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Office of Regulations and Interpretations
Employee Benefits Security Administration (EBSA)
Room N-5669
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210
Attn: Default Investment Regulation

Re: Proposed Regulations on Default Investments

Dear Sir or Madam:

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") to comment on recently proposed regulations on default investment alternatives under participant directed individual account plans. The Committee is a coalition of life insurance companies that was formed in 1982 to participate in the development of federal policy with respect to annuities. The Committee's current 29 members represent most of the nation's most prominent issuers of annuities and are among the largest issuers of annuity contracts to retirement plans subject to Title I of ERISA. A list of the Committee's member companies is attached.

The Committee greatly appreciates the proposed regulations and looks forward to increased utilization of automatic enrollment arrangements once the regulations are finalized and effective. As discussed below, the Committee has a number of suggestions for improving the final regulations. Specifically, the Committee recommends that the final regulations (1) confirm that annuities may be used to provide qualified default investment alternatives, (2) clarify how the regulations apply to a variable annuity contract, (3) include fixed income investments in the list of qualified default investment alternatives, (4) explain that fees should be considered in the context of the investment features that are being purchased, and (5) ensure that the list of qualified default investment alternatives does not act as a barrier to the development of new investment products.

I. The final regulations should confirm that annuities may be used to provide qualified default investment alternatives.

The proposed regulations are silent on the use of annuity contracts to provide default investments. The regulations are carefully drafted to refer to "investment fund products" and the Committee appreciates that the regulations are intended to encompass a broad range of investment products. The Committee believes that an investment in a variable annuity contract separate account is an "investment fund product" that may qualify as a qualified default investment alternative ("QDIA"), if all of the applicable requirements otherwise are met. However, without a specific reference in either the preamble or the final regulations, the Committee is concerned that questions may arise about whether default investments may be made through annuity contracts, and we urge you to explicitly state that annuity contract investments may qualify as QDIAs.

Annuity contracts have a long history in the retirement plan context. Many of the earliest employer-sponsored retirement plans were arrangements where employers made contributions to group or individual annuity contracts. Today, annuities make even more sense in retirement plans. With increases in longevity and the shift from defined benefit plans to defined contribution plans, retirees face new challenges. Not only must they save enough for retirement, they must also learn how to manage their savings during a retirement of uncertain length. Annuities help retirees to manage their savings by offering a guaranteed income for life. For that reason, annuities are a critical part of our retirement savings system and it is essential that our retirement policies encourage annuitization in defined contribution plans.

One way to encourage annuitization is to facilitate the use of annuities as default investments. Unlike other investments, investments in deferred annuities work well as defaults both during the accumulation phase of a participant's working life and during the payout phase after a participant has retired. In this sense, annuities are the ideal default investment because they can serve as the accumulation default and the payout default. Annuity defaults also make sense from a policy perspective because they generally invoke the spousal consent requirements of ERISA and create a default form of payout that is a qualified joint and survivor annuity.

Moreover, annuities make particular sense as default investment alternatives because they send a normative message about how plan participants should behave. In this regard, automatic enrollment arrangements are good for retirement savings not just because they get participants who might not otherwise save to do so, but also because they send a message to other plan participants about the importance of savings. Annuity defaults can serve a similar function by sending a message to all plan participants that they should be considering payouts in the form of life-contingent annuities.[1]

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[1] As a policy matter, annuitization in plans is preferable to annuitization in the individual market because of economies of scale. Group pricing and efficiencies in administration both can result in lower fees relative to annuities that are available in the individual market. For women,

II. The final regulations should clarify how the regulations apply to variable annuity contracts.

In a typical variable annuity contract that is held by a plan (either as an investment held by a trust or as the plan's funding vehicle), participants may elect to invest in a fixed account option and/or one or more variable investment options. Amounts that are allocated to the fixed account are held by the insurance company in its general account, and such amounts earn interest at a rate declared by the insurer from time to time, subject to a guarantee of principal and a minimum guaranteed interest rate.[2] Amounts allocated to a variable investment option are held in an account that, pursuant to state law or regulation, is segregated from the insurer's general asset accounts (the "separate account"). The separate account is generally divided into sub-accounts that are invested in various investment funds, *e.g.*, an S&P 500 index fund, a balanced fund, *etc.*, whose values fluctuate with market performance. Under some variable annuity contracts, the sub-account invests in funds that are registered investment companies but the separate account itself will not be a registered investment company. In other variable annuity contracts, the separate account and the sub-account investments are both registered investment companies.

One or more of a variable annuity's sub-account investments will generally be able to serve as QDIAs under the proposed regulations, either independently, *e.g.*, where a sub-account is a balanced fund, or as elements that comprise a "fund of funds," *e.g.*, where a model asset allocation functions as a life cycle fund. However, the QDIA is literally an investment in a variable annuity contract that has a sub-account invested in the appropriate type of investment fund (*e.g.*, a balanced fund), and not the sub-account itself. For this reason, the default fund will have the characteristics of the sub-account fund, the insurance company separate account and the insurance features of the annuity.[3] This structure raises certain issues that should be clarified in the final regulations, discussed below.

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unisex mortality tables also can make annuities in the employment context more attractive than annuities in the individual market.

[2] Under some variable annuity contracts, amounts may also be allocated to an account that guarantees principal subject to a market value adjustment (MVA) in the event monies are withdrawn from the account prior to the end of a stated period.

[3] For convenience of presentation, this letter refers to the sub-account investment as the default investment fund.

A. The final regulations should clarify that (1) the mere fact that an insurance company separate account is interposed between the plan and the sub-account does not affect whether the sub-account is a QDIA and (2) an insurer need not be an investment manager by reason of its role in the selection of sub-account investments.

The proposed regulations provide that a QDIA must be (1) managed by an investment manager, described in section 3(38) of ERISA or (2) an investment company registered under the Investment Company Act of 1940. Because the QDIA is technically an investment in a variable annuity contract separate account as well as an underlying sub-account, it would be helpful if the regulations clarified the entity that must satisfy this requirement. To this end, the Committee recommends that the final regulations clarify that only the sub-account investment, and not the separate account, is subject to the investment manager/registered investment company requirement.

The mere fact that an investment in a variable annuity contract sub-account is through an insurance company separate account should not affect whether the sub-account investment is a QDIA. The separate account is a form of custodial arrangement that effectively provides investing participants comfort that amounts are set aside from the insurer's general account. As a result, the status of the separate account as a registered investment company or the insurer as an investment manager of such account should not have any significance in determining whether a sub-account investment is a QDIA.

A related issue is the extent to which an insurer must be an investment manager by reason of any authority it may have in selecting and monitoring sub-account investment options, including a sub-account investment in a default fund that is intended to be a QDIA. The Committee recommends that the final regulations clarify that the insurer need not be an investment manager described in section 3(38) of ERISA by reason of its role in the selection of sub-account investments.

As a threshold matter, the sub-account investment options generally cannot be changed unilaterally to the extent the separate account is registered. The Investment Company Act of 1940 imposes significant restrictions on such changes. In some annuity contracts where the separate account is not registered, the insurer has the authority to change the sub-account investments that are available to participants with the consent of the plan sponsor. In others, the insurer has the unilateral authority to change the sub-account investments. Some have suggested that an insurer that has a non-registered separate account should be required to be an investment manager because of the control it has over the plan's investment options and therefore over the default investment. This analysis, however, seems ill-conceived. First, many insurers are not acting as fiduciaries relative to a plan's investment options. To the extent that an insurer can only change the sub-account investments with the consent of the plan sponsor (or other fiduciary), the insurer is not acting as a fiduciary. This is confirmed in Advisory Opinion 97-16A. Second, where the insurer is acting as a fiduciary under ERISA, the insurer is simply taking on shared fiduciary liability with the plan sponsor for the selection of the investment

options that are available through the insurer's separate account. It seems apparent that the plan sponsor's control over the selection of a plan's investment options does not mean that it needs to be an investment manager described in 3(38) of ERISA. We see no reason why a different standard should apply to an insurer that is exercising the same fiduciary authority as the sponsor, and the Committee urges the Department to confirm this analysis.

B. The final regulations should clarify that a QDIA may include an annuity purchase right.

Another distinguishing feature of an investment in a variable annuity contract is that an investing participant typically is purchasing both an interest in the annuity contract, *i.e.*, a right to convert the investment into an annuity stream at a stated annuity conversion rate, and an interest in the underlying sub-account investment, *e.g.*, a balanced fund.[4] It is critical that final regulations clarify that the mere fact that such an investment includes a right to convert the investment into an annuity payout does not cause the investment to fail to be a QDIA.

In many plans, the plan's entire investment menu will be comprised of a contract's fixed account and sub-account investment options so that a participant's election to transfer values from the default fund to another fund will not affect the participant's annuitization rights. In effect, a participant's right to convert all or a portion of his or her individual account into an annuity payout is simply an aspect of the plan, rather than the investment options. In other plans, the investment menu may include both variable annuity contract investment options and non-annuity investment options (*e.g.*, mutual funds or collective trusts). In this context, if a participant opts out of a variable annuity contract sub-account default and into a mutual fund investment, the participant will be moving out of the annuity investment and into a fund that does not have an annuitization right.

The proposed regulations require that a default investment have a high degree of liquidity and indicate that a default investment may not impose a financial penalty for electing out of the default. The Committee strongly believes that the loss of an annuitization right as a result of a transfer out of an annuity contract and into a non-annuity contract investment should not be considered a financial penalty. The participant will invariably have the right to invest back into the annuity contract and obtain the annuity purchase right. The annuity right is not lost in the sense that a redemption fee or other charge on sale is lost. It is merely an aspect of the investment and there is no sense of forfeiture attributable to an election out of a typical annuity contract investment. It is analogous, for example, to investing in a fund that charges a fee of X basis points, which fee is based in part on the costs of certain hedging strategies pursued by the fund. If a participant leaves that fund, she may not reap the benefits of these strategies, but she

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[4] Some annuity contracts used with employer plans do not include a permanent guaranteed annuity purchase right. The contract will include an annuity purchase rate, but that rate may be subject to change. A participant investing in a sub-account investment in a variable annuity contract of this type is effectively investing solely in the sub-account investment fund.

should not be viewed as suffering a "financial penalty" because she will not receive that benefit absent reinvesting in the fund. More generally, the right to convert an individual account into an annuity payout is qualitatively different from other investment features. As discussed above, annuity payment forms are an integral part of the fabric of our nation's retirement system. Annuity payouts represent sound retirement policy and have a long history in retirement planning. For these reasons, annuitization payout rights are entirely consistent with prudent retirement policy and should be considered a permissible aspect of a QDIA.

Some variable annuity contracts provide for enhanced annuity purchase rights if a participant holds the contract to a stated date or age, *e.g.*, normal retirement age. In effect, these contracts guarantee a minimum rate of return if the participant holds the contract through the stated duration. One way to think of these guarantees is that a participant is entitled to the greater of the investment return on a sub-account investment fund and a minimum rate of return attributable to the guarantee. These guarantees are attractive from a retirement policy perspective because they give participants the opportunity to participate in the potential upside of equity rates of return while providing downside protection. These contracts are well-suited to functioning as default investments, and the Committee urges the Department to make clear in the final regulations that the mere fact that a QDIA has a guarantee, including a guarantee that is contingent upon holding the investment until a stated age, does not cause the investment fund to be something other than a QDIA.

These contracts generally have all of the liquidity features that are required by the proposed regulations. If a participant who has been defaulted into such a contract elects to invest in a non-annuity fund, the participant will generally receive the amount contributed, adjusted for investment return based on the performance of the underlying sub-account investment fund. As a result, a short-term participant that has automatic contributions of $100 made to the contract generally will be entitled to transfer $100 to any other available plan investment option. For a participant that stays in the investment fund for a more than a short-period, the effect of the guarantee depends on the investment performance of the underlying sub-account. If the sub-account, *e.g.*, a balanced fund, has adverse investment performance (*i.e.*, the guarantee is "in-the-money"), then the participant will be in a better position than if the participant had invested in the same balanced fund without the guarantee. It is true that the participant will lose the guarantee if he or she exchanges the annuity investment for another investment. However, the participant will be in no worse a position than if he or she had invested in the same balanced fund without the guarantee. Conversely, if the sub-account balanced fund has positive investment performance (*i.e.*, the guarantee is "out-of-the-money"), the participant will not lose any material rights if they choose to exchange their contract investment for another investment. In short, the only difference between the fund with the guarantee and the fund without the guarantee is that a participant may be better off with the guarantee and the participant's account will be charged a fee for the guarantee.[5] An ongoing fee for a guarantee is not a financial penalty and we urge the Department to make this clear in the final regulations.

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[5] The typical annual charge for such a guarantee is less than 100 basis points.

III. The final regulations should broaden the list of QDIAs to include fixed income investments, including stable value, general account investments, and fixed annuities.

The Committee also has concerns regarding the proposed regulations' failure to include fixed income investments in the list of QDIAs. Many plan sponsors have chosen to use fixed income investments, like stable value funds, insurance company fixed accounts and fixed annuities, as default investments because these investment options provide for capital preservation and minimize volatility while maximizing a participant's investment return. Many of these investments will satisfy all of the requirements for QDIA status, *e.g.*, liquidity, but are not currently listed as QDIAs.

The Committee appreciates that a fixed income investment means foregoing the potential upside of the equity markets. However, not every financial expert is of the belief that equity investments are inherently better than fixed income investments. In this regard, we are concerned that the proposed regulations arguably substitute the Department's judgment about the capital markets for that of a plan fiduciary.

Moreover, as the preamble to the proposed regulations recognizes, there are clearly plans where a fixed income investment is a prudent and sound selection. This may be because of plan demographics, such as a plan that covers younger, higher turnover employees or because a plan covers older, near-retirement employees. It may also be the case where a particular plan population, *e.g.*, hospital doctors, is difficult to reach for initial elections but ultimately exercises investment control or where an employer has a proactive human resources department that ultimately cajoles participants into making affirmative investment elections. Similarly, a fixed income default may be appropriate where participants have a significant portion of their retirement savings in an Employee Stock Ownership Plan (ESOP).

We also note that the approach taken in the proposed regulations fails to accommodate possible approaches to default investments. For example, one design that employers may wish to consider would combine an insurance company fixed account and a balanced fund as the default option. Participants would be defaulted into the fixed account for the first 90 days of participation and then moved over to a balanced fund option on the assumption that participants are unlikely to exercise investment control if they have not done so in the first 90 days. These approaches may be attractive to plan fiduciaries, and the final regulations should not preclude the development of these default options.

IV. The final regulations should confirm that fees and other charges are an important consideration in choosing a default that need to be considered in the context of services or investment features that are being purchased.

The preamble to the final regulations notes that "[l]ike other investment alternatives made available under a plan, a plan fiduciary would be required to carefully consider

investment fees and expenses in choosing a qualified default investment alternative for purposes of the proposed regulation. To the extent that a plan offers more than one investment alternative that could constitute a qualified default investment alternative, the Department anticipates that fees and expenses would be an important consideration in selecting among alternatives."

The Committee agrees that fees are an important consideration in selecting a default investment. However, it is essential that plans consider fees relative to the services or features that are being purchased, and not in the abstract. For example, a plan sponsor that selects a balanced fund in a variable annuity contract may choose a contract that includes a return of premium benefit. Under a return of premium benefit, the participant's beneficiary upon death is entitled to the greater of the account value or the sum of all premiums paid by the participant during the contract's life. Such a contract may have modestly higher fees than another balanced fund option. However, it should still be prudent for the fiduciary to select the annuity contract balanced fund in light of the enhanced benefit that is being purchased. Our point is simply that it makes no sense to consider fees in the abstract. The question is whether the fees are appropriate in light of the benefits that are being purchased, and the final regulations should clarify this point.

V. The final regulations should facilitate the ongoing evolution of financial products and should not be a barrier to innovations.

The Committee has a final and more general observation about the proposed default investment regulations. We appreciate that the Department has attempted to craft the proposed regulations in a manner that accommodates a range of existing investment funds. However, by identifying a list of permitted default funds (*i.e.*, life cycle funds, balanced funds, and managed account options), the proposed regulations could easily prove to be a barrier to future innovation in investment products. For this reason, the Committee urges the Department to draft the regulations as broadly as possible to facilitate innovative new financial products, including enhanced benefits under fixed and variable annuity contracts, discussed below.

Recent years have shown that the investment landscape is evolving at a rapid pace. A number of insurers have introduced exciting new variable and fixed annuity contracts that provide participants with attractive and important financial guarantees. These enhanced benefits typically protect participants against financial risks that could adversely affect their preparedness for retirement. For example, as discussed above, some contracts offer a guarantee that a participant will be able to annuitize a contract at a certain age and be guaranteed annuity payments at a minimum level regardless of the contract's actual account value on the annuitization date. By way of another example, as mentioned above, some contracts offer a "return of premium" death benefit. These benefits can play an important role in facilitating retirement security and should be encouraged.

The Committee recognizes that every enhanced benefit is not necessarily an appropriate feature of a default investment fund. However, some enhanced benefits can play an important role in providing investment protections that are appropriate and useful features of a

default investment, and the Committee believes that plan fiduciaries should have the flexibility to include these benefits as part of a default fund. Moreover, in many plans that are funded exclusively through variable annuity contracts, an enhanced benefit, such as the return of premium benefit described above, will often be a feature of all of the available sub-account investments under the plan. Any rule that suggests that such features cannot be included in a QDIA would suggest that fiduciaries of such plans are entirely ineligible for the relief provided by the regulation. This would obviously be an inappropriate result. For this reason, it is important that the final regulations be drafted in a manner that does not make inclusion of enhanced benefits *per se* impermissible. The Committee also recommends that the preamble to the final regulations make clear that, depending on the facts and circumstances, enhanced annuity contract benefits may be appropriate for default investment funds.

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Thank you for your time and consideration of these matters. Please do not hesitate to contact the undersigned if you have any questions.

Sincerely,

Joseph F. McKeever

Jason K. Bortz

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The Committee of Annuity Insurers was formed in 1982 to participate in the development of federal tax and securities law policies with respect to annuities. The member companies of the Committee represent over half of the annuity business in the United States.