

# Implementing a 401(k) Automatic Enrollment Arrangement

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## **PRACTICE AREAS**

Qualified Retirement Plans

## **STRATEGIES**

401(k) Plan Nondiscrimination  
Testing Solution

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Under most 401(k) plans, an eligible employee who does not make an affirmative election to defer salary under the plan has no contributions deducted from his or her paycheck - *i.e.*, the employee is deemed to have elected to make no contributions to the plan. ERISA permits another option, whereby an employee who does not make an affirmative election either to contribute or opt out is deemed to have elected to make a positive contribution of X % of compensation, with the default percentage established under the terms of the plan.

Recent changes in the law under the Pension Protection Act of 2006 and regulations issued thereunder have made this type of "automatic enrollment arrangement" easier to implement and more palatable to both employers and employees. Most importantly, the law and regulations provide safe harbor investment vehicles in which the plan can deposit automatic contributions with reduced risk of a fiduciary breach lawsuit under ERISA. The law and regulations also give employees the right to a minimum 30-day decision period during which an employee can opt-out of automatic contributions before they begin; plus, in most cases, a 90-day "second-chance" opt-out opportunity whereby an employee can cancel participation and get an immediate refund of any automatic contributions made through the effective date of the cancellation.

The primary decision points for adoption and implementation of such an arrangement are the following:

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1. Which employees will be subject to automatic enrollment: Any employee who does not have an affirmative election on file, or only new employees hired after the arrangement is first adopted?
2. What is the appropriate default contribution rate(s)?
3. Where should default contributions be invested until the employee exercises investment control?
4. What are the initial set-up and ongoing administrative costs?

### Which Employees to Cover

An employer can specify in the plan document which employees are subject to automatic enrollment. For example, the plan could cover all eligible employees or limit automatic enrollment to non-union employees, employees in particular divisions, or employees hired after a specified date, to give a few examples.

While the regulations provide this flexibility, in our experience the decision typically boils down to a choice between the following three coverage alternatives:

- **Option 1:** Include any employee who has not yet made an affirmative election to contribute a positive amount or zero.
  - This option is feasible only if the plan can distinguish between employees who never submitted a deferral election (and thus have a zero contribution rate by default) and employees who affirmatively elected zero.
  - The option has the benefit of not forcing non-contributing employees, who already signaled their decision not to contribute by submitting a deferral election of zero, to affirmatively opt out of the automatic enrollment program.
  - A potential down side is that in the first year, current employees whose failure to submit a deferral election may reflect a conscious decision *not* to make contributions will be forced to affirmatively opt-out of automatic enrollment if they do not wish to participate.
  - Another down side is that leaving current zero-electing employees out of the program will limit initial participation in automatic enrollment.
- **Option 2:** In the first year following adoption of automatic enrollment, include all eligible employees who are not making positive contributions; thereafter, include only new hires and employees who as of each January 1 have not yet made an affirmative election either to contribute or opt-out.
  - This option has the benefit that it initially extends eligibility for the automatic contribution arrangement to all employees who have not made an affirmative election to contribute a positive amount, even employees who previously elected to contribute zero. (Any employee can still opt-out.)

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- Then in future years, only employees who do not have an affirmative election on file (either to contribute a positive amount or zero) are bothered with the notice and opt-out requirements. Employees who have previously expressed their wishes are left alone - just as under option 1.
  - The down side of this alternative is that in the first year, current employees who may have made a conscious decision not to make contributions - either by not making a deferral election or affirmatively electing zero - will be forced to affirmatively opt-out of automatic enrollment if they do not wish to participate.
- 3. **Option 3:** Include only employees hired after adoption of the automatic enrollment option. Extend eligibility for automatic contributions upon hire and in each subsequent year in which the employee has not yet made an affirmative election to contribute a positive amount or zero.
- This option has the benefit of not forcing non-contributing current employees to affirmatively opt out of the automatic enrollment program.
  - The down side is that leaving current employees out of the program will severely limit initial participation in automatic enrollment.

#### Notice and Other Requirements

The regulations require that employees covered by an automatic contribution arrangement generally be given notice at least 30 days (and no more than 90 days) before the arrangement is first implemented, and then again at least 30 days before the beginning of each plan year. For new employees, the notice must be provided as soon as practicable (which can be after the employee has commenced employment, but before any automatic paycheck withholding would go into effect).

The notice need only be provided to employees who will be deemed to have made a contribution election if they do not make an affirmative election to participate or opt-out. After the first year, this generally would include any new employees and employees who did not have an affirmative deferral election on file with the plan.

Once notice is provided, an employee must be given a reasonable amount of time to make an affirmative election to select his or her preferred deferral rate or to opt out. Automatic paycheck withholding (for employees who fail to make an affirmative election) generally should not begin until about 30 days have passed from the notice date.

#### Default Contribution Rate

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The default contribution rate for employees who do not opt-out generally must be a uniform percentage of pay for all employees subject to automatic enrollment - *e.g.*, 3% of pay for all covered employees. However, plans are permitted to have different default rates for union vs. non-union employees, for different unions, and for different "qualified separate lines of business."

It is also permissible to have graduated rates - *e.g.*, 1% in the first year, 2% in the second year, 3% in the third year, etc., maxing out at 10% in the tenth year. Other variations are permitted as well, though certain "uniformity" standards apply.

#### Default Investment

An employee who neglects to affirmatively elect to make 401(k) contributions or opt out will likely not provide instructions as to how his automatic contributions will be invested within a plan. Accordingly, plans need to designate a default investment or investments. The regulations provide three "safe harbors" which, if utilized, generally shield plan fiduciaries from claims of fiduciary breach related to the performance of the investments.

Two of the safe harbors are not available under most plans and may be costly and/or controversial to implement. Safe harbor one is a so-called "life-cycle" or "target-date" fund. Another safe harbor is to offer professional management of each employee's account, the manager aiming for an optimal allocation for each participant's investments among the plan's various investment offerings based on factors such as age or target retirement.

The remaining safe harbor is a "balanced" fund. Many plans have a fund that may qualify for this safe harbor, though it requires close examination to be sure. One of the requirements for a safe harbor balanced fund is that the selected fund reflect "a target level of risk appropriate for participants of the plan as a whole," taking into account the demographics of the participant population, at a minimum. A plan's existing balanced fund offering would have to be analyzed to determine if it satisfies this standard.

Following the recent stock market collapse, some investment advisors and policy-makers have been critical of the three regulatory safe harbors. As a result, some plans have been considering default investment options that do not meet one of the safe harbors, such as money market or stable value funds. Although these options do not automatically shield plan fiduciaries from fiduciary risk, the potential exposure is likely quite low. A compromise position might be to use the plan's money market

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fund for the first 120 days of a participant's initial contribution under the automatic contribution arrangement, with assets shifting to the balanced fund thereafter. Indeed, the regulations provide a safe harbor for this structure.

Optional Design Features

More complex designs are permitted under the regulations, and some come with "rewards" in the form of relief from specific rules with which a 401(k) plan must comply. For example, if the default contribution rates meet the standards for a "qualified" automatic contribution arrangement, the plan is excused from annual ADP/ACP nondiscrimination testing (comparing average deferral rates for highly-paid and non-highly-paid employees). To qualify for this testing exclusion, the minimum automatic deferral percentage is 3% for the first full plan year and increases by 1% for each of the three succeeding plan years, up to 6%. Furthermore, the employer would be required to provide either matching or nondiscretionary contributions to all non-highly compensated employees. The minimum match is 100% of the first 1% deferred and 50% of the next 5% deferred, for a total contribution of 3.5% for participants who defer at least 6%. The minimum employer contribution (the alternative to the matching contributions described above) is 3%, regardless of the deferral amount. Matching or company contributions must be 100% vested after two years of service. This structure is more generous than currently provided under many plans.

Another available design option is to apply the automatic contribution feature to each employee every year - so that employees would have to either make a new affirmative deferral election each year or be subject to the applicable default contribution rate. The regulations would reward this design by giving the plan an extra 3 ½ months to refund any discriminatory deferrals made by highly-compensated employees during the year. Unless the plan frequently fails the ADP/ACP test, requiring refunds or other correction strategies, this hardly seems worth the inconvenience of requiring every employee to renew his or her contribution election each year or be defaulted into the plan at the automatic contribution rate.

Plan Amendment and Qualification

Ideally, an automatic contribution arrangement should be implemented as of the first day of a plan year - e.g., January 1, 2010. To encourage employers to adopt automatic contributions in 2010, the Treasury Department on September 5, 2009 released sample amendments to streamline the adoption and implementation process. If an employer uses the sample amendments, modified to the extent necessary

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to reflect plan-specific design choices, the amendment will be deemed to have received IRS approval even in the absence of a determination letter specifically addressing the amendment. See IRS Notice 2009-65.

If it is not feasible to implement automatic contributions by January 1, 2010, the regulations provide a roadmap for a mid-year implementation. The Treasury sample amendment can be used for mid-year implementations to the same extent as January 1 adoptions.

Administrative Costs

Initial set-up and ongoing administrative costs can be determined in consultation with the plan's administrators. Many 401(k) third-party administrators have already programmed their systems to accommodate automatic enrollment, which should reduce implementation costs significantly.