March 27, 2008

CC: PA: LPD:PR (REG-104946-07)
Room 5203
Internal Revenue Service
P.O. Box 7604 Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

On behalf of the American Benefits Council (the "Council"), I am writing with comments regarding the proposed regulations providing guidance with respect to cash balance plans, pension equity plans, and other hybrid defined benefit plans. We are very appreciative of all the hard work reflected in the proposed regulations and we thank you for this opportunity to share our views.

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 request a public hearing on these proposed regulations and we request the opportunity to testify at that hearing.

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Pre-Effective Date Period.

The regulations are proposed to be effective for plan years beginning on or after January 1, 2009. We strongly urge you to clarify that prior to such regulatory effective date, a plan will be treated as having complied with the law if the plan complies with a reasonable interpretation of the applicable statutory provisions. Otherwise, the proposed regulations will function effectively as temporary regulations since they would provide the only clearly acceptable means of compliance before the issuance of the final regulations.

Market Rate of Return.

Under the Pension Protection Act of 2006 (the "PPA"), an "applicable defined benefit plan" is treated as failing to satisfy the applicable age discrimination rules unless the plan provides that any interest credit (or an equivalent amount) shall not exceed a market rate of return. The issues regarding what constitutes a market rate of return are critical issues for hybrid plans.

Process. The proposed regulations reserve several critical issues with respect to the market rate of return rule. These issues, along with possible regulatory approaches, are discussed very generally in the preamble. As a matter of process, we strongly urge that the reserved issues be addressed in proposed regulations. It would not be appropriate for these very important issues to be published in final form without going through the proposed regulation process. General discussions in the preamble are quite helpful, but they are not an adequate substitute for a fully articulated and detailed regulatory provision. The plan community needs the opportunity to evaluate and comment on actual proposed rules that can only be fully understood when they are fleshed out in regulatory form.

Transition rule. Changing key provisions to a cash balance plan often involves considerable efforts from many disciplines (including legal, administration, communication, and finance). Accordingly, employers are very hesitant to make temporary changes based on incomplete guidance, lest they need to modify the changes in the near future and thereby create unnecessary confusion for participants and other stakeholders, incur unnecessary plan-related expenses, and increase the likelihood of errors or oversights. Thus, a very large number of employers have been waiting for final guidance before changing their interest crediting rate and, if needed, their contribution crediting rate.

For example, assume that a plan credits interest at a fixed 8.5% rate. Assume further that this rate was established at a time when interest rates were much higher than they are today. What should such an employer do today? The employer can only do one thing: wait for final guidance. In order to reduce the 8.5% under the statutory anti-cutback relief, the employer would need to conclude that 8.5% is above market. There is no guidance confirming such a rate is above market. On the contrary, there are good arguments that such a rate is not above market. For example, if the employer could show that certain average equity returns over a past period of years were approximately 8.5%, there is a very strong argument that such a rate is not above market, as discussed further below. Or if the rate was reasonable when it was set, there is a powerful argument that its market rate status should not be affected by the current low interest rate market.

Also, a reduction of the interest crediting rate could trigger backloading issues, which could require prospective reductions in contribution credits: such a reduction in

contribution credits would require a section 204(h) notice. (In fact, if these changes had been made as of the effective date of the market rate rule, the section 204(h) notice would have been required well before the issuance of the proposed regulations.) So not only is it unclear whether a reduction of the rate is permissible, such a reduction could trigger extensive other plan changes.

So for these very good reasons, a plan with, for example, an 8.5% fixed rate would have been well-advised not to modify its rate as of the effective date of the market rate rule. This is especially so since the proposed regulations, issued a few days before the effective date, reserved on many critical interest rate rules, thus shedding almost no light on the issue of whether a rate like 8.5% could be a market rate.

In this context, it is important that the final regulations establish a transitional rule under which any reasonable interpretation of the market rate rule will be treated as compliance with the statute. For example, if an 8.5% fixed rate is determined to be above market (which, under our analysis below, we would strongly disagree with) as of the statutory effective date of the market rate rule, that would be quite an unfair "gotcha." Before the issuance of guidance, the employer cannot know if it can reduce its rate under the anti-cutback relief; as soon as the guidance is issued, the plan has a retroactive qualification defect. That would be unfair. We ask for transitional guidance deeming fixed rates up to at least 9% not to be above market at least until the effective date of the final regulations. That is the only way to establish a fair and workable system that does not put employers in an untenable no-win situation.

Effect of minimum rates on the market rate determination. The statute states:

> A plan shall not be treated as failing to meet the requirements of this subclause merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return.

This statutory provision is clear. Assume, for example, that a cash balance plan credits interest at the greater of 3% or the third segment rate described in Code section 430(h)(2)(C)(iii), and assume further that the third segment rate is exactly a market rate. The statutory provision clearly states that the third segment rate will not fail to be a market rate solely because of the 3% minimum. In other words, in this case, no adjustment to the third segment rate would be necessary to satisfy the market rate of return rule.

This result is squarely supported by a colloquy between Senator Enzi and Senator Gregg on August 3, 2006:

> Mr. Gregg: . . . My understanding is that the term "market rate of return" is intended to allow plans to adjust benefits in ways that

> benefit participants. For example, a plan could provide a variable market rate of return and, in addition, protect participants by preventing the rate of return in their accounts from falling below a reasonable, minimum level without having to reduce the variable market rate of return. . . . is this correct?
>
> Mr. Enzi: Yes, it is.

This colloquy is consistent with the clear statutory language. And the colloquy demonstrates Congress' intent. Congress did not want to force employers across the country to reduce their interest crediting rates by reason of the existence of a reasonable floor rate. Any contrary interpretation of the statute would harm participants and would be inconsistent with the statutory language and Congress' expressed intent.

Unfortunately, the discussion in the preamble to the proposed regulations appears to be squarely inconsistent with the statute. For example, the preamble states:

> the Treasury Department and the IRS have concerns that the use of a minimum guaranteed rate of return or the use of the greater of a fixed and a variable rate could result in effective interest crediting rates that are above market rates of return and are soliciting comments on how to avoid that result.

In this regard, the preamble is inconsistent with the statute. The statute is clear that the use of a reasonable minimum guaranteed rate of return shall be disregarded in determining whether a plan's crediting rate is above a market rate. Accordingly, the issue is not whether the minimum interest rate causes the crediting rate to be above market, but rather whether the minimum rate is reasonable. This is an important difference that needs to be reflected in the regulations in order to conform to the statute.

Minimum rates. Guidance is needed with respect to what constitutes a "reasonable minimum guaranteed rate of return". We urge you to clarify that any fixed crediting rate that would, on its own, be treated as not exceeding a market rate of return would be a reasonable minimum guaranteed rate of return for purposes of the above-quoted provision. See the discussion below of what fixed rates should be treated as not exceeding a market rate. Any other rule would require an entirely new and artificial economic analysis regarding minimum rates that are sufficiently below market to qualify as "reasonable". And there is nothing in the legislative history indicating that Congress intended to establish such an artificial set of new rules.

It would be very helpful if the regulations could include a safe harbor minimum interest crediting rate of at least 5%, so that any minimum rate of at least 5% or less would be deemed to be reasonable. It should be clarified, however, that higher minimum or fixed rates are also permitted based on the principles discussed below with respect to fixed rates.

In the context of rates that are not based on equities, we believe that the minimum should be permitted to be applied as frequently as monthly. We see nothing unreasonable about the application of a minimum crediting rate with that frequency. Any more restrictive rule would be inconsistent with the statute and would unnecessarily require participants' crediting rates to be reduced.

We believe that the approach described in the preceding paragraphs is also appropriate where the plan's variable crediting rate is based on equity returns, but the plan guarantees a minimum rate. However, in response to the discussion in the preamble, we would add one caveat. In such cases, the minimum should only be applicable at benefit commencement, not on an annual or more frequent basis. Because of the constant fluctuations in equity returns, it would not be reasonable to guarantee a minimum each year, but it would be eminently reasonable to guarantee a minimum over the life of the equity investment with respect to any participant. Accordingly, if a plan has an equity-based crediting rate and applies a minimum rate on a more frequent basis (such as annually), it may be appropriate to require a "haircut", i.e., a reduction of the equity-based rate to make up for the more frequent application of the minimum rate.

We disagree with the suggestion in the preamble that the capital preservation rule (discussed below) may require a reduction in the plan's crediting rate if the crediting rate is based on a nondiversified equity measure. Congress established the capital preservation rule in clear recognition of the fact that equity-based rates can be used. Yet Congress did not at any time suggest that this mandatory rule requires a reduction in the equity rate. Requiring such reduction would hurt participants in a way never intended by Congress. If, however, the regulations do require reductions attributable to the capital preservation rule (or attributable to a minimum interest rate), we believe that such reductions should only apply when the plan uses an equity rate that is not based on any diversified measure. In that regard, we believe that a broad range of measures should be treated as diversified for this purpose, including the plan's asset portfolio, broadly recognized diversified indexes (such as the S&P 500 index), or mutual funds that are not limited in a material way (such as funds limited to a specific industry sector).

Capital preservation rule: date of application. The PPA provides with respect to applicable defined benefit plans:

> An interest credit (or an equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate of contributions credited to the account. ["capital preservation rule"]

Similarly, with respect to all defined benefit plans, the PPA provides that a plan shall not fail to satisfy the age discrimination rules solely because the plan provides for indexing of accrued benefits. The PPA then states:

> Except in the case of any benefit provided in the form of a variable annuity, clause (i) [which permits indexing] shall not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing. ["loss protection rule"]

The first question is: when are those rules applied? The answer is clear: at the time of benefit distribution. We are in complete agreement with the proposed regulations on this point and urge retention of the proposed rule. There is no other time when the amount of a participant's benefit has any concrete relevance to the participant. In other words, the only date on which a benefit amount is relevant is the date of distribution. A contrary argument might be made that the preservation of capital rule should be applied annually. Why? Why not daily? Why not monthly? There is just as much theoretical logic - - or more - - for a daily rule as there is for an annual rule. If Congress had intended an annual or monthly or daily rule, it would have said so. Congress' silence demonstrates that the determination should be made at the only date relevant to the participant.

This interpretation is again squarely supported by a colloquy on the Senate floor:

> Mr. Burr: At what point are the [capital preservation and loss protection] rules applied?
>
> Mr. Enzi: The capital preservation and loss protection rules are intended to provide long-term protection to employees, so the determination of whether the rules are satisfied is made at the time benefits commence but not beforehand.

How to apply the capital preservation rule. There are administrative issues with respect to the application of the capital preservation rule. For example, if a cash balance plan has changed recordkeepers in the past, the new recordkeeper may only have received information on account balances, not on past contribution credits. Thus, the new recordkeeper will be unable to determine the aggregate amount of contribution credits. Because of situations like this, the regulations should include the following rule. If a plan administrator cannot reasonably determine the aggregate amount of contributions credited to a participant, and such inability is attributable to a reasonable cause (such as the failure to receive the needed information from a prior recordkeeper), then the plan administrator may either:

(1) Determine the aggregate contribution credits based on reasonable estimates, or
(2) Treat the entire current account balance as attributable to contribution credits.

The proposed regulations also raise a substantive issue with respect to the capital preservation rule. Assume, for example, that during active service, a cash balance plan credits interest at the third segment rate, but for any post-employment periods, the plan credits interest at the 30-year Treasury rate. Assume, for simplicity of presentation, that those two rates are 6% and 5%, respectively. Under the proposed regulations, each year that an employee works, the employee earns three things: (1) a contribution credit, (2) a 5% interest credit that is treated as an interest credit because it is not conditioned on current service, and (3) a 1% interest credit that is treated as a contribution credit because it is conditioned on current service.

We agree that the 1% interest credit should be treated like a contribution credit for certain purposes, such has section 401(a)(4) and, as discussed below, the age discrimination rules. But there is no justification for treating it as a contribution credit for purposes of the capital preservation rule. In the above example, if the active employee interest crediting rate were an equity-based rate, rather than the third segment rate, the capital preservation rule could require a minimum benefit far in excess of the total contribution credits, a result never intended by Congress.

Also, the minimum benefit required by the preservation of capital rule should be the sum of all contribution credits. For example, if a plan previously credited interest at a fixed rate, then switched to an equity-based rate, all contribution credits at all times should be taken into account (and none of the interest credits should be taken into account) in determining the required minimum benefit.

Higher crediting rates conditioned on employment. Assume that a plan credits interest at 10% during employment and at the third segment rate after termination of employment. For ease of presentation, assume that the third segment rate is 6%. In that case, for purposes of the market rate of interest rule, under the proposed regulations, only the first 6% of interest credit each year is treated as "interest" subject to the market rate of interest rule. The additional 4% is treated as a contribution credit. Aside from the application of this rule to the capital preservation rule discussed above, we strongly agree with the proposed regulations in this respect, and urge that the proposed rule be finalized in this manner.

Variable annuity plans. Variable annuity plans are specifically excepted from the loss protection rule, but are not referenced in the capital preservation rule. In light of the specific intent not to apply the loss protection rule to variable annuity plans, it would make little sense to apply the capital preservation rule to hybrid variable annuity plans. We agree with the proposed regulations in this regard.

Rates of returns. As reflected in the proposed regulations, there are generally three types of interest crediting rates: (1) fixed by reference to a number (such as 6%), (2) pure variable rates (such as floating with the return on the S&P 500 index), and (3) variable rates that are fixed for specific periods (such as a provision under which for each year, accounts are credited with interest at the third segment rate, determined as of a specified date in the prior year). The third category is generally thought of as a variable rate, and in fact we refer to it as such above in the discussion of minimum rates. In some instances below, however, we refer to it as a temporarily fixed rate.

With respect to all three types of rates, we do not believe that there is any justification for limiting the range of market-based rates to, for example, the rates referenced in the proposed regulations or in the preamble. The statute refers broadly to a market rate of return, whereas the regulatory approach seems, to date, focused on identifying specific conservative spot interest rates. We believe that any rate of return determined by reference to returns available in the market - - such as any bond and/or equity returns - - should be considered a market rate, subject to the conditions set forth below.

Moreover, there is no reason to require the use of spot rates for purposes of setting fixed rates or variable rates fixed for a specified period. For example, a plan should be permitted to base such rates on average bond and/or equity rates available within a specified period (such as three to five years or longer) prior to the date that the plan's rate is set. Such average rates can in some circumstances be better measures of a market rate than a particular spot rate. On the other hand, in the case of bond-based rates, the use of spot rates should also be permitted, provided that the spot rate used was available within a limited period (such as a year) preceding the date that the plan's rate was set. Such spot rates could be based on a specified day, week, or month, for example.

We agree that a fixed rate or a temporarily fixed rate should not be determined by reference to an investment product or index involving an unreasonable risk to principal, unless a "haircut" is applied to the rate available in the market. However, no haircut should be required with respect to a fixed rate or temporarily fixed rated determined by reference to a diversified equity measure determined over a reasonable period of time. Similarly, all investment grade corporate bond rates should be permitted without a haircut, as should many non-investment grade corporate bonds. We would urge you to adopt a safe harbor for investment grade corporate bonds, but we do not believe that there should be an absolute rule precluding the use of non-investment grade corporate bonds without a haircut.

Certainly, the rate on any government bond should also be treated as a market rate. The rates referenced in the proposed regulations should also be permitted, of course. As in Notice 96-8, the PBGC immediate rate should also be referenced. And the "associated margins" permitted in the proposed regulations should be updated to

reflect the fact that the "target" rate is the third segment rate, rather than the 30-year Treasury rate. In addition, the safe harbor for the third segment rate should be expanded to refer to each of the three segment rates as permissible crediting rates; logically, if the third segment rate is permitted, so should the first and second segment rates.

Another issue is: how often does a fixed rate have to be adjusted? Obviously, economic conditions change constantly, but plans need consistency and predictability. Accordingly, we believe that fixed rates, if at or below market when set, should be permitted to be applied indefinitely. If the regulations do require periodic reevaluations of fixed rates, it would be appropriate to permit fixed rates to remain in effect for at least five years before they must be reevaluated in the context of changed economic conditions.

If periodic reevaluations of fixed rates are required, the section 411(d)(6) rules need to be clarified with respect to any needed adjustments of those rates. A plan should be permitted to provide that the rate of return shall be adjusted in accordance with economic conditions at the end of specified period (which, as noted should be permitted by law to be at least five years)[1]. If the methodology for adjustment is specified in the plan document in such a way as to preclude any material employer discretion, the adjustment should be permitted under section 411(d)(6). However, since plans with fixed rates do not today contain such plan terms, plans should be permitted under PPA section 1107 to add such terms without any violation of section 411(d)(6), as long as the adjustment methodology is conceptually consistent with the fixed rate in effect.

If periodic reevaluations of fixed rates are required, additional transitional guidance is needed so that plans have sufficient time after the issuance of final regulations to make any needed reevaluations and rate adjustments.

Predetermined actual investments. An interest crediting rate based on a predetermined actual investment (including, for example, a predetermined index such as an equity index or a bond index) should also be permitted, since such investments are, by definition, in the market.

Changing rates. One of the most important issues is the extent to which employers may change the applicable interest crediting rate. Because of two factors, many plan sponsors have been unable to raise interest crediting rates to the level they want: (1) the whipsaw issue, and (2) the use of the artificially low 30-year Treasury rate as the whipsaw measure. Many plans sponsors would welcome the opportunity to modify their interest rates to provide a more favorable crediting rate. However, if the

[1] It should be clarified that for purposes of the backloading rules, the current fixed rate may be treated as applicable indefinitely.

anti-cutback rule is applied in a mechanical fashion, such modifications - - even if very favorable to employees based on historical data - - would only be permitted through the use of a wear-away approach. Use of a wear-away approach is administratively cumbersome, which will dissuade many employers from modifying their interest crediting rate in an employee-favorable fashion.

We were very pleased to see the following statement in the preamble:

> In addition, to the extent permitted under future guidance, the IRS and the Treasury Department expect that section 411(d)(6) relief under section 1107 of PPA '06 will be available in the case of an amendment to change the plan's interest crediting rate to a rate that is expected to be higher than the plan's current rate (such as an amendment to change to an equity-based rate of return).

We urge the IRS and Treasury to implement this statement and to provide very clear guidance. Plan sponsors will need certainty in this area; if the relief does not provide an easily implemented mechanical rule, the fear of liability attributable to unusual market conditions could well deter most employers from implementing pro-participant changes. We urge a rule such as the following:

> A plan may be amended to modify the interest crediting rule with respect to all benefits (including benefits accrued prior to the adoption of the amendment) if the plan can demonstrate that over a prior period of at least five years, the new rate would have produced total returns equal to or in excess of the old rate. If a period of less than 10 years is used, the plan must be able to demonstrate that the period used is reasonably representative of historical patterns.

Also, it should be confirmed that where any change in the interest crediting rate is made at the election of the employee, the change is permitted unless the new rate is systematically less favorable than the old rate. In this regard, it would be helpful for the regulations to clarify that employers have flexibility to decide how often employee elections may be made and the date on which such elections become effective.

Finally, we request clarification of the rules and choices applicable to a plan that currently provides a crediting rate explicitly tied to the rate applicable under section 417(e).

Plan amendments. Section 1107 of the PPA provides that plan amendments made pursuant to PPA provisions shall not violate the anti-cutback rule, except as otherwise provided by Treasury. We applaud the indications in the preamble that this

provision authorizes the following types of plan amendments: (1) a reduction of an above-market interest rate to a market interest rate, and (2) elimination of a provision entitling participants to a whipsaw calculation.

With respect to the both types of reductions, the guidance should confirm that such reduction would, of course, apply to previously accrued benefits as well as to future benefits. Also, the guidance should not impose any requirement of a "make-up benefit" to compensate for the reduction. There is no hint in the legislation or legislative history that such a make-up benefit is intended, which is significant in light of the long and detailed legislative process. Requiring a make-up benefit would also be an inappropriate punishment of employers that (1) had tried to provide a beneficial rate to employees but are required to reduce it, or (2) felt compelled to add the whipsaw provision. Finally, any such make-up benefit could have an age discriminatory effect because it would be compensating younger employees immediately for the future time value of money.

There will also be questions regarding whether an interest crediting rate is above market and thus can be reduced pursuant to section 1107 of the PPA. We recommend that the regulations establish a flexible standard for employers to determine whether a rate is above market for this purpose.

It should also be provided that any plan that, as of the date of enactment, provided the whipsaw benefit to its participants shall not fail to satisfy the age discrimination rules by reason of retaining that benefit. Some employers may not wish to eliminate the whipsaw feature, which participants may view favorably. It would be unfortunate and unfair if the whipsaw provision - - which the government required - - is now treated as age discriminatory unless it is promptly taken away from participants. On the other hand, as noted above, employers should be free to eliminate the whipsaw benefit under section 1107 of the PPA.

Whipsaw Effective Date.

The legislative elimination of whipsaw applies "to distributions made after the date of enactment of [the PPA]". We believe that this language is clear on its face: no distribution after the date of enactment should be required to take into account the whipsaw calculation.

The issue that has been raised relates to distributions made prior to the date of enactment. The following argument has been made: if a plan should have provided a whipsaw benefit but did not, that is a plan defect with respect to a pre-PPA distribution. Because that distribution occurred prior to the PPA, it is not affected by the prospective elimination of whipsaw. That analysis is fundamentally flawed. We assume arguendo that whipsaw was the law prior to the PPA (although we do not agree with that). Accordingly, we assume arguendo that the prior distribution was erroneous. We

strongly believe that those points are irrelevant. The relevant point is that Congress clearly intended that there be no post-enactment "correction" of those "erroneous distributions." In other words, the language of the statute is clear. The new law applies to all distributions after the date of enactment, regardless of whether the distribution is the first one made to a participant or a claim for a "correction" to a prior distribution. If Congress had intended that there be post-enactment corrections, it could easily have provided that (1) the new rule applies to distributions with an "annuity starting date" after the date of enactment, or (2) the new rule applies to distributions after the date of enactment, other than distributions made to correct pre-enactment distributions. Congress did not say either of those things, leaving the statute absolutely clear that post-enactment corrective distributions are not required.

This result is also consistent with Senator Enzi's floor statement, which made it clear that Congress believed that whipsaw was never the law:

> The hybrid language also corrects the so-called pension whipsaw language for distributions after the date of enactment. The parties to the pension discussions took the view that the position taken by the IRS in Notice 96-8 was an incorrect interpretation of present law. Many of us who were engaged in the pension reform discussions noted that Notice 96-8 was never finalized by the IRS in their regulations and we observed that the Treasury Department had been reviewing the position in Notice 96-8 for some time, but without result. The approach taken in Notice 96-8 can actually harm many participants. Many employers have reduced the rate of interest crediting under their hybrid plans due to concerns that over the requirements of the notice. In addition to its other flaws, the approach taken in the notice provides a larger benefit to be paid to a participant who takes a distribution before normal retirement age than for a participant who waits to take his or her benefit distribution. Thus Notice 96-8 would penalize an employee who waits to take a distribution. This is a perverse result for a rule governing retirement plans.

Also, we are quite concerned with reports from our members that, without any regulatory guidance, whipsaw is being applied by the IRS in the context of the review of determination letter requests. IRS Notice 96-8 - - which is the basis for whipsaw - - was simply issued to invite comment prior to the issuance of regulations that were applied <u>prospectively</u>. In the interim, Notice 96-8 established a good faith compliance standard. And IRS Notice 2007-6 clearly indicated that regulatory guidance would be issued before the determination letter process is reopened with respect to plans subject to the whipsaw issue. In this context, we are quite concerned with the active

enforcement of a rule that has never been officially set forth by the IRS or Treasury as the law.

Finally, we urge you to consider expanding the scope of the regulatory whipsaw rule, so that a participant's account balance or current value is treated as the participant's accrued benefit for certain other purposes. We are quite concerned that the proposed rules could be interpreted to create new types of whipsaw, such as with respect to annuity benefits. This is an issue that we would like to explore further with you.

Vesting.

Three-year vesting. The PPA requires that, under an applicable defined benefit plan, all employees with at least three years of service must be 100% vested in their employer-derived benefit. The PPA defines an applicable defined benefit plan to mean:

> a defined benefit plan under which the accrued benefit *(or any portion thereof)* is calculated as the balance of a hypothetical account maintained *for the participant* or as an accumulated percentage of *the participant's* final average compensation. [emphasis added]

Under regulations, an applicable defined benefit plan also includes any defined benefit plan (or any portion thereof) which has an effect similar to an applicable defined benefit plan.

Under the proposed regulations, if any portion of a participant's benefit is based on a hybrid formula, the participant is wholly covered by an applicable defined benefit plan and, accordingly, the three-year vesting rule applies to the participant's entire benefit. This proposed rule reflects an incorrect reading of the statute. If a participant's benefit has a hybrid portion and a traditional portion, the intent was clearly to treat the hybrid portion as an applicable defined benefit plan, not to treat the whole benefit as an benefit plan. Any contrary interpretation leads to results that do not make sense. For example, under a contrary interpretation, the market rate of return rule would apply to the entire benefit of any participant if any portion of the participant's benefit is determined under the hybrid formula. This is not possible and was clearly not intended.

Moreover, a contrary interpretation would be inconsistent with the statutory direction to Treasury to:

> include in the definition of an applicable defined benefit plan any defined benefit plan *(or any portion of such a plan)* which has an effect similar to an applicable defined benefit plan. [emphasis added]

Under this language, it is clear that only the part of the plan that has the effect of a hybrid plan would be an applicable defined benefit plan, not any traditional components. It would not make sense to apply this rule in this context, but apply a conceptually different rule under the basic definition of an applicable defined benefit plan. The conceptually sound rule is that hybrid benefits are part of an applicable defined benefit plan, and traditional benefits are not. The statute supports that conceptually sound approach.

This approach, as applied to the following fact patterns, should yield the following results:

1. A participant's benefit is the sum of a traditional benefit and a hybrid benefit: only the latter benefit is subject to three-year vesting.
2. A participant's benefit is the greater of a hybrid benefit or a traditional benefit: the hybrid benefit is subject to three-year vesting, but the excess (if any) of the traditional benefit over the hybrid benefit is not.
3. A participant's benefit is a traditional benefit, offset by a hybrid benefit under <u>another</u> plan: none of the traditional benefit is subject to three-year vesting.

<u>Vesting effective date.</u> The three-year vesting rule should not be applied to participants who do not have an hour of service on or after the effective date of the new vesting rule. It is so burdensome and unusual for plans to be required to vest previously terminated employees that such a rule should only be applied where there is clear Congressional intent to apply such a rule. Since there is no evidence of any such intent in PPA section 701(e), such a rule should not be applied. We see no need to wait for a technical correction to confirm this point.

<u>Age Discrimination.</u>

<u>Choice, greater of, and grandfathering.</u> The new age discrimination safe harbor applies differently based on the type of benefit formula used by the plan. In this regard, there are three types of benefit formulas: (1) formulas expressed as an annuity payable at normal retirement age, (2) formulas expressed as a balance of a hypothetical account, and (3) formulas expressed as the current value of the accumulated percentage of the employee's final average compensation. Under the proposed regulations, subject to specified exceptions, the age discrimination harbor does not apply if the plan contains different types of formulas that must be compared. Briefly, set forth below is our understanding of how the proposed rule would work.

1. <u>All participants under the same type of formula.</u> Safe harbor applies.

2. Greater of traditional or hybrid formula for all existing participants; new hires under hybrid formula. New hires are not similarly situated with respect to existing participants, so new hires can be separately tested under the hybrid formula safe harbor. For existing hires, a special regulatory rule permits use of the safe harbor.

3. Greater of traditional or hybrid formula for existing participants over a specified age; other existing participants and new hires under hybrid formula. Slightly different analysis, but the same result as situation # 2 above.

4. Choice of traditional or hybrid formula for all existing participants; new hires under hybrid formula. New hires are not similarly situated with respect to existing participants, so new hires can be separately tested under the hybrid formula safe harbor. Existing participants who elected one of the formulas are only similarly situated with respect to other participants who made the same election. So the plan may use the safe harbors. COMMENT: The provision clarifying the application of the similarly situated rule to election arrangements is in the preamble; it would be helpful if that provision could be moved to the regulation itself.

5. Choice of traditional or hybrid formula for existing participants over a certain age; other existing participants and new hires under hybrid formula. Apparently, this plan cannot use the safe harbor. COMMENT: This result does not make sense. When compared to situation #4, it is clear that by treating younger participants less well, the plan creates an age discrimination issue, which is not logical. The only conceivable concern underlying this rule is a fear that some older participants will make unwise elections and end up being treated less favorably than some younger participants. Not only is there no basis for this concern, but the concern is also inconsistent with the treatment of a plan providing all participants with a choice.

6. Division A under traditional formula; division B under hybrid formula. Since division A employees and division B employees are not similarly situated, the safe harbor applies.

7. Grandfather: older participants are grandfathered under the traditional formula; younger participants and new hires are under the hybrid formula. Safe harbor does not apply at all.

   COMMENT: We urge you to clarify how the pre-existing age discrimination rule applies to these facts. There could certainly be cases where a grandfather arrangement like this is age discriminatory, such as a situation where the new formula is systematically more generous than the old formula. There are also cases where such grandfathering is clearly not age discriminatory, such as

where the old formula is systematically more generous. But actual fact patterns may not fit neatly into either category.

For example, assume the following facts. The plan grandfathers in the old traditional formula all participants who had attained age 50 by the date of the conversion. Assume further that grandfathered participants who remain employed for at least five years will fare better under the traditional formula (on a present value basis)[2], but if they terminate earlier, some grandfathered participants would have fared better under the hybrid formula (on a present value basis). We urge you to treat this type of grandfathering arrangement as satisfying the pre-existing age discrimination rule. Unless there is some clear expectation of widespread employee turnover by reason of a publicly anticipated event, it should be permitted to cover older employees under a formula that will be more favorable for them in the long term (on a present value basis).

A contrary rule could in effect ban grandfathering in some cases. Assume, for example, a rule prohibiting any grandfathered employee from receiving a less valuable benefit in any year than any non-grandfathered employee. That rule could be difficult to satisfy in some conversion cases. Thus, an employer in this situation that would like to use grandfathering to avoid the administrative burdens and cost involved in "choice" or "greater of" would likely use none of these transition approaches. This is an example of how an overly restrictive rule that appears to be protective of participants would have exactly the opposite effect.

Determination of a plan's formula. As noted above, the new age discrimination safe harbor applies differently based on whether the "accrued benefit [is], under the terms of the plan, . . . expressed as an annuity payable at normal retirement age, the balance of a hypothetical account [cash balance], or the current value of the accumulated percentage of the employee's final average compensation [pension equity]." The issue is: under what circumstances will a plan be considered to "express" an accrued benefit as a cash balance amount or a pension equity amount? We believe that the proposed regulations address this issue well in Proposed Regulation § 1.411(b)(5)-1(e)(2), (3).

The analysis under the proposed regulations should not be affected by a change in the plan terms on or after termination of employment. For example, some cash balance plans have worked as follows in order to avoid whipsaw issues. The benefit is determined under a cash balance formula, with an interest crediting rate equal to the

[2] If all grandfathered participants would at all times fare better under the traditional formula, there would, of course be no problem under either the pre-existing age discrimination rule or the new safe harbor (which could be made applicable simply by adopting a "greater of" amendment for all grandfathered participants, which would have no economic effect).

section 417(e) interest rate. At termination of employment, the cash balance account is converted to an annuity beginning at normal retirement age. It is clear that this type of plan determines the accumulated benefit under a cash balance formula and thus should be treated as such for purposes of the age discrimination safe harbor.

Participants working post-normal retirement age. In the context of a traditional, non-hybrid formula that "expresses" the accrued benefit as an annuity payable at normal retirement age, it is important that, for purposes of the new age discrimination safe harbor, the accrued benefit of a participant who is older than the plan's normal retirement age be determined as of the participant's age. We believe that the proposed regulations address this point well. See Proposed Regulation § 1.411(b)(5)-1(b)(1)(i)(A).

Other types of formulas. Some benefit formulas do not fit within any of the three categories described above (as set forth in Code section 411(b)(5)(A)(iv)). Treasury should modify Proposed Regulation § 1.411(b)(5)-1(b)(1)(ii)(A) and exercise its inherent regulatory authority to permit such formulas to be tested under the new age discrimination safe harbor based on the plan's formula. For example, some pension equity plans ("PEPs") base the lump sum benefit on a percentage of each year's pay. Such plans should be permitted to apply the new age discrimination safe harbor by reference to whether such formula contains any element that favors similarly situated younger participants.

Conversion Issues.

Applicability of conversion rule. In the case of an applicable plan amendment adopted after June 29, 2005, the PPA deems the amendment to be age discriminatory unless the accrued benefit is at least a minimum amount. The first issue is: what constitutes an applicable plan amendment? In general, under the statute, an "applicable plan amendment means an amendment to a defined benefit plan which has the effect of converting the plan to an applicable defined benefit plan."

Under the proposed regulations, if certain participants are grandfathered under the old formula, there has clearly been no applicable plan amendment with respect to such participants. The analysis is more complicated where participants are given a choice of coverage under the old or new formula. Certainly, there has not been an applicable plan amendment with respect to any participant who elects to remain under the old formula. Our view is that there is also no applicable plan amendment with respect to participants who elect coverage under the new formula. The reason is that it is not the amendment that "reduces or eliminates" the participant's benefit but rather the participant's election that does so. There is no evidence of any Congressional intent to apply the new minimum benefit rules to formulas voluntarily elected by a participant and the regulations should be clarified to reflect this position.

In many contexts, the proposed regulatory definition of an applicable plan amendment is far too broad, clearly going beyond Congressional intent. The statute defines an applicable plan amendment as an amendment that converts a plan to an applicable defined benefit plan. Yet the proposed regulations are so broad that they cover plan amendments that do not in any way adopt or modify a hybrid plan formula. The proposed regulations are, in this respect, so overly broad that they would be unlikely to withstand any judicial scrutiny.

For example, assume that a plan is currently providing certain participants with the greater of the old traditional formula or the new hybrid plan formula. If the traditional formula is, for example, amended prospectively to take bonuses out of the definition of compensation, that is a "conversion" under the proposed regulations. This result simply cannot be reconciled with the statute or the legislative history. The proposed regulations should be modified so that a conversion amendment is limited to an amendment that (1) eliminates or materially reduces a traditional formula, and (2) establishes or materially enhances a hybrid formula. That was the clear Congressional intent; anything further would go far beyond the statute.

In addition, plans may adopt a "greater of" provision the expires after a certain period time. In those cases, there is an applicable plan amendment. In the case of such an applicable plan amendment, the proposed regulations should be modified to provide that for purposes of applying the new minimum benefit requirement, the effective date of the amendment is the effective date of the plan amendment itself, not the expiration date of the "greater of" provision. Any other rule is not consistent with the statute and would only serve to discourage the adoption of temporary "greater of" provisions. Again, the proposed regulations, on their face, appear to go beyond the statute in order to benefit participants, but the real effect of the proposed rule will be decidedly anti-participant.

If our above recommendation regarding temporary "greater of" provisions is not adopted, the effective date of the new conversion rule should be clarified with respect to such provisions. Specifically, if such a provision was adopted on or before June 29, 2005, the new conversion rule does not apply, regardless of when the provision is treated as effective. See PPA section 701(e)(5).

Minimum benefit. Under the proposed regulations, the minimum post-conversion benefit with respect to a participant is the sum of (1) the participant's benefits accrued under the old formula for pre-conversion years of service, and (2) the participant's benefits accrued under the new formula for post-conversion years of service.

In addition, the proposed regulations provide a helpful alternative. Under the alternative, a plan may convert the pre-conversion benefit to an opening account balance on the effective date of the conversion amendment. Very generally, upon a

subsequent distribution, the benefit attributable to the account may be distributed as long as the amount attributable to the opening account balance is, at that time, at least equal to the benefit attributable to the pre-conversion benefit. While this alternative is helpful, we believe it is too narrowly drawn in requiring the account balance to be established on the conversion effective date. We believe there should be broader discretion as to when the opening balance attributable to the pre-conversion benefit is established (e.g., upon termination of employment after the conversion effective date). The requirement that upon distribution that portion of the account balance must be at least equal to the benefit attributable to the pre-conversion benefit will ensure fairness in any event.

The preamble to the proposed regulations raises the possibility of a far more administrable approach. We applaud Treasury and the IRS for raising this issue in the preamble and strongly support the following modified version of the approach outlined in the preamble.

Under our proposed approach, the pre-conversion benefit can be converted into an opening account balance and there need not be any subsequent comparison of that opening account balance with the pre-conversion benefit if:

(1) The participant elects a lump sum distribution,
(2) The pre-conversion plan either did not provide a lump sum option or such plan based the lump sum option on the benefit payable at normal retirement age (rather than the benefit payable at early retirement age),
(3) The opening account balance is <u>at least</u> equal to the present value of the pre-conversion benefit determined in accordance with section 417(e), and
(4) The interest credits on the opening account balance are, <u>based on historical data,</u> reasonably expected to be no lower than the interest rate used to determine the opening account balance.

We do not include the death benefit/mortality decrement component of the approach outlined in the preamble. The statute makes reference to the pre-conversion "accrued benefit". Accordingly, we see no reason for rules related to pre-retirement death benefits.

We applaud the proposed regulations for clarifying that the minimum benefit discussed above is simply that, a minimum. In that regard, it would be helpful if the regulations could specifically refer to the following possible enhancements of the minimum benefit: (1) in the context of a service-weighted new benefit formula, taking pre-conversion years of service into account in applying the new formula, (2) increasing the old formula benefit by taking into account post-conversion compensation increases, or (3) providing the greater of a benefit under a formula described above or the benefit the participant would have had if the hybrid formula had always been in effect.

Subsidies. It should be clarified that early retirement benefits or subsidies may be disregarded under Code section 411(b)(5)(A)(iii) even if (1) incorporated into the opening new formula benefit, (2) added to the new benefit formula at the date of distribution, or (3) reflected in transitional credits under the hybrid formula that are designed to make up, in whole or in part, for such benefits or subsidies. The statute can be read either way on this point, but the narrower reading will simply result in lower benefits to participants. This is yet another example of how a narrow interpretation of the law that on its face is protective of participants will in practice result in lower benefits.

Mergers and acquisitions. Under PPA section 702, Treasury and the IRS shall prescribe regulations within 12 months of the date of enactment regarding the application of the new hybrid plan rules in the content of a conversion related to a merger, acquisition, or similar transaction. The clear intent was to make the rules simpler in this context in light of the changes in the plan sponsor and the corresponding administrative system. Minimum benefit approaches like the one described in the second preceding section (entitled "Minimum Benefit") are essential in the context of mergers and acquisitions. Continued maintenance of the seller's benefit formula and administrative system is often not practicable where the individuals with knowledge of how to administer that system are no longer employed by the successor employer. In that context, comparisons with the pre-conversion benefit are very difficult.

Pre- and post-June 29, 2005 conversions. Some post-June 29, 2005 conversions have already occurred, including some prior to the date of enactment of the PPA. Other conversions may take place before regulatory guidance is finalized clarifying the numerous unclear conversion issues. All of these conversions need a transition period to conform in operation to the new requirements. (With respect to plan amendments, the PPA's delayed amendment date applies, of course.) The operational transition period should not end until at least 12 months after the issuance of final regulations regarding conversions. Any earlier date would simply mean that the plan sponsors would have to guess as to how the numerous regulatory issues will be resolved.

Also, it should be clarified that for purposes of determining whether a plan amendment was "adopted" on or before June 29, 2005, a plan amendment should be considered adopted when a legally enforceable commitment is made to amend the plan, such as a binding resolution of a company's board of directors. The statutory language is clearly intended to turn not on the ministerial act of reducing a plan amendment to writing; the key substantive act is the legally binding commitment of a company. At that point, the company can no longer walk away from the amendment. Thus, the plan amendment is "adopted" at that time from a substantive perspective.

Additional guidance is also needed regarding the application of the effective date rule to deemed conversion amendments attributable to a change in the conditions of a participant's employment. See Proposed Regulation § 1.411(b)(5)-1(c)(4)(ii)(C). In such

cases, if the applicable plan provisions giving rise to a deemed conversion amendment were adopted on or before June 29, 2005, there is no statutory basis for a position that the PPA conversion rules apply. The regulations should be clarified in this regard.

Section 401(a)(4) issue. For many years, there has been a serious section 401(a)(4) issue hanging over conversions to hybrid plans. That issue needs to be fixed to avoid creating a major disincentive for employers to adopt generous transition approaches.

The transition approaches at issue are: a choice between the traditional formula and the new formula, a provision providing the greater of the two formulas, or a straightforward grandfather provision. (For convenience of presentation, all employees who continue to be covered by the traditional formula by reason of such transition arrangements are referred to in this part of our letter as "grandfathered employees".) In almost all cases, the traditional formula will have benefits, rights, and features that are not available under the new formula. The most notable example is an early retirement subsidy, which is very common in traditional formulas and extremely rare in hybrid plans.

Under Regulation § 1.401(a)(4)-4, any benefit, right, or feature must be "currently available" to a group of employees that satisfies the nondiscriminatory classification test. At the time of the conversion to a hybrid plan, the grandfathered employees generally satisfy this test. The problem is that typically the turnover rate among nonhighly compensated employees (NHCEs") is higher than among highly compensated employees ("HCEs"). Accordingly, many years after the conversion, the grandfathered employees will typically fail to satisfy the nondiscriminatory classification test.

Since the widespread conversion to cash balance plans has occurred relatively recently, few plans have reached the point where the grandfathered employees fail the nondiscriminatory classification test. But it is starting to happen. And it is almost inevitable that such failures will become widespread in a few years.

Any company confronting this situation will, as a practical matter, have little choice regarding how to solve this problem. The companies will need to remove HCEs from the traditional plan prospectively, or at least make the problematic benefit, right, or feature inapplicable to them. Companies do not want to do this, but may have no choice if the current section 401(a)(4) regulations are not amended.

The regulatory solution is straightforward. Very generally, in the case of a business merger or acquisition, a benefit, right, or feature available to the "acquired group of employees" is, under current law, treated as satisfying the current and effective availability tests if that acquired group satisfied those tests at a specified date shortly after the acquisition. See Regulation § 1.401(a)(4)-4(d)(1). This is an eminently

sensible rule that permits a company that acquires another company and its plan to preserve the acquired plan's benefits, rights, and features for the acquired employees.

This rule would work very well to solve the conversion problem. If the availability of a benefit, right, or feature to a group of grandfathered employees satisfies the current and effective availability tests as of the date of the conversion, such availability should be deemed to continue to satisfy those tests (subject to all the existing safeguards in Regulation § 1.401(a)(4)-4(d)(1), such as the rule generally requiring that the availability of the benefit, right, or feature not be modified after the conversion).[3]

In short, our proposed rule would apply to any conversion that results in a benefit, right, or feature being limited prospectively to a frozen group of employees. The proposal would require the group of plan participants who continue to be eligible for the benefit, right, or feature to be identified solely by a reference to their age, their service, or a combination of their age and service. (Of course, transition provisions applicable to all current participants or employees would fit within this rule.) Under the proposal, if the availability of the benefit, right, or feature to the grandfathered group of employees satisfies the current and effective availability tests on the effective date of the plan amendment, such availability would be deemed to continue to satisfy the tests (subject to the safeguards noted above).

We do not envision potential abuse of our proposed rule, since the most significant benefits, rights, and features (<u>i.e.</u>, early retirement benefits and retirement-type subsidies) are subject to amounts testing under Regulation § 1.401(a)(4)-3. Amounts testing ensures that NHCEs are provided benefits comparable to those available to HCEs, taking into account any subsidies. Accordingly, if the subsidies are too generous and/or the grandfathered group is too disproportionately highly compensated, the plan will fail to satisfy Regulation § 1.401(a)(4)-3.[4]

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[3] There is no policy or technical rationale to limit this rule to conversions from a traditional plan to a hybrid plan. That is currently the most common situation where the issue arises, but there are many other situations where an employer is making significant changes to its plan and wishes to provide transition relief to older, longer service employees. The current rules can prevent such transition relief and there is no policy justification for this.

[4] Because subsidies are tested under Regulation § 1.401(a)(4)-3, we see no reason for them to also be subject to the current and effective availability tests. In our view, this is an anomaly that is clearly inconsistent with the structure of the section 401(a)(4) regulations. Accordingly, we would urge you to fully correct this anomaly by exempting from Regulation § 1.401(a)(4)-4 any benefit, right, or feature that is taken into account under Regulation
§ 1.401(a)(4)-3. But if the government is not prepared to take this step, we urge at a minimum that the rule in the text be adopted.

In short, we see a crisis looming ahead for almost all hybrid plans that have provided "choice", "greater of", or simple grandfathering. The crisis will hurt older, longer service employees unless Treasury and the IRS step in to solve this problem.

Backloading.

A number of issues have arisen recently with respect to backloading rules. We anticipate writing separately on that topic.

Effect Similar to an Applicable Defined Benefit Plan.

Under Code sections 411(b)(5)(B)(v)(IV) and 411(a)(13)(C)(ii), Treasury is to issue regulations that include in the definition of an applicable defined benefit plan any defined benefit plan (or portion thereof) that has an effect similar to an applicable defined benefit plan. Subject to three exceptions, the proposed regulations provide that a plan will be treated as having such a similar effect if "a participant's accumulated benefit … payable at normal retirement age (or benefit commencement, if later) is expressed as a benefit that includes the right to periodic adjustments … that are reasonably expected to result in a larger annual benefit at normal retirement age (or benefit commencement, if later) for the participant than for a similarly situated [older] individual … who is or could be a participant in the plan. The three exceptions in the proposed regulations are for (1) plans with only post-annuity starting date adjustments, (2) variable annuity plans with an assumed interest rate ("AIR") of at least 5%, and (3) the portion of a defined benefit plan that provides benefits attributable to employee contributions.

We believe that in general the proposed regulations provide a workable framework with respect to this issue, subject to the following recommended clarifications and modifications. First, it should be clarified that the reference to "the right to periodic adjustments" is a reference to adjustments that are not conditioned on continued service.

Also, with respect to variable annuity plans, the requirement of a minimum AIR of 5% is not appropriate. We understand the rationale for having a minimum, but 5% is too high. The use of a 5% minimum would treat most existing variable annuity plans as statutory hybrid plans. That in itself is quite significant. These plans were not established to avoid statutory hybrid plan status, because obviously they were designed before such status existed. On the contrary, the AIRs of these plans were generally based on conservative estimates of risk-free future rates of return. This is eminently reasonable, as it can give a plan or participant the ability to avoid benefit reductions. It also gives plans and participants the ability to enjoy the upside if more aggressive investments yield higher rates of return. And there is no reason to think that the AIRs were set artificially low, as that would establish artificially low initial benefit levels, which would be difficult to sell.

The floor on AIRs should be reduced to 3%, which would be consistent with the standard for variable annuity plans set forth in the minimum distribution rules; such rules address an analogous issue, as they identify payments that are nonincreasing. Regulation §1.401(a)(9)-6 Q/A-14(d)(3)(iv). This change would treat variable annuity plans with AIRs at the low end as statutory hybrid plans while preserving the current status of the majority of variable annuity plans.

The above approach to variable annuity plans is also consistent with the statutory structure. Congress was clearly aware of variable annuity plans, as evidenced by the explicit reference to such plans in the loss protection rule. If Congress had meant to treat the majority of variable annuity plans as statutory hybrid plans, it would have been natural for Congress to provide, for example, that "except as otherwise provided by the Secretary, variable annuity plans shall be treated as applicable defined benefit plans."

Also, it should be permitted for variable annuity plans to refer to separate asset pools of assets within the plan for separate measurement against the AIR and separate benefit adjustments. This separate pool of assets rule would be conditioned on each pool containing assets that are sufficiently diversified that they would qualify as reasonable and prudent plan investments if held by a separate plan.

In addition, it would be helpful for the regulations to confirm that the variable annuity rule - - permitting pre-retirement adjustments if the AIR is at a minimum level - - also applies for purposes of Code section 411(b)(5)(E)(ii).

Finally, we would urge you to modify the proposed regulations so as not to treat career average plans that are indexed through normal retirement age (without regard to continued service) as statutory hybrid plans. Again, these plans have been in existence for a long time and Congress certainly would have explicitly treated them as statutory hybrid plans if that were intended. And treating such plans as statutory hybrid plans would only serve to discourage such designs and lead to more plans where indexing is conditioned on continued service.

Indexed Plans.

Under Proposed Regulation § 1.411(b)(5)-1(b)(2)(i), a plan does not fail to satisfy section 411(b)(1)(H) solely because a benefit formula under the plan (other than a lump sum-based benefit formula) provides for periodic adjustments of the accrued benefit and meets certain other conditions. The exclusion of lump sum-based formulas from this rule is inconsistent with the statute and legislative history. Since there is no support for this regulatory exclusion, it should be deleted.

In addition, the list of permitted "indices" in the proposed regulations is extremely limited. There is no support for this limitation in the statute or legislative history; the latter refers broadly to any "recognized investment index or methodology". The regulations should be revised in accordance with the law to permit the use of any market rate of return as an index.

Contributory Defined Benefit Plans.

Under Code section 411(c)(2)(C)(iii)(II), "mandatory" employee contributions to a defined benefit plan earn interest at the plan's section 417(e)(3) rate for the period beginning on the determination date and ending on the date the employee attains normal retirement age. In light of the enactment of the 3-segment yield curve under section 417(e)(3), clarification of how this rule works would be very helpful.

PEP Issues.

We anticipate filing supplementary comments with respect to pension equity plans. In the meantime, we believe that a meeting to discuss those issues would be a very helpful step. We will be requesting such a meeting soon and we would appreciate your consideration of our request.

Plan Termination Issues.

Under Code section 411(b)(5)(B)(vi) and Proposed Regulation § 1.411(b)(5)-1(d)(3), if the interest crediting rate under an applicable defined benefit plan is a variable rate, then upon plan termination, the rate of interest used to determine accrued benefits shall be equal to the average of the rates used under the plan during the 5-year period ending on the plan termination date. Numerous issues arise under this provision.

First, assume that the rate in effect at plan termination is a fixed rate (such as 6%) but such rate has been changed during the past five years. Is such a plan subject to this provision? The statutory answer appears to be no; confirmation would be helpful.

Second, is the above rule applied separately with respect to each participant or to the plan as a whole? For example, assume that different participants are or have been subject to different interest crediting rates. It should be confirmed that the rule applies on a plan-wide basis, not separately to each participant. A participant-by-participant rule would be unadministrable in many cases; in other cases it could add significantly to a plan's administrative costs. A participant-by-participant rule would also result in strange inconsistent treatment of employees with different periods of employment. Finally, it is important for the regulations to provide that any reasonable means of determining a plan-wide rate should be permitted, including reliance on reasonable estimates.

Third, if there has been a change in the crediting rate during the 5-year period, guidance should confirm that the 5-year lookback takes into account the crediting rates actually in effect, not what the new crediting rate would have been if the change had been in effect at all times.

Fourth, a special rule should be applied in the case of equity rates of return. Under the special rule, the interest crediting rate at plan termination should be based on historical rates of return for the equity class at issue. Reliance on the 5-year period alone can lead to terribly skewed results, including very high or very low -- even negative -- rates of return. (Since the capital preservation rule only applies at benefit commencement, a 5-year period can have negative returns.)

Finally, we would also urge you to consider providing plans with flexibility not to apply the 5-years average rate in situations where it is clear that the plan's current rate reflects the market. Otherwise, there will be many situations where the five-year rule has an adverse effect on participants.

We very much appreciate the opportunity to provide our views on these important issues.

Sincerely,

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