The Retirement Security Project

1755 Massachusetts Ave., NW, Suite 550
Washington, DC 20036
p: 202.483.1370 f: 202.483.1460

November 13, 2006

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

Attention: Default Investment Regulation

Ladies and Gentlemen:

I am writing on behalf of the Retirement Security Project to comment on the Department's proposed regulation titled "Default Investment Alternatives Under Participant Directed Individual Account Plans," 71 Fed. Reg. 56806 (Sept. 27, 2006).

The Retirement Security Project is supported by the Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution. The Project works on a nonpartisan basis to promote common sense solutions to improve the retirement income prospects of middle- and lower-income Americans. The Project is led by Peter Orszag, Bill Gale and the undersigned.

One of the major priorities of the Retirement Security Project has been to contribute to the understanding, and promote the use, of automatic features in 401(k) and similar retirement savings plans, including the use of sensible defaults in enrollment (including automatic escalation) and investment.[1] The efforts of the Project in this area are one of the factors that have contributed ultimately to the automatic 401(k) provisions in the recently enacted Pension Protection Act of 2006 (PPA).

For further information on the Retirement Security Project's policy proposals, see www.retirementsecurityproject.org

We commend the Department for issuing the proposed regulation. It represents an important step forward, encouraging plan sponsors to feel free to select

[1] See William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Discussion Paper, No. 2005-01, March 2005; William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices", Retirement Security Project Discussion Paper, No. 2005-04, May 2005.

prudent default investments with asset allocation that includes significant exposure to diversified equity investments. Set out below are our specific comments.

1. The Regulation's Notice Requirement Should Be Sufficiently Flexible to Accommodate Automatic Enrollment That Begins on the Date of Hire.

Recommendation

Encourage automatic enrollment by allowing it to begin with a new employee's first paycheck, without a reduction in take home pay. To make this possible, plans that provide for immediate participation while allowing employees to opt out retroactively during the first 90 days should be required to give advance notice of automatic enrollment on date of hire, but not 30 days in advance of the first automatic contribution. A specific 30-day requirement could still apply to plans that begin automatic enrollment later.

Discussion

For more than eight years, administrative guidance has made clear that automatic enrollment may take effect as of an employee's first paycheck, provided that advance written notice is given on the date of hire.[2] "Within a reasonable period thereafter," the employee may opt out with respect to the first pay check.[3] The right to opt out is prospective: an employee can opt out only with respect to pay checks that have not yet been paid. Thus, the initial opt out period lasts from date of hire for as long as it continues to be administratively possible to implement the opt out with respect to the first pay check. If the employee submits an opt out election after it is too late to stop an automatic contribution from the first pay check, the opt out election applies only to the subsequent pay checks.

The Department's proposal would postpone the implementation of automatic enrollment until at least 30 days after employees have received the initial notice – typically after the employee has received at least one pay check. This generally

---

[2]The guidance has not required the notice to be provided a specified period of time in advance of the effectiveness of automatic enrollment. However, the final Labor regulation on default investments could retain the specified time period (such as 30 days) for all circumstances except the initial pay period.

[3] Automatic enrollment was first officially recognized, defined and approved in Revenue Ruling 98-30,1998-25 I.R.B. 8, issued by the Internal Revenue Service in 1998. In the ruling, which includes a footnote supplied by the Department of Labor, the employees eligible to participate in a 401(k) plan that uses automatic enrollment receive notice of the terms of the automatic enrollment arrangement when they are hired. Beginning on the date of hire and "within a reasonable period thereafter," employees may opt out of the arrangement. This standard was reiterated in Revenue Ruling 2000-8, 2000-1 C.B. 617 (which contained a similar footnote from the Department of Labor), Revenue Ruling 2000-33, 2000-31 I.R.B. 1, and Revenue Ruling 2000-35, 2000-2 C.B. 138. When the Executive Branch subsequently addressed automatic enrollment -- in an IRS General Information Letter to one of The Retirement Security Project's principals, and in Treasury Regulation Section 1.401(k)-1(a)(3)(ii) -- nothing was said to change these notice provisions.

would mean that automatic enrollment would reduce take home pay, changing current practice after numerous plans have followed the existing guidance, and after Congress has enacted a 90-day unwind provision that lends further support to the current approach.

The current approach – permitting automatic enrollment to take effect with an employee's first pay check if notice is given on the date of hire -- has reflected a policy of encouraging automatic enrollment by permitting employers to avoid reducing employees' take home pay. The behavioral assumptions and evidence underlying the use of automatic features in 401(k) plans suggest that saving can be made easier by taking account of common behavior patterns and perceptions. For example, the choice to save tends to be more attractive and easier to make if it does not involve a drop in take home pay. Because people often become accustomed to what they currently have, even a modest reduction in take home pay may disrupt expectations in a household of moderate means, and the prospect of such a reduction can therefore discourage saving. (Some employees might even be reluctant to open the discussion with their spouse or other family members about whether to reduce current take home pay.) By contrast, when take home pay is not reduced from current levels, the understanding that take home pay would have been greater absent the contributions to the plan may be less of an obstacle because the potential additional take home pay has not become a reality to which family expectations and expenditures have been geared.

With these considerations in mind, we recommend a balancing of the advance notice requirement with one of the two central purposes of the regulation – to encourage automatic enrollment. The regulation could preserve a specific advance notice requirement (such as the 30-day requirement) for employers that begin automatic enrollment after a waiting period, but should accommodate employers that choose to begin automatic enrollment with a new employee's first pay check and avoid a reduction in take home pay. Under these plans, an employee who wishes to opt out would normally need to do so in time for the plan to prevent the automatic contribution from being deducted from the first pay check. For employee who do not opt out (normally the vast majority), this avoids a reduction in take home pay. At the same time, any employee who wishes to opt out could not only preclude automatic contributions from all subsequent pay checks, but could still reverse the automatic contribution from the first pay check by opting out within 90 days under the PPA "unwind" provision.[4]

> Example: Jane, a newly hired employee, is paid every two weeks. She receives notice of employer's 401(k) and automatic enrollment arrangement on her date of hire. The notice indicates that the plan administrator will immediately implement opt out elections for all paychecks that have not been processed by the time the opt out election is received, and

[4] Because plans are not required to offer employees the 90-day unwind opportunity, the rule we suggest could be conditioned on the plan offering that opportunity, although the regime in place since 1998 has operated without any such condition.

> will implement the opt out election retroactively for all paychecks if the election is received within 90 days after the first automatic contribution is made.
>
> Jane files an opt out election. However, her election is received shortly after her first pay check has been cut and therefore applies to prevent automatic contributions from all pay checks except the first. Since Jane's annual salary is about $50,000, her first pay check is about $2,000, and the plan's automatic contribution percentage is 4%, $80 is contributed to the plan from her first pay check. The plan promptly returns the $80 to Jane pursuant to the 90-day "unwind" provision.

If the proposed 30-day notice requirement were imposed with respect to the initial paycheck, the drop in take home pay that would occur for those who accepted automatic enrollment might discourage employees from participating. In addition, some employers may be less willing to use automatic enrollment if they know it will involve an actual cut in take home pay (i.e., relative to previous take home pay actually received, not merely relative to take home pay that might have been received absent the plan contributions).[5]

The issue here is not how early the notice regarding automatic enrollment and opt out rights should be given. It should be given on the date of hire if the plan enrolls employees without a waiting period. The issue is how much time, after providing the initial notice on the date of hire, should plans be required to provide an employee to opt out with respect to the initial paycheck *on top of the PPA's 90-day retroactive opt-out period.* We suggest that the appropriate answer (consistent with the guidance that has applied to automatic enrollment from its inception) is as much time as it is administratively practicable for the plan to provide between the date-of-hire notice and the first paycheck.

<u>2. The Notice to Employees Regarding Automatic Enrollment and Their Right to Opt Out of the Default Contribution Level and Investment Should Not Be Provided Only as Part of a Summary Plan Description.</u>

<u>Recommendation</u>

The proposed regulation appears to allow plans to provide the notice of automatic enrollment and of the employees' right to opt out of the default contribution level and default investment solely through the summary plan description (SPD). The regulation should require this information to be disclosed in a separate notice and should also require a brief reminder of this information to be included in election notices and forms as well as investment performance information provided to employees.

---

[5] If the final regulation required the opt out election period to last at least 30 days only for plans that begin automatic enrollment after a waiting period, the Department should not be concerned about inconsistency in permitting a shorter time for plans that do not impose a waiting period. Only in the case of the first few pay periods, the opt out period in effect lasts 90 days, and the objective of encouraging automatic enrollment by avoiding a potential reduction in take home pay justifies a difference in the opt out periods.

Discussion

SPDs contain a considerable amount of information for plan participants. The notice of automatic enrollment and of employees' right to opt out of the default contribution level and default investment should not be "buried" in a significantly longer document. It should be provided separately on the date of hire or, if the plan imposes an eligibility waiting period, sufficiently in advance of the date automatic enrollment would take effect. In addition, participants who are automatically enrolled at a particular contribution level and in default investments should generally be reminded of this fact and of their right to opt out in favor of alternative contribution levels and investments each time they receive information about their contributions or investments.

3. The Regulation Should Approve "Investment Escalation" By Making Clear That Qualified Default Investment Alternatives Include Investments That Preserve Principal in the Short Term Before Transitioning to Life Cycle or Balanced Funds or Managed Accounts.

Recommendation

The final regulation should make clear that a qualified default investment alternative ("QDIA") includes an "investment escalation" default alternative which invests a nonelecting participant in a principal-preserving investment (such as stable value or money market) in the short term and transitions automatically to one of the three existing QDIAs in the long term. The duration of the short term phase could be determined by the plan sponsor. Some plan sponsors might choose to limit it to 90 days simply to avoid a risk of loss for any employees who elect to revoke their automatic enrollment retroactively, while others might choose to extend the short term principal preserving phase for a longer period, such as a year or two.

"Investment escalation" -- starting with a principal-preserving default investment for a short time before shifting automatically to an asset-allocated default – is somewhat akin to contribution escalation (increasing the default contribution over time to overcome the inertia that would otherwise keep too many participants at a relatively modest initial default contribution level indefinitely). Both strategies make it possible for risk-averse or hesitant employers and employees to "ease in" to full-fledged automatic enrollment and automatic investment.

Discussion

Many plan sponsors are comfortable with the risk of nominal losses for some employees who liquidate their plan investments in the short term. Many believe that asset-allocated investments, such as those treated as qualified default investment alternatives in the proposed regulation, can generally be expected to serve employees' best interests overall, and that the risk of losses in the value of employee contributions for some employees in the short term is more than justified by the overall expected results. Other employers are not overly concerned about the reactions of employees who leave the job very soon, or are comfortable that employer matching contributions and tax-favored treatment will tend to offset possible losses in the value of employee contributions.

However, many plan sponsors, concerned about employee relations or potential liability, have used principal preserving defaults to avoid the risk that employees cashing out, especially in the short term, would lose principal if market values declined. Although this risk tends to diminish over time, it could be nontrivial in the short term.

Moreover, it is hard to predict which investments in a self-directed plan will ultimately be held for the short or long term. It is uncertain how long any given employee will remain with the employer, and when plan investments will be liquidated after employment terminates. Some departing employees do not liquidate because they leave their account balances in the former employer's plan or transfer their plan investments in kind to an IRA trusteed by the same institution that offered the plan investments. However, departing employees commonly liquidate their investments, and this – together with events such as in-service hardship withdrawals -- means that many plan investments are of short duration.[6]

Employers that have such concerns (including employers that wish to preclude the risk of loss at least for employees who opt out during the 90-day retroactive opt out period and employers that might wish to preclude the risk of loss for more short-term employees) could more readily "ease in" to automatic enrollment if the regulation treated our suggested "investment escalation" strategy as a QDIA.

In fact, if the Department decided to make principal preserving investments, such as stable value or money market funds, an additional QDIA in their own right (not limited to the short term as under the investment escalation approach), then we would still recommend that the final regulation also treat the investment escalation approach outlined here as a QDIA. Plan sponsors may not be comfortable concluding that the investment escalation approach is a QDIA based solely on the fact that a stable value fund is a QDIA (if the final regulation so provides) and a life cycle or balanced fund (or managed account) is a QDIA.

4. The Regulation Should Encourage Fiduciaries to Focus Hard on the Level of Fees and Expenses Associated With Default and Other Investments and to Consider the Use of Index Funds or Other Low-Cost Vehicles.

[6] In the future, the system may achieve sufficient portability to enable most workers to avoid liquidating their plan investments when they change jobs.

Recommendation

The regulation should require plan fiduciaries to justify and document their selection of a default investment. This analysis should include comparison to alternative investments, including a comparison of the fees and expenses of the default investment to similar investments that are not used as defaults, and an explanation of why a lower-cost investment option was not selected. The Department should determine how best to encourage fiduciaries to consider appropriate low-cost passive investments such as index funds. For example, the regulation should make specific reference to the types of lower-cost alternatives currently available (such as index funds) and should make clear that fiduciaries need to understand and compare the costs of investment alternatives, should consider lower-cost alternatives, and should be able to justify any decisions not to use them.

Discussion

It is a commonplace that participants' investment returns can be importantly affected by investment and administrative expenses that are not borne by the plan sponsor. Accordingly, it is important that plan investments not impose excessive or hidden fees or other expenses. This is especially true in the case of default investments, which in many cases could attract a very large share of plan assets, and which some participants, perceiving an employer endorsement, may scrutinize less carefully than other investment options. For these reasons, plan fiduciaries' responsibility to monitor fees and expenses and ensure that they are not excessive may be heightened in the case of default investments.

Moreover, the particular qualified default investment alternatives specified in the proposed regulation, while appropriate types of default investment, can be structured in some cases with multiple layers of fees and expenses. For example, life cycle and balanced funds can take the form of a "fund of funds" that could involve expenses at the level of each constituent fund and additional expenses at the aggregate level, and managed accounts could involve expenses at the level of each constituent investment or investment fund that makes up the portfolio as well as additional fees or expenses for the management. In addition, fiduciaries need to be alert to the risk of investing in a "fund of funds" that is being used as a dumping ground for selected funds that have underperformed, have proven hard to sell, or are particularly costly.

Of course higher fees and expenses might or might not be accompanied by better investment performance (in terms of returns and risk management). However, a plan fiduciary considering alternative investment offerings should be responsible for acting as a "prudent expert" focusing attention on fees and expenses and the extent to which they are competitive and justified. In this regulation or other guidance, the Department should encourage plan fiduciaries to consider, for purposes of default investments or other investment options, the use of low-cost alternatives that are equally likely to achieve the desired risk and return objectives. These might include, for example, investments that use as their components low-cost index funds or other low-cost passively managed investments that track a large portion of the market.

The specific types of investments available will vary as creativity and innovation continue to give rise to new and improved financial products and services (such as broadly diversified exchange traded funds as opposed to index funds).[7] However, the Department can make specific reference to the types of lower-cost alternatives currently available and can make clear that fiduciaries need to understand and compare the costs of investment alternatives, should consider lower-cost alternatives, and should be able to justify any decisions not to use them.

* * * * *

If you have any questions about our comments, or if further information would be helpful, please let me know.

Respectfully submitted,

J. Mark Iwry

J. Mark Iwry
Senior Adviser and Principal
The Retirement Security Project

---

[7] The specific QDIAs approved in the regulation could lag behind developments in the market and become outdated, given the lapse of time and the effort ordinarily involved in opening up and amending an existing regulation. On the other hand, if the Department were to consider establishing a streamlined process for the consideration of additional QDIAs, the process should still require notice and public comment.

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.
www.retirementsecurityproject.org

Appendix

Extract from Revenue Ruling 98-30:

"Under Plan A, a newly hired employee is immediately eligible to participate in Plan A. If the employee does not affirmatively elect to receive cash or have a specified amount contributed to Plan A, his or her compensation is automatically reduced by 3 percent and this amount is contributed to Plan A. An election not to make compensation reduction contributions or to contribute a different percentage of compensation can be made at any time. The election is effective for the first pay period and subsequent pay periods (until superseded by a subsequent election) if filed when the employee is hired or if filed within a reasonable period thereafter ending before the compensation for the first pay period is currently available. Thus, if an employee files an election to receive cash in lieu of compensation reduction contributions and the election is filed when the employee is hired or within a reasonable period thereafter ending before the compensation is currently available (and if the employee does not later elect to have compensation reduction contributions made), then no compensation reduction contributions for the first pay period are made on the employee's behalf to Plan A. Elections filed at a later date are effective for payroll periods beginning in the month next following the date the election is filed.

At the time an employee is hired, the employee receives a notice that explains the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election. The employee is subsequently notified annually of his or her compensation reduction percentage and the employee's right to change the percentage."

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.
www.retirementsecurityproject.org