INVESTMENT COMPANY INSTITUTE

BY ELECTRONIC DELIVERY

September 7, 2005

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

Re: Automatic Enrollment and Default Investments

Dear Mr. Doyle:

The Investment Company Institute strongly supports the Department of Labor's efforts to encourage automatic enrollment in 401(k) plans. By boosting participation in plans, automatic enrollment programs significantly encourage individuals to save for retirement. A recent study by the Institute and the Employee Benefit Research Institute (EBRI) found that automatic enrollment in 401(k) plans increases participation rates dramatically, particularly among lower-income workers.[1] This study also demonstrates that the type of default investments selected by employers as part of automatic enrollment programs can have a significant impact on participants' 401(k) accumulations at retirement.[2] The Department's initiative to provide greater clarity to plan fiduciaries in their selection of default investments is vitally important.

[1] Holden and Vanderhei, *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, Investment Company Institute and Employee Benefit Research Institute (July 2005). *See* http://www.ici.org/stats/res/1per11-02.pdf. The study presents results from the EBRI/ICI 401(k) Accumulation Projection Model, which examines how 401(k) assets might contribute to retirement income for future retirees.

[2] Four different automatic enrollment scenarios were studied: a 3 percent default contribution rate and a money market fund, a 3 percent contribution rate and a life-cycle fund, a 6 percent contribution rate and a money market fund, and a 6 percent contribution rate and a life-cycle fund. Life-cycle funds shift from higher weightings in equities to more conservative holdings over a time period intended to correspond to investors' retirement age. All else being equal, the higher the contribution rate, the higher the income replacement rate at retirement. In addition, given the historical tendency of equity securities to generate higher returns than fixed-income securities, participants in 401(k) plans that select a life-cycle investment option as the default tend to have higher projected replacement rates than those in plans with a money market fund.

Importance of Default Investment Guidance

Plans with automatic enrollment features have greater participation, even though employees have the right to opt out of participation or stop participating at any time. To date, however, many plans do not include these features, in part because of uncertainty about their treatment under ERISA. Because these automatic programs enroll employees in plans following employment (unless the employee affirmatively elects otherwise), plans that adopt this feature must specify how an employee's account will be invested should the employee not immediately direct his or her plan investments. While ERISA section 404(c) provides liability relief to plan fiduciaries where participants direct their plan investments, it does not expressly provide relief for a fiduciary's designation of a default investment.

Consequently, plan fiduciaries have chosen not to implement automatic enrollment arrangements or select investments designed to preserve principal, such as money market funds, as default investments. These investment options, however, may not have risk and return characteristics that are appropriate for many participants. It is widely accepted, for example, that participants in their 20's typically should not invest their plan balances in money market investments. Indeed, it is prudent for any plan participant with a relatively long horizon before retirement to have his or her account allocated to investments offering the possibility of greater returns. For participants who remain in default investments for extended periods, often due to inertia, their ability to accumulate retirement savings above the rate of inflation is compromised if their accounts consist only of investments designed to preserve principal.

Recommendations

Safe Harbor Investments

We urge the Department to provide safe harbor relief under ERISA for certain types of investments selected as the default under a plan. Two categories of investments should qualify under the safe harbor.

First, the Department should provide fiduciary relief where plan accounts are invested in a specific investment option or model portfolio that is:

- intended to provide diversification by investing in a range of asset classes; and
- intended to vary the emphasis and exposure among such asset classes in a manner that is consistent with the expectation that the participant or beneficiary will take distributions beginning on or about an anticipated year of retirement or during an anticipated distribution period.

Default investments with the foregoing features will be well diversified and tailored generally to an individual's age (and possibly other factors). These options are available through life-cycle funds and retirement date mutual funds. This category also would encompass structured model portfolios that are designed to function much in the same way as life-cycle funds. That is, a plan could structure a combination of equity and fixed income options as a default investment. Participants who rarely change their plan investments particularly will benefit from this approach because their asset allocation will adjust automatically over time.

Second, the Department should provide fiduciary relief for an investment designed to be the complete investment program of a prudent investor. Specific investment options or model portfolios that invest in a mix of equity and fixed-income securities designed to provide long-term appreciation and capital preservation should be eligible for the safe harbor. Such investments, too, will provide diversification across asset classes, reducing the risk of large losses while providing the potential for appropriate retirement saving returns. Indeed, IRS revenue rulings in the context of automatic enrollment identified "balanced funds" as investments into which plan amounts could be invested where participants did not make an affirmative election.[3]

Both categories will provide flexibility to plan sponsors to designate either a specific investment option or a model portfolio that invests among the investment options offered by the plan. Safe harbor guidance along these lines will provide the regulatory clarity necessary to encourage plan fiduciaries to adopt automatic enrollment programs, resulting in greater plan participation and long-term savings. The guidance also should enable sponsors with existing automatic enrollment programs using only investments that preserve principal to select default options offering greater potential returns.

Participant Disclosure and Opportunity to Direct to Different Investments

Any safe harbor guidance should require clear and timely disclosure (in written or electronic form) to plan participants of the designated default investment. Plan enrollment materials and other participant communications, for example, could provide this information.

In addition, participants whose accounts are invested under a plan's default investment provision should be permitted to change their investment allocation pursuant to normally applicable plan and investment-level rules. Thus, where a plan and its underlying investments permit participants to make investment changes with a certain degree of frequency, those same rules should govern participants' ability to direct their investments out of the default option.

Scope of Safe Harbor

The need for a safe harbor for default investments is not limited to automatic enrollment programs. While guidance on default investments is critical to encourage plans to adopt these programs, plan sponsors face other default investment situations for which the safe harbor should be available. For example, participants may enroll in a plan but neglect to designate the investment(s) into which contributions should be invested. Sponsors also may face situations

[3] *See, e.g.,* Rev. Rul. 98-30, 1998-25 I.R.B. 8 (automatic enrollment guidance on cash or deferred arrangements); Rev. Rul. 2000-33, 2000-31 I.R.B. 142 (automatic enrollment guidance on 457 plans); Rev. Rul. 2000-35 (automatic enrollment guidance on government plans.)

where one or more investment options on a plan menu are replaced or eliminated and some participants fail to specify their investment choices among the new investment options.

The Department should clarify that the selection of a default investment under the safe harbor is not the exclusive means by which an employer might satisfy its duties under ERISA. Depending on the facts and circumstances, including factors particular to the employer's workforce, an employer may be able to meet its fiduciary responsibilities by providing other types of default investments.

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Thank you for your consideration of our recommendations. We are pleased to assist the Department in other ways to advance this important initiative. If you have any questions concerning our views or recommendations, please do not hesitate to contact me at 202-326-5826 or Elizabeth Krentzman at 202-326-5815.

Sincerely,

/s/ Mary S. Podesta

Mary S. Podesta
Senior Counsel