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VIA FEDERAL EXPRESS AND ELECTRONIC SUBMISSION

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

Re: Proposed Regulations Under Section 404(c)(5) of ERISA
(Default Investment Alternatives Under Participant Directed Individual Account Plans)

Dear Reader:

Thank you for the opportunity to comment on the proposed regulations for Default Investment Alternatives Under Participant Directed Individual Account Plans (Prop. 29 C.F.R. § 2550.404c-5), published in the Federal Register on September 27, 2006 (71 Fed. Reg. 56,806). The Department of Labor and Employee Benefits Security Administration proposed regulations provide a good framework for qualified default investment alternatives. Nevertheless, due to the complexity of the Pension Protection Act, there are a number of provisions that we believe could be further clarified. Therefore, we offer the following comments.

I. Effective Dates

Section 624(b) of the Pension Protection Act[1] provides that the effective date for newly added section 404(c)(5) of ERISA[2] shall be "plan years beginning after December 31, 2006." Section 624(b) also requires the Secretary of the Department of Labor to issue final regulations no later than February 17, 2007 (six months after the enactment of the Pension Protection Act).[3] The proposed regulations under section 404(c)(5) indicate that the final regulations under section 404(c)(5) are proposed to have an effective date 60 days after the final regulations are

[1] Pension Protection Act of 2006, Pub. L. 109-280 (2006). For convenience, these comments simply refer to the act as the Pension Protection Act.

[2] 29 U.S.C. § 1104(c)(5) (2006) (ERISA § 404(c)(5)). References to ERISA in the body of the comments use the section of ERISA rather than the United States Code cite. The United States Code cite is generally provided in the notes to the text for convenience.

[3] President Bush signed the Pension Protection Act into law on August 17, 2006.

published in the Federal Register.[4] Because the comment period is open until November 13, 2006, the effective date of final regulations may be as late as April 16, 2007 if the final regulations are published on February 17, 2007. This will be after the Pension Protection Act's effective date for retirement plans with a calendar year as a plan year.

In addition, section 902(g) of the Pension Protection Act provides that the effective date for newly added section 514(e)[5] is August 17, 2006. The definition of an automatic contribution arrangement, contained in section 514(e)(2), limits such arrangements to those under which contributions are invested in accordance with the regulations under section 404(c)(5). The regulations, however, could not have been issued on the date of enactment and, therefore, will be effective after the Pension Protection Act's effective date.

The Department of Labor did not draft the effective dates provided under the Pension Protection Act. Nevertheless, it would be helpful if the Department of Labor issued guidance regarding its interpretation of the effective dates for these sections.

A. Effective Date of Section 404(c)(5)

We ask the Department of Labor to clarify that the reference to the regulations in section 404(c)(5)(A) does not delay the effective date of the section as provided under section 624(b)(1) of the Pension Protection Act. If Congress had intended the effective date to be the date on which the Department of Labor issued final regulations, it could have drafted the effective date in this manner. One example of this is the effective date for the automatic rollover of small amount distributions as provided under section 657 of the Economic Growth and Tax Relief Reconciliation Act of 2001.[6] Based on this, the effective date of section 404(c)(5) should not be conditioned on the effective date of final regulations under section 404(c)(5).

B. Good Faith Compliance for Section 404(c)(5)

As part of clarifying the effective date, the Department of Labor may wish to consider whether to require plan sponsors to act in good faith compliance with the proposed regulations. Many plan sponsors desire to take advantage of the fiduciary relief provided under section 404(c)(5) as soon as possible. Because section 624(b) provides the effective date for such relief is the first plan year beginning after December 31, 2006 and

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4 *See* Default Investment Alternatives Under Participant Directed Individual Account Plans , 71 Fed. Reg. 56,806, 56,808 (top of right column).

5 29 U.S.C. § 1144(e) (2006) (ERISA § 514(e)).

6 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, § 657(d) __ Stat. __, ___ (2001) (providing that the effective date of the amendments made by section 657 applied "to distributions made after final regulations implementing subsection (c)(2)(A) [of section 657] are prescribed").

most retirement plans use a calendar year as their plan year, we request that the Department of Labor provide guidance, even informal guidance, that compliance with the proposed regulations constitutes good faith compliance, and plans that comply with the requirements (including issuing a notice by December 1, 2006) shall be entitled to the fiduciary relief provided under section 404(c)(5). If the Department of Labor requires good faith compliance, it would assist plan sponsors if they were not required to distribute a new notice based on the final regulations under the next annual notice requirement.

C. Effective Date of Section 514(e)

We ask the Department of Labor to clarify that the reference to the regulations in section 514(e)(2) does not delay the effective date of section 514(e) as provided under section 902(g) of the Pension Protection Act. The same principle noted above with respect to the effective date for section 404(c)(5) applies to the effective date for section 514(e).

II. Notice Requirements Under Section 404(c)(5)

Section 624 of the Pension Protection Act amended ERISA to add section 404(c)(5). Section 404(c)(5) provides relief from fiduciary responsibility for the investment performance of a participant's assets invested in a default investment. If under a plan (i) the plan invests a participant's assets in a default investment, (ii) the default investment satisfies the regulations issued by the Secretary of the Department of Labor, and (iii) the plan provides the participant with the notice required under section 404(c)(5)(B), then the participant is deemed to have exercised control of the investment of the participant's assets.

A. Initial Notice

We ask the Department of Labor to consider whether notice is required at the time a plan initially invests a participant's assets in a default investment. Section 404(c)(5)(B) requires a plan to provide annual notice[7] but does not require a plan to provide an initial notice. If Congress had intended an initial notice or more frequent notice, it would have included such a requirement and, indeed, Congress did elsewhere in the Pension Protection Act. For example, section 902(b) of the Pension Protection Act added section 414(w) to the Internal Revenue Code, which requires annual notice (see section 414(w)(4)(A)) and notice before the first elective contribution is made from a participant's pay (see section 414(w)(4)(B)(ii)). For another example, section 902(a) of the Pension Protection Act added section 401(k)(13) to the Internal Revenue Code, which

[7] *See* 29 U.S.C. § 1104(c)(5)(B) (2006) (ERISA § 404(c)(5)(B)).

requires annual notice (see section 401(k)(13)(E)(i)) and notice before the first elective contribution is made from a participant's pay (see section 401(k)(13)(E)(ii)(III)). For an additional example, section 508(a) of the Pension Protection Act amended section 105(a) of ERISA to require quarterly benefit statements for individual account plans. If Congress had intended an initial notice requirement to obtain relief under section 404(c)(5)(B), it would have incorporated this requirement in the Pension Protection Act.

If the Department of Labor determines section 404(c)(5) requires plan administrators to provide an initial notice, we believe the participant does not need a notice period of more than five days. If a notice period is required of more than five days, several pay periods may pass without a deduction being made to be contributed to an employer's 401(k) plan. Participants will become accustomed to not having amounts automatically deducted from their pay and contributed to their employer's 401(k) plan. This in turn is likely to increase the opt out rate once the deductions begin and leave these participants less prepared for retirement.

The vast majority of 401(k) plans today allow participants to change their contribution rate or to cease participating each pay period. A notice period of five days or less provides participants with a reasonable opportunity to opt out. Because most 401(k) plans allow for changes each pay period, even if the participant fails to opt out within the five days the participant could stop contributing the next pay period.

Whatever position is adopted, we ask that the Department of Labor adopt a consistent initial notice period for the notices under section 404(c)(5)(B) and section 514(e)(3).

B. Default Investment Prior to Expiration of Notice Period

We ask the Department of Labor to clarify the impact of default investments made before the end of the notice period. For example, it is likely some plan sponsors will automatically enroll participants at the time of hire and direct their investments into a default fund regardless of the notice period required. These plan sponsors are likely to select a default fund that, except for the notice, in all other ways satisfies the requirements under section 404(c)(5).

The initial direction of investment is subject to the fiduciary standards under section 404(a).[8] Once the notice period ends, presumably the default investments made before the end of the notice period come under section 404(c)(5) at the time the notice period ends – the investment in all other manners complied with section 404(c)(5) and the

[8] 29 U.S.C. § 1104(a) (2006) (ERISA § 404(a)).

participant has now had the required notice period to consider alternative investments but has failed to direct the investment of the participant's account. We ask the Department of Labor to clarify this is the impact and to describe whether such default investments made prior to the end of the notice period have any impact such investments have on whether default investments made after the end of the notice period qualify for the protection provided under section 404(c)(5).

C. Combining Separate Notices

We ask the Department of Labor to provide guidance on how plan administrators may combine required notices. For example, if a 401(k) plan is an automatic enrollment arrangement that satisfies the requirements of section 404(c)(5) and offers employer stock as an investment option, the plan will be subject to three notice requirements: (i) the notice under section 404(c)(5)(B) (qualified default investment alternative), (ii) the notice under section 514(e)(3) (automatic contribution arrangement), and (iii) the notice under section 101(m)[9] (diversification of investment). Ideally, these three notices may be combined in a single notice. We ask the Department of Labor to provide guidance on the whether the notices may be combined and, if combined, guidance on any requirements for a combined notice (for example, the order of the notice given to the participant).

III. Preemption

Section 902(f) of the Pension Protection Act amended ERISA to add a new section 514(e). Section 514(e) provides ERISA shall preempt state laws (such as state wage and hour laws) that would prevent a plan from containing an "automatic contribution arrangement." Section 514(e) defines which arrangements constitute an automatic contribution arrangement and requires plan administrators of plans with an automatic contribution arrangement to provide notice to plan participants of their rights and obligations under the arrangement. If a plan administrator fails to provide such notice, the Secretary of the Department of Labor may impose a penalty of up to $1,000 per day.[10]

A. Effect of Section 514(e)(3) on Broad Preemption Under Section 514(a)

We ask that the Department of Labor clarify the impact the addition of section 514(e)(3) has on section 514(a) and on the Department of Labor's prior guidance that ERISA

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[9] 29 U.S.C. § 1021(m) (2006) (ERISA § 101(m)). Section 507 of the Pension Protection Act added this diversification notice requirement under section 101(m) (and renumbered the existing section 101(m)).

[10] Section 902(f)(2) of the Pension Protection Act amended section 502(c)(4) of ERISA to include a reference to the notice requirement under the newly added section 514(e)(3) of ERISA.

generally preempts state wage and hour laws. Prior to the enactment of the Pension Protection Act, some individuals were concerned as to whether ERISA preempted state wage and hour laws, despite the broad preemption provided under section 514(a).[11] The Department of Labor addressed this issue in two ERISA Opinion Letters which indicated that state wage and hour laws were preempted.[12] Nevertheless, because such laws may impose criminal penalties, some individuals remained concerned and believed the uncertainty would slow the adoption of automatic enrollment in 401(k) plans. To address this concern, Congress amended ERISA to add section 514(e). This change, however, has raised the issue of whether the addition of section 514(e) narrows the scope of the broad preemption provided under section 514(a) of ERISA. The issue is whether the effect of the section 514(e) is (i) to clarify that payroll deductions for automatic contribution arrangements are specifically exempt from state law under ERISA but that this has no effect on ERISA's preemption of payroll deductions for other plans subject to ERISA,[13] or (ii) to indicate that payroll deductions related to plans subject to ERISA other than automatic contribution arrangements are not exempt from state law (in effect, limiting the scope of preemption under ERISA to only payroll deductions made to automatic contribution arrangements).

Our understanding is that Congress intended to clarify and supplement the Department of Labor's existing guidance rather than to narrow the scope of preemption under ERISA.[14] The Pension Protection Act did not amend section 514(a). If Congress had intended section 514(e) to be an exception or limit section 514(a), Congress could have amended section 514(a) to add an exception as is already present for section 514(b).[15] Instead, Congress drafted section 514(e) to provide, "Notwithstanding any other provision of this section, this title shall supersede any law of a state which would directly or indirectly

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11 Section 514(a) provides:
"Except as provided in subsection (b) of this section, the provisions of this title and title IV shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan described in section 4(a) and not exempt under section 4(b)."
29 U.S.C. § 1144(a) (2006) (ERISA § 514(a)).

12 *See* ERISA Op. Ltr. 94-27A (July 14, 1994) (concluding ERISA preempts state wage and hour laws). *See also* ERISA Op. Ltr. 96-27A (February 8, 1996) (concluding ERISA preempts Puerto Rico's wage and hour laws).

13 For example, 401(k) plans that do not have an automatic contribution arrangement and cafeteria plans under which payroll deductions are used to fund ERISA covered plans such as health insurance and health flexible spending accounts.

14 As noted in the discussion below regarding the penalty for failure to comply with section 514(e)(3), the decision by Congress to impose a penalty for failing to provide a notice under section 514(e)(3) may be taken as an indication that otherwise there would be no penalty under ERISA – an employer could simply rely on ERISA's broad preemption provision instead of attempting to comply with section 514(e).

15 Section 514(a) begins, "Except as provided in subsection (b) of this section, . . .". 29 U.S.C. § 1144(a) (2006) (ERISA § 514(a)). If Congress had intended to narrow the scope of this broad preemption, Congress presumably would have inserted a reference to subsection (e) after subsection (b).

prohibit or restrict the inclusion in any plan of an automatic contribution arrangement." This indicates Congress intended to clarify the preemption afforded to automatic contribution arrangements and not to narrow the broad preemption provided under ERISA with respect to other employee benefit plans subject to ERISA.

The application of broad preemption under ERISA to state wage and hour laws may be seen in light of the purpose of such laws. State wage and hour laws are primarily designed to assure employees that they receive a certain level of pay for hours worked. Payroll deductions for benefits provided to the employees simply results in the employee receiving benefits rather than compensation. If ERISA did not preempt state wage and hour laws, employers would be at risk of not being able to comply with the requirements under the Internal Revenue Code regarding the permanency of certain elections.[16] This could lead employers to decrease their use of pre-tax benefit programs. A narrow interpretation in which ERISA generally did not preempt state wage and hour laws would likely slow the use of automatic enrollment arrangements, not all of which will satisfy the requirements to be an automatic contribution arrangements under section 514(e).[17]

The Department of Labor can avoid confusion over the impact of the addition of section 514(e) by clarifying that broad preemption under ERISA applies to state wage and hour laws and affirming its prior guidance.

B. Automatic Enrollment Arrangements Subject to Section 514(e)

We ask the Department of Labor to confirm that not all automatic enrollment arrangements under a 401(k) plan are covered under section 514(e). Section 514(e)(2) defines an automatic contribution arrangement as a plan under which:
(i) a participant may elect to make a contribution or receive cash (a 401(k) plan),
(ii) the employer automatically enrolls the participant but the participant may opt out, and
(iii) the contributions are invested in accordance with the regulations under section 404(c)(5).

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16 The regulations under section 125 of the Internal Revenue Code indicate that an election to have an amount deducted from pay for benefits under a cafeteria plan on a pre-tax basis must be irrevocable subject to certain limited exceptions. *See* Prop. 26 C.F.R. § 1.125-1, Q&A 8 (see *Proposed Regulations: Tax Treatment of Cafeteria Plans*, 49 Fed. Reg. 19,321, 19,323 (May 7, 1984)). If ERISA did not preempt state wage and hour laws, a participant in a cafeteria plan would be able to require an employer to terminate the participant's contributions at any time, which would mean that the plan would fail to satisfy the regulations.

17 The Congressional Research Service reports that in 2004, "automatic enrollment had been adopted by an estimated 11% of § 401(k) plans" and that of plans with 5,000 or more participants, the ones most likely to be concerned about preemption, approximately 31% of those plans had adopted an automatic enrollment arrangement. Patrick Purcell, *Automatic Enrollment in 401(k) Plans,* Congressional Research Service, RS21954, p. 1 (Aug. 9, 2006).

Almost all (if not all) automatic enrollment arrangement under a 401(k) plan will satisfy the first two conditions. This definition indicates that to obtain the preemption provided under section 514(e) and be an "automatic contribution arrangement" that the arrangement must also have its investments invested in accordance with the regulations under section 514(e)(3).

A plan sponsor of an automatic enrollment arrangement, however, may choose not to take advantage of the fiduciary relief provided by section 404(c)(5). Given this, we ask that the Department of Labor confirm (i) an automatic enrollment arrangement under a 401(k) plan that does not seek the protection of section 404(c)(5) is not an automatic contribution arrangement, and (ii) such an arrangement is protected by ERISA's broad preemption and prior Department of Labor guidance even if it is not protected by the specific statutory preemption of section 514(e).

C. Plan Sponsor Election to be Subject to Section 514(e)(3)

We ask that the Department of Labor clarify whether a plan sponsor of an automatic enrollment arrangement under a 401(k) plan that has satisfied the requirements of section 404(c)(5) must affirmatively elect to the preemption provided under section 514(e), or if such arrangements are automatically covered under section 514(e). A plan sponsor of an automatic enrollment arrangement may wish to obtain the fiduciary relief offered under section 404(c)(5) and, therefore, may take steps to satisfy the requirements under that section. If an automatic enrollment arrangement takes such action and complies with section 404(c)(5), based on the definition of "automatic contribution arrangement" in section 514(e)(2),[18] it is unclear whether the arrangement now automatically receives the preemption provided under section 514(e) (and is subject to the notice requirement under section 514(e)(3)), or if a plan sponsor needs to take some affirmative action to come under section 514(e).

A plan sponsor of an automatic enrollment arrangement may wish to obtain the fiduciary relief offered by section 404(c)(5) but not the preemption provided under section 514(e). If the plan sponsor's decision to comply with section 404(c)(5) automatically brings the arrangement under section 514(e), the plan sponsor may choose not to adopt the relief available under section 404(c)(5) and instead continue to require a fiduciary to make a prudent decision regarding the default investment for the arrangement. Requiring an affirmative action by a plan sponsor to obtain preemption under section 514(e)(3) would

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[18] As noted above, the definition of "automatic contribution arrangement" consists of three requirements. *See* 29 U.S.C. § 1144(e)(2) (2006) (ERISA § 514(e)(2)). An automatic enrollment arrangement under a 401(k) plan satisfies the first two. The third requirement is that the contributions are invested in accordance with the regulations under section 404(c)(5).

also help plans avoid failing to comply with section 514(e) because a plan that invested default investments in accordance with section 404(c)(5) would not automatically come under section 514(e) and perhaps fail to satisfy the notice requirements under section 514(e)(3). Therefore, we ask the Department of Labor to clarify whether an automatic enrollment arrangement under a 401(k) plan that has satisfied the requirements of section 404(c)(5) automatically is covered under section 514(e).

D. When the Notice is to be Provided

We ask that the Department of Labor clarify whether the notice under section 514(e)(3) would need to be given to new participants in an automatic contribution arrangement. Section 514(e)(3) indicates that the notice requirement is only an annual notice and does not appear to require notice when an employee is automatically enrolled in an automatic contribution arrangement.[19] Therefore, we ask that the Department of Labor clarify the notice requirement under section 514(e)(3) is an annual notice.

If the Department of Labor determines section 514(e)(3) requires plan administrators to provide an initial notice, as indicated in the comments above regarding the initial notice under section 404(c)(5), we believe the participant does not need a notice period and that if a notice period is required that the notice period should be no more than five days. If a longer notice period is required, participants will become accustomed to not having amounts automatically deducted from their pay and contributed to their employer's 401(k) plan. This in turn is likely to increase the opt out rate and leave these participants less prepared for retirement. Whatever position is adopted, we ask that the Department of Labor adopt a consistent initial notice period for the notices under section 404(c)(5) and section 514(e)(3).

E. Penalty for Violation of Section 514(e)(3)

We ask that the Department of Labor clarify how the penalty for failure to issue an automatic contribution arrangement notice under section 514(e)(3) would be applied. Section 902(f)(2) of the Pension Protection Act amends section 502(c)(4) of ERISA[20] to add failure to provide the notice as a basis for the Secretary to impose a penalty of $1,000[21] per day. As amended, section 502(c)(4) provides, "The Secretary may asses a civil penalty of not more than $1,000 a day for each violation of any person of section 302(b)(7)(F)(vi), or section 514(e)(3)."[22]

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19 *See* 29 U.S.C. § 1144(e)(3)(A) (2006) (ERISA § 514(e)(3)(A)).
20 29 U.S.C. § 1132(c)(4) (2000) (ERISA § 502(c)(4)).
21 Section 502(c)(4) provides the penalty as $1,000 per day. *Id.*
22 *See id.* (as amended by section 902(f) of the Pension Protection Act).

The penalty imposed under section 902(f)(2) of the Pension Protection Act is an unusual penalty. Prior to the enactment of the Pension Protection Act, there was no monetary penalty associated with ERISA's preemption provisions. Failure to comply with section 514(e)(3) results in a loss of the specific statutory preemption provided by that section and monetary penalties. Because broad preemption under section 514(a) appears to apply to automatic contribution arrangements, Congress appears to have imposed the monetary penalty to assure that a plan failing to provide the automatic contribution arrangement notice faced some penalty.

A more concrete issue regarding the penalty is how the penalty is to be calculated. The issue is whether the penalty of $1,000 per day under section 502(c)(4) applies (i) to each day a plan fails to provide the notice to any participant (with the maximum penalty being $1,000 per day no matter how many participants are affected), or (ii) to each day and for each participant to whom a plan fails to provide notice.[23] If the proper interpretation is the later interpretation, this may discourage employers from establishing automatic contribution arrangements due to the risk of a penalty of $1,000 per day per participant (in effect, a potential penalty of $365,000 per year per participant). We ask that the Department of Labor clarify how the penalty is to be calculated.

IV. Benefit Statements

We ask the Department of Labor provide initial guidance, even informal guidance, for plan administrators on how to comply with the benefit statement requirements under section 105. Section 508(a) of the Pension Protection Act amended section 105(a)(1) of ERISA to require plan administrators of individual account plans to provide participants with quarterly benefit statements. The vast majority of individual account plans already provide such statements. In many cases, participants are able to check their account balances on a daily basis through either the Internet or access to a call center. This change is effective for plan years beginning after December 31, 2006, which means that benefit statements for calendar year plans issued in April of 2007 will be subject to the new requirements. We ask that the Department of Labor provide guidance on good faith compliance with the requirements.[24]

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[23] The Joint Committee on Taxation report on the Pension Protection Act appears to indicate that the penalty is per day for each participant. It states, "A plan administrator must provide notice to each participant to whom the automatic contribution arrangement applies. If the notice requirement is not satisfied, an ERISA penalty of $1,100 per day applies." Joint Committee on Taxation, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, JCX –38-06, Title IX.C, p. 230 (Aug. 3, 2006).

[24] Section 508(b)(2) of the Pension Protection Act provides the Secretary of Labor with the authority to promulgate interim final rules with respect to model notices under section 105 of ERISA.

V. Diversification Notice

We ask the Department of Labor provide initial guidance, even informal guidance, for plan administrators on how to comply with the diversification notice requirements under section 101(m). Section 507(a) of the Pension Protection Act amended ERISA to add a new section 101(m), which requires the plan administrator to give participants notice of their ability to diversify investment in employer securities under an individual account plan. The notice is to be provided "[n]ot later than 30 days . . . before the first date on which a [participant] . . . is eligible to exercise the right" to diversify the investment in employer securities.[25] This change is effective for plan years beginning after December 31, 2006, which means that calendar year plans will be subject to this requirement on January 1, 2007. We ask the Department of Labor to provide guidance on two issues:
(i) when a plan subject to the requirement must issue the first notice to participants (may the plan issue such a notice on January 1, 2007 or is it to provide the notice on December 1, 2006 to comply with the 30-day notice requirement), and
(ii) with respect to a newly hired employee, that a plan satisfies the requirement by providing the new employee notice at the time the employee becomes a participant in the plan or within a reasonable period of time after the employee becomes a participant (consistent with other notice requirements provided for under the Pension Protection Act).

Conclusion

Thank you for your consideration of our comments. Please contact me if you have any questions.

Sincerely

Timothy D.S. Goodman

[25] 29 U.S.C. § 1021(m) (2006) (ERISA § 101(m)).