AMERICAN BENEFITS
COUNCIL

December 4, 2007

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

Re: Follow-Up Guidance on Final Default Investment Regulations

Dear Mr. Doyle:

The American Benefits Council (Council) is writing to suggest items for inclusion in the follow-up guidance that we understand the Department of Labor (Department) is developing in connection with the recently-issued final regulations on default investment alternatives under participant-directed individual account plans. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

We would like to start by applauding the Department for all of its hard work in developing the final regulations. We appreciate that the issue of default investments raised numerous issues and that many of these issues were challenging. As with any complicated and important regulation, there are inevitably unresolved issues and ambiguities, and we strongly support the Department's plan to issue follow-up guidance that addresses these issues. To that end, we have a number of suggestions for clarifying the regulations that are discussed below.

Transition

The Council understands that the final regulations provide relief for amounts that were invested in a default fund prior to the December 24, 2007 effective date of the regulations if the default fund satisfies the final regulations. As a result, for example,

the fiduciaries of a plan that currently uses a target retirement date fund as its default investment will be eligible for the relief in the final regulations as of the first date the plan satisfies the regulations. Similarly, for example, the fiduciaries of a plan that previously used a stable value fund that otherwise meets the grandfather requirements in the regulations but was closed to new default contributions prior to December 24, 2007 will be eligible for the fiduciary relief in the final regulations as of the first date the plan satisfies all of the requirements in the regulations.

It would, however, be helpful if the follow-up guidance expressly stated that pre-existing default funds are eligible for the fiduciary relief in the regulations for investment gains or losses on or after the date the fund satisfies the regulations' requirements, regardless of whether that satisfaction is as of December 24, 2007. In this regard, many plans will not have provided the requisite notices on November 24, 2007 – 30 days prior to the December 24 effective date. The fiduciaries of these plans will therefore have a period of time before they are entitled to the fiduciary relief in the regulations. It would also be beneficial if the Department clearly stated that the plan's fiduciaries are entitled to fiduciary relief on the date that all of the requirements are satisfied with respect to pre-existing default funds, even if there is a gap after December 24. Further, it would be appropriate if the guidance indicated that such a gap will not adversely affect the grandfather for stable value funds.

Prohibition Against Financial Penalties

The final regulations include a prohibition against "any restrictions, fees or expenses" resulting from the participant's election to make a transfer or withdrawal during the 90-day period beginning on the date of such participant's first investment in the qualified default investment alternative. For existing default funds, the regulations could be read to suggest that the special 90-day period needs to be made available to defaulted participants beginning on the date the fund is first a qualified default investment alternative, which is generally the date beginning 30 days after notice is provided. As a result, for example, the regulations could be read to suggest that a long-standing default needs to offer previously-defaulted participants a special 90-day window. This special window would be very cumbersome for existing defaults, particularly because these plans will almost invariably have provided significant notice to participants regarding their rights. The Council urges the Department to state in the follow-up guidance that this requirement does not apply to existing default funds that are otherwise eligible for fiduciary relief.

The special prohibition against financial penalties raises a number of other issues. One particular issue of importance is the extent to which certain restrictions that are intended to preclude market timing are impermissible financial penalties on sale. In particular, many otherwise-qualified default funds impose "round-trip restrictions" that prevent a participant from repurchasing the fund within a stated period following the sale of the fund, *e.g.*, 60 days. The preamble seems to suggest that round-trip

restrictions are not permitted notwithstanding that these restrictions are very common, serve an important public policy purpose and have a very indirect impact on participants. We urge the Department to clarify that round-trip restrictions of limited duration, *e.g.*, of less than 120 days, are permissible. Any other reading would greatly limit the universe of funds that may be qualified default investment alternatives and could even create an incentive for funds to drop these market timing restrictions, which benefit the overwhelming majority of investors and plan participants.

A related issue that is not addressed in either the preamble or the text of the final regulations is the status of equity wash restrictions, which are very common in stable value funds. These restrictions typically preclude a participant that sells a stable value fund and moves to a money market fund from repurchasing the stable value fund within a specified period of time. The Council believes that this type of attenuated restriction on sale is not the type of restriction that is prohibited under the final regulations. However, it would be helpful if the follow-up guidance clarified this point.

A further issue deals with the status of financial penalties for default funds other than registered investment companies, such as pooled separate accounts or funds that are constructed out of the plan's basic investment menu. It is not uncommon for the investments underlying these default funds to have restrictions or fees that would otherwise run afoul of the 90-day prohibition on financial penalties. For example, a pooled separate account may invest in a mutual fund that has a redemption fee or a "fund of funds" may invest in a fund that is otherwise restricted. It seems clear that the 90-day financial penalty rule applies to the fund itself and not to its underlying investments. However, the regulations are silent on this point and a simple clarification would be welcome.

Stable Value Grandfather

We also urge the Department to clarify that the grandfather for stable value funds is available to the full range of these funds. In particular, it would be very helpful if the Department confirmed that the grandfather is available without regard to whether the stable value fund itself provides a guarantee of principal and return or whether it invests in contracts that provide the requisite guarantee. Similarly, it would be appropriate to clarify that the grandfather applies without regard to whether the wrap or investment contract is issued by a bank or an insurance company. There is no substantive reason to distinguish between funds that hold wraps and guaranteed investment contracts and other stable value funds that directly provide a guarantee. Similarly, there is no reason to distinguish between bank contracts and bank-issued wraps and insurance company contracts and wraps.

It would also be helpful if the Department confirmed that the requirement that the fund provide a rate of return generally consistent with investment grade intermediate corporate bonds is to be understood broadly. In this regard, a stable value

fund may hold some cash for liquidity purposes, and the rate of return over time may vary from intermediate corporate bonds. Similarly, there is no precise standard that governs the median duration of the bonds that a stable value fund invests in, and it is important that the Department accommodate all variations.

<u>120-Day Short-Term Capital Preservation Funds</u>

The final regulations include a new approach to qualified default investments, which allows a plan to "park" default investments in a capital preservation fund for up to 120 days. Following the end of this period, the default investments need to be moved to another type of qualified default. The preamble includes an extensive discussion of how this option is intended to coordinate with the new "unwind" distribution under section 414(w) of the Internal Revenue Code of 1986. In addition, the 120-day period is determined based on the date of the first contribution as determined under section 414(w). Some have wondered whether this means that the 120-day capital preservation default depends on the plan offering the unwind distribution option under section 414(w). We believe that the unwind right is not part of the 120-day capital preservation default. It is important, however, to confirm this point because the unwind distribution under section 414(w) is very complicated and many plans may be loathe to make this available to participants.

Another issue is whether the 120-day capital preservation default is somehow limited to the context of automatic enrollment, as some have suggested. On the face of the regulations, the 120-day capital preservation option appears to be available to the full range of default investments, including the elimination of an investment option or a change in investment providers. Moreover, the underlying logic of the 120-day capital preservation default applies in these contexts. The fundamental notion is that some participants will exercise affirmative control over their accounts shortly after a default investment. However, if a participant does not do so shortly after the default investment, then they are unlikely to do so for the foreseeable future. We appreciate the Department's reasoning and we believe that it applies to all default investments. Accordingly, we urge the Department to confirm that the 120-day capital preservation default is not limited to automatic enrollment arrangements.

<u>Managed Accounts</u>

The preamble to the final regulations indicates that its fiduciary relief is available with respect to a portion of the participant's account. For example, if a plan matches employee contributions with company stock, the plan may use a qualified default for the employee contributions and obtain fiduciary relief for that portion of the participants' accounts. In this regard, for example, the investment manager of a managed account that is a qualified default need not have authority to dispose of matching contributions of company stock. However, if the manager does not have discretion over the portion of he account that is invested in company stock, there is no

fiduciary relief afforded the investments in company stock under the final regulation. Nonetheless, managed account services may be structured to take into account the company stock investment and to adjust the managed account investments to reflect the equity exposure inherent in the company stock holdings. It would be helpful if the follow up guidance confirmed that it is permissible for a managed account to take into account the investments in the portion of a participant's account that is not invested in a qualified default in making investment decisions.

Named Fiduciaries

The proposed regulations provided that a qualified default investment alternative must be either a registered investment company or be managed by an investment manager described in section 3(38) of the Employee Retirement Income Security Act of 1974 (ERISA). The final regulations, however, expand the list of permitted managers to include the plan sponsor acting as the plan's named fiduciary. The Council greatly appreciates this change and we strongly believe that this will be helpful to many plans. However, the final regulations are not entirely clear about the fiduciary responsibilities of the plan sponsor in such a circumstance, particularly where the default fund is developed pursuant to a computer model that is developed by an independent third-party financial expert. In this regard, it would be appropriate for the Department to clarify that the plan sponsor has a fiduciary duty to prudently select and monitor the computer model but that the sponsor does not have a duty to review the particular investment decisions made by the model.

Another issue related to the named fiduciary rule is the extent to which it is available where a committee or corporate officer is the plan's named fiduciary. The final regulations state that the plan sponsor must be the named fiduciary if the plan does not use an investment manager or a registered investment company. However, we see little reason to distinguish between the plan sponsor and employees of the sponsor or the plan's benefit committee. Accordingly, we suggest that the follow up guidance clarify that either a committee comprised of employees or a particular employee may serve as the plan's named fiduciary and rely on the named fiduciary rule.

Elections

The final regulations apply where a participant has had an opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets. A central determination is therefore whether a participant has directed the investment of his or her account. A number of questions have arisen about what is considered an investment direction. In this regard, for example, a participant may make an affirmative election as to the investment of new contributions but not existing balances. Similarly, a participant may make an affirmative election as to the investment of his or her existing balances without making an election as to new contributions. In

such cases, it seems very reasonable to assume that a failure to make a change as to the other amounts should be treated as an affirmative election. Stated differently, if a participant has taken some action with respect to his or her account balance, such action should represent an affirmation that the default investment for the remaining portion of the account balance reflects an affirmative choice. To this end, it would be very helpful if the follow up guidance clarified when a participant will be treated as having directed the investment of his or her account.

Notices

The final regulations generally require notice of the circumstances under which default investments may be made on behalf of a participant 30 days in advance of the first default investment. Many plans may have trouble satisfying this advance notice requirement in all circumstances, including where a plan is transitioning to the new rules. One important question is whether the plan fiduciaries will be entitled to the relief in the final regulations once the 30-day period has lapsed. In this regard, it is important that the Department clarify that the relief will arise upon expiration of the 30-day period even if the first default investment predated expiration.

Another set of concerns deals with the other information with which the default investment notice may be combined. The final regulations provide that the default investment notice may not be combined with the plan's summary plan description or a summary of material modifications. The preamble seems to suggest that the prohibition may even be broader and that the default investment notice generally must be a stand-alone notice. The preamble confirms that the notice may be combined with the notice intended to satisfy ERISA preemption, the notice required under section 414(w) and the notice required under the new nondiscrimination safe harbor of section 401(k)(13) of the Internal Revenue Code. However, there are numerous questions beyond these simple examples. In this regard, it has been suggested that the default investment notice cannot be combined with the notices required under the nondiscrimination testing safe harbors of section 401(k)(12) of the Internal Revenue Code, even thought the context of those notices is largely the same as the content of the notices required under section 401(k)(13). We appreciate the Department's desire to ensure that the default notice is not buried within a larger document. However, we urge the Department to clarify that the notice may be combined with common notices, such as the 401(k)(12) notice.

Another question pertaining to notices has to do with the requisite description of the qualified default investment alternative. The regulations do not explicitly address the requisite disclosure for a plan that constructs its default fund out of its investment menu. The Council believes that in such a case the plan does not need to disclose the investment objectives and fees of all of the underlying funds, but rather should disclose the key characteristics of the fund of funds. In this regard, it would be very difficult for a plan fiduciary to construct an expense ratio for the fund of funds based on the

different fee ratios of the underlying funds and the extent to which amounts are allocated to each underlying fund. Moreover, this information would be constantly changing as the allocation between the different underlying funds changes. We believe that it should be permissible for the plan to disclose any fees that apply in connection with the default fund and refer participants to the underlying disclosures for each of the funds that are or may be part of the fund of funds for further information.

Another set of issues deals with the extent to which the notice required under the final regulations must be specific to the default investment. The final regulations are clear that the notice need not be provided proximate to the default investment. Instead, the final regulations require only that the notice be provided at least 30 days prior to the initial default investment. We greatly appreciate this flexibility and we anticipate that many plans will provide a blanket notice upon initial enrollment which provides that there are a number of situations in which a default investment may be made. We anticipate that the blanket notice will include examples of typical default investment situations, including rollovers, profit sharing contributions, automatic enrollment and elimination of an investment option. The follow-up guidance should clarify that blanket notices are permissible and that there is no requirement that the blanket notice identify every possible default investment situation.

Balanced Funds

The final regulations require a special suitability determination before a fiduciary may select a balanced fund as the plan's qualified default investment alternative. The special suitability determination requires the plan's fiduciary to determine whether the particular balanced fund is appropriate to the plan's participant population as a whole and thereafter monitor the ongoing suitability of the balanced fund. We believe that the suitability determination will be very burdensome for plan fiduciaries and it is far from clear the kind of analysis that goes into this determination. Moreover, we question whether the special determination effectively undermines the fiduciary relief in the regulations by exposing plan fiduciaries to claims that the selection of the balanced fund was not appropriate to the plan's participant population. For this reason, we urge the Department to reconsider the portion of the final regulations that imposes this special determination.

ERISA Preemption

The Council applauds the Department for providing that ERISA preempts state laws that might otherwise preclude an automatic enrollment arrangement without regard to whether the arrangement satisfies the final default investment regulations. The final regulations, however, are not entirely clear on whether a notice is required for ERISA preemption. In this regard, the regulations provide that "[a] State law that would directly or indirectly prohibit or restrict the inclusion in any pension plan of an automatic contribution arrangement is superseded as to any pension plan." However,

another paragraph dealing with ERISA preemption seems to suggest that a notice is required under section 514(e)(3) of ERISA. It would be appropriate for the Department to clarify that notices are not required. While we anticipate that plans will almost universally provide advance notice of automatic enrollment, there may be situations in which inadvertent errors arise and it would be inappropriate for one of the consequences of such an error to be the loss of ERISA preemption.

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Again, we appreciate the Department's willingness to attempt to address these issues. We believe that the American Benefits Council offers an important and unique perspective of the employer sponsors of, and service providers to, retirement plans and we look forward to working with you on these important new rules.

Sincerely,

Jan Jacobson
Retirement Policy Legal Counsel