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## **SUBMITTED ELECTRONICALLY**

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

Attention: Default Investment Regulation

*Re: Comments on Proposed Regulation § 2550.404c-5*

Ladies and Gentlemen:

### **Applicability of ERISA § 404(a)(1)(B)**

Notwithstanding that the proposed regulation is made under ERISA § 404(c)(5),<sup>1</sup> and that in the preamble the Department explains why it abandoned a somewhat similar section 404(a) regulation project (F.R. p. 56814), I find it troubling that neither the proposed regulation itself nor the preamble pays respect to one of the fundamental principles of ERISA prudence set forth in section 404(a) – that the fiduciary’s conduct must be measured against that of “a prudent man . . . in the conduct of *an enterprise of a like character with like aims.*” (Emphasis added.) ERISA § 404(a)(1)(B).

Both implicit and explicit in the proposed regulations is that an individual account plan (“IAP”) is a retirement plan. If you believe that’s true, I’d like to invite you to see the Emperor’s new clothes. While encouraging employees (personally and through employer contributions) to save and invest for retirement is a laudable policy goal, certainly worthy of the tax subsidy provided to tax-qualified IAPs, tax-qualified IAPs are neither required by law to be retirement-oriented<sup>2</sup> nor, in fact, are most designed and operated as retirement plans. Rather, existing law and regulations, as they play out in the marketplace, both on the employer side and the plan provider side, conspire to discourage the design and operation of IAPs as retirement plans.

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<sup>1</sup> Except as otherwise expressly stated, all section references are to sections of ERISA.

<sup>2</sup> I am ignoring as inconsequential the relatively small number of money purchase pension plans of various sorts.

The typical IAP is what we all generally refer to as a 401(k) plan that is tax-qualified under IRC § 401(a) as a profit sharing plan providing for the deferral of income. Unlike pension plans, there is no qualification requirement that a profit sharing plan's principal purpose be to provide retirement benefits. Under the law, the typical IAP may, and does, include such a wide variety of features and investment options that it is unrealistic to call it a retirement plan. In fact, implicit in the design of a typical IAP is that it can be almost anything the participant wants it to be. That is why the typical IAP is an attractive tax-favored benefit to employers and employees. If a consultant suggests to the employer that his "401(k) plan" should not function as lender to participants, should not permit in-service withdrawals for any purpose, should not permit participants to direct the investment of their accounts, should pay benefits only through annuity contracts, and so on, the employer would hire a different consultant. The typical employer, rightly or wrongly, believes that its IAP will not be attractive to employees as an employee "benefit" unless it provides participants with the flexibility to use the plan for such purposes as they see fit within the limits of the law.

While some participants certainly do consider their IAP plan accounts as a source of retirement income at retirement, many more, I would guess, do not.

At the risk of stating the obvious, let me explain the essential characteristics of a retirement plan. First and foremost, the plan would be designed primarily to provide a meaningful stream of income to the participant at retirement (which is essentially the IRS's definition of a "pension plan" for qualification purposes, except for the "meaningful" part). The income will be derived from contributions to the plan and earnings on those investments. Therefore, contributions must be meaningful and investments made with a view to building a fund from which meaningful retirement income can be paid.

Unfortunately, there is nothing in the law that *requires* IAPs to follow this model. Sure, there are a few tax benefit carrots here and there to encourage relative longer deferrals of relatively more money, but nothing more. Congress could have dictated that the protections of new ERISA § 404(c)(5) be available only for IAPs whose default investment fund was consistent with "retirement" plan objectives. It did not. It simply provided that the default investment must be made "in accordance with" Labor Department regulations. What it could have said, quite simply, was that the default investment must be made "*with a view to providing retirement income*" in accordance with regulations prescribed by the Secretary." But that is not what the law says.

Section 404(c)(5) goes on to say that the "regulations shall provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both."

The Department does not have the authority to change the law and regulations that govern the design essentials of IAPs, which for the most part reflected in the Internal Revenue Code (“Code”) and Treasury Department regulations, but the Department does have the responsibility and the authority to recognize the existence of such law and regulations and to take into account the “enterprise” criteria in section 404(a)(1)(B).

Therefore, the regulations should be revised to make clear that the QDIA must be selected in light of the plan’s *principal* character and aims as reflected by its stated purpose and design. In other words, if the character and aims of the plan are to be a vehicle primarily for short-term savings, then the QDIA must be consistent with such purpose. That is where the law’s requirement that guidance be provided about the appropriateness of “capital preservation” comes in. It follows that the range of QDIA possibilities must be broadened to include appropriate investments for short-term savings.

Notice that the benchmark I’ve referred to is a plan’s “*principal* character and aims.” The typical IAP is designed with a variety of contribution, distribution and investment options so that it may serve a variety of purposes, depending on the wishes of individual participants. Thus, in truth one could say the principal purpose of a typical IAP is to serve a wide variety of employee needs and desires ranging from short-term savings with a quick cash-out to long-term investing for retirement. However, the use of a single safe-harbor default fund necessarily implies a principal underlying purpose for the plan. If you continue to follow that approach, then plan sponsors should be forced to confront that issue head-on, both by expressly stating in the plan document the principal purpose of the plan that will dictate the default investment absent participant investment direction, and by including in the plan design features consistent with such principal purpose, both as conditions for availing themselves of the protections afforded by the proposed regulation.

#### **Section 2550.404c-5(c)(4)**

Section 2550.404c-5(c)(4) requires that “under the terms of the plan any material provided to the plan relating to a participant’s or beneficiary’s investment in a [QDIA] . . . will be provided to the participant or beneficiary.” This requirement raises three questions that should be expressly answered by the regulations:

(1) What does the phrase “under the terms of the plan” mean? If you answer this question in the way the IRS would have historically answered it, you would say that the requirement must be spelled out in writing in the “plan document” that is acceptable to the IRS for qualified plan determination letter purposes. Typically, many plans are maintained under prototype documents or other standard formats pre-approved to one degree or the other by the IRS. Naturally, these documents are designed primarily with a view to satisfying the qualification requirements of the Code, and the timing of amendments or changes to the documents are keyed to the IRS’s complex and ever-changing opinion and determination letter

procedures. As a practical matter, sponsors of form documents are not likely to be able to incorporate this requirement in their standard forms quickly, if their history in responding to the requirements of ERISA § 404(c) generally is any measure. Therefore, you should amend the proposed regulations to make clear that the requisite “terms of the plan” may also be reflected in documents adopted by the plan administrator or an investment fiduciary (*e.g.*, administrative rules adopted by the Plan Investment Committee), and need not be included in the plan document in the traditional, IRS sense.

(2) What does the phrase “provided to the plan” mean? Here is a typical scenario. A bank “plan provider” sells an IAP to an employer. The bank provides the plan documents and very substantial administrative services, including a website and a variety of electronic systems that participants may use to obtain investment information and make investment option selections and changes. The bank may also serve as the plan’s “directed trustee.” As investments under the plan, the bank offers some of its own in-house mutual funds, as well as several mutual funds operated by other financial institutions (“third party funds”). Notwithstanding the bank’s substantial involvement in “setting up and running the plan,” any and all agreements between the bank and the employer expressly provide that the bank has no discretionary responsibility under the plan, is not a plan fiduciary and is not the plan administrator or administrator of the plan within the purview of the Code or ERISA. In this context, when have documents (material) been “provided to the plan”?

For example, let’s focus on mutual fund prospectuses and annual reports. One could argue that given the close association of the bank with the operation of the plan, any such documents in the custody of the bank and its affiliates should be considered as having been provided to the plan. They might be in the custody of the bank because its own affiliate manages the mutual funds offered under the fund and produces the documents (*e.g.*, the fund prospectus and annual report), or because the bank has received a copy of the documents from a third party fund sponsor. Alternatively, one could argue that such documents have not been provided to the plan until actually furnished to the official plan administrator or investment fiduciary. The regulations should make clear whether the material relating to a participant’s or beneficiary’s investment in a QDIA is provided to the plan when it is (i) within the custody of the of the plan’s principal service provider, (ii) in the hands of the “legally designated” plan administrator or (iii) in the hands of the plan’s investment fiduciary that selected the QDIA.

Obviously, there are many variations of the plan provider model. Insurance companies and mutual fund companies as well as independent, professional third-party administrators provide plan services from limited to relatively complete “turn-key” programs. Administrators strive for automation. In many cases, the employer would rather have the provider “do everything” and assumes that the provider will run the plan properly, notwithstanding the plan providers’ contract disclaimers. You are aware of how the typical arrangements operate. With the context of such arrangements generally, the regulations should explain exactly when documents are “provided to the plan.”

(3) What does the phrase “provided to the participant or beneficiary” mean? The current section 404(c) regulations require that a participant be provided a mutual fund prospectus when the participant initially invests in the fund, having no existing investment in the fund. Reg. § 2550.404c-1(b)(2)(B)(I) (viii). There is purported uncertainty about whether in the current regulation “provided” means actually provided or simply provided by being “made available.” Some large plan providers advise their plan customers that the “made available” approach is satisfactory, and that a prospectus need not be provided to the participant either directly or by e-mail. Rather, “it is sufficient that the prospectus is available on line through the plan provider’s website or the mutual fund company’s website and the participant can go get it if he wants to.” I disagree with that interpretation of the regulations, but based on past experience, plan providers are not going to want to actually provide material relating to default investments to plan participants and are going to want try to avoid doing that by whatever means possible. Therefore, you should revise the regulations to make very, very clear what it will take to “provide” such material to participants.

#### **Section 2550.404c-5(e)(5)(ii)**

Section 2550.404c-5(e)(5)(ii) discusses what I’ll refer to as the balanced fund QDIA. Section 2550.404c-5(e)(5)(i) discusses what I’ll call the life-cycle QDIA, and makes clear that in selecting life-cycle QDIAs the fiduciary need only take into account the participant’s age, target retirement date (such as normal retirement age under the plan) or life expectancy in selecting asset allocations. Conversely, this subparagraph also expressly provides that the fiduciary is not required to take into account risk tolerances, investments or other preferences of an individual participant.

However, in discussing the balanced fund QDIA, subparagraph (ii) simply says that the target level of risk must be “appropriate for participants of the plan as a whole.” In a manner similar to subparagraph (i), subparagraph (ii) makes clear that individual participant characteristics, including age, are not taken into account on an *individual* basis, but offers no clue regarding the factors that should be taken into account in determining what is appropriate for the plan as a whole.

By way of contrast, the preamble to the proposed regulation makes clear that the DOL's position is that in selecting the balanced fund QDIA the fiduciary must “take into account the demographics of the plan's participants.” The preamble also says that the fund must have a “target level of risk appropriate for the participants of the plan as a whole” and that in selecting the fund you must “focus on the demographics of the participant population as a whole.”<sup>3</sup> The

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<sup>3</sup> If the fiduciary must focus on demographics, then I commend the DOL for suggesting that the demographics of the plan population as a whole should be considered, and not simply the demographics of the defaulters.

preamble goes on to point out that the fiduciary must continuously consider significant changes in demographics in deciding whether to keep or replace a fund.

In general, “demographics” or population characteristics includes such things as age, sex, race (ethnicity), location of residence, socioeconomic status, religion, nationality, occupation, education, family size, marital status, ownership of such things as home, car, etc., language, mobility and life cycle. Relevant demographics vary by the context. That is, in looking at demographic factors, you would consider different demographics depending on the purpose for which you are going to use the data. Certainly, not all of the demographic factors I’ve referred to above would be relevant in any material sense to determine an appropriate target level of investment risk for the plan as a whole. For example, if the principal purpose of the plan is to accumulate funds to provide retirement income, you would have to stretch to include “nationality” and “religion” as relevant demographic factors. On the other hand, demographic factors of age, sex, socioeconomic status, occupation, education, family size, marital status, mobility and life cycle (and other factors) might all be relevant demographic factors to consider for the purpose of determining an appropriate target level of investment risk for the plan as a whole. Therefore, just as subparagraph (i) focuses on age (or a proxy therefore) alone in the case of life-cycle funds, subparagraph (ii) should be changed to identify the specific demographic factors that the fiduciary should take into account in selecting a balanced fund as a QDIA. It is not enough to simply refer to demographic factors in the preamble – this requirement should be set for with specificity in the regulation itself.

As an aside, I will add that I am not aware of existing analytical tools or models used to select optimum “balanced funds” for retirement investing taking into account group demographics, although there is plenty of such work relating to the *relatively* simple process of determining age-appropriate retirement investment strategies. If such tools or models do not exist, then the balanced fund option will not be a viable QDIA until financial experts develop them, which is unlikely to be soon.

#### **Section 2550.404c-5(d)**

The notice contents requirements of section 2550.404c-5(d) should be expanded to include a requirement that the notice explain exactly how the QDIA is consistent with the character and aims of the plan. Section 2550.404c-5(d)(2) requires an explanation of the investment objectives, risk and return characteristics (if applicable) and fees and expenses attendant to the investment alternative. This information by itself, however, is too abstract for the average participant. In very simple terms, if the plan is designed and operated as a retirement plan, then the notice should be required to point out that the QDIA has been chosen because it is suitable for long-term investment purposes, presumably for retirement, and that if the participant has different objectives in mind for his plan account, then the QDIA may not be suitable for him.

On a more complex level, let's assume that the QDIA is a "balanced fund," and that the balanced fund has been selected as suitable as a retirement investment based on plan demographics as a whole. In a diverse plan population, the QDIA will necessarily serve certain participants better than others. In this case, the notice should explain in understandable language the demographics on which the selection is based, and that in situations where the demographics of a particular individual are not substantially in line with the "average," the QDIA may not be suitable for him as a retirement investment.

On the other hand, if life-cycle funds are adopted as the QDIA, the fiduciary need only take into account the participant's age (or proxy). But because other factors may make the QDIA unsuitable as a retirement investment for a particular participant, the notice should be required to explain that the QDIA has been selected for the participant based solely on his age, point out that other factors might be more important in a particular case, and that therefore the QDIA might not be suitable for certain participants as a retirement investment.

In other words, the notice should be required to **fully disclose** not just the abstract investment characteristics of a particular QDIA, but also why the particular QDIA was chosen for the plan and why it may or may not be suitable in an individual case. Any lesser requirement would fall far short of the protections Congress has presumably intended for participants in the Pension Protection Act. (Emphasis added.)

### **Section 2550.404c-5(c)(3)**

At a minimum, Section 2550.404c-5(c)(3) should be changed to make clear the consequences when a plan cannot meet the 30-day advance notice requirement, for example, in the case of an employee who becomes a participant immediately upon hire by the employer and makes his first contribution to the plan sooner than 30 days after hire. If the plan fiduciary is simply "exposed" for that period, you ought to make that result clear. Better, you could change the regulation to make an exception to the general rule for the first 30 days of employment as long as the employee is furnished the explanation at or before the time he makes his initial contribution election.

In addition, the phrase a "reasonable period of time of at least 30 days in advance of the first such investment and within a reasonable period of time of at least 30 days in advance of each subsequent plan year" should be clarified. All it really tells us is that the notice cannot be given closer than 30 days to the date of the first investment or closer than 30 days to the end of the plan year. The notice may be given in the SPD. Given the tendency of employers and contract administrators to try to avoid unnecessary communications with participants, I would expect the argument to be made that if an SPD explaining QDIA provisions is given to a participant, then as soon as the first 30 days thereafter have passed, the 30-day requirement has necessarily been satisfied for that participant initially and for each year thereafter. A more conservative approach,

along the same line, would be to give the notice 60 days in advance, since 30 days is an “at least” period, although not necessarily reasonable.

My preference would be for a more specific rule. For example (and with an appropriate exception for freshly hired new participants as suggested above), I suggest that the regulation require that the notice be given at least 30 days, but no more than 90 days before the first investment in the QDIA, as well as at sometime during the tenth and eleventh month of each plan year. The regulation should also make clear that “furnished” means effectively delivered, not simply “available” or “made available.”

### **Section 2550.404c-5(b)(1)**

Section 2550.404c-5(b)(1) should be clarified with regard to how one determines whether the participant or the fiduciary has invested the participant’s account. If the default investment is a QDIA, this issue may be of little consequence. However, if the default does not meet the QDIA requirements, then this becomes an important question. For example, let us assume the default investment fund chosen (without specific plan language direction) is a money market fund, which could not be a QDIA under the regulations as proposed. Participant A initially makes no investment election and his account is invested in the money market fund. A year later, the participant elects to move 70 percent of his account to an equity index fund offered under the plan, and leave the remaining 30 percent in the money market fund. Is the plan’s investment fiduciary still responsible for the continuing prudence of the money market fund, and if so, is the fiduciary’s prudence determined with respect to money market investment in the context of the entire account, or based on the assumption that the entire account of the participant is invested in the money market fund?

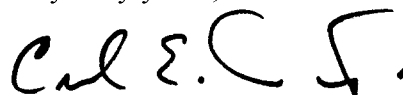
It may be that the simple answer to the first question is that it depends on the nature of the election. For example, the plan’s electronic election system may require that any time the participant makes an election to change investments, the participant must make affirmative elections for the investment of 100 percent of his account. In this case the participant will be required to elect that going forward 70 percent of his account is to be invested in the equity index fund, and 30 percent in the money market fund, and the fiduciary should be off the hook. However, many systems also permit the participant to move dollars. For example, the participant’s entire account, valued at \$10,000, may be invested in a money market fund by default. The plan may simply permit the participant to elect to transfer \$7,000 to the equity index fund. Under those circumstances it is less clear that the participant has also elected the money market fund for the remaining \$3,000 in his account, and the question regarding the fiduciary’s obligation to take into account the participant’s election for the \$7,000 then remains to be answered.



This issue has broader 404(c) implications than simply its implications for the proposed regulation. Therefore, it may be appropriate to address the issue under a different 404(c) regulation.

Respectfully submitted.

Very truly yours,

A handwritten signature in black ink that reads "Carl E. Johnson, Jr." in a cursive style.

Carl E. Johnson, Jr.