Spurgeon, Melissa - EBSA

From: Louis S. Harvey [LHarvey@DALBAR.com]
Sent: Tuesday, October 10, 2006 9:44 AM
To: EBSA, E-ORI - EBSA
Subject: Comments of omissions in proposed default investment regulation
Attachments: Comment Letter on DOL Default Investments.pdf

Attached is our comment letter that details four areas of concern in the proposed regulation.

These concerns arise from:
1) Failure to address default alternative at retirement
2) Absence of protection when employees make a conscious choice to use the default
3) Fiduciary exposure caused by undefined "calculated to be understood" in notices
4) Fiduciary adviser included in prudent selection requirement of default investment

Respectfully submitted.

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October 10, 2006

The Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N- 5669
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210

Attn: Default Investment Regulation

E-mail to e-ORI@dol.gov

Ladies and Gentlemen:

DALBAR appreciates the opportunity to submit comments regarding the proposed regulations regarding default investment alternatives under participant directed individual account plans.

DALBAR has analyzed and measured investor behavior, starting in 1994. The purpose of this work has been to focus attention on the causes and effect of imprudent investor actions or inactions with the goal of improving financial results for investors. Our work (Quantitative Analysis of Investor Behavior -www.QAIB.com) has been widely used by most major financial institutions and often quoted in the press. This work has led to DALBAR's evaluations and industry forums focused on effective communications and practices in participant directed defined contribution retirement plans. In 2004 DALBAR published the report "Quality versus Quantity" which was highly critical of the current ERISA regulations and industry practices.

The comments offered here reflect this deep understanding of the causes and effects of investor behavior.

In our opinion, the proposed regulations represent an enormous improvement in the effectiveness of ERISA to meet the defined goal of employee retirement income security. The Default Investment Alternatives present an approach that will eliminate the greatest hurdle to participant directed plans. This hurdle has been the difficulty that most employees (estimated at 70%) have in making investment choices. The Default Investment Alternative regulation as proposed would address this issue for a large proportion of employees that face this difficulty.

In our review of the proposed regulation, we have identified four areas that need additional attention, within the context of what has been proposed. These areas are described, the rationale provided and suggested amendments to the proposal offered.

The four areas needing attention are:

- ✓ Inappropriate default alternative at retirement
- ✓ Employees "electing" the default create exposure to plan sponsor
- ✓ The term "calculated to be understood" is a condition for protection but remains undefined.
- ✓ Fiduciary adviser is not explicitly protected when using default

Inappropriate Retirement Default

The proposed age based defaults address the accumulation of retirement assets but fails to include consideration for the critical pre-retirement employment stage. Employees that make no election are supported by the proposed regulation during working years but face an abrupt end to this support at the important decision of using those assets for retirement income.

The proposed regulation is seriously flawed since the age based defaults are inappropriate for an employee at retirement. The most important need at retirement is for long-term income and this is true whether the employee is retiring at 40 or at 80 years old.

Employees relying on the default will find that their retirement portfolio is very poorly structured to replace a paycheck for the rest of their lives.

The proposed alternative of using an average risk is equally inappropriate for the pre and post-retiree. The demographic of the employee base is not applicable to the employee that enters retirement.

The Pension Protection Act requires that the default arrangement address the contributions and earnings in the plan but the proposed regulation fails to address the needs of employees at retirement, the time when a default is most urgently needed.

The three proposed default alternatives should be amended to require an automatic switch into an appropriate post-retirement fund or portfolio at the time employees are retired.

We suggest the following amendment to correct this problem:

> Proposed Sec. 2550.404c-5(e) *sets forth five requirements for qualified default investments, which should be amended by adding a sixth:*
>
> > *(6) A qualified default investment alternative must include at least one investment product, portfolio or service that is designed to produce maximum income for the purpose of replacing employment income at retirement. Employees who have made no election must be automatically transferred into a maximum income investment product, portfolio or service upon retirement.*

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Employees Electing the Default

Based on the large number of employees that have difficulty with making investment choices, it can be expected that many employees that currently have investment elections will want to use the default investment. The Proposal does not address the implications for the plan sponsor of employees "electing" the default or removing existing elections. Clarification is needed as to whether the fiduciary protection for the default applies when employees make a conscious choice to use the default.

Plan sponsors remain exposed to the risk of employees who make a conscious choice to use the default.

We suggest the following amendment to correct this problem:

> *Proposed Sec. 2550.404c-5(a) contains the phrase "in the absence of an investment election by the participant,", which should be replaced by:*
>
> > *"in the absence of an investment selection or election of a default investment or removal or withdrawal of a previous election,"*

No Definition of "Calculated to Be Understood"

The Proposal leaves the question of what is "calculated to be understood" open to interpretation and litigation. There is no guidance provided as to what methods should be used to determine if a notice or disclosure has been "calculated to be understood".

This omission is particularly significant since the requirement is for the "average plan participant" and this average varies widely across employers. Can the notice "calculated to be understood" by employees of an investment firm also be used for academic institutions and for employees at a manufacturing plant?

Plan sponsors are exposed to litigation that could claim that no calculation was performed and therefore notice of default was inadequate.

We suggest the following amendment to correct this problem:

> *Proposed Sec. 2550.404c-5(d) contains the sentence "The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant and contain the following:", which should be replaced by:*
>
> > *"The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant. This notice must be tested for understanding by average participants and tests documented to provide evidence of understanding by typical participants in the plan or others that can reasonably be expected to have similar reading and comprehension skills. This notice shall contain the following:"*

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Fiduciary Adviser Protection

The Proposal is explicit about the protection provided to the plan sponsor and the fiduciary responsibility of the investment manager but is silent about the responsibility of the fiduciary adviser that is engaged to advise plan participants:

- ✓ Does the fiduciary adviser who directs employees into default investments have the same protection as the plan sponsor?
- ✓ If not, what control does the fiduciary adviser have in the selection of the default investment?

Fiduciary advisers are exposed to liability if they confirm that the default is appropriate for a participant. This creates a perverse disincentive to use the investment alternative that is most appropriate for the largest number of participants in the plan.

We suggest the following amendment to correct this problem:

> *Proposed Sec. 2550.404c-5(a)(1) contains the phrase "in order for a plan fiduciary to obtain the relief under this section", which should be replaced by:*
>
> > *"in order for a plan fiduciary or fiduciary adviser to obtain relief under this section"*
>
> *Proposed Sec. 2550.404c-5(b)(1) contains the phrase "fiduciary of an individual account plan", which should be replaced by:*
>
> > *"fiduciary of an individual account plan or fiduciary adviser"*
>
> *Proposed Sec. 2550.404c-5(b)(2) contains the phrase "Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA", which should be replaced by:*
>
> > *"Nothing in this section shall relieve a plan fiduciary from his or her duties under part 4 of title I of ERISA"*

Thank you for your consideration of these comments in developing the final regulations.

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President

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