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May 18, 2007

SENT VIA U.S. MAIL

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5669
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210
ATTENTION: Fee Disclosure RFI

Re: **Fee and Expense Disclosures to Participants in Individual Account Plans**
(RIN 1210-AB07)

RECEIVED
MAY 22 2007
EMPLOYEE BENEFITS SECURITY ADMINISTRATION
ROOM N-5669
U.S. DEPARTMENT OF LABOR
WASHINGTON, DC 20210

Dear Ladies and Gentlemen:

We appreciate the opportunity to provide comments to the U.S. Department of Labor's request for information regarding fee and expense disclosures provided to participants in individual account plans (the "RFI"). We are pleased that the Department is focused on these important issues.

As employee benefits attorneys, our practice includes providing guidance to plan sponsors and service providers to retirement plans regarding the requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA). In reviewing the RFI, we noticed that comments previously prepared for testimony Fred Reish delivered to the 2006 ERISA Advisory Council working group on select issues of a procedurally prudent investment process are particularly responsive to the information requested by the Department and, in particular, Question 7. As such, we have enclosed a copy of written comments regarding that testimony.

Please note that we will also be addressing the categories of information in the RFI in separate letters.

Very truly yours,

Stephanie Bennett
STEPHANIE L. BENNETT

CFR:SI.B:esk:mes
Enclosure

Written Comments
for Testimony of C. Frederick Reish
Reish Luftman Reicher & Cohen

Prepared by C. Frederick Reish
and
Stephanie L. Bennett

Before the
2006 ERISA Advisory Council
Working Group on Select Issues
of a Procedurally Prudent Investment Process

Washington, DC
September 21, 2006

Introduction

My name is Fred Reish. I am a shareholder in the law firm of Reish Luftman Reicher & Cohen in Los Angeles, California. My firm specializes in employee benefits and tax matters. I have more than thirty years experience as an employee benefits attorney.

I am here to present my views on section 404(c) of the Employee Retirement Income Security Act ("ERISA") and the regulation thereunder. (In this testimony, I refer to the statute and the regulation, collectively, as 404(c) unless otherwise specified.) My views reflect my extensive experience in this area. That experience includes: assisting employers in complying with 404(c); advising providers on their programs to assist fiduciaries in complying with 404(c); auditing plans for 404(c) compliance; writing and speaking about fiduciary and 404(c) issues; and acting as an expert witness on 404(c) compliance. In my experience, the vast majority of plans do not satisfy the conditions for obtaining 404(c) protection. As a result, for the vast majority of plans, the fiduciaries retain responsibility for the prudence of all investment decisions made, including participant-directed investment decisions.

Further, it is my observation that most participants, and many fiduciaries, do not understand that, under ERISA, the investment role of the participant is to develop a portfolio in his account by allocating his money among prudently selected investment options. That is, the objective is for participants to properly balance their tolerance for risk and their need for investment returns by developing appropriate portfolios in their accounts. While that concept is incorporated into the 404(c) regulation, it is actually based on ERISA's adoption of Modern Portfolio Theory ("MPT") and other generally accepted investment theories. (ERISA's adoption of MPT is well documented in DOL guidance and court decisions.) Unfortunately, it is now obvious to even the most casual observer that most participants lack the knowledge to develop appropriate portfolios in their accounts. (That would require, for example, an understanding of basic investment concepts—such as asset classes, correlation, strategic asset allocation and re-balancing—which most participants lack.) Nonetheless, participant-directed plans are popular with both employers and employees, and are the primary retirement vehicles for many American workers. Thus, participant-directed plans must be made to work and to work well. In order to achieve this goal, the interests of employers, fiduciaries and participants must be balanced in a way that the system encourages and enhances quality retirement benefits and that plan sponsors and fiduciaries enjoy reasonable protections when participants control their investments. But that can only work if the 404(c) regulation requires that both meaningful information and prudent investments be offered.

Background

Employer sponsorship of defined contribution plans, particularly participant-directed 401(k) plans, has grown in recent years. These plans are now seen as the primary retirement vehicle—by both employers and employees. However, in many ways the responsibilities of plan sponsors, fiduciaries and employees are not well-understood and, in some cases, are commonly misunderstood. For example, some plan sponsors and fiduciaries (collectively referred to as "plan sponsors" in this testimony) do not believe that they can be legally responsible for the prudence of participant investment decisions. Further, in my experience many plan sponsors believe that their plans comply with 404(c), even though they are not aware of the detailed

requirements in the regulation.¹ That is, both of those groups of plan sponsors believe that, even if participants make imprudent investment decisions, the officers who serve as fiduciaries are protected from liability. However, based on my experience and on conversations with others in the industry, few plans actually comply with the conditions in the 404(c) regulation. As a result, most plan decision-makers, including committee members, are legally responsible for the prudence of participant investment decisions. As the court in *Enron* opined, "If a plan does not qualify as a §404(c) [plan], the fiduciaries retain liability for all investment decisions made, including decisions by the plan participants."²

Before the Enron judge made that ruling, she had read the "friend of the court" brief submitted by the U.S. Department of Labor:

The only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualifies as a 404(c) plan. . . . Under ERISA §404(c) . . . a fiduciary is not liable for losses to the plan resulting from the participant's selection of investments in his own account, provided that the participant exercised control over the investment **and the plan met the detailed requirements of a Department of Labor regulation.**³ (Emphasis added.)

The benefits of 404(c) compliance are significant. Compliance provides fiduciaries of participant-directed plans with protection from liability for allocation decisions made by participants⁴ (that is, the fiduciaries will not be legally responsible for how the participants use the investments). There are approximately 20 to 25 distinct conditions in the 404(c) regulation⁵ that a plan sponsor must satisfy to obtain 404(c) protection. Of course, the opposite is true, such that in the case of a plan which does not meet the conditions of 404(c), the fiduciaries are responsible for the prudence of participant-directed investment decisions.⁶

In my experience, the most common failures to comply with 404(c) are the following:

1. Failure to provide a copy of the prospectus most recently received by the plan to a participant immediately preceding or following a participant's initial investments in an option;

¹ See Deloitte 2005/2006 Annual 401(k) Benchmarking Survey in which 87% of plans surveyed by Deloitte reported that they complied with 404(c).

² *Tittle v. Enron Corp.*, 284 F.Supp.2d 511, 578 (S.D. Tex. 2003).

³ DOL Enron Amicus Brief, Part 1, August 30, 2002.

⁴ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1). Those conditions under 404(c) must be satisfied for both participants and beneficiaries. This report uses "participant" to refer to both

⁵ 29 C. F.R. § 2550.404c-1(b)

⁶ See *Tittle v. Enron Corp.*, 284 F.Supp.2d 511, 578 (S.D. Tex. 2003). But see *Jenkins v. Yager & Mid America Autoworks, Inc.*, No. 04-4258 (7th Circuit, April 16, 2006); Fred Reish and Bruce Ashton, "Jenkins V. Yager: The Court Of Appeals Gets It Wrong," JOURNAL OF PENSION BENEFITS, VOL. 14, NO.1 (forthcoming Autumn 2006).

2. Failure to notify the participant of the identity of the 404(c) fiduciary, that is, the fiduciary (often the plan committee) who is responsible for overseeing the satisfaction of the conditions in the regulation;
3. Failure to notify the participants of the five categories of information that must be given to them upon request;
4. Failure to notify the participants that the plan intends to comply with 404(c) and that, as a result, fiduciaries may be relieved of liability; and
5. For plans that offer company stock, the failure to develop and communicate a confidentiality procedure to protect the identity of participants who buy, sell, hold and vote company stock, and the failure to operate the plan consistent with the 404(c) requirements for that procedure.

While most plans do not comply with those (and some of the other) 404(c) conditions, the good news is that, for the most part, plan sponsors and providers are furnishing participants with the balance of the information required in 404(c).

It is my recommendation that the 404(c) regulation be improved by the following:

- A. Addition of a participant education element;
- B. Clarification on what information must be furnished to participants;
- C. Elimination of the prospectus delivery requirement;
- D. Disclosure of all expenses, revenue and conflicts of interest;
- E. Addition of disclosures regarding company stock;
- F. Notifications that the summary plan description transfers liability;
- G. Representation in the SPD concerning fiduciary responsibility and participant responsibilities;
- H. Facilitation of use of default investments;
- I. Clarification of responsibilities concerning brokerage accounts;
- J. Modification of definition of broad range; and
- K. Facilitation of electronic delivery.

A. Addition of a participant education element

The 404(c) regulation states that plan fiduciaries are not obligated to provide investment advice to participants, nor are they obligated to assist participants in any way to understand prospectuses, financial reports, or other materials that are passed on to them. In Interpretive Bulletin 96-1, the DOL reiterated its position and, unfortunately, further provided that plan sponsors are not obligated to provide investment education to participants.⁷

Although the 404(c) regulation does not include a condition that would require fiduciaries to provide investment education to participants, the general fiduciary provisions under ERISA Section 404(a) could reasonably be interpreted to require that the fiduciaries offer a prudent package of investment products and services to participants—including investment options, education, information, advice, and other services—that would permit participants to make informed and reasoned investment decisions for investing for retirement. (In effect, I am saying that, under the circumstances now prevailing, a fiduciary of a participant-directed plan, when acting with “care, skill, prudence and diligence,” would need to provide participants with the basic information and knowledge needed to understand the investments and to use them properly.) In this regard, there is a considerable amount of data showing that most employees lack basic investment skills:

- Most participants don't change the allocation of their accounts during their participation in a plan;⁸
- Approximately 20% of the participants hold only one mutual fund in their account—and the mutual fund only represents only one asset class;⁹
- About 32% of the participants own only two investment options in their account, representing only one or two asset classes;¹⁰
- Many participants hold amounts of company stock at a level that investment professionals consider to be risky;¹¹
- Many participants hold high levels of cash equivalents in their accounts—to a point that investment experts are concerned about whether the accounts can grow adequately to provide needed retirement benefits;
- Many participants mis-use lifestyle funds by treating them as the equivalent of a mutual fund, that is, they hold several lifestyle funds or they hold a lifestyle fund together with other mutual funds.¹²

Because of these problems, I believe that the regulation should include participant education as a condition for obtaining relief under section 404(c). That education should

⁷ 29 C.F.R. § 2509.96-1, n.1.

⁸ Putnam Investments, DC Plans Missing the Forest for the Trees, 2004.

⁹ Fidelity, Building Futures, 2004 Annual Report; Hewitt Universe Benchmarks, 2003.

¹⁰ Hewitt, How Well Are Employees Saving and Investing in 401(k) Plans, 2005.

¹¹ *Id.*

¹² Putnam Investments, Re-thinking the Smorgasbord Approach to DC Fund Offerings, 2003.

be consistent with the guidance under Interpretive Bulletin 96-1(d). As a practical matter, for the vast majority of plans, basic investment education is already offered to participants and these services are already included in the cost structure of the plan. To the extent that my recommendation, if adopted, would impose additional investment education requirements on some plans, both the burden and expense of providing that education would most likely fall on the providers, rather than plan sponsors and participating employees and the ability to pass through the cost would be limited by marketplace forces because most quality providers already offer those services. That is because, in most cases, the marketplace limits the abilities of providers to charge more than a competitive price.

B. Clarification on what information must be furnished to participants

The 404(c) regulation requires that participants be provided with:

sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments. For purposes of this subparagraph, a participant or beneficiary will not be considered to have sufficient investment information unless—¹³

The regulation goes on to describe the information that must be furnished to the participants. The current wording of the regulation leaves the reader questioning whether providing participants with the enumerated information is sufficient to satisfy the requirement or if the language “sufficient information to make informed decisions” imposes an additional requirement upon fiduciaries of 404(c) plans.

The 404(c) notice requirements are best understood when they are analyzed in light of mutual funds and similar investment vehicles. However, a weakness in the regulation is revealed when one applies them to illiquid or non-diversified or non-publicly traded investments. In effect, the 404(c) regulation appears to place the greatest disclosure requirements on diversified mutual funds, which may be the easiest of the different types of investments to evaluate (in the sense that there is a great deal of information that is publicly available, for example, the popular media, the financial media and the internet). In my opinion, the disclosure requirements should be just the opposite, that is, the greatest disclosure burden should attach to the investments that are the most risky and that are the most difficult to evaluate.

While it seems clear that, under the regulation plan sponsors must at least furnish the information enumerated in the regulation, it is my belief that the language in the regulation should be expanded to require (or to clarify that it already requires) fiduciaries of 404(c) plans to provide participants with the information needed to make informed and reasoned decisions about using the investment choices offered by the plan. For example, participants either must be provided, or have the right to get, financial statements and reports about the investments, to the extent those reports are supplied to the plan.¹⁴ The

¹³ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B).

¹⁴ 29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2).

regulation should be more specific and provide explicit rules about what should be provided to the participants. That is, the regulation should clarify whether the plan sponsor is responsible for providing other, possibly conflicting, information such as analysts' reports to the employees (which may not be generally available to the public without charge). The need for this change is highlighted by the expanding lineups of investments being offered to participants and by the introduction of new investment vehicles, such as hedge funds and partnership interests.

Viewed from the participants' perspective, it seems clear that plan sponsors should be required to furnish participants with sufficient information about the investments offered by the plan—particularly when one considers the difference in investment sophistication between the plan sponsors and the average participant. Further, that information requirement should not be limited to the information supplied to the plan. Since the plan sponsors decide which investments a plan will offer, they are in the position to ensure that the investment provider will deliver sufficient information to the plan or, if it will not, to refuse to include that investment in the plan. In other words, as the gateway to the plan, the plan sponsors can require that investment providers give the plan and the participant adequate information to properly evaluate and use the investments. Finally, in my opinion, 404(c) protection should not apply in situations where the plan sponsors cannot provide adequate information to the participants to enable them to make informed and reasoned decisions.

C. **Elimination of prospectus delivery requirement**

The 404(c) regulation requires that participants be provided with:

in the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant's or beneficiary's initial investment, **a copy of the most recent prospectus provided to the plan. This condition will be deemed satisfied if the participant or beneficiary has been provided with a copy of such most recent prospectus immediately prior to the participant's or beneficiary's initial investment in such alternative. . . .**¹⁵ (Emphasis added.)

Note that the plan must comply with this requirement only if the prospectus is "provided to the plan" but not otherwise. The importance of this language is illustrated by plans that use a group annuity to fund the plan. In most cases, for plans that invest in group annuity contracts which hold mutual funds, insurance companies are not required to provide mutual fund prospectuses to the plans. That is because, for group annuity contracts, the insurance company is viewed as the shareholder. Those plans would not, as a practical consequence, need to deliver prospectuses under the securities law and, as a practical consequence, under 404(c). (Instead, insurance companies typically deliver fact sheets and other information to participants. That information usually is an easy-to-read and

¹⁵ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(viii).

easy-to-understand summary of key data about the mutual funds.) However, where a plan invests directly in mutual funds, the mutual fund is required by federal securities laws to provide prospectuses to the plan. In my opinion the prospectus delivery requirement should be modified to instead require that the plan make the prospectuses available (for example, through the plan's or the provider's website).

As a practical matter, one must consider whether the prospectus delivery accomplishes the goal of educating participants about the investments. A recent survey revealed that more than 60% of investors find prospectuses "very or somewhat difficult to understand."¹⁶ The survey also revealed that more than half of investors said they read little or none of the prospectus, 12% don't read it but save it for later and 18% throw it away.¹⁷

So it seems that most investors find little, if any, value to prospectuses. As a result, prospectuses are not the "best" format for furnishing participants the information they need to make decisions about investment options. Therefore, I also recommend that the regulation require a more effective means of communicating the information participants need regarding the investment options. In my view, the regulation should reflect the industry practices that have been developed by quality recordkeepers and service providers. For example, the regulation should identify the sources of information that most investors rely on for investment assessment (e.g., Morningstar, Lipper and Standard & Poors) and should consider the format used, and the information provided, by those services. This could be done by amending the regulation to permit plan sponsors to satisfy the "prospectus" requirement by providing the essential information from prospectuses, and other needed information, in other formats that investors rely on and deem relevant.

D. Disclosure of all expenses, revenue and conflicts of interest

The current regulation requires that:

A description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales load, deferred sales charges, redemption or exchange fees).¹⁸

The weakness in the regulation is that the requirement to disclose fees is only triggered by participant purchases or sales. As stated in the preamble to the regulation:

This requirement relates to the disclosure of fees and expenses directly assessed against the participant's or beneficiary's account, not expenses, fees or commissions incurred by the investment

¹⁶ Tracey Longo "Advisors in the Spotlight" Financial Advisor July 2006 citing to an Investment Company Institute Survey

¹⁷ *Id.*

¹⁸ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(v).

alternative attendant to the operation and management of the investment alternative.¹⁹

This weakness is illustrated when one considers that participant accounts may be charged for certain plan level expenses or fees that are not the result of participant acts. For example, in the case of a surrender charge on a group annuity contract or a market value adjustment on a stable value investment that is triggered when the plan surrenders the contract, under the current 404(c) regulation the participants are not required to be notified of such fees or adjustments, but their accounts may be negatively impacted in those situations. Thus, for transparency and meaningful disclosure, the regulation should be amended to require mandatory disclosure of the existence of all fees or possible charges that impact or could impact the value of the participants' benefits, and not just those triggered by participant-directed purchases and sales. That includes information about plan expenses such as investment advisory fees, contract charges, administration fees and other fees charged to the plan as whole.

In addition, the regulation should incorporate guidance on the impact of fees. That is, plan sponsors should be responsible for explaining, in language calculated to be understood by the average participant, that expenses and fees reduce benefits available to them at retirement.²⁰ Although this seems like an obvious conclusion, a recent experimental study reveals that investors do not give adequate consideration to the effect of fees and expenses on their investments.²¹

E. Addition of disclosures regarding company stock

In order for a plan to provide a participant with the opportunity to exercise control over assets in his account, the participant must be provided (or have the opportunity to obtain) sufficient information to make informed decisions with regard to investment alternatives available under the plan.²² The information is not sufficient unless the participant is actually provided with (as opposed to it being made available), at the least, the information specified in the 404(c) regulation (although more may be required) including, but not limited to, the following:

(ii) [A] description of the investment alternatives available under the plan and, with respect to each 'designated investment alternative'²³ a general description of the investment objectives and

¹⁹ 57 FR 46906 at 46911.

²⁰ See Alicia H. Munnell, Mauricio Soto, Jerilyn Libby and John Prinzivalli, "Investment Returns: Defined Benefit VS. 401(k) Plans," AN ISSUE IN BRIEF CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE, Number 52, September 2006. This report presents the results of a study of rates of return on defined benefit and 401(k) plans over the period of 1988-2004. The outcome of the study revealed that over the period of 1988-2004 defined benefit plans outperformed 401(k) plans by one percentage point. The authors attributed part of this difference to the higher fees charged to defined contribution plans.

²¹ James J. Choi, David Laibson and Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (May 4, 2006), available at: <http://www.som.yale.edu/faculty/jjc83/fees.pdf>

²² 29 C.F.R. § 2550.404c-1(b)(2)(i)(B).

²³ A *designated investment alternative* is a specific investment identified by a plan fiduciary as an available investment alternative under the plan [29 C.F.R. 2550.404c-1(e)(4)].

risk and return characteristics of each such alternative [referred to as the ‘Description of Available Investments’], including information relating to the type and diversification of assets comprising a portfolio of the designated investment alternatives.²⁴

Under the regulation, the Description of Available Investments must include: (i) a description of each investment alternative; (ii) a general description of its investment objectives and risk and return characteristics; and (iii) information relating to the type and diversification of assets comprising a portfolio of the designated investment alternatives.²⁵

The regulation should be clarified to provide that disclosure of the risk and return characteristics of an investment should include an additional disclosure for non-diversified investments. This disclosure should be similar to the disclosure language in the DOL’s model blackout notice, which states “You should be aware that there is a risk to holding substantial portions of your assets in the securities of any one company, as individual securities tend to have wider price swings, up and down, in short periods of time, than investments in diversified funds.”²⁶ The regulation could also require language similar to that which will be drafted by the DOL for the quarterly participant statements under the new Pension Protection Act provision on that subject.²⁷ Because of the extreme losses suffered by some participants when their employers have gone bankrupt (for example, Enron), the notice should also mention the possibility of total and permanent loss.

F. Notifications that the summary plan description transfers liability

The 404(c) regulation provides that the participants must be provided with:

an explanation that the plan is intended to constitute a plan described in section 404(c) of the Employee Retirement Income Security Act, and Title 29 of the *Code of Federal Regulations* Section 2550.404c-1, and that the fiduciaries of the plan may be relieved of liability for any losses which are the direct and

²⁴ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(ii).

²⁵ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(ii).

²⁶ 29 C.F.R. § 2520.101-3(e)(2).

²⁷ Pension Protection Act of 2006 § 508; see Joint Committee of Taxation Report on the Pension Protection Act of 2006 comments on § 508. “A quarterly benefit statement provided to a participant or beneficiary who has the right to direct investments must also provide: (1) an explanation of any limitations or restrictions on any right of the individual to direct an investment; (2) an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified; and (3) a notice directing the participant or beneficiary to the Internet website of the Department of Labor for sources of information on individual investing and diversification.”

necessary result of investment instructions given by such participant or beneficiary. . . .²⁸

There are two aspects to the explanation: first, that the plan is intended to be a 404(c) plan; and, second, that the fiduciaries of the plan may be relieved of liability. One disclosure without the other fails to satisfy the 404(c) condition and, as a result, precludes 404(c) protection for the fiduciaries.

There is no specific requirement in the 404(c) regulations that the disclosures be made in the Summary Plan Description (“SPD”). However, the regulation governing the contents of the SPD requires that the employer state in its SPD whether the plan is a 404(c) plan.²⁹ This statement, by itself, would not satisfy the requirement to explain the impact of the plan electing to be a 404(c) plan.

In my view, the SPD is the most effective instrument for informing the participants that the plan intends to satisfy the 404(c) conditions and to obtain the relief provided by 404(c), that is, relieving the fiduciaries of any losses which are the direct and necessary result of investment instructions by participants and beneficiaries. It is the one document that is almost certainly provided to all participants, and there is little risk that the information will be mislaid or not delivered. Thus, it is my recommendation that the 404(c) regulation and the SPD regulation both be amended to require that the notification to the participants (that the plan intends to comply with 404(c) and that, as a result, fiduciaries may be relieved of liability) be included in the SPD.

The proposed modification would not impose an additional burden as the SPD regulation already requires that that SPD state whether the plan is a 404(c) plan, therefore implementing the recommendation would only require that an additional statement be added to the SPD providing that, as a result, the fiduciaries of the plan may be relieved of liability resulting from participant investment decisions.

G. Representation in the SPD concerning fiduciary responsibility and participant responsibilities

404(c) of ERISA provides fiduciaries of participant-directed plans protection from liability for allocation decisions made by participants (that is, the fiduciaries will not be legally responsible for how the participants use the investments), as long as the plan fully complies with the conditions of 404(c). Despite this conditional relief, fiduciaries of participant-directed plans remain responsible for the prudence of the investment options under the plan, as the DOL stated in the preamble to the final 404(c) regulation:

All of the fiduciary provisions of ERISA remain applicable to both the initial designation of investment alternatives and investment managers and the ongoing determination that such alternatives and managers remain suitable and prudent investment alternatives for

²⁸ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)(i)

²⁹ 29 C.F.R. § 2520.102-3(d)

the plan. Therefore, the particular plan fiduciaries responsible for performing these functions must do so in accordance with ERISA.³⁰

Included in that obligation is the duty to remove specific investments when, under a prudence standard, they should no longer continue to be available as investment options for participants:

Thus, for example, in the case of look-through investment vehicles, the plan fiduciary has a fiduciary obligation to prudently select such vehicles, as well as a residual fiduciary obligation to periodically evaluate the performance of such vehicles to determine, based on that evaluation, whether the vehicles should continue to be available as participant investment options.³¹

In my opinion the participants should be aware of the ongoing duties of fiduciaries of 404(c) plans as well as their own duties with respect to the plan. That is, the participants should be informed of the duties of fiduciaries to prudently select and monitor the investment choices and of their own responsibility to allocate the assets in their accounts among the investment choices offered by the plan in order to balance their needs for return and their tolerance for risk.

It is my recommendation that, in order to obtain 404(c) protection, the regulation requires plan sponsors to state in the SPD that the investment options are prudently selected and monitored as investments for retirement purposes. This representation would heighten awareness among plan sponsors of this ongoing duty to prudently monitor, and possibly replace, the investments. More importantly, it would emphasize to both fiduciaries and participants that their respective roles are:

- for fiduciaries—to prudently select and monitor mutual funds and to offer a broad range of asset classes; and
- for participants—to combine prudently selected funds in a manner which develop portfolios in their accounts that properly balance risk and reward.

In addition, the SPD or a separate 404(c) communication should explain the role of the participant. That is, the SPD should explain that the participant's responsibility is to allocate the assets in his account among the plan's investment options in order to properly balance the participant's need for return and tolerance for risk.

Ultimately, these recommended changes would not impose any additional burdens, as the fiduciaries responsible for selecting and monitoring the investments already have an ongoing duty to continually monitor those investments. Further, plans are already required to furnish SPDs to participants, so that the inclusion of language in the SPD

³⁰ 57 FR 46922.

³¹ 57 FR 46924 n.27.

informing participants of their role as well as that of the fiduciaries would impose little, if any, additional burden.

H. Facilitation of use of default investments

In order for the 404(c) protections to be applicable, the participant must have exercised independent control over the investment of his account. The Pension Protection Act of 2006 (PPA) extends 404(c) protection to fiduciaries of plans that invest participant account balances, in the absence of a participant investment election, into “default investments,” provided that certain requirements are met. In order to obtain this relief, the plan must comply with new a DOL regulation (which the PPA directed the DOL to issue within six months from the date of enactment) and to provide notice to participants.³² The statute requires that the new regulation define the criteria for determining whether an investment qualifies for this 404(c) protection, including the requirement that the investments consist of multiple asset classes. (For ease of reference, my testimony refers to these vehicles as “qualifying default investments” and/or as “professionally designed portfolios.”) Hopefully, the regulation will also require that the investments be structured in a manner consistent with Modern Portfolio Theory, which is the foundation of ERISA’s investment provisions.

In addition to the guidance about default investments, I recommend that the DOL develop 404(c) guidelines (either through the new regulation or in separate guidance) that would permit a plan to exclusively offer age or risk-based lifestyle or lifecycle mutual funds and/or managed accounts to satisfy the broad range requirement.³³ Some employers are interested in sponsoring plans that offer only those investments, but it is not clear that such an arrangement would satisfy the 404(c) broad range requirement.

In addition, while the new guidance will encourage employers to offer automatic enrollment programs (since they will be able to obtain relief from certain aspects of fiduciary liability where they default participants into qualified multi-asset class investments), the notice requirement contained in section 404(c)(5) raises additional issues that should be addressed. In particular, section 404(c)(5)(B) provides that each participant must receive a notice before the beginning of the plan year. While I do not take issue with the annual notice requirement, there is a danger that the notice requirement will be interpreted to apply only to default arrangements that are implemented at the beginning of a plan year. That is because the statute literally requires that notice be provided before the beginning of the year. However, a plan may decide to switch to a safe harbor investment in the middle of the year. In that case, a literal reading of the provision on the timing of the notice could lead to a conclusion that the notice

³² Pension Protection Act of 2006 § 624.

³³ See Vanguard Report, “How America Saves 2005: A report on Vanguard 2004 defined contribution plan data,” available at:

https://institutional2.vanguard.com/VGApp/iip/Research?Category=Retirement_Research&FW_Activity=LibraryActivity&FW_Event=category The report reveals that life-cycle funds are being misused by many investors. The study found that 29% of people who invested in life-cycle funds as part of their company’s retirement plan used them as an all-in-one investment, however, about 49% invested in a life-cycle fund and one or more stock funds and 22% of investors owned more than one life-cycle fund.

requirement cannot be satisfied until the next year and, as a result, the fiduciary protections would be delayed. Therefore, I encourage the DOL to issue guidance that would allow a plan that switches to a qualifying default investment in the middle of the year to issue a notice of such change during that year, but within a reasonable time before the change is made. By providing this guidance the DOL will further encourage the use of professionally designed portfolios as default investments.

I. Clarification of responsibilities concerning brokerage accounts

The 404(c) regulation does not clearly address whether certain vehicles are considered to be investments. As a result, the application of the regulation is not clear. For example, is a brokerage account an investment or a service? If the latter, which I believe it is, then apparently the 404(c) regulation applies to the thousands of investments that may be purchased through the brokerage account. That should be clarified. Assuming that a brokerage account is a service, or at least is not an investment, the regulation should be clarified to provide that there is no 404(c) protection for the issue of whether it is prudent to offer the brokerage account. (That is, fiduciaries make that decision subject to the prudence standard.) The regulation should further provide that 404(c) protection for brokerage accounts, if available, extends only to investment decisions in the underlying investments.

J. Modification of definition of broad range

The regulation states that, in order for a participant to be considered to have exercised control over the assets in his account, the participant must have the opportunity to choose from a broad range of investments, which consist of at least three diversified investment alternatives, each of which has materially different risk and return characteristics.³⁴

The regulation should be amended to increase the number of diversified investment alternatives from three to at least five. This change would reflect prevailing investment industry thinking and would pose little additional burden, since the average plan already offers 15 to 20 investment options to participants.³⁵ In addition, it would encourage better analysis of asset classes at both the fiduciary and the participant levels.

K. Facilitation of electronic delivery

Current guidance makes the use of electronic delivery for satisfying certain notice requirements difficult.³⁶ I recommend a significant expansion of the rules concerning the use of electronic delivery for communicating information to participants. I acknowledge that electronic delivery may have some drawbacks. For example, participants may pay less attention to electronic information than they would to hard copies of information. Of course, that concern is counter-balanced by the fact that many participants do not read what they believe are routine mailings from the employer. In weighing these and other

³⁴ 29 C.F.R. § 2550.404c-1(b)(3)(i)(B).

³⁵ Deloitte 2005/2006 Annual 401(k) Benchmarking Survey.

³⁶ 29 C.F.R. § 2520.104b-1(c).

competing considerations, it seems that the benefits afforded by electronic delivery (that is, reduced plan expenses) outweigh the possibility that electronic communications may not be given as much attention by participants. (Where plan sponsors do not have valid email addresses for some participants, the plan information could be delivered in the same manner as the employer uses to communicate other critical or required information to employees.) Further, it is likely that, for some of the less-engaged participants, the new rules on safe harbor automatic enrollment plans and default investments will protect those individuals from any limitations of electronic communications.

Thank you for the opportunity to express my views to the Advisory Council. I would be glad to answer any questions from members of the Advisory Council or from the staff at the Employee Benefits Security Administration of the U.S. Department of Labor.