THE
ERISA
INDUSTRY
COMMITTEE

November 13, 2006

By Hand

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

Attn.: Default Investment Regulation

Ladies and Gentlemen:

We are pleased to submit the enclosed comments of The ERISA Industry Committee ("ERIC")[1] on the proposed regulation regarding default investment alternatives under participant-directed individual account plans.

If you have any questions about our comments, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: See following page

[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and compensation plans of America's largest employers. ERIC's members provide comprehensive benefits to tens of millions of active and retired workers and their families and beneficiaries. ERIC's members' plans are the benchmarks against which industry, third-party providers, consultants, and policy makers measure the design and effectiveness of employee benefit, incentive, and compensation plans. ERIC's members are engaged daily with meeting the demands of both their enterprise and the needs of employees while dealing with an increasingly complex web of benefit and compensation laws. ERIC, therefore, is vitally concerned with proposals affecting its members' ability to provide employee benefits, incentive, and compensation plans, their costs and effectiveness, and the role of those plans in the American economy.

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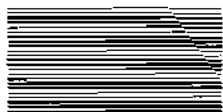

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SUBMISSION OF THE ERISA INDUSTRY COMMITTEE TO THE EMPLOYEE BENEFITS SECURITY ADMINISTRATION U.S. DEPARTMENT OF LABOR

COMMENTS ON THE PROPOSED REGULATION ON DEFAULT INVESTMENT ALTERNATIVES

November 13, 2006

The ERISA Industry Committee ("ERIC")[1] is pleased to submit its comments on the Department's proposed regulation on default investment alternatives under participant-directed individual account plans. In general, the proposed regulation provides that if a participant[2] in a participant-directed individual account plan does not submit an investment direction, the participant will be treated as having exercised control over the assets allocated to the participant's account if the plan invests those assets in a qualified default investment alternative (a "QDIA") and meets other requirements set forth in the regulation.

ERIC applauds the Department's issuance of this important regulation so promptly, only six weeks after the enactment of the Pension Protection Act of

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[2] Except where otherwise indicated, "participant" refers not only to a plan participant, but also to a beneficiary of a deceased participant and to an alternate payee who has an interest in a participant's account as a result of a qualified domestic relations order (a "QDRO").

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2006 (the "PPA"). ERIC looks forward to working with the Department to address the concerns identified in this submission.

The proposed regulation would implement § 404(c)(5) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which was added to ERISA by § 624(a) of the PPA. Section 404(c)(5)(A) provides that a participant in an individual account plan will be treated as exercising control over the assets in his or her account if (1) the participant does not submit an investment direction under the plan, (2) the plan meets the notice requirements in § 404(c)(5)(B), and (3) the plan invests the participant's account balance in accordance with regulations issued by the Secretary of Labor ("default investments"). Section 404(c)(5)(A) requires the regulations to provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with (i) capital preservation, (ii) long-term capital appreciation, or (iii) a blend of both capital preservation and long-term capital appreciation.

A plan meets the notice requirements under § 404(c)(5)(B) if (1) each participant receives, within a reasonable time before each plan year, a notice explaining (a) the participant's right to designate how contributions and earnings will be invested and (b) how contributions and earnings will be invested if the participant does not make such a designation (the default investment) and (2) the plan gives each participant a reasonable period of time, after receiving the notice and before the beginning of the plan year, to make such a designation. In addition, the notice must meet the requirements of Internal Revenue Code § 401(k)(12)(D) regarding the accuracy, comprehensiveness and understandability of the notice.

The proposed regulation was published in the Federal Register on September 27, 2006. *See* 71 Fed. Reg. 56,806. The preamble states that comments on the proposed regulation should be received by the Department by November 13, 2006. Because of the relatively brief comment period, ERIC prepared this submission with dispatch. ERIC reserves the right to submit additional comments as its members have more time to study the proposed regulation.

ERIC's Interest in the Proposed Regulation

All of ERIC's members sponsor individual account plans, including both relatively small plans, usually sponsored by members' subsidiaries, and some of the largest individual account plans in the country, covering tens of thousands of employees and beneficiaries. Because the great majority of these plans make each participant responsible for directing how all or part of the participant's account balance will be allocated among the plan's investment options, the regulation will, in one way or another, affect the great of the individual account plans sponsored by ERIC's members. The regulation will affect the following plan features and transactions, among others:

- **Automatic Enrollment:** A participant-directed plan with an automatic enrollment feature that (1) automatically enrolls eligible employees unless the

employee opts out and (2) specifies how an employee's account balance will be invested if an automatically enrolled employee fails to submit investment instructions.

- **Incomplete Enrollment Form:** A participant-directed plan that (1) allows an eligible employee to participate only if the employee affirmatively enrolls in the plan and (2) specifies how an eligible employee's account balance will be invested if the employee enrolls in the plan, but fails to submit investment instructions. (Some plans do not allow an employee to enroll without submitting investment instructions.)

- **Rollovers/Transfers:** A plan that (1) accepts rollovers and/or transfers from other plans and (2) specifies how the rolled over or transferred amount will be invested if a participant makes a rollover or transfer to the plan, but fails to submit investment instructions. (Some plans do not accept rollovers and transfers unless the participant submits investment instructions.)

- **Removal of Investment Option:** A participant-directed plan that (1) eliminates one or more of its investment options and (2) specifies how the affected portion of a participant's account balance will be invested if the participant fails to submit investment instructions.

- **Beneficiaries/Alternate Payees:** A plan that specifies how a beneficiary's or alternate payee's account balance will be invested if (1) the beneficiary or alternate payee acquires an interest in a participant's account as a result of the participant's death or the entry of a QDRO and (2) the beneficiary or alternate payee (or the domestic relations order) does not submit investment instructions.

- **Disputes:** A plan that specifies how a participant's account balance will be invested if there is a dispute over the account (for example, a dispute between the would-be beneficiaries of a deceased participant or a dispute between a participant and the participant's current or former spouse in connection with a domestic relations proceeding).

- **Missing Persons:** A plan that specifies how an account balance will be invested if the relevant participant, beneficiary, or alternate payee cannot be located.

The regulation is likely to have its most pronounced effect on plans with automatic enrollment features. Automatic enrollment operates on the basis of a presumption that is the opposite of the presumption currently applied by most contributory plans. Today, under most contributory plans, an eligible employee is *not* enrolled in the plan until and unless the employee affirmatively elects to participate.

By contrast, a plan with an automatic enrollment feature admits eligible employees automatically unless they opt out and informs them that they must opt out by a specified date if they do not wish to participate in the plan. ERIC's members' experience with automatic enrollment confirms that an automatic enrollment feature can significantly increase plan participation and thereby increase employees' retirement savings.

Some employers have had concerns about automatic enrollment. Some have been concerned that automatic enrollment could expose plan fiduciaries to potential liability under ERISA based on the investment decisions that the fiduciaries make on behalf of automatically-enrolled participants who fail to submit investment directions. Some employers also have been concerned that automatic enrollment might violate the anti-garnishment laws of those States that make it a crime for an employer to withhold from an employee's pay without the employee's written consent. Because ERISA's broad preemption provision does not apply to any generally applicable criminal law of a State, some employers have been concerned that ERISA might not preempt the laws in some States.

Section 404(c)(5) and the Department's regulation have the potential to alleviate very substantially the concern regarding ERISA liability. If a plan satisfies all of the requirements prescribed by the statute and the regulation, no person who is otherwise a fiduciary will be liable under ERISA for any loss or by reason of any breach that is the direct and necessary result of (1) investing all or part of the participant's account in a QDIA or (2) investment decisions made by the manager of the QDIA.

Section 902(f) of the PPA amended ERISA's preemption provision to make clear that ERISA preempts any State law that would prohibit certain automatic enrollment arrangements. The Department's proposed regulation, however, does not address the subject of preemption -- even though the principal impact of the proposed regulation will be on automatic enrollment arrangements. We strongly urge the Department to confirm promptly -- if not in this regulation, then in other authoritative guidance -- that ERISA preempts State laws that purport to prohibit automatic enrollment arrangements under ERISA-governed plans.

ERIC's members have a vital interest in assuring that the regulation achieves its objectives in a way that is consistent with effective and efficient plan administration and communication. ERIC looks forward to working constructively with the Department to attain that goal.

Comments

A. Applicability of the Regulation

1. *Broad Application:* The regulation should be clarified to state that it applies not only to automatic enrollment features, but also to other arrangements that allow a plan participant to direct the investment of all or part of the participant's account balance. See, for example, the plan features and

transactions identified on pages 2 and 3, above. Although footnote 5 in the preamble to the proposed regulation recognizes the broad application of the regulation, the Department should address this point in the text of the regulation itself, since a footnote in a preamble does not carry the same weight as a regulation.

2. *Participant Directions:* The regulation should be clarified to provide that, for purposes of § 404(c)(5) and § 2550.404c-5(c)(2), a participant will be considered to have directed the investment of the assets in his or her account only if and to the extent that the participant gives such a direction in accordance with the plan's requirements regarding such matters as the timing and form of investment directions.

3. *Transactional Approach:* The regulation should make clear that § 404(c)(5) and the regulation apply on a transactional basis (rather than on an all-or-nothing basis) so that a plan will not fail to satisfy the requirements of § 404(c)(5) with respect to *all* participants merely because it fails to meet those requirements with respect to *some* participants (for example, because the plan fails to satisfy the QDIA or investment transfer requirements (§§ 2550.404c-5(c)(1) & -5(c)(5)) with respect to some participants but not others).

B. Definition of "Qualified Default Investment Alternative"

1. *Multiple QDIAs:* The regulation should make clear that a plan may have more than one QDIA (for example, one for employees age 20 - 30, another for employees age 30-40, and so on). Although the regulation's reference to "life-cycle" and "targeted-retirement date" funds strongly suggests that this is what the drafters intended, the regulation otherwise refers to a QDIA in the singular -- raising the question whether a plan may have more than one QDIA. *See, e.g.,* § 2550.404c-5(c)(1) (requiring assets to be invested in a QDIA).

2. *Fund of Funds:* The regulation should allow a QDIA to consist of funds that are comprised of several funds designated by a plan fiduciary (which may be affiliated with the plan sponsor) if each of the constituent funds meets the requirements of § 2550.404c-5(e)(3), so that each constituent fund is either managed by an investment manager (as defined by ERISA § 3(38)) or a mutual fund registered under the Investment Company Act of 1940.

3. *Multi-Manager Fund:* The regulation should allow a QDIA to be a single fund that is managed by a number of investment managers (as defined by ERISA § 3(38)), where a plan fiduciary (which may be affiliated with the plan sponsor) (a) appoints each investment manager, (b) specifies the percentage of the fund's assets allocated to each manager, (c) designates the investment guidelines that apply to each manager (e.g., investments limited to domestic or international equities or to domestic or international bonds), (d) reviews the

performance of each manager and the fund as a whole, and (e) has the right to terminate each manager and to change each manager's investment objectives.

4. *Fund Managers:* The regulation should not provide that mutual funds and funds managed by investment managers are the *only* funds that can qualify as QDIAs. The regulation should permit a QDIA to be managed by (a) the plan's trustee or (b) a named fiduciary, such as an investment committee whose members are employed by the plan sponsor. ERISA *presumes* that the plan's trustee is responsible for managing the plan's assets, but allows a plan to provide for management by either an investment manager or a named fiduciary. *See* ERISA § 403(a). Moreover, unlike the manager of a mutual fund, the trustee or named fiduciary is subject to ERISA's standards of fiduciary responsibility with respect to the assets that it manages. Many plan sponsors have found that their in-house investment managers perform just as well as, or better than, outside managers *and* at a lower cost. The categorical prohibition against appointing either the plan's trustee or named fiduciary to manage the plan's QDIA is unwarranted and should be withdrawn.

5. *Stable Value Funds:* The regulation should allow a money market fund or a stable value fund to serve as a QDIA. Depending on the characteristics of the employees who are eligible to participate in the plan, a money market or stable value fund might be well-suited to serve as the plan's QDIA. For example, if the eligible employees consist primarily or exclusively of older employees, employees with a high turnover rate, or employees covered by another defined contribution plan with a pronounced equity orientation, a money market or stable value fund might be the most appropriate fund to serve as the plan's QDIA.

6. *Factors Other Than Age:* The regulation should state that a plan or investment manager may take into account factors other than the employee's age in designating the applicable QDIA or in managing the employee's account in a managed fund. *See* §§ 2550.404c-5(e)(5)(i) & (iii). Other relevant factors might include the employee's accrued benefit under a defined benefit pension plan, the employee's investments in employer stock (either outside or inside the plan), or the employee's other investments outside the plan. Although the plan or investment manager might not have access to such information in many cases, the regulation should clarify that, to the extent such information is available, it is permissible (but not mandatory) to take such information into account.

7. *Redemption Fees:* The regulation should expressly provide that a redemption fee imposed by a mutual fund on short-term traders will not cause a plan to violate the requirement in §§ 2550.404c-5(c)(5) and -5(e)(2) that participants be permitted to transfer their investments in a QDIA to any other investment option without financial penalty. Short-term trading by even a small group of investors can distort a fund's investment decisions, inflate its trading costs,

and harm the vast majority of fund investors. By discouraging short-term trading, redemption fees can benefit the vast majority of plan participants and other fund investors. Sections 2550.404c-5(c)(5) and -5(c)(2) should apply only to any financial penalties that the plan itself imposes.

8. *Three-Month Period:* The regulation should clarify that a plan may measure the three-month period referred to in § 2550.404c-5(c)(5) in any reasonable manner so that, for example, a plan may allow a participant to direct a transfer from a QDIA once in each calendar quarter, once in each plan-year quarter, or once in any other three-month period specified by the plan and that a plan may either designate the transfer date within each designated three-month period or allow each participant to choose the date within each three-month period when he or she will direct a transfer. *Cf.* 29 C.F.R. § 2550.404c-1(f)(*2*), (*3*).

9. *Amount to be Transferred:* The regulation should clarify that the amount eligible for transfer in accordance with § 2550.404c-5(c)(5) is not simply the "assets invested" in the QDIA (as the proposed regulation requires), but the value of the assets so invested, *adjusted to reflect investment performance and reduced by any plan administration expenses allocated to those assets.*

10. *Employer Stock:* In general, the proposed regulation bars a QDIA (other than an investment management service) from holding, and from permitting the acquisition of, employer stock unless the employer stock is held or acquired by a mutual fund or similar pooled investment vehicle and the investment in employer stock is made in accordance with the investment vehicle's stated investment objectives and independent of the plan sponsor. *See* § 2550.404c-5(e)(1). The Department should modify the regulation (a) by adding a 10% rule and (b) by making the restriction on the fund's holdings of employer stock solely an *operational* limit, rather than *both an operational limit and a formal limit*:

    - The regulation should allow a QDIA that is managed by an investment manager who is not affiliated with the plan sponsor to hold employer stock as long as (i) the stock is a "qualifying employer security" (within the meaning of ERISA § 407(d)(5)) and (ii) immediately after any acquisition of employer stock by the fund, the value of the employer stock held by the fund does not exceed 10% of the value of the fund's assets (*cf.* ERISA § 407(a)(2)); and

    - The Department should delete the bar against investment funds that "permit" the holding of employer stock, which will create an unnecessary technical trap; the fund should simply be required to comply, in operation, with whatever restriction the regulation imposes on the fund's holdings of employer stock.

11. *Index Funds:* The regulation should allow an index fund to serve as a QDIA or as the equity portion of an index fund, regardless of the identity of the fund manger. *Cf.* Comments B.2, B.3 and B.4, above.

C. Notice Requirements

1. *30-Day Rule*: The 30-day rule should be modified to accommodate newly hired employees (under a plan with immediate or accelerated eligibility), transferred employees (where a job transfer causes an ineligible employee to become eligible to participate in the plan immediately), beneficiaries, and alternate payees. In such circumstances, it will not be possible for the plan to give 30 days' advance notice of the first investment in the QDIA. The Department should consider requiring the plan in such circumstances to provide the notice as soon as reasonably practical and to allow the affected individual to transfer the then-current value of his or her investment out of the QDIA on any business day within the 30-day period following receipt of the notice.

2. *Website:* The regulation should allow the annual notice required by § 2550.404c-5(c)(3) to be made available on the plan's website, provided that the plan notifies each affected participant annually (electronically or otherwise) that the notice is there..

D. Preemption

1. *Guidance:* The Department should make clear promptly -- if not in this regulation, then in other authoritative guidance -- that ERISA preempts state anti-garnishment laws (criminal as well as civil) to the extent they relate to amounts withheld from employees' compensation to fund ERISA-governed employee benefit plans, regardless of whether the arrangement is described by ERISA§ 514(e). The PPA's addition of § 514(e) to ERISA illustrates -- but does not limit -- the application of ERISA's preemption provision. *See* PPA § 902(f).

2. *Investments:* ERISA § 514(e) applies only to "automatic contribution arrangements," which are defined by § 514(e)(2) as arrangements under which, among other things, contributions are invested in accordance with the regulations under § 404(c)(5). The Department should make clear that this requirement does not apply to a plan with no assets to invest, such as an insured heath plan under which employees' share of the premiums are withheld from their pay on a pay-as-you-go basis.

E. Review of Fund Performance

1. *Periodic Review.* Proposed § 2550.404c-5(b)(2) should refer to a fiduciary's duty to "periodically review the performance of" a QDIA, rather than the duty

to "monitor" a QDIA. The term "monitor" could be interpreted to mean that the appointing fiduciary must continuously look over the shoulder of the fund manager -- which would be wholly impractical and so intrusive that it would probably be counter-productive even if it were practical. By contrast, "periodically review" implies that the fiduciary should review the manager's performance at reasonable and appropriate intervals, without being obligated to look over the fund manager's shoulder continuously. *See* 29 C.F.R. § 2509.75-8 at FR-17 ("At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary . . ."). The Department has used the two expressions interchangeably. *See, e.g.*, Amended Brief of the Secretary of Labor as Amicus Curiae Opposing the Motion to Dismiss, *Tittle v. Enron Corp.* at 8-12 (Aug. 30, 2002). We urge the Department to eliminate any confusion by stating that although a fiduciary's obligation to review the performance of an appointee has been articulated in a number of different ways, FR-17 of § 2509.75-8 (quoted above) sets the legal standard.

F. Pre-Existing Default Arrangements

1. *Pre-Existing Default Arrangements Involving QDIAs:* The Department should clarify how the regulation applies to pre-existing default investment arrangements. In the preamble, the Department observed that the notice requirement -- that notice be given before the first investment in a QDIA -- was not intended to foreclose the availability of relief under § 404(c)(5) for fiduciaries that had previously invested in a default fund that qualifies as a QDIA. In the preamble to the proposed regulation, the Department states that, in these circumstances, the phrase "in advance of the first such investment" means the first investment for which § 404(c)(5) relief is intended to apply *after* the effective date of the regulation (60 days after the final regulation is issued). *See* 71 Fed. Reg. at 56,808. This point should be made in the regulation itself rather than in the preamble.

2. *Pre-Existing Default Arrangements with Funds That Are Not QDIAs:* In the past, some employers have established default investment arrangements that will not qualify as QDIAs. The Department should clarify how such arrangements can qualify for § 404(c)(5) protection after the final regulation becomes effective. In our view, the plan sponsor can eliminate the prior default investment arrangement, designate a different fund as the QDIA, give

the affected employees a § 404(c)(5) notice, and receive the benefit of § 404(c)(5) protection on a prospective basis. *See* 71 Fed. Reg. 56,806 at n. 5.

We very much appreciate the opportunity to submit these comments. The proposed regulation was a good start, and we look forward to working with the Department to make the final regulation even better.

THE ERISA INDUSTRY COMMITTEE