INVESTMENT COMPANY INSTITUTE

April 1, 2004

BY ELECTRONIC DELIVERY

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

Re: Automatic Rollover Regulation

Ladies and Gentlemen:

The Investment Company Institute[1] strongly supports the ability of plan sponsors to effectively utilize the automatic rollover provisions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). The recently proposed automatic rollover regulations, however, contain restrictions on fees that will be so difficult to administer, relative to any benefit they may provide to individual IRA owners, that many financial services firms may be discouraged from offering automatic rollover accounts. Thus, we urge that the relief provided by the regulations to a plan fiduciary be available so long as the fees and expenses chargeable against the rollover account do not exceed those charged by the IRA provider against other comparable IRA accounts.[2]

I. Scope of Regulatory Relief

The automatic rollover provisions of EGTRRA were enacted to encourage the preservation of retirement assets by requiring that retirement plans with cash-out provisions automatically roll amounts (generally between $1,000 and $5,000) into an IRA, unless the participant elects otherwise. EGTRRA directed the Department to issue regulations providing safe harbor relief under ERISA section 404(a). Under such safe harbor regulations, a fiduciary that satisfies the safe harbor requirements is deemed to

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,595 open-end investment companies ("mutual funds"), 612 closed-end investment companies, 124 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.554 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] This fee limitation, one of two in the proposed regulations, should be the only fee limitation.

have met his or her section 404(a) duties with respect to both the selection of the IRA provider and the investment of the rolled-over funds. EGTRRA also provides plan fiduciaries with statutory relief under ERISA section 404(c) for automatic rollovers "upon (A) the earlier of (i) a rollover of all or a portion of the amount to another individual retirement account or annuity; or (ii) one year after the transfer is made; or (B) a transfer that is made in a manner consistent with guidance provided by the Secretary." ERISA section 404(c)(3).

To assess the impact of the proposed regulations' fee limitation under the section 404(a) safe harbor, the relationship between the section 404(c) statutory relief and the regulatory relief under section 404(a) should be clarified. This question is important because section 404(c)(3) essentially cuts off fiduciary liability for investment losses arising more than one year (at the latest) after the cash-out amount is automatically rolled over into an IRA.[3] Among other things, it would be useful to clarify whether the Department intended the proposed safe harbor regulations under section 404(a) also to be the "guidance provided by the Secretary" for purposes of section 404(c)(3)(B). If this guidance applies for section 404(a) and section 404(c)(3)(B) purposes, the relief in section 404(c)(3) will apply earlier than the period following one year after an automatic rollover is made.

II. Fee Limitation

We understand that plan sponsors will likely seek safe harbor relief under section 404(a) with regard to their selection of IRA providers and investments. Consequently, every effort should be made to ensure that safe harbor relief is effectively available. In this regard, the cost to investment product providers of satisfying the safe harbor conditions will have a significant impact on whether they are willing to offer automatic rollover IRAs. As discussed below, the costs to IRA providers of implementing the proposed regulations' limitation on fees to earnings will be substantial, while the benefits to individuals perhaps will be negligible. We therefore urge the Department to eliminate this requirement.

The typical automatic rollover IRA invested in money market mutual funds will be subject to no more than three types of fees or expenses: IRA account opening fees, investment product expenses (typically embedded in the net return on the underlying investment), and IRA account maintenance fees. The first type of fee or expense, IRA account opening expenses or "establishment" fees, are expressly excepted by the proposed regulations from the fee limitation. The second type of fee or expense, investment product expenses, should never exceed income from the investment since money market funds distribute their net income (which does not historically go below

[3] Section 404(c)(3) relief appears to apply to cash-out automatic rollovers from all pension plans because a plan providing for cash-outs is a plan, which with respect to this feature, provides for individual accounts and permits an individual to exercise control over the account assets. Thus, the safe harbor guidance provided under section 404(a) effectively applies only (1) during the period of up to one year before section 404(c)(3) applies and (2) beyond that period only to the extent that the safe harbor relief under section 404(a) is greater than the relief provided by section 404(c).

zero). However, the third type of fee or expense, the IRA account maintenance fee, would appear to be implicated by the fee limitation.

The fee limitation in the proposed regulations (that fees may not exceed earnings) provides a distinct disincentive to financial services firms because the costs of implementing that rule with regard to annual maintenance fees would be significant. The required systems changes could depend, in part, on how the account maintenance fee is charged. Some firms charge the account on a specified day each year for all IRAs; others charge the account annually at the account's origination date. These fee structures, as well as others, would present unique recordkeeping issues.

Specifically, fund firms would likely have to take some or all of the following steps in order to comply with the safe harbor's limitation on fees to income:

- modify recordkeeping systems to identify automatic rollover accounts and differentiate them from other rollover IRAs/traditional IRAs;

- create a new fee assessment process that compares the annual maintenance/custodial fee to the earnings of a particular IRA in the money market fund and determines the lesser of the two amounts;

- program fee assessment systems to enable them to charge a customized fee (if earnings are lower than the annual maintenance fee), which could differ for every automatic rollover IRA held by that financial institution; and

- modify the systems governing customer notification and shareholder communication materials to reflect the safe harbor's disparate fee restriction.

The systems difficulties and related costs can be illustrated by an example of amounts automatically rolled into a money market fund with an annual net return of 3.6 percent that is offered by an IRA provider that charges a fixed IRA maintenance fee of $24 on December 31 of each year. If the account is opened on January 1, the smallest possible rollover account of $1,001 would have earned $36 before the annual $24 account maintenance fee were charged.[4] If the account were opened on July 1, however, the earnings on the $1,001 account would only be $18, resulting in a fee cap that must be tracked separately. Even if the account were $5,000 — which would produce annualized earnings of $180 on a 3.6 percent return — the earnings cap would be hit for any account opened after mid-November. The costs of setting up systems for such separate tracking and customized fee assessment would be considerable.[5] The limitation on fees to

[4] If the return were less than one percent, as it is for many money market funds today, a $1,000 account would not generate enough earnings in a year to absorb even a $10 IRA account maintenance fee.

[5] For example, a preliminary estimate by one firm suggests that the systems and process modifications for that company would require about 2,000 hours of work. The cost of such labor alone would run well into a range of six-figures.

earnings also would arbitrarily reduce (or eliminate) the maintenance fee for the year based on the date the IRA is established.

Because of the need to set up these systems to comply with the fee limitation, financial services firms may resist automatic rollovers that seek to qualify for the safe harbor under section 404(a). Indeed, the costs of establishing a safe harbor-compliant system most likely would exceed the revenue lost by waiving IRA maintenance fees (particularly during the first year)[6] and any liability that a plan sponsor might incur were it to roll over cash-out amounts into an account without protection under section 404(a). Coupled with the fact that these accounts would be small[7] and there would be little likelihood of additional contributions, a regulatory restriction that effectively requires a separate recordkeeping system to be built and maintained would serve as a powerful disincentive for fund companies considering whether to offer safe harbor IRAs.[8]

To the extent that many IRA providers are discouraged from offering accounts under the automatic rollover rules, plan fiduciaries would have fewer financial institutions from which to choose automatic rollover account providers. A shortage of IRA trustees and custodians offering these accounts would cause difficulties for plan sponsors charged with selecting IRA providers under the automatic rollover rules. Ultimately, a shortage of vendors and lack of competition among them would harm the interests of individuals with automatic rollover accounts.

Equally troubling would be the harm to other retirement investors caused by the restriction on fees to earnings. The Department, in the preamble to the proposed regulation, acknowledges that automatic rollover accounts may need to be subsidized

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[6] The preamble states that the Department found annual maintenance fees to range from $7 to $50, with a mid-point of $29. 69 Fed. Reg. 9906 (March 2, 2004).

[7] Section 648 of EGTRRA permits plans to disregard amounts attributable to rollover contributions for purposes of the cash-out rule. Thus, amounts subject to the automatic rollover provisions could exceed $5,000. As the Department observes, however, "those with prior rollover contributions, especially those with large rollover contributions, may be more likely to accumulate more than $5,000 from new contributions and more likely to affirmatively direct the disposition of their accounts." 69 Fed. Reg. 9905 (March 2, 2004).

[8] It is important to note that IRA maintenance fees charged by fund companies cover actual costs incurred for services provided to account owners, including mailings to IRA owners (*e.g.*, disclosure statements, quarterly statements, newsletters) and account recordkeeping services. Because individuals for whom automatic rollover IRAs are established would be more likely to be "nonresponsive" or "missing" (a status which may result in, for example, mailings to be resent, efforts to research/verify addresses), the cost of providing services for these accounts, in fact, would likely be greater.

by other IRAs.[9] Indeed, to the extent that individuals benefiting from the automatic rollover process are not paying for such services (or only a portion thereof), the costs — including those required to establish new systems — would necessarily be borne by other parties. We question whether this result was intended by Congress.

We therefore urge that the only safe harbor fee limit be the first fee limit in the proposed regulations — that fees and expenses attendant to the IRA may not exceed the fees and expenses charged by the IRA provider for comparable IRAs established for rollover distributions (that are not subject to the automatic rollover provision). This limit, in almost any interest rate environment other than the present historic low one, should protect most automatic rollover IRAs from any reductions in balances and all from anything other than *de minimis* reductions.

III. Effective Date

Finally, while the Institute appreciates the Department's proposed delayed effective date, we urge the Department to extend the implementation period to 1 year. As the Department is aware, there are a number of core legal and operational issues that require clarification from the Treasury Department and the Internal Revenue Service.[10] Although it is anticipated that guidance under the Code will be issued in advance of or simultaneously with the Department's issuance of its final regulations,[11] we are concerned that efforts to comply with such guidance (while, at the same time, implementing the Department's final regulations) may require a transition period far in excess of 6 months, particularly since plan sponsors also will need to select an appropriate automatic rollover provider and modify various disclosure documents. Moreover, should the Department retain the rule limiting IRA maintenance fees to earnings in its current form, an implementation period of at least 1 year would be necessary for those fund companies that decide to offer automatic rollover accounts.

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[9] The preamble provides: "If adopted as proposed, this guidance may also result in a transfer of individual retirement plan costs to other individual retirement plans or to plan sponsors to the extent that earnings and available profit are less than the fees that the individual retirement plan provider would ordinarily charge for comparable individual retirement plans." 69 Fed. Reg. 9904 (March 2, 2004); *see also* pp. 9906-9907. Given that the automatic rollover mechanism applies to former employees, we question whether plan sponsors would have a strong incentive to incur the costs arising from the automatic rollover rules.

[10] *See* Institute Letter to the Department of Labor (March 10, 2003).

[11] 69 Fed. Reg. 9903 (March 2, 2004).

In sum, we urge the Department to (1) clarify the scope of the safe habor guidance, (2) eliminate the limitation on fees to earnings provided in the proposed safe harbor regulations, and (3) extend the effective date of the automatic rollover provisions to 1 year following the Department's issuance of final safe harbor regulations.

The Institute appreciates the Department's consideration of our recommendations. Please do not hesitate to contact me at 202-326-5837 if you have any questions concerning our comments.

Sincerely,

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Associate Counsel

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