November 13, 2006

VIA ELECTRONIC FILING

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

Re: Proposed Regulation on Default Investment Alternatives Under Participant Directed Individual Account Plans

Ladies and Gentlemen:

The Investment Company Institute1 applauds the Department of Labor for proposing regulations on default investments for participants who fail to give investment direction in individual account plans. We strongly support this initiative and have worked closely with the Department on several issues the Department considered in the course of drafting the proposed regulation.2 This guidance will encourage employers to select default investments that are appropriate to help participants meet their retirement needs over the long term. Our letter makes several suggestions, discussed below, to clarify and improve the regulation.

The Pension Protection Act of 2006 amended ERISA section 404(c) to provide relief under section 404(c)(1) to fiduciaries that invest individual account plan assets in certain default investment alternatives. Previously, there was no express fiduciary relief for the investment of participant accounts absent specific direction from the participant. Under new section 404(c)(5) of ERISA, a participant is treated as exercising control over the assets in his or her account with respect to assets invested in a

---

1 Institute members include 8,798 open-end investment companies (mutual funds), 655 closed-end investment companies, 254 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the Institute have total assets of approximately $9.610 trillion (representing 98 percent of all assets of U.S. mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

2 See, e.g., Institute Letter to the Department of Labor, dated September 7, 2005.
default investment alternative in accordance with the Department’s regulations.\(^3\) When adopted, the proposed regulation should increase plan participation and overall retirement savings rates, as some sponsors previously had been reluctant to institute automatic enrollment programs or to invest participant assets in anything other than capital preservation vehicles.

Research shows that automatic enrollment works to increase plan participation and that the selection of a default investment that includes equity exposure positively impacts account balances over a worker’s career.\(^4\) It is critically important that the regulation be designed to encourage plan sponsors to use automatic enrollment and to select default investments that have risk and return characteristics appropriate for retirement investing. The proposal permits lifecycle funds, balanced funds, and managed account programs to qualify as default investments under the safe harbor. We strongly support designation of these three types of investment programs as qualified default investment alternatives (“QDIAs”). Unfortunately, the proposal imposes a number of conditions on use of these products or programs that we believe are not necessary and undermine the usefulness of the rule. Our comments reflect our strong belief that if a plan menu contains one or more options that are regarded as a complete investment program for retirement savings, a plan sponsor should be able to select those options for the plan’s default without the imposition of additional conditions. In addition, we believe it is essential for the regulation to provide appropriate certainty for plan sponsors in selecting and monitoring default investments and notifying participants. Otherwise, plan sponsors may be reluctant to select default investments generally and, in particular, investments designed to produce long-term growth.

Specifically, we recommend that the Department:

- Include a formal statement in the regulation that fiduciary relief provided by the regulation is not limited to automatic enrollment;
- Revise the balanced fund option to clarify that plan sponsors selecting a balanced fund default do not have to adjust the choice of default fund for changes in plan demographics;
- Expand the types of products that may be used as a QDIA to include model portfolios constructed by investment advisers and plan sponsors, “lifestyle” funds, and managed-account programs based on the SunAmerica advisory opinion;
- Clarify that for some age groups, lifecycle/target-date funds and managed accounts do not need to include all asset classes;

\(^3\) The proposed rule would not provide relief from the general fiduciary duties associated with selecting and monitoring a default investment alternative, or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses.

• Modify the initial notice requirement to require notice within a reasonable period of time;
• Clarify that the disclosure rules would not require greater disclosure to defaulted participants than participants who actively direct investment of their accounts;
• Clarify the restriction on imposing a financial penalty for transfers to another investment option;
• Provide guidance on the conversion of assets invested in existing default investments to a QDIA; and
• Provide immediate guidance that allows plan sponsors to rely on the regulation pending adoption of the final regulation.

Our recommendations are discussed in more detail below.

Scope of the Regulation

We applaud the Department’s determination to extend this relief to non-404(c) plans and to situations other than automatic enrollment. According to footnote 5 of the preamble of the regulation, other circumstances when default investments may be used in the absence of participant direction include elimination of an investment option, change of service provider, rollover from another plan, or when a participant simply neglects to provide investment direction after enrolling in the plan. We strongly agree with the Department that this guidance should apply in situations beyond the context of automatic enrollment, including when all or part of a participant’s account is assigned to an alternate payee pursuant to a qualified domestic relations order and neither the alternate payee nor the order provides investment direction. The Institute recommends that the circumstances described in footnote 5 be included in the text of the regulation, or at the very least, in the text of the preamble, rather than in a footnote. We believe that this is an important point that deserves more direct attention in the regulation.

Qualified Default Investment Alternative

Under the proposed regulation, a QDIA either must be managed by an investment manager (as defined under ERISA section 3(38)) or must be an investment company registered under the Investment Company Act of 1940 (“1940 Act”). In addition, QDIA must constitute one of three types of investment products:

---

5 Although issued under section 404(c), the guidance is not limited to plans that comply with the existing regulation under section 404(c), since as the Department noted, the Pension Protection Act provision does not condition its relief on compliance with the existing section 404(c) regulation.

6 The rules also would apply to default investments made on behalf of a beneficiary. For ease of reference, this letter will refer only to participants.
1. A fund or model portfolio designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income securities based on the participant’s age, target retirement date (such as the normal retirement date under the plan), or life expectancy. The product’s investment allocation will change over time to become more conservative with increasing age. The proposal provides that an example of this type of product is a "lifecycle" or "targeted-retirement date" fund or account.

2. A fund or model portfolio designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income securities consistent with a target level of risk appropriate for participants in the plan as a whole. The product is not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. The proposal provides that an example of this type of product is a “balanced” fund. The preamble to the regulation notes that plan sponsors selecting a balanced fund as the default investment will have to monitor changes in the demographics of their participant populations and modify the choice of balanced fund as necessary.

3. An investment management service with respect to which an investment manager (who must be an investment manager under ERISA) allocates the assets of a participant’s individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment options available under the plan, based on the participant’s age, target retirement date, or life expectancy. The portfolio’s investment allocation will change over time to become more conservative with increasing age. The proposal provides that an example of this type of product is a “managed account.”

Although we agree that these three types of products should be QDIAs, we have concerns about the limitations the Department seeks to impose on them. By requiring that a QDIA that is not a stand-alone mutual fund or fund of funds must be managed by an ERISA investment manager, and by imposing an obligation on plan sponsors to consider worker demographics in selecting and retaining a balanced fund default, the rule will exclude many products or arrangements that would be equally suitable default investments. If the changes recommended below are not made, we believe that the only viable default option for most plan sponsors will be lifecycle or target-date funds. The responsibility to monitor demographics, as discussed below, is unnecessary and will make balanced funds unattractive to plan sponsors. Use of lifecycle or balanced model portfolios will be significantly curtailed by the ERISA investment manager requirement and the managed account option will be more expensive – perhaps too expensive to justify its use with the small balances likely to be associated with defaulted participants. We do not believe that plan sponsors should be forced to add new options to take advantage of the safe harbor, when an existing investment option or model portfolio under the plan would be considered a complete and prudent investment program.
Balanced Funds

We commend the Department for recognizing that balanced funds can serve as appropriate default options. Balanced funds invest in a mix of equity securities and bonds, generally with the three-part objective of conserving principal, providing income, and achieving long-term growth of both principal and income. A balanced fund would be an appropriate default investment for any participant population. We agree with the Department’s decision to include balanced funds in the realm of QDIAs, but, as discussed below, the Department should modify the proposal’s limitation on balanced funds to make them a more usable option for plan sponsors.

The Institute does not agree with the requirement, expressed in the preamble to the proposed regulation, that a plan sponsor must monitor, as part of its periodic review of plan investment options, plan demographics to make sure that the balanced fund remains suitable for participants as a whole.7 A balanced fund would not become inappropriate due to changes in worker demographics, for example, because the average age of plan participants has increased or decreased.

It is important to understand balanced fund portfolios and how they differ from lifecycle or target-date funds. Most target-date funds have more than 60%, and as much as 80%, of their portfolios invested in stocks until 5 to 7 years before retirement, when the stock allocation begins to approach 50%. Balanced funds as a group hold about 60-65% of their portfolios in stocks.8 The typical balanced fund would be somewhat more conservatively invested than most target date funds. Hence, balanced funds are an appropriate default option for all workers.

Because balanced funds typically are less heavily invested in equities than most target date funds, once an employer has chosen a balanced fund default for the plan, periodic monitoring of the age of the employer’s workforce simply would add unnecessary costs. In practice, the periodic monitoring likely never would produce an impetus for changing to a different balanced fund default. This is because the typical balanced fund is more conservatively invested than all target date funds, except for those whose target date is designed for those just a few years from retirement.

Although the Department intended balanced funds to be a simple and inexpensive type of QDIA, a duty to monitor demographics will make balanced funds less attractive to plan sponsors. In adopting the default rule, the Department should eliminate the duty to monitor demographics set out

---

7 In imposing this condition, the Department draws a parallel between the selection of a balanced fund default and management of an individual account plan that does not provide for participant direction. 71 Fed. Reg. 56810 (Sept. 27, 2006). We do not believe that non-participant directed individual account plans are managed based on participant demographics, but rather are managed much like a balanced fund, with investment decisions made in response to market conditions.

8 Investment Company Institute, *Quarterly Supplementary Data for the Quarter Ending June 30, 2006.*
in the preamble. This will provide the comfort necessary for sponsors to select balanced funds as a default investment. Otherwise, we believe that sponsors will be unlikely to make use of this option.

**Model Portfolios**

Although model portfolios are expressly included in the proposed regulation, the requirement that a QDIA that is not a registered investment company be managed by an investment manager who is a fiduciary under ERISA would exclude many model portfolio products popular in the market today. The Department included this condition to address concerns over accountability in constructing model portfolios. We see little reason for concern, however, where a model portfolio consists of funds that are registered investment companies under the 1940 Act or common or collective trust funds, which typically are managed by ERISA fiduciaries. The selection and monitoring of a default investment is a fiduciary function and the sponsor must act prudently in constructing a model portfolio or selecting a model portfolio constructed by a broker or adviser. Requiring an ERISA investment manager to manage the model portfolio is unnecessary.

There are different approaches to creating model portfolios. A model portfolio may be constructed by a service provider who is registered under the Investment Advisers Act of 1940 or exempt from regulation or registration under that Act. The principles in Interpretive Bulletin 96-1 that allow an investment adviser to create an asset allocation model without giving investment advice or becoming an ERISA fiduciary have worked well and the Department should not change course by requiring these managers to assume additional ERISA obligations now in order to have model portfolios of their funds used as default options. A plan sponsor today could construct a model portfolio for its plan based on asset allocation models created by an adviser under I.B. 96-1, and should be able to designate this portfolio as a default investment in accordance with the regulation.

It is also common for a plan sponsor to construct a model portfolio with help from a broker or pension consultant who is subject to regulation under the Securities Exchange Act of 1934 or the Investment Advisers Act, respectively. Some sponsors may want to construct the model portfolio on their own, using the plan’s menu of investment options. Constructing a model portfolio from the plan’s menu may be less expensive for some plan sponsors (as well as participants) than adding lifecycle funds or a managed account option. It also would alleviate the burden of having to shop for a new investment option, as many plans would not currently have an option that would satisfy the proposal’s QDIA criteria. Plan sponsors are subject to fiduciary duties and thus would be accountable for the

---

9 Banks, broker dealers, and certain state-registered advisers are exempt from Investment Advisers Act regulation in recognition of their regulation under other laws. See §§ 202(a)(11), 203(b)(1) and 203A of the Investment Advisers Act.

10 A consultant that advises a plan sponsor on selecting particular funds for a plan likely is giving investment advice within the meaning of the Investment Advisers Act and thus would be subject to regulation under that Act.
prudent selection of a model portfolio, just as when a plan sponsor chooses any other default investment.

Facilitating the use of model portfolios, as well as stand-alone funds or funds of funds, would maintain competitive equality among asset managers and provide flexibility for plan sponsors. We believe that a model portfolio of mutual funds or collective funds constructed by an investment adviser or constructed by the plan sponsor from a plan’s menu of investment options should be treated as a QDIA, assuming the model portfolio satisfies other applicable requirements of the regulation.

Managed Accounts

Requiring that the manager of a managed account default must be an ERISA investment manager is unnecessary and will prevent plan sponsors from using existing managed account programs as default options. Of the managed account options offered by plan providers today, some use an ERISA investment manager and some do not. For example, it appears that a managed account program modeled on the discretionary investment advice program described in Advisory Opinion 2001-09A (Dec. 14, 2001) (the “SunAmerica Opinion”) would not qualify as a QDIA under the proposed regulation. This type of discretionary advice program, created by an independent third-party expert and offered by the plan’s service provider (who would not have any discretion to alter the program), does not involve an ERISA investment manager. When used as a default investment, a computer model would generate an asset allocation for the participant and automatically adjust the allocation over time. Many plans have products like this in place. Given the usefulness of these products, which have become more common since the SunAmerica Opinion was issued, the QDIA regulation should cover them.

Lifestyle Funds

It is unclear whether a “lifestyle” fund would be considered a QDIA under the proposal. Lifestyle funds provide varying degrees of long-term appreciation and capital preservation through a mix of equity and/or fixed income securities, much like lifecycle funds. But unlike lifecycle funds, the allocation in a given lifestyle fund does not change over time to become more conservative. The investment manager of a lifestyle fund invests the fund’s assets according to a pre-set level of risk, such as “conservative,” “moderate,” or “aggressive.” We believe lifestyle funds would be appropriate default investments when the plan sponsor uses a package of lifestyle funds that includes movement of participants through the series of funds automatically over time as participants reach predetermined ages. This is functionally equivalent to selecting a package of lifecycle or target-date funds as default investments. Certain lifestyle funds also could be appropriate default investments under the criteria for balanced fund QDIAs. The Department should make clear that lifestyle funds can be used as a QDIA.
Asset Allocation in Lifecycle Funds and Managed Accounts

The proposed regulation’s description of the first and third types of QDIA could be interpreted to require inclusion of both equity and fixed income securities in the fund or model portfolio for every age or age group.11 The Institute assumes that the Department did not intend to require an investment product or manager to include both equity and fixed income exposure for every age or age group. For example, some lifecycle funds offered for individuals who are 25 years or more away from retirement do not include any fixed income investment exposure, but rather will add this exposure over time. Read literally, the proposed regulation could require that fixed income investments be part of QDIAs for all ages, even if reasonable investment principles would suggest otherwise.

Notice Requirement

The proposed regulation would require plan sponsors to provide notice at least 30 days before the first investment in a QDIA. Plan sponsors who automatically enroll workers into their plan on the date of hire may have difficulty meeting the initial 30-day notice requirement because the first contribution to the plan likely would be made within 30 days of the date of hire. Likewise, when a participant makes a rollover contribution into a plan without providing investment direction, to comply with the notice rule, the sponsor would have to wait at least 30 days before investing the contribution in a QDIA. In these situations and others, it would be impractical to provide notice 30 days in advance of the first investment in a QDIA.

Section 624 of the Pension Protection Act requires an annual notice to participants and that the participant must have a reasonable period of time after receipt of the notice and before the beginning of the plan year to make an investment election. The statute does not require 30-day advance notice and the Department thus should revise the proposed regulation to require notice within a reasonable period of time. This standard could be satisfied, for example, by providing the notice with plan enrollment materials. As a policy matter, the regulation should not provide any impediment to automatic enrollment of workers immediately upon hire. Participants who are enrolled immediately may be more likely to stay enrolled because they will see no decrease in take-home pay upon being automatically enrolled.

11 Subsection (e)(5)(i) of the proposed regulation reads, in relevant part, as follows: “An investment fund product or model portfolio that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant’s age, target retirement date (such as normal retirement age under the plan) or life expectancy.” Section 624 of the Pension Protection Act requires the regulation to “provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.”
Disclosure Requirement

The proposed regulation would require that any material provided to the plan relating to a participant’s investment in a QDIA, such as account statements, prospectuses, and proxy voting material, be provided to the participant or beneficiary. We recommend that the proposal be changed to require the same information and materials to be provided to defaulted participants as are provided to other participants with respect to the default investment. Not all materials provided to plans by fund companies are provided to participants. For example, proxy voting materials for mutual fund shares are not passed on to participants when participants do not vote proxies. In addition, under the existing section 404(c) rules, mutual fund annual reports are required to be made available upon request and thus are not commonly passed on to participants. The Institute believes that a uniform disclosure regime is essential for participants in self-directed plans, and that the Department should require disclosure of information that is relevant to participant investment decisions.

There is no reason to require more disclosure for defaulted participants than for participants who have made affirmative elections. Providing more information to this class of participants also could have unintended consequences. For example, it is possible that the additional materials provided to defaulted participants could be considered a “right or feature” under Internal Revenue Service regulations that require certain benefits, rights or features to be provided on a nondiscriminatory basis.

Financial Penalty

Under the proposal, participants must be able to transfer assets invested in a QDIA to any other investment option available under the plan without financial penalty, consistent with the terms of the plan, but not less frequently than once per any three-month period. The proposal states that this condition is not intended to confer greater rights on participants whose accounts are invested by default in a QDIA than are otherwise available under the plan with respect to the timing of investment directions. We request clarification that the condition also is not intended to confer greater rights on these participants with respect to financial penalties and other restrictions. For example, short-term redemption fees that would be imposed by a mutual fund on any shareholder engaged in frequent trading should not constitute a financial penalty. Prohibiting the application of a redemption fee that

---

12 In many plans, a plan fiduciary votes fund shareholder proxies instead of passing them on to participants.

13 The regulations under section 404(c) require the following materials to be provided to participants directly or upon request: copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternatives available under the plan, to the extent such information is provided to the plan. 29 CFR §2550.404c-1(b)(2)(i)(B)(2)(ii).

otherwise applies to any shareholder would be wholly inconsistent with trading restrictions designed to protect investors. Also, losses incurred in the participant’s account while assets are invested in a QDIA should not be considered a financial penalty, as there would be no assets available to cover such losses in an individual account plan.

Prior Default Investments

Prior to enactment of the Pension Protection Act, sponsors had started using default investments in their plans. In many cases, existing default investments are money market or stable value funds, which do not qualify as a QDIA under the safe harbor.\(^\text{15}\) The Department should provide guidance to plan sponsors on its expectations regarding whether and how to convert existing default investments to a QDIA. The purpose of the proposed regulation will be better served if plans are able to move participant balances in such a prior default investment to a QDIA.

At the same time, moving assets from the old default fund to a new default fund may not be a simple task. For example, certain contract provisions associated with stable value funds may prevent easy movement into and out of the fund.\(^\text{16}\) In addition, it may be difficult for plan recordkeepers to distinguish between assets that were invested in the existing default fund pursuant to a plan’s default investment provision and assets that were invested in the same fund by affirmative election. The Department should make clear that a plan sponsor will fulfill its obligations if it makes a prudent decision on whether to move assets to the new default fund, based on all the facts and circumstances.

In addition, the Department should provide guidance on the administrative issues associated with the conversion. There is more than one option to address these administrative issues. For example, for participants who are invested solely in the old default fund,\(^\text{17}\) the Department could permit plans to notify these participants that, unless the participant affirmatively elects by a specified deadline to stay in the old fund, the participant’s assets will be moved to the new default fund. As an additional alternative, the Department could provide that if a plan sponsor makes a reasonable conclusion based

\(^{15}\) The Department stated in the proposal that the limitations on the types of investment products identified in the regulation should not be construed to indicate that the use of other investment alternatives (such as money market and stable value funds) as defaults would be imprudent. We agree that there may be situations in which, in the absence of investment direction, it would not be imprudent for a plan to place a participant’s or beneficiary’s account in an investment designed to preserve principal. Although there may be particular facts and circumstances that would warrant use of a capital preservation default, we believe that in the majority of situations, default investments that provide for capital appreciation would be most appropriate and should be encouraged in the regulation.

\(^{16}\) For example, financial institutions that issue investment contracts in connection with stable value funds impose “equity wash” restrictions that limit transfers to competing funds.

\(^{17}\) Under this approach, participants who are invested in other options are presumed to have exercised control over their accounts.
on available plan records that the participant is invested in the old fund by default, the plan sponsor could move the participant’s assets to the new default fund after providing notice. These approaches would facilitate a smooth transition to the QDIA regime for sponsors and participants.

**Effect of Participant Direction**

The proposed regulation does not address the point at which an investment ceases to be a default investment with respect to a given participant. Certain actions on the part of a participant should be considered an exercise of control that would cause any remaining investment in the default fund to be treated as affirmatively invested. For example, if a participant whose assets have been invested in a QDIA in accordance with the plan’s default provision later elects to move a portion of his or her assets out of the QDIA, the participant should be treated as having exercised control over the account. Other facts and circumstances, such as an election to change the participant’s contribution rate, may be less clear. While we do not believe the Department should specify bright-line rules in this area, we think it is important to be aware that plan sponsors will have to make determinations, based on facts and circumstances, as to whether a participant should continue to receive the annual default notice after taking some action with respect to his or her account.

**Good Faith Compliance Prior to Effective Date**

Prompt guidance is needed on reliance prior to the effective date of the final regulation. The regulation is proposed to be effective 60 days after the date of publication of the final rule in the Federal Register. Because the Pension Protection Act provision for default investments is effective January 1, 2007, a gap period between the statutory effective date and the regulation’s effective date will occur. We urge the Department to issue interim guidance that will protect plan fiduciaries relying on the regulation beginning January 1, 2007. Plan sponsors who implement default investments designed to meet the regulation’s requirements at the beginning of 2007 should not fail to receive protection under the Pension Protection Act merely because the final regulation is not yet effective. In addition, under the proposed 30-day notice requirement, notice to participants would have to be provided by December 2, 2006 in order to receive protection under the safe harbor for investments made on January 1, 2007. If the Department intends to retain this 30-day requirement, guidance on good faith compliance is essential.

A similar issue arises with respect to the Pension Protection Act’s preemption provision for automatic contribution arrangements, which is effective upon the date of enactment (August 17, 2006), but which requires that contributions be invested in accordance with the Department’s regulation under section 404(c)(5). We request guidance as to the effect of good faith reliance on the regulation during the period between August 17, 2006 and the effective date of the final regulation. We believe that sponsors should get the benefit of ERISA preemption during this period of time.
Guidance also would be helpful on when the required default notice would have to be provided to participants in order to get the benefit of preemption upon the provision’s effective date.

* * *

The Institute strongly supports the Department’s decision to include lifecycle products, balanced fund products, and managed accounts as appropriate default investments. We urge the Department, however, to reconsider certain limitations in the proposal that will prevent balanced funds, model portfolios, and managed account programs being used today from qualifying as QDIAs. Specifically, we recommend that the Department eliminate the requirements that a QDIA that is not a registered investment company be managed by an ERISA investment manager and that plan sponsors who select a balanced fund default must monitor changes in participant demographics. The Institute also recommends that the Department clarify certain procedural requirements and provide additional guidance for several issues not addressed in the proposal, as described above. Plan sponsors must be provided greater assurance that actions taken in reliance on the regulation will be protected.

The Institute appreciates the opportunity to comment on this important proposed regulation and we look forward to continuing to work with the Department on the issues raised in our letter. If you have any questions or would like more information from the Institute, please contact the undersigned at (202) 326-5815 (ekrentzman@ici.org) or Mary Podesta at (202) 326-5826 (podesta@ici.org).

Sincerely,

/s/ Elizabeth Krentzman

Elizabeth Krentzman
General Counsel

cc: Robert Doyle
Lou Campagna
Erin Sweeney