

## **Comments on Proposed Regulations Relating to Default Investment Alternatives Under Participant- Directed Individual Account Plans**

**November 13, 2006**

Department of Labor

29 CFR Part 2550  
Section 2550.404c-5

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to comment on the proposed regulations under Section 404(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, that provide guidance regarding default investment alternatives for participant-directed individual account plans (Proposed Regulations).

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the employer-sponsored pension system. Its membership consists of over 6,000 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans, especially for small to mid-size employers.

The Proposed Regulations are welcome first steps for practitioners who must advise sponsors of employee benefit plans that permit self-directed investments and must determine appropriate default investments for participants who do not affirmatively direct their investments. ASPPA requests clarification of several issues addressed in the Proposed Regulations on qualified default investment alternatives (QDIA), and guidance on certain issues not covered in the Proposed Regulations. Issuing timely and comprehensive guidance on all aspects of default investment alternatives will allow plan sponsors to appropriately implement applicable provisions of the Pension Protection Act of 2006 (PPA).

### **Summary of Recommendations**

The following is a summary of ASPPA's recommendations. These are described in greater detail in the Discussion of Issues section.

- A. An investment designed for principal preservation, such as a stable value fund, should be a permitted QDIA for limited periods of time.
- B. Existing default investments should be given a fresh start if they would otherwise constitute a QDIA.

- C. Relief should be provided for the advance notice requirement in specific situations where the 30-day prior notice requirement is impractical or impossible to meet.
- D. The final regulations should clarify that an investment will not fail to be a QDIA solely because it is subject to fees and restrictions imposed by investment or insurance companies pursuant to securities laws and Securities Exchange Commission (SEC) guidance.
- E. Plan sponsors should be permitted to rely on a good-faith interpretation of the Proposed Regulations for calendar year 2007.
- F. Model portfolios should be permitted QDIAs when created by investment managers not listed in ERISA §3(38), or investment managers under ERISA §3(38) that are not considered fiduciaries to the plan.
- G. The Department of Labor (DOL) should provide additional guidance regarding appropriate QDIA fee disclosure.
- H. The DOL should clarify that if the “terms of a plan” are required to contain certain provisions (such as requiring a plan to distribute QDIA material to plan participants), then the inclusion of such provisions in procedures or other instruments governing the plan is considered to be inclusion in the “terms of the plan.”
- I. The final regulations should provide that a plan is only required to distribute to participants invested in a QDIA the same investment information that the plan would otherwise distribute to participants who made affirmative investment elections in the same or similar investment.

## **Discussion of Issues**

### **A. Principal Preservation Investment as a Short-Term Option**

In many situations a participant’s investment horizon under a retirement plan is long-term, where more aggressive investment options with greater emphasis on returns, rather than preservation of principal, is more suitable. ASPPA, however, suggests that the DOL provide relief for plan fiduciaries choosing a principal preservation as the default investment in certain specific, short-term circumstances.

The PPA provides incentives for plan sponsors to adopt eligible automatic contribution arrangements under which employees who do not make affirmative elections to contribute to the plan may be automatically enrolled at a specific deferral percentage. One of these incentives is the ability to “unwind” a participant’s automatic enrollment deferrals. Under this provision, a participant may elect within 90 days of the participant’s first automatic contribution to have his or her deferrals refunded.

The Proposed Regulations also suggest that plan fiduciaries consider fees and expenses of an investment alternative when choosing a QDIA. Many investment alternatives that would otherwise satisfy QDIA requirements charge redemption fees in connection with certain

short-term investments. Redemption fees, however, are typically not imposed by investments that have principal preservation as a primary objective, such as money market accounts or stable value funds (referred to collectively as “principal preservation investments”). As a result, permitting principal preservation investments as QDIAs could avoid the imposition of redemption fees on participants requesting refunds of automatic deferrals. Additionally, these participants would not have as much risk of losing principal as they otherwise would face when invested in the QDIAs listed in the Proposed Regulations. Principal preservation investments should be permitted QDIAs for a limited period of time in order to avoid interfering with long-term earnings.

*ASPPA recommends* that a principal preservation investment be added to the list of QDIAs for a period of 120 days or less. The 120-day period would allow plans to have sufficient time to process participants’ requests to return their deferrals, particularly for participants who make their requests at the end of the 90-day period. A plan sponsor would have the option to include a principal preservation investment. Therefore, inclusion of a principal preservation instrument as a QDIA would not increase any administrative burden on plan sponsors or plan service providers and should not increase the risk of operational failures if they choose not to offer this alternative.

## **B. Existing Default Investments**

The fiduciary protection provided by the Proposed Regulations only applies to participants who have not directed the investment of their accounts. Accordingly, the fiduciary protection would not apply to a participant who directed his or her account to an investment option that may now be a plan QDIA. For some plans, because such records may not be available, it may not be possible to ascertain whether the participant’s investment in the QDIA was the result of the participant’s affirmative election. For example, when plans are transferred to another recordkeeper, these records may not be maintained by the new service provider or made available by the prior provider.

Pursuant to the Proposed Regulations, a plan would be able to get a fresh start (*i.e.*, it could provide participants with the option to select their investments under the new provider) if it transferred its assets to a new provider. Where participants do not select their investments with the new provider, the Proposed Regulations provide for fiduciaries to place their accounts in a QDIA and obtain relief. In order to provide comparable relief for existing arrangements, the final regulations should also allow the benefit of a fresh start for plan sponsors who do not change service providers.

*ASPPA recommends* a fresh start for continuing investments as an option that would otherwise be a plan QDIA. The final regulation should permit plan sponsors to provide notices to participants in a current default fund that will be a QDIA informing them that their accounts would remain in the current investment unless they elect otherwise. Thereafter, all account balances remaining in the investment would be invested in a QDIA pursuant to the final regulations under ERISA §404(c)(5).

### C. Advance Notice Requirement

The Proposed Regulations provide that to have fiduciary protection for a QDIA, participants must be given at least 30 days advance notice prior to the first QDIA investment and within a reasonable time at least 30 days prior to the beginning of each subsequent plan year. Many plans provide that employees enter the plan on the date of hire, permitting employees to start saving as soon as possible for their retirement. Congress has encouraged such plan designs by providing limited relief from some of the 401(k) plan nondiscrimination requirements where such plans provide for liberal age and service conditions. [See IRC §401(k)(3)(F).] Furthermore, most 401(k) plans are required under current IRS rules to provide for the immediate participation of former participants who are rehired.

Plans that allow participation in fewer than 30 days (*e.g.*, new hires, rehires, acquisitions, plan mergers, etc.) would not be able to rely on the safe harbor provided in the Proposed Regulations until 30 days after the notice is given. In addition, there would be no federal preemption of state laws for those plans that also include an automatic contribution arrangement, as compliance with the ERISA §404(c)(5) regulations is required for preemption to apply.

The preamble of the Proposed Regulations recognizes the goal of encouraging retirement savings. The Proposed Regulations, however, would require plan sponsors to delay an employee's participation in order for the arrangement to qualify for federal preemption or to qualify for relief under the safe harbor default investment. Additionally, 30 days' advance notice may not be possible in some circumstances, such as for rehires. It is not feasible, practical or desirable to require that such participants make an affirmative investment election on their date of hire or rehire. The investment information provided to participants must be read and understood, and many want to discuss the investment alternatives with a spouse or investment advisor.

**ASPPA recommends** that the DOL provide relief from the advance notice requirement for plans that allow, or require, participants to enter the plan in fewer than 30 days from their date of hire or rehire. Should the DOL be concerned about participants having sufficient time to elect the investments for their account, ASPPA suggests that the final regulations provide that under these circumstances a plan provide the notice within a reasonable period of time on or after the date of hire or rehire.

**ASPPA further recommends** that the plan allow participants to transfer their accounts out of the QDIA within the first 30 days (or some other time period) for plans that do not provide more frequent investment election changes.

Alternatively, **ASPPA recommends** that the DOL coordinate with the IRS to ensure that plans permitting employees to participate immediately, but not applying automatic enrollment provisions until 30 days after their initial eligibility commenced (*e.g.*, date of hire or rehire, etc.), will still be an "automatic contribution arrangement" within the meaning of PPA §902.

## D. Financial Impediment

Under the Proposed Regulations, an investment alternative will not constitute a QDIA if financial penalties or other restrictions limit the ability of a participant to transfer investments out of the QDIA. An investment option that meets the other requirements for a QDIA, however, may be subject to fees and trade restrictions imposed by investment or insurance companies pursuant to securities laws and SEC guidance, such as short-term redemption fees to address market timing issues. The imposition of such fees or restrictions should not prevent an investment from being a QDIA.

*ASPPA recommends* that the final regulations clarify that any fees or trading restrictions imposed consistent with securities laws and SEC guidance are not financial penalties or restrictions for determining whether an investment is a QDIA.

## E. Interim Protection

The Proposed Regulations do not provide relief under ERISA §404(c)(5) until 60 days after the final default investment rules are published in the Federal Register. As a result, ERISA §514(e), which provides for federal preemption of state laws for automatic contribution arrangements that invest contributions in accordance with the ERISA §404(c)(5) regulations, will not be available until then, even though the effective date of ERISA §514(e) was the date of enactment of PPA, August 17, 2006. Additionally, even for those plans that do not include automatic contribution arrangements, fiduciaries will need time to implement the final regulations in order to be entitled to the relief afforded by the regulations.

*ASPPA recommends* that the DOL issue guidance providing that the Proposed Regulations may be relied upon for calendar year 2007 (or when final regulations are issued, if later) if fiduciaries apply the Proposed Regulations in good faith.

## F. Plan Model Portfolios

The Proposed Regulations provide that model portfolios managed by investment managers as defined by ERISA §3(38), and investment companies registered under the Investment Company Act of 1940, may qualify as QDIAs. [See 29 CFR § 2550.404c-5(e)(3).] To satisfy the definition of an “investment manager” under ERISA §3(38), an entity must generally be a registered investment manager under state or federal law, a bank or an insurance company. That entity must also have discretion over the assets of the plan, and must represent to the plan that it is a plan fiduciary.

Many plans provide model portfolios to participants as plan investments. Some plans provide model portfolios that are prepared by entities that are not listed under ERISA §3(38), such as affiliates of entities that would qualify as investment managers under ERISA §3(38). Other plans may use model portfolios prepared by entities listed in ERISA §3(38), but do not have fiduciary status. Still other plans may obtain fiduciary investment advice from ERISA §3(38) entities, but may not provide those entities the full discretion to implement management decisions with respect to the model portfolios without approval by, for example, the plan’s Board of Trustees. In each of these circumstances, under the Proposed Regulations, the

model portfolio would not satisfy the investment manager requirements of ERISA §3(38), and therefore would not constitute a QDIA.

*ASPPA recommends* that the final regulations permit an entity described in ERISA §3(38)—or its affiliates—to establish a model portfolio as a QDIA without representing that it is a plan fiduciary, and allow an entity described in ERISA §3(38) to advise another fiduciary to adopt its model asset allocation as a QDIA, without exercising the discretionary authority otherwise required under ERISA §3(38).

## **G. Fee Disclosure**

The Proposed Regulations require that the advance notice provided to participants describe the “fees and expenses attendant to the investment alternative.” This required description may be subject to inconsistent interpretations. For example, it is unclear whether indirect fees and expenses, such as 12b-1 fees or wrap fees, are “attendant to the investment alternative.”

*ASPPA recommends* that the final regulations provide details on required fee disclosure.

## **H. Terms of the Plan**

The Proposed Regulations require that materials must be distributed pursuant to the “terms of the plan” and that a participant must be able to make transfers in a manner that is “consistent with the terms of the plan.” It is unclear whether documents other than the formal plan document, such as a directed investment procedure, would be “terms of the plan.” If outside documents are not considered “terms of the plan,” then the cost of complying with the final regulations may result in unwarranted plan expenses. Many plan sponsors use IRS pre-approved plans (master and prototype or volume submitter plans). Therefore, once approved, the ability to amend such a plan is considerably expensive unless such amendment is made with prescribed timeframes determined by the IRS (generally, modifications to pre-approved plans may be made once every six years).

*ASPPA recommends* that the final regulations provide that where a plan is required to contain certain provisions (such as requiring a plan to distribute QDIA material to plan participants), such requirement is satisfied if it is contained in procedures or other instruments governing the plan.

## **I. Materials to be Provided**

The Proposed Regulations provide that all QDIA-related materials be provided to participants, such as account statements, prospectuses and proxy voting material. The materials required by the Proposed Regulations may differ from those that must be distributed to participants for other plan investments, even for those plans trying to fall within ERISA §404(c). For example, most plans do not distribute proxy materials to participants. ERISA §404(c) protection is still available for the participant’s investment selections, even though the plan fiduciaries retain fiduciary responsibility for any rights that are not passed through to participants. Similarly, the PPA includes a requirement that quarterly statements be provided to participants; thus the imposition of a pass-through of statements from a QDIA investment is at best duplicative.

**ASPPA recommends** that the information required for distribution to participants be limited to the information that the plan is otherwise providing regarding other investments in the plan.



These comments were prepared by ASPPA's DOL Subcommittee of the Government Affairs Committee, Debra A. Davis, Esq., Chair, and were primarily authored by A. Michael Marx, Esq., APM. Please contact us if you have any comments or questions regarding the matters discussed above. Thank you for your consideration of these comments.

Sincerely,

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