable to the disclosure of plan and investment fee and expense information, for participant directed individual account plans. The Department anticipates that furnishing the information required under that regulation would satisfy the investment-related fee and expense disclosures required by paragraph (d)(3) of § 2550.404c-5.

With regard to the form of disclosure of the fee and expense information, the Department notes that there is nothing in the QDIA regulation that would preclude the use of separate, but simultaneously furnished, documents to satisfy the notice requirements of § 2550.404c-5(c)(3). Accordingly, in the absence of additional guidance, the furnishing of a prospectus or profile prospectus of an investment alternative subject to the Securities Act of 1933, along with the other information required by paragraph (d) of § 2550.404c-5, could be used to satisfy the disclosures required by paragraph (d)(3) of § 2550.404c-5.

Q-7. Does the flexibility permitted with respect to use of the Treasury Department's electronic distribution rules apply only to the QDIA notice requirement, or more broadly (i.e. to pass-through of investment materials)?
The preamble to the QDIA regulation provides the Department's view that "plans that wish to use electronic means by which to satisfy their notice requirements may rely on either guidance issued by the Department of Labor at 29 CFR § 2520.104b-1(c) or the guidance issued by the Department of Treasury and Internal Revenue Service at 26 CFR § 1.401(a)-21 relating to use of electronic media." Accordingly, in the absence of further guidance, the Department's views extend only to the QDIA regulation's notice requirement at paragraph (c)(3) of § 2550.404c-5. However, the Department currently is working on a separate regulatory initiative concerning the broader application of disclosure by electronic means.

Q-8. Do plan sponsors have to combine the QDIA notice required by the regulation with a notice required by Code sections 401(k)(13) and 414(w)?
No. Although the Department did coordinate with Treasury and the Internal Revenue Service to ensure that plan sponsors could comply with the notice requirements of the Code (sections 401(k)(13) and 414(w)) and ERISA (sections 404(c)(5) and 514(e)(3)) with a single, stand-alone document, plan sponsors are not required to combine these notices. Some plan sponsors offering a qualified automatic contribution arrangement (QACA) under Code section 401(k)(13) will not seek the fiduciary relief provided by ERISA section 404(c)(5). Alternatively, a plan sponsor could select a QDIA and avail itself of the fiduciary relief provided by ERISA section 404(c)(5) under circumstances other than automatic enrollment or under an automatic enrollment provision that is not intended to qualify under Code sections 401(k)(13) and 414(w). Plan sponsors are free to satisfy these notice requirements independently if they choose to do so.

For plan sponsors that wish to combine these notices, the Department coordinated with the Department of Treasury and the Internal Revenue Service in providing a sample notice which is available on the internet that may be used to help a plan sponsor satisfy these notice content requirements.

Q-9. Are the timing requirements for the notices required by the Department of Labor's QDIA regulation the same as the timing requirements for the notices required by the Treasury Department's proposed regulations under Code sections 401(k)(13) and 414(w)?
The timing requirements for these notices are not inconsistent. Under the Department's QDIA regulation, an initial notice generally must be provided at least thirty days in advance of a participant's date of plan eligibility or any first investment in a QDIA, or on or before the date of plan eligibility (if the participant has the opportunity to make a permissible withdrawal as

determined under section 414(w) of the Code). An annual notice also must be provided at least thirty days in advance of each subsequent plan year.
Under the Treasury Department's proposed regulations on QACAs and eligible automatic contribution arrangements (EACAs), the Treasury Department articulated the timing requirements for the notices required under Code sections 401(k)(13) and 414(w). See 72 FR 63144. Specifically, a notice must be provided within a reasonable period of time before the beginning of each plan year or a reasonable period of time before an employee first becomes eligible under the plan. A notice is deemed to satisfy these timing requirements if the notice is provided at least thirty days (and not more than ninety days) before the beginning of each plan year or, if an employee did not receive the annually-required notice because it was provided before his or her date of eligibility for the plan, at least by the employee's eligibility date (and not more than ninety days before the employee's eligibility date).

Although the timing provisions for these notices are not identical, plan sponsors can easily satisfy both requirements for a plan year. A plan sponsor can satisfy the annual notice requirements under the QDIA regulation and the Treasury Department's proposed regulations if a notice is provided at least thirty, and not more than ninety, days before the beginning of each plan year. For example, the sponsor of a calendar year plan may choose to distribute a notice on November 1 of each year. A notice distributed on September 1 would not necessarily comply with the Service's rules, because September 1 is more than ninety days before the first day of the subsequent plan year.

Further, a plan that includes an EACA under section 414(w) of the Code and permits an employee to withdraw default contributions during the 90-day period following the date of the employee's first elective contribution can satisfy the Department's initial notice requirement, as well as the Service's special rule for employees who do not receive the annually-required notice due to their eligibility date, by providing a notice on or before, but no more than ninety days before, an employee's date of plan eligibility. For example, if a new employee is immediately eligible for participation on his or her first day of employment, which is June 1, the distribution of a notice to that employee on June 1 would satisfy both regulations.

Q-10. Can the QDIA notice be combined with the Code section 401(k)(12) safe harbor notice in the same manner that it can be combined with the Code section 401(k)(13) and 414(w) notices?
Yes. While the QDIA regulation generally provides for disclosure through a separate notice, the Department indicated in the preamble to the QDIA regulation that it anticipates that the QDIA notice requirements and the notice requirements of Code sections 401(k)(13)(E) and 414(w)(4) could be satisfied in a single disclosure document. See 72 FR at 60455. It is the view of the Department that the information required to be disclosed in a notice pursuant to Code section 401(k)(12)(D) is sufficiently related to the information required to be disclosed in the QDIA notice that combining the notices would improve, rather than complicate, the disclosure of plan information to participants and beneficiaries.

90-Day Limitation on Fees and Restrictions
Q-11. Would the payment of a fee or expense (e.g., redemption fee) by a plan sponsor or service provider that would otherwise be assessed to the account of a participant or beneficiary during the initial 90-day period satisfy the requirements of paragraph (c)(5)(ii) of § 2550.404c-5?

Yes. Paragraph (c)(5)(ii) of § 2550.404c-5 generally provides that, for a 90-day period following the first investment in a QDIA on behalf of a participant or beneficiary, any transfer or withdrawal of assets from the QDIA by a participant or beneficiary cannot be subject to any restrictions, fees, or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment). The Department included this requirement to ensure that participants and beneficiaries would not be restricted from or penalized for moving assets out of the QDIA during the period of time that they would be most likely to opt out of the plan or redirect their plan investments. To the extent that any such fees or expenses otherwise assessed to the account of a participant or beneficiary are paid by the plan sponsor or a service provider, and not by the participant or beneficiary or the plan generally, the assessment of the fees or expenses would not serve to inhibit a participant's or beneficiary's decision to opt out of the investment alternative and the policy objective of the requirement at § 2550.404c-5(c)(5)(ii) would be satisfied. This Bulletin does not address the character of these payments for Code purposes.

Q-12. For purposes of § 2550.404c-5(c)(5)(ii), does the 90-day clock start from the date an investment becomes a QDIA, or does it begin only in reference to a participant who is being newly "defaulted" into a QDIA?

Paragraph (c)(5)(ii) of § 2550.404c-5 generally provides that, for a 90-day period following the first investment in a QDIA on behalf of a participant or beneficiary, any transfer or withdrawal of assets from the QDIA by a participant or beneficiary cannot be subject to restrictions, fees, or expenses.

For purposes of this requirement, the 90-day condition on restrictions, fees or expenses does not apply to participants or beneficiaries who have "existing" assets invested in the plan as of the effective date of the QDIA regulation. For example, if a plan, prior to the effective date of the QDIA regulation, used a balanced fund as its default investment, and the balanced fund qualifies as a QDIA under the QDIA regulation, the plan sponsor may wish to continue to use this fund as its default investment and obtain relief under the regulation. With respect to "existing" assets, the plan sponsor is not subject to the condition described in paragraph (c)(5)(ii) of the regulation for a 90-day period following the effective date of the regulation (or the date the balanced fund becomes a QDIA). Of course, consistent with paragraph (c)(5)(iii) of the regulation, assets invested in the QDIA cannot be subject to any restrictions, fees, or expenses that are not otherwise applicable to participants and beneficiaries who elected to invest in the QDIA.

However, if a new participant is enrolled in the plan on or after the effective date of the QDIA regulation, the restriction in paragraph (c)(5)(ii) of the final regulation will apply with respect to the first elective contribution or other investment that is made into the balanced fund QDIA on behalf of that participant.

Q-13. Is a QDIA prohibited from including any "round-trip" restriction for the first ninety days?

No. The Department has concluded that the reference in the preamble to the QDIA regulation to "round-trip" restrictions was too broad and should not have been included as an example of an impermissible restriction. As stated in the preamble to the technical corrections to the regulation, "round-trip" restrictions, unlike fees and expenses assessed directly upon liquidation of, or transfer from, an investment, generally affect only a participant's ability to reinvest in the qualified default investment alternative for a limited period of time. This is not a restriction prohibited by paragraph (c)(5)(ii) of the final regulation. However, to the extent that a "round-trip" restriction would affect a participant's or beneficiary's ability to liquidate or transfer from a qualified default investment alternative or restrict a participant's or beneficiary's ability to invest in any other investment alternative available under the plan, it would be impermissible for purposes of paragraph (c)(5)(ii) of the QDIA regulation.

QDIAs – Management and Asset Allocation

Q-14. Can an investment fund or product with zero fixed income (or, alternatively, zero equity) qualify as one of the permanent, long-term QDIAs described in paragraph (e)(4)(i) through (iii) of the final regulation?

No. Each of the QDIA categories described in paragraph (e)(4)(i) through (iii) of the QDIA regulation requires that the investment fund product, model portfolio, or investment management service be "diversified so as to minimize the risk of large losses" and be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures. In the preamble to the QDIA regulation, the Department explains that it did not intend to include funds, products, or services with no fixed income exposure. Although an investment option with no fixed income component may be appropriate for certain individuals actively directing their own investments, the Department determined that a QDIA should have some fixed income exposure. Similarly, a fund, product, or service with no equity exposure cannot qualify as a QDIA under paragraph (e)(4)(i) through (iii) of the QDIA regulation.

The regulation does not establish minimum fixed income or equity exposures necessary to satisfy the requirement for a mix within a QDIA. The Department continues to believe that such a determination is best left to the discretion of the entities described in paragraph (e)(3) of the QDIA regulation in assessing the appropriateness of a particular QDIA and, therefore, the Department does not plan to provide further guidance on the issue.

Q-15. The QDIA regulation, at § 2550.404c-5(c)(4), requires that defaulted participants be provided material in accordance with the regulations governing ERISA section 404(c) plans. Is the QDIA regulation intended to require that all of the referenced information be furnished automatically, without regard to whether some of the information for ERISA section 404(c) plans is required to be provided only upon request of a participant or beneficiary?

No. In response to comments, the Department explained in the preamble that it believed that defaulted participants should be furnished neither less nor more material than would be provided to participants who direct their own investments in an ERISA section 404(c) plan. The disclosure rules set forth in paragraph (c)(4) of § 2550.404c-5, therefore, are intended to operate in the same manner as under the section 404(c) regulations (29 CFR § 2550.404c-1). That is, for purposes of the QDIA regulation, defaulted participants are required to be automatically furnished, in the case of registered investment companies, the most recent prospectus or profile prospectus (see Advisory Opinion No. 2003-11A (September 8, 2003)) and furnished any material relating to voting, tender or similar rights provided to the plan. See 29 CFR § 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix). In addition, plans are required to furnish either automatically or upon request certain information concerning the plan's investment alternatives, such as annual operating expenses and the value of shares or units in the investment alternatives. See 29 CFR § 2550.404c-1(b)(2)(i)(B)(2).

Q-16. Can a plan sponsor use two different QDIAs, for example, one for its automatic contribution arrangement, but another for rollover contributions?
Yes. Nothing in the QDIA regulation limits the ability of a plan sponsor to use more than one QDIA, so long as all requirements of the regulation are satisfied with respect to each QDIA.

Q-17. In the case of an individual account plan sponsored by a single employer, can a committee that is established by a plan sponsor and that, pursuant to the documents and instruments governing the plan, is a named fiduciary of the plan be treated as managing a QDIA for purposes of paragraph (e)(3)(i)(C) of § 2550.404c-5?
Yes. In response to comments on the proposed regulation, paragraph (e)(3) of the final QDIA regulation was expanded to include a plan sponsor who is a named fiduciary of the plan in response to comments on the proposed regulation. The Department intended that this expansion would broadly accommodate employers that manage their plan investments in-house. However, the reference to "plan sponsor" in paragraph (e)(3)(i)(C) has raised questions as to whether a committee that is a named fiduciary of the plan and is comprised primarily of employees of the plan sponsor can manage a qualified default investment alternative when that committee, pursuant to plan documents, is a named fiduciary. To address this uncertainty, the Department has amended paragraph (e)(3)(i)(C) in the technical corrections to the QDIA regulation to make clear that such a committee of the plan sponsor may manage a qualified default investment alternative.

120-Day Capital Preservation QDIA
Q-18. Is the 120-day capital preservation QDIA, described in paragraph (e)(4)(iv) of § 2550.404c-5, available only for plans that include an EACA?
Yes. The 120-day capital preservation QDIA, described in paragraph (e)(4)(iv), permits investment in a capital preservation product for a 120-day period following a participant's first elective contribution (as determined under Code section 414(w)(2)(B)) to an eligible automatic contribution arrangement (EACA). This QDIA is intended to provide administrative flexibility to plans that satisfy the EACA requirements and allow employees to make permissible withdrawals in accordance with Code section 414(w)(1). Accordingly, a plan fiduciary that uses the 120-day capital preservation QDIA for the investment of assets other than assets contributed pursuant to an EACA will not obtain fiduciary relief under the regulation. For example, use of the 120-day capital preservation QDIA for a rollover from an IRA or other plan would not relieve a plan sponsor from liability under the QDIA regulation (unless the rollover was made during the 120-day period following a participant's first EACA contribution).

Q-19. Are plans required to provide a 120-day capital preservation QDIA?
No. A plan sponsor is not required to use any of the QDIAs described in the regulation for its plan, including the 120-day capital preservation QDIA. The 120-day capital preservation QDIA, described in paragraph (e)(4)(iv) of § 2550.404c-5, was included in the regulation to afford plan sponsors the flexibility of using a capital preservation investment alternative for the investment of contributions during the period of time when employees are most likely to opt out of plan participation.

Q-20. Can a plan sponsor manage the 120-day capital preservation QDIA?
Generally, no. The investment fund or product must be offered by a State or federally regulated financial institution as required in paragraph (e)(4)(iv)(A)(2) of the QDIA regulation.

Grandfather-Type Relief for Stable Value Funds

Q-21. Must a plan sponsor distribute a notice thirty days before the effective date of the QDIA regulation to obtain relief for prior contributions to a stable value fund or product?

No, but the relief provided by the QDIA regulation generally will not take effect until thirty days after the initial notice required by § 2550.404c-5(c)(3) is furnished to participants and beneficiaries. For example, if a plan sponsor distributes the initial notice on January 1, 2008 to participants and beneficiaries who were defaulted into a stable value fund prior to the effective date of the regulation, and assuming all other requirements of the regulation have been satisfied, the fiduciary relief provided by the regulation would be available to the plan sponsor on January 31, 2008 (i.e., thirty days later). Of course, regardless of the date on which fiduciary relief is available to the plan sponsor, the relief will extend only to assets that were invested in the stable value product or fund on or before the effective date of the final regulation.

Q-22. What types of stable value products or funds did the Department intend to include as QDIAs for purposes of the "grandfather"-type relief described in paragraph (e)(4)(v) of § 2550.404c-5?

Paragraph (e)(4)(v) of the QDIA regulation provides "grandfather"-type relief for assets invested in certain stable value products or funds prior to the effective date of the regulation. Following publication of the QDIA regulation, the Department determined that the description of stable value products and funds as set forth in paragraph (e)(4)(v) may limit the availability of the "grandfather"-type relief, contrary to the intention of the Department. Accordingly, to ensure broad application of this relief to stable value products and funds, the Department amended paragraph (e)(4)(v) of the QDIA regulation. As amended, paragraph (e)(4)(v)(A) provides that relief is available with respect to "an investment product or fund designed to preserve principal; provide a rate of return generally consistent with that earned on intermediate investment grade bonds; and provide liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives." Two additional conditions apply: no fees or surrender charges can be imposed in connection with withdrawals from the product or fund initiated by a participant or beneficiary, and the product or fund must invest primarily in investment products that are backed by State or federally regulated financial institutions. For example, the product or fund may be issued directly by a State or federal regulated financial institution. Alternatively, the principal and accrued interest on the product or fund may be backed by contracts issued by such institutions.

IRS – Notice 2008-32: Section 67 Limitations on Estates or Trusts for Bundled Investment Management and Advisory Costs

Background

On February 27, 2008 the IRS has issued interim guidance and requested comments on the treatment under IRC § 67 on investment advisory costs and other costs subject to the 2-percent floor under § 67(a) that are bundled as part of one commission or fee paid to the trustee or executor ("Bundled Fiduciary Fee") and are incurred by a trust other than a grantor trust or an estate.

On January 16, 2008, the Supreme Court of the United States issued its decision in *Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. ___, 128 S. Ct. 782 (2008), holding that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the 2-percent floor for miscellaneous itemized deductions under § 67(a). The IRS and the Treasury Department expect to issue final regulations under § 1.67-4 of the Income Tax Regulations consistent with the Supreme Court's holding in *Knight.* The final regulations also will address the issue raised when a nongrantor trust or estate pays a Bundled Fiduciary Fee for costs incurred in-house by the fiduciary, some of which are subject to the 2-percent floor and some of which are fully deductible without regard to the 2-percent floor. The final regulations, however, will not be issued prior to the due date for filing 2007 income tax returns, and will apply only prospectively. Accordingly, in light of the Supreme Court's decision in *Knight*, the IRS and the Treasury Department are providing interim guidance that specifically addresses the treatment of a Bundled Fiduciary Fee.

Interim Guidance

Taxpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2-percent floor under § 67 for any taxable year beginning before January 1, 2008. Instead, for each such taxable year, taxpayers may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2-percent floor. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee.

The IRS and the Treasury Department anticipate that final regulations under § 1.67-4 will be published without delay after the extended comment period granted in this Notice. The final regulations may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not. Any safe harbors in the final regulations for determining the allocation of a bundled fiduciary fee between costs subject to the 2-percent floor and those not subject to the 2-percent floor may be available for taxpayers to use for taxable years beginning on or after January 1, 2008.

Requests for Comments

Interested parties are invited to submit comments on this notice and § 1.67-4 of the proposed regulations published in the Federal Register of July 27, 2007 (2007-36 I.R.B. 551 [72 FR 41243-01]) by May 27, 2008.

The IRS and the Treasury Department are considering various modifications to § 1.67-4 of the proposed regulations that may include safe harbors for determining the allocation of a Bundled

Fiduciary Fee between costs subject to the 2-percent floor and those that are not. The IRS and the Treasury Department request comments on whether safe harbors would be helpful and request suggestions on how the safe harbors may be formulated. Comments are specifically requested on reasonable estimates of the percentage(s) of the total costs of administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor including, but not limited to, costs for investment management and advice. Comments are also requested on whether the safe harbors should reflect the nature or value of the assets in the nongrantor trust or estate, and/or the number of beneficiaries of the nongrantor trust or estate.

IRS – Private Letter Ruling 200811028: Preservation of the Stretch Individual Retirement Account

Background

In the IRS Private Letter Ruling 200811028 the IRS determined that a "stretch individual retirement account" which allows a designated Individual Retirement Account (IRA) beneficiary, the person named as a beneficiary on the IRA beneficiary form may extend distributions over his/her lifetime rather than over a shorter and less favorable payout period. Below is a recap of the Private Letter Ruling.

Summary

In this case, the IRA owner died in 2002 at age 66 before his required beginning date and before taking any distributions. His daughter was the sole named beneficiary on his two IRAs. In 2003, the year after her father's death (when RMDs would have had to begin), the daughter was 31 and her life expectancy for the stretch IRA was 52.4 years.

After inheriting the two IRAs, the daughter set them up as properly titled inherited IRAs in the name of the deceased IRA owner. She neglected to take her RMDs for 2003 and 2004 but in 2005 took RMDs for all three years (2003, 2004 and 2005) to make up for what she missed. She did not elect to use the five-year distribution rule and took the RMDs based on her life expectancy. In 2007, she paid the 50% penalty for the missed 2003 and 2004 RMDs.

The daughter requested this private-letter ruling from the IRS in order to know for sure if the fact that she neglected to take the 2003 and 2004 RMDs in a timely way would nullify the stretch IRA for her and force her to default to the five-year rule.

The IRS ruled in her favor, stating that missing RMDs do not cause the beneficiary to default to the five-year rule. The fact that the custodial agreements on both IRAs stated that the inherited IRA was to be paid out under the life expectancy method was helpful to her.

Although a private-letter ruling is authoritative only for the person who requested it, this ruling provides guidance on how the IRS would rule in similar cases, and there are probably many beneficiaries who forget or are unaware that they are subject to RMDs when they inherit an IRA. The favorable ruling made it clear that the stretch IRA is the default when there is a designated beneficiary.

The IRS also pointed out that the IRA custodial agreement for each of the IRAs required the life expectancy payout. This means that if the IRA custodial agreement had said that the five-year rule applied — even though the law clearly does not say that — it is likely that the beneficiary would be stuck with that rule. In addition, the 50% penalty will apply to all missed RMDs. The IRS will waive this penalty for reasonable cause.