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

*Re: Default Investment Alternatives Under Participant Directed Individual Account Plans*
*[RIN 1210-AB10]*

Ladies and Gentlemen:

The American Council of Life Insurers ("ACLI") appreciates the opportunity to comment on the regulation proposed by the Department of Labor (the "Department") regarding default investment alternatives under participant directed individual account plans. 71 Fed. Reg. 56806 (Sept. 27, 2006). Our members share the Department's view that encouraging employers to adopt individual account plans with automatic enrollment features can improve participation in retirement savings plans. Developing clear and workable rules for obtaining fiduciary relief in connection with selecting default investment alternatives will greatly further this goal. We commend the Department for its efforts to reach out to affected constituencies in its development of the proposed regulation and we look forward to continuing to work with you through finalizing the regulation. Nonetheless, we believe that the range of investment products eligible for treatment as qualified default investment alternatives ("QDIAs") should be expanded in several important respects, as described more fully below.

The ACLI represents three hundred seventy-seven (377) member companies accounting for 91 percent of the life insurance industry's total assets in the United States. In addition to life insurance and annuities, ACLI member companies offer pensions, including 401(k)s, long-term care insurance, disability income insurance and other retirement and financial protection products, as well as reinsurance. Life insurers are among the country's leaders in providing retirement security to American workers, providing a wide variety of group annuities and other products, both to achieve competitive returns while retirement savings are accumulating and to provide guaranteed income past retirement.

Group annuities, especially fixed annuities and other guaranteed insurance products, have been among the foremost investment products offered to pension plans subject to regulation under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Regrettably, under the Department's proposed regulation, questions have arisen regarding the permissibility of offering annuities and other guaranteed insurance products as default investment alternatives. Importantly, the failure to include guaranteed insurance products, such as fixed annuity contracts, annuities with a fixed component, guaranteed investment contracts ("GICs"), stable value funds and other guaranteed products (collectively referred to as "Guaranteed Products") in the list of products eligible for QDIA status is an unacceptable shortcoming in the proposed regulation that must be addressed. [1]

In addition, as described more fully below, we request confirmation of QDIA treatment of separate account investments offered in connection with an annuity contract under two specific circumstances. We ask the Department to confirm that a separate account that is either registered as an investment company or managed by a section 3(38) investment manager would be eligible for QDIA treatment. Secondly, we ask the Department to confirm that an unregistered separate account could qualify for QDIA treatment if it invests in a registered investment company regardless of whether it is managed by a section 3(38) manager.

## I. Guaranteed Products Should Be Qualified Default Investments

We believe that by excluding Guaranteed Products from the types of investments eligible for QDIA treatment, the Department has failed to take into account directions from Congress in enacting the Pension Protection Act and overlooked the many circumstances under which Guaranteed Products may constitute an appropriate and perhaps superior default investment alternative. See Pension Protection Act of 2006, Pub. L. 109-280 § 624(a) (the "PPA").

### A. The Use of Guaranteed Products as Default Investments is Prevalent

The use of Guaranteed Products as a default investment option is widespread. According to a survey of 1,900 defined contribution plan sponsors undertaken by Vanguard Center for Retirement Research, more than 81 percent of plans with default investment options selected a fixed income vehicle for default investments. The Department itself has recognized in numerous circumstances that the use of capital preservation funds will satisfy ERISA's fiduciary requirements where participants have not made an affirmative investment election. Specifically, the Department's regulations on automatic rollovers provide safe harbor relief in connection with cash outs of small account balances of terminated employees that are rolled over into an individual retirement account, which in turn is invested in a product designed to "preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity." 29 C.F.R. § 2550.404a-2. Similarly, the Department reiterated its favorable position on the use of capital preservation investment vehicles where plan sponsors seek to distribute missing participant account balances in defined contribution plan terminations and where a plan is terminated under the Department's abandoned plans program. See DOL Field Assistance Bulletin 2004-02 (Sept. 30, 2004); 29 C.F.R. § 2550.404a-3 (Safe Harbor for Distributions from Terminated Individual Account Plans).

[1] The term "Guaranteed Products" as used throughout this letter encompasses fixed annuity contracts as well as the fixed component of variable annuity contracts, GICs, stable value funds and other insurance products that provide a principal protection guarantee, or guaranteed income over time. "Guaranteed Products" is not intended to include other forms of "fixed income" investments that involve a risk of loss to principal, such as bond funds or money market investments.

### B. Proposed Regulation Creates a Negative Inference

Notwithstanding this favorable guidance regarding the use of Guaranteed Products, our members are concerned that the proposed regulation creates a negative inference regarding the permissibility of selecting Guaranteed Products as default investments. While we recognize that the Department acknowledged that capital preservation products may play a useful role as a component of a diversified portfolio, and that the selection of these products as a default option could be prudent under some circumstances; as a practical matter, the failure to grant Guaranteed Products QDIA treatment will dramatically reduce, and possibly eliminate, their use in defined contribution plans. See 71 Fed. Reg. at 56807. As confirmed in the proposed regulation, the majority of plans with a default investment option currently use a fixed income or stable value fund. Presumably, the plan sponsors of these plans determined, consistent with ERISA's fiduciary requirements, that these alternatives were the most appropriate default investments available. The Department appears to be suggesting that these decisions were imprudent, even when they were based on the advice of outside experts.

### C. Guaranteed Products Should Not Be Lumped Together with Money Market Funds

Our members are also troubled by a number of other aspects of the proposal. First, we are disappointed that the Department has "lumped" Guaranteed Products into the same category as money market funds in explaining their treatment under the Department's default investment proposal. In fact, Guaranteed Products have very different investment characteristics and risk and return features from money market funds. Historically, yields for Guaranteed Products have been substantially higher than those of money market funds and their performance relative to inflation has been superior to that of money market funds.[2] Guaranteed Products are also insulated from some of the market risks associated with money market funds, and they typically have lower expense structures than the products included in the proposed regulation's list of QDIA products. Importantly, in many cases where a Guaranteed Product imposes a fee or charge, it is because a risk has been assumed by the insurer, e.g., a principal guarantee that represents real value added to the plan's investment. Guaranteed Products are also unique in that they combine preservation of principal with relative liquidity – in many cases providing for guaranteed withdrawals at book value for participant-initiated withdrawals.

### D. The Statute Supports the QDIA Status of Guaranteed Products

As noted, we are surprised and frustrated that the Department failed to take into account the explicit language of the PPA, specifically directing the Department to issue regulations that address the "appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital

[2] In addition, the performance of stable value funds compares favorably with many balanced funds. Our members have developed data that compares the performance of stable value funds to other investment classes over the past 15 years, based on a composite of 25 stable value funds maintained by major financial institutions. Our data shows that an investment in stable value funds for the past 15 years would have performed within two percentage points of a typical balanced fund with a 70/30 split between equities and fixed income investments. And, if performance is compared over the last ten years and five years, respectively, the relative performance of stable value funds to such a balanced fund would fall within one percent at ten years and 8 basis points at five years, even though the risk profile is much lower for stable value funds. Moreover, over the last 15 years, the balanced fund would have experienced 18 quarters with negative returns, while a stable value fund would have provided guaranteed returns with no negative quarters.

appreciation, or a blend of both" (emphasis added).[3] PPA § 624. It is simply unfathomable that Congress intended the Department to categorically bar relief under section 404(c)(5) for default investments in Guaranteed Products. If Congress had deemed Guaranteed Products to be unworthy of QDIA status, Congress would have explicitly said so.

### E. The Proposed Regulation Should Be Structured As A Safe Harbor

Relief provided by the proposed regulation is conditioned on the exclusive use of one of three investment alternatives; this means that the only way to obtain fiduciary relief under section 404(c)(5) is by using one of these exclusive alternatives. The exclusionary approach taken by the Department directly contradicts its historical position with respect to the selection of plan investments generally. In particular, at the time the Department issued its "prudence" regulation, it stated "[T]he Department does not consider it appropriate to include in the regulation any list of investments, classes of investment, or investment techniques that might be permissible under the 'prudence' rule. No such list would be complete; moreover, the Department does not intend to create or suggest a 'legal list' of investments for plan fiduciaries." 44 Fed. Reg. 37255 (June 26, 1979) (Preamble to Final Investment Duties Regulation). Rather, the Department's prudence regulation makes clear that ERISA requires each plan investment decision to be made in light of the role the investment is intended to play within the plan's overall portfolio, based on an evaluation of the unique facts and circumstances of the plan, the investment and the relevant portion of the plan's portfolio. See 29 C.F.R. § 2550.404a-1.[4]

We believe that plan fiduciaries are in a better position to determine appropriate default investments than regulators. Accordingly, we urge the Department to reconsider the exclusionary approach set forth in the proposed regulation. In this regard, it is worth mentioning that where the Department has addressed the application of ERISA's fiduciary rules to specific investment strategies or asset classes in the past, it has frequently done so in the form of a safe harbor.[5]

### F. New Products Should Not Be Excluded From QDIA Status

We are concerned that the Department's regulation, if finalized as proposed, will stifle creativity in the development of investment products. The investment and insurance industries are highly competitive and dynamic, and new investment products are developed and refined every day. In particular, we draw the Department's attention to target retirement date or "life-cycle" funds, products designated as QDIAs under the proposed regulation. There is no question that these ingenious products will play an important role in a plan's diversified menu of investment options.

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[3] Further confirmation of this direction is found in the Technical Explanation of the Pension Protection Act which provides that the Department's default investment regulations must provide guidance on "asset classes which the Secretary considers consistent with long-term capital appreciation *or* long-term capital preservation (or both)" (emphasis added). Technical Explanation of H.R. 4, the Pension Protection Act, No. JCX-38-06, at 148 (Aug. 3, 2006).

[4] Moreover, the Department refuses to issue advisory opinions addressing the prudence of a specific proposed investment. ERISA Procedure 76-1, sec. 5.02(o), 41 Fed. Reg. 36281 (Aug. 27, 1976). ERISA does not permit the Department to place hard and fast limits on particular investment strategies that satisfy ERISA's fiduciary standards today any more than it did in 1979 when its prudence regulation was issued.

[5] See, e.g., Safe Harbor Regulation for Automatic Rollovers, 29 C.F.R. § 2550.404a-2; Field Assistance Bulletin 2004-02 (Sept. 30, 2004) (safe harbor treatment for the investment of missing participant account balances in investments designed to preserve principal).

As revolutionary as life-cycle and target retirement date funds are in today's market, there is no doubt that new products will be designed in the future that will provide a better solution for plan participants. For example, new forms of Guaranteed Products have recently been developed that enable participants to participate in an equity component while at the same time, protect against downside risk. Other products are designed to provide long-term appreciation with a guarantee of income payments starting at retirement, including a death benefit if the participant dies before retirement.

In this regard, we are concerned that the Department's approach favors only a few products currently available in the marketplace. Instead, the Department's selection and description of QDIA vehicles should be flexible and based on more general criteria rather than specific conditions. In this way, the regulation will not have the unintended consequence of stifling the creativity that could lead to the next generation of innovative retirement products.

### G. Guaranteed Products May be Appropriate Under Specific Circumstances

Finally, we note that not every default investor is a long-term investor, and the equity exposure inherent in the proposed QDIA investment alternatives could in fact harm investors who are defaulted in the short term.[6] Nor do we believe that every default investor would be willing to accept the amount of risk inherent in the Department's proposed QDIA vehicles. In this regard, we believe there are numerous circumstances under which Guaranteed Products may be an appropriate choice for the plan's default option, and that plan fiduciaries should have the freedom to consider their use.

#### 1. Plans With Predominantly Older or Younger Populations

For example, fiduciaries of plans with predominantly older populations may find a deferred annuity or other Guaranteed Product most appropriate. Similarly, Guaranteed Products may also be more appropriate for younger employees who tend to change jobs over short time frames, or in any industry where employee turnover is high and participants are likely to cash their savings out of the plan when they leave. In addition, they may be appropriate investments for certain short-term purposes, such as during enrollment or re-enrollment periods, until opt-out periods for participation expire, or during a service provider transition where the plan's investment options are changed. Under these circumstances and others, plan sponsors should be given the opportunity to select QDIAs appropriate to their circumstances and achieve relief in connection with those choices under ERISA section 404(c)(5).

#### 2. Guaranteed Products May Be Appropriate For A Select Group Within A Plan

Guaranteed Products may be an appropriate default investment for discrete participant groups *within one plan*. We believe that participants who are unlikely to provide investment instructions may differ demographically from those participants who exercise affirmative control over their account balances. For example, a 2001 study indicated that participants who are auto-enrolled are more likely to be lower compensated than plan

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[6] Our members have developed data showing that if an investor traded out of an S&P 500 index fund within a period of approximately 90 days going all the way back to 1950, the investor would have incurred a loss 35% of the time. This illustrates the high volatility to which short-term investors can be subject through equity investments. The Department's proposed QDIA vehicles, in effect, deny a plan sponsor the opportunity to pick an appropriate vehicle if it reasonably believes default investors will cash out of the plan in the short term.

participants who make affirmative investment elections.[7] In this regard, the Department's regulation permits the plan to consider the demographics of individual participants in selecting an appropriate default option (for example, in selecting an appropriate life-cycle fund for a particular participant and through a managed account). In addition, plan fiduciaries are permitted to consider the demographics of the plan's population as a whole in the context of selecting an appropriate balanced fund as a QDIA. Nowhere does the Department's proposal permit a fiduciary to consider the characteristics of those participants who are least likely to provide instructions where those participants, as a group, may differ significantly from the plan's population as a whole.

Final regulations should explicitly allow fiduciaries to consider the unique characteristics of this group in identifying an appropriate default investment option. In this regard, we note that the peer reviewers of the PENSIM model used by the Department to estimate the impacts of its regulatory action questioned many of the assumptions used by the model and some of the proposal's potential effects that were overlooked by the Department.[8] Specifically, one reviewer noted the Department's failure to take into account the risk aversion of lower income individuals who may make up a disproportionate number of default investors. Another commented on the lack of consideration of the degree to which new 401(k) contributions may be cashed out by default investors at separation. The inclusion of Guaranteed Products as a QDIA would address the concerns of plan fiduciaries who wish to take these factors into account in identifying an appropriate default investment. In its response to the peer reviews of the assessment underlying its proposed regulation, the Department stated that it would expand its examination of the risk of losses to lower-income individuals and provide a summary in its final regulatory impact analysis. As the Department does so, it should reconsider the exclusion of Guaranteed Products from the list of eligible QDIAs. For many plans, we believe that an investment option that is unlikely to decline in value may well be an appropriate default investment choice.

## II. Clarify the Treatment of Separate Accounts Offered Under Annuity Products

The proposed regulation does not address several important questions regarding the application of the regulation to plan investments in separate accounts through variable annuity contracts. In this regard, variable annuity contracts typically permit participants to invest in a variety of investment media through one or more separate accounts (or sub-accounts within a separate account). Typically, each separate account (or sub-account within a separate account) has a unique investment style. We request confirmation that a separate account, or a sub-account of a separate account, offered under an annuity contract could constitute a QDIA provided the conditions of the regulation are met. Specifically, we ask the Department to confirm that a separate account that qualifies as a balanced or "life-cycle" fund within the meaning of the Department's proposed regulation based on its underlying investments could qualify as a QDIA if (1) the account is managed by a section 3(38) investment manager, or (2) the account is registered as an investment company.

Another common structure under variable annuity contracts involves the investment of participant account balances in unregistered separate accounts (or sub-accounts) that, in turn, invest exclusively in shares of a registered investment company. In such a structure, the participant's account would technically hold units of a separate account rather than shares of an investment company, but the result of the investment would be the same as if

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[7] Madrian, Brigitte C. and Dennis F. Shea, (2001), "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics, vol. CXVI (November), pp. 1149-1187.

[8] We also are surprised by the rate of return assumptions used by the Department in its PENSIM model used to estimate the impact of its regulatory action. In particular, we note that the rate of return selected for large company stocks is based on equity performance over a 78-year period, a period that predates all stable value funds, all life-cycle funds, and even defined contribution plans. See 71 Fed. Reg. at 56817.

the participant's account were invested directly in the investment company. We ask for confirmation that QDIA status would be available to such an account regardless of whether it is managed by a section 3(38) investment manager if the account invests in a registered investment company that itself qualifies as a life-cycle or balanced fund.

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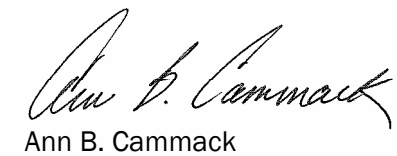
Thank you for the opportunity to provide our comments on this vital matter. We look forward to continuing to work with the Department on providing the guidance that will encourage more plan sponsors to adopt automatic enrollment features.

While we have focused our comments on the treatment of Guaranteed Products under the Department's regulation, we wish to endorse and lend our support to other comments that we understand will be filed with the Department. In particular, we understand that comments will be filed by the Stable Value Investment Association and the Committee of Annuity Insurers. In addition, we understand that the American Benefits Council will file comments requesting that the Department broaden the range of default investments that may give rise to preemption of state wage withholding laws under ERISA section 514(e). We urge the Department to carefully consider the concerns raised in these comments.

In addition, we respectfully request a public hearing to discuss the significant concerns of our members.

Please do not hesitate to contact us if you would like to discuss any of our suggestions in more detail.

Respectfully submitted,



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