DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR 2550

RIN 1210-AB10

Default Investment Alternatives under Participant Directed Individual Account Plans

AGENCY: Employee Benefits Security Administration

ACTION: Proposal

SUMMARY: This document contains a proposed regulation that, upon adoption, would implement recent amendments to title I of the Employee Retirement Income Security Act of 1974 (ERISA) enacted as part of the Pension Protection Act of 2006, Public Law 109-280, under which a participant of a participant directed individual account pension plan will be deemed to have exercised control over assets in his or her account if, in the absence of investment directions from the participant, the plan invests in a qualified default investment alternative. A fiduciary of a plan that complies with this proposed regulation will not be liable for any loss, or by reason of any breach that occurs as a result of such investments. The types of investments that qualify as default investment alternatives under section 404(c)(5) of ERISA are described in the proposal. Plan fiduciaries remain responsible for the prudent selection and monitoring of the qualified default investment alternative. The proposed regulation conditions relief upon advance notice to participants and beneficiaries describing the plan's provisions governing the circumstances under which contributions or other assets will be invested on their behalf in a qualified default investment alternative, the investment objectives of the default

investment alternative, and the right of participants and beneficiaries to direct investments out of the default investment alternative without penalty. The regulation, upon adoption, will affect plan sponsors and fiduciaries of participant directed individual account plans, the participants and beneficiaries in such plans, and the service providers to such plans.

DATES: Written comments on the proposed regulation should be received by the Department of Labor on or before [ENTER DATE THAT IS 45 DAYS FROM THE DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Comments should be addressed to the 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. Commenters are encouraged to submit comments electronically to e-ORI@dol.gov or www.regulations.gov (follow instructions for submission). Comments will be available to the public at www.dol.gov/ebsa and www.regulations.gov. Comments also will be available for public inspection at the Public Disclosure Room, N-1513, Employee Benefits Security Administration, 200 Constitution Avenue, NW, Washington, DC 20210.

FOR FURTHER INFORMATION CONTACT: Erin M. Sweeney or Lisa M. Alexander, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500. This is not a toll-free number.

SUPPLEMENTARY INFORMATION

A. Background

It is well established that many of America's workers are not adequately saving for retirement. Part of the retirement savings problem is attributable to employees who, for a wide variety of reasons, do not take advantage of the opportunity to participate in their employer's defined contribution pension plan (such as a 401(k) plan). The retirement savings problem is also exacerbated by those employees who enroll in their employer's plan, but do not assume responsibility for investment of their contributions, leaving their accounts to be invested in a conservative default investment that over the career of the employee is not likely to generate sufficient savings for a secure retirement.

A number of recent studies indicate that significant improvements can be made in 401(k) plan participation and in retirement savings levels through plan design changes. Specifically, the studies show that adoption of automatic enrollment provisions (provisions pursuant to which employees are automatically enrolled in the plan and must affirmatively opt-out of plan participation) by 401(k) plans can dramatically increase plan participation rates.[1] However, most surveys suggest that fewer than 20 percent of the employers sponsoring 401(k) plans have adopted an automatic enrollment provision.[2]

Many of the studies also indicate that the accumulation of retirement savings in automatic enrollment plans depends heavily on the default investment alternative and the default contribution rate provided under the plan.[3] The scope of this proposal is limited to default investment alternatives in which individual account plan assets are invested on behalf of those participants or beneficiaries who fail to give investment instructions. Modification of contribution rates implicates issues beyond the jurisdiction of the Department of Labor.

Several studies note that the contributions of automatically enrolled participants are frequently invested in products that present little risk of capital loss, e.g., money market funds, stable value funds and similarly performing investment vehicles.[4] It also

[1] Stephen P. Utkus & Jean A. Young, *Lessons from Behavioral Finance and the Autopilot 401(k) Plan*, (Vanguard Center for Retirement Res.) April 2004; Sarah Holden & Jack VanDerhei, *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, 283 Employee Benefit Res. Inst. Issue Brief (2005). The issue brief indicates that the "EBRI/ICI model shows that prior to automatic enrollment, 66 percent of eligible workers at year-end 2000 were participants in 401(k) plans, while immediately after adding automatic enrollment to the model, the participation rate rises to 92 percent of eligible employees." Id. at 4. See also James J. Choi, David Laibson, & Brigitte C. Madrian, *Plan Design and 401(k) Savings Outcomes*, 57 National Tax J. 275 (2004); see also James J. Choi, David Laibson, Brigitte Madrian, & Andrew Metrick, *For Better or For Worse: Default Effects and 401(k) Savings Behavior* (Pension Research Council, Working Paper No. 2002-2, 2001), available at http://prc.wharton.upenn.edu/prc/PRC/WP/WP2002-2.pdf.

[2] The incidence of automatic enrollment appears to be growing, by one estimate from 8.4 percent of plans in 2003 to 10.5 percent in 2004 (*48th Annual Survey of Profit Sharing and 401(k) Plans*, (Profit Sharing/401(k) Council of America, Chicago, Ill.), 2005, at 36), by another from 14 percent in 2003 to 19 percent in 2005 (*Survey Findings: Trends and Experiences in 401(k) Plans 2005*, (Hewitt Associates LLC), 2005, at 1, 13). Another survey found no growth between 2003 and 2004 (*2004 Annual 401(k) Benchmarking Survey* (Deloitte Consulting LLP), 2004, at 6).

[3] See studies cited *supra* note 2. See also Stephen P. Utkus, *Selecting a Default Fund for a Defined Contribution Plan* (Vanguard Center for Retirement Res.), July 2004.

[4] Of the responding plans with automatic enrollment, the default investment option was a stable value fund for 26.9%, a money market fund for 23.7%, a balanced fund for 29%, a life cycle fund for 8.6%, a professionally managed account for 6.5%, and 5.4% were reported as "other." *48th Annual Survey of Profit Sharing/401(k) Plans*, *supra* note 2, at 37, Table 64. Other surveys indicate the use of money market,

appears that many plans without automatic enrollment provisions[5] utilize similar capital preservation default investment products for those employees who enroll in the plan but fail to direct the investment of their contributions or their employer's matching contributions. As a short-term investment, money market or stable value funds may not significantly affect retirement savings. Such investments can play a useful role as a component of a diversified portfolio. However, when such funds become the exclusive investment of participants or beneficiaries, it is unlikely that the rate of return generated by those funds over time will be sufficient to generate adequate retirement savings for most participants or beneficiaries.[6]

A frequently cited impediment to adoption of automatic enrollment provisions in individual account plans is the assumption of fiduciary responsibility for the investment decisions that the plan fiduciary must make on behalf of the automatically enrolled participants. In the case of a participant directed individual account plan designed to comply with the requirements of ERISA section 404(c)(1), responsibility for the result of specific investment directions rests with the directing plan participant or beneficiary, rather than the plan sponsor or other fiduciaries.[7] Before enactment of the Pension

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stable value and similarly performing investment vehicles at 58 percent (*2004 Annual 401(k) Benchmarking Survey*, *supra* note 2, at 7, Exhibit 20) and 81 percent (Stephen P. Utkus, *Selecting A Default Fund for a Defined Contribution Plan*, (Vanguard Center for Retirement Res.), Volume 14, June 2005, at 3).

[5] This proposal encompasses situations beyond automatic enrollment. Examples include: failure of a participant or beneficiary to provide investment instruction following the elimination of an investment alternative or a change in service provider, failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant or beneficiary to provide investment instruction.

[6] Investments in capital preservation vehicles deprive investors of the opportunity to benefit from the returns generated by equity securities that have historically generated higher returns than fixed income investments.

[7] See Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46,906 (Oct.13, 1992) (codified at 29 CFR 2550.404c-1).

Protection Act, which became law on August 17, 2006, the Department indicated that a participant or beneficiary would not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary.[8] In effect, the Department treated the plan fiduciary's investment decision on behalf of a participant or beneficiary as if the decision were made in connection with a participant directed individual account plan that is not designed, or fails, to meet the conditions for a section 404(c) plan. While some employers, in adopting automatic enrollment provisions or otherwise dealing with the absence of investment direction from plan participants, have been willing to assume fiduciary responsibility for their investment decisions, many of those employers attempt to minimize their fiduciary liability by limiting default investments to funds that emphasize preservation of capital and little risk of loss (e.g., money market and stable value funds).

As part of the Pension Protection Act, section 404(c) of ERISA was amended to provide relief accorded by section 404(c)(1) to fiduciaries that invest participant assets in certain types of default investment alternatives in the absence of participant investment direction. Specifically, section 624(a) of the Pension Protection Act added a new section 404(c)(5) to ERISA. Section 404(c)(5)(A) of ERISA provides that, for purposes of section 404(c)(1) of ERISA, a participant in an individual account plan shall be treated as exercising control over the assets in the account with respect to the amount of

[8] See Rev. Rul. 98-30, 1998-1 C.B. 1273; see also Rev. Rul. 2000-8, 2000-1 C.B. 617; see also Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. at 46924; see also Retirement Plans, Cash or Deferred Arrangements Under Section 401(k) and Matching Contributions or Employee Contributions Under Section 401(m) Regulations, 69 Fed. Reg. 78144, 78146 n. 2 (Dec. 29, 2004) (codified at 26 CFR pts. 1 & 602).

contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary of Labor. Section 624(a) of the Pension Protection Act directed that such regulations 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. In the Department's view, this statutory language provides the stated relief to fiduciaries of any participant directed individual account plan that complies with its terms and with those of the Department's proposed regulation under section 404(c)(5) of ERISA. This relief therefore, is not contingent on a plan being an "ERISA 404(c) plan" or otherwise meeting the requirements of the Department's regulations at 2550.404c-1.

Section 624(a) of the Pension Protection Act also added notice requirements in section 404(c)(5)(B)(i) and (ii) of ERISA. Section 404(c)(5)(B)(i) requires that each participant—(I) receive, within a reasonable period of time before each plan year, a notice explaining the employee's right under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election by the participant, such contributions and earnings will be invested, and (II) has a reasonable period of time after receipt of such notice and before the beginning of the plan year to make such designation. Section 404(c)(5)(B)(ii) requires each notice to be sufficiently accurate and comprehensive to appraise the employee of such rights and obligations, and to be written in a manner calculated to be understood by the average employee eligible to participate.

The amendments made by section 624 of the Pension Protection Act shall apply to plan years beginning after December 31, 2006. Section 624(b) of the Pension Protection Act directed the Department to issue final regulations under section 404(c)(5)(A) of ERISA no later than 6 months of the date of enactment of the Pension Protection Act.

In an effort to increase plan participation through the adoption of automatic enrollment provisions, and increase retirement savings through the utilization of default investments that are more likely to increase retirement savings for participants and beneficiaries who do not direct their own investments, the Department, exercising its authority under section 505 of ERISA and consistent with section 624 of the Pension Protection Act, is proposing to provide relief to fiduciaries of participant directed individual account plans that invest participant assets in certain types of default investment alternatives in the absence of participant investment direction. The proposed regulation is described below.

B. Overview of Proposal

Scope of the Fiduciary Relief

The proposal would, upon adoption, implement the fiduciary relief afforded by ERISA section 404(c)(5), under which a participant, who does not give investment directions, will be treated as exercising control over his or her account with respect to assets that the plan invests in a qualified default investment alternative. See § 2550.404c-5(a)(1).

The relief provided by the proposed regulation is conditioned on the use of certain investment alternatives, but the limitations of the proposed regulation should not be construed to indicate that the use of investment alternatives not identified in the proposed regulation as qualified default investment alternatives would be imprudent. For example, the Department recognizes that investments in money market funds, stable value products and similarly performing investment vehicles may be prudent for some participants or beneficiaries.

Paragraph (b) of § 2550.404c-5 defines the scope of the fiduciary relief provided. Specifically, paragraph (b)(1) provides that, subject to certain exceptions, a fiduciary of an individual account plan that permits participants and beneficiaries to direct the investment of assets in their accounts and that meets the conditions of the regulation, as set forth in paragraph (c) of § 2550.404c-5, shall not be liable for any loss under part 4 of title I, or by reason of any breach, that is the direct and necessary result of investing all or part of a participant's or beneficiary's account in a qualified default investment alternative, or of investment decisions made by the entity described in paragraph (e)(3) in connection with the management of a qualified default investment alternative. The scope of this relief is the same as that extended to plan fiduciaries under ERISA section 404(c)(1)(B) in connection with carrying out investment directions of plan participants and beneficiaries in an "ERISA section 404(c) plan" as described in 29 CFR 2550.404c-1(a), although it is not necessary for a plan to be an ERISA section 404(c) plan in order for the fiduciary to obtain the relief accorded by this proposed regulation. As with section 404(c)(1) of the Act and the regulation issued thereunder (29 CFR 2550.404c-1), the proposed regulation would not provide relief from the general fiduciary rules applicable to the selection and monitoring of a default investment alternative or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. See paragraph (b)(2) of § 2550.404c-5. Paragraph (b) further makes clear that nothing in the proposed regulation relieves an investment manager from its general fiduciary duties or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. See paragraph (b)(3) of § 2550.404c-5. In addition, the proposed regulation provides no relief from the prohibited transaction provisions of section 406 of ERISA or from any liability that results from a violation of those provisions, including liability for any resulting losses. See paragraph (b)(4) of § 2550.404c-5.

Like other investment alternatives made available under a plan, a plan fiduciary would be required to carefully consider investment fees and expenses in choosing a qualified default investment alternative for purposes of the proposed regulation. To the extent that a plan offers more than one investment alternative that could constitute a qualified default investment alternative, the Department anticipates that fees and expenses would be an important consideration in selecting among the alternatives.

Conditions for the Fiduciary Relief

The conditions for relief are set forth in paragraph (c) of the proposal. The proposal has six conditions.

The first condition requires that assets invested on behalf of participants or beneficiaries under the proposed regulation be invested in a "qualified default investment alternative." See § 2550.404c-5(c)(1). "Qualified default investment alternatives" are defined in paragraph (e) of the proposed regulation and discussed in detail below. The second condition provides that the participant or beneficiary on whose behalf assets are being invested in a qualified default investment alternative had the opportunity to direct the investment of assets in his or her account but did not direct the assets. See § 2550.404c-5(c)(2). In other words, no relief is available when a participant or beneficiary has provided affirmative investment direction concerning the assets invested on the participant's or beneficiary's behalf.

The third condition requires that the participant or beneficiary on whose behalf an investment in a qualified default investment alternative may be made is furnished a notice within a reasonable period of time of at least 30 days in advance of the first such investment, and within a reasonable period of time of at least 30 days in advance of each subsequent plan year. As described in the regulation, the required notice can be furnished in the plan's summary plan description, summary of material modifications, or as a separate notification. See § 2550.404c-5(c)(3). The specific content requirements for the notice are described in paragraph (d) of the proposed regulation and discussed in detail below.

The Department notes that a similar notice requirement is contained in section 401(k)(13)(E) of the Internal Revenue Code (Code), as amended by the Pension Protection Act. The Department anticipates that the notice requirements of this proposed regulation and the notice requirements of section 401(k)(13)(E) of the Code could be satisfied in a single notice.

The Department further notes that the phrase - "in advance of the first such investment [in a qualified default investment alternative]" - is not intended to foreclose availability of relief to fiduciaries that, prior to the adoption of a final regulation, invested assets on behalf of participants and beneficiaries in a default investment alternative that would constitute a "qualified default investment alternative" under the regulation. In such cases, the phrase "in advance of the first such investment" should be read to mean the first investment with respect to which relief under the proposed regulation is intended to apply after the effective date of the regulation. The Department is proposing to make this regulation effective 60 days after publication of the final rule in the Federal Register.

The fourth condition of the proposed regulation requires that the terms of the plan provide that any material provided to the plan relating to a participant's or beneficiary's investment in a qualified default investment alternative (e.g., account statements, prospectuses, proxy voting material) will be provided to the participant or beneficiary. See § 2550.404c-5(c)(4).

The fifth condition requires that any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative be afforded the opportunity, consistent with the terms of the plan (but in no event less frequently than once within any three month period), to transfer, in whole or in part, such assets to any other investment alternative available under the plan without financial penalty. See § 2550.404c-5(c)(5). This provision assures that participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative have the same opportunity as other plan participants and beneficiaries to direct the investment of their assets, and that neither the plan nor the qualified default investment alternative impose financial penalties that would restrict the rights of participants and beneficiaries to direct their assets to other investment alternatives available under the plan. This provision does not confer greater rights on participants or beneficiaries whose accounts the plan invests in qualified default investment alternatives than are otherwise available under the plan with respect to the timing of investment directions. Thus, if a plan provides participants and beneficiaries the right to direct investments on a quarterly basis, those participants and beneficiaries with investments in a qualified default investment alternative need only be afforded the opportunity to direct their investments on a quarterly basis. Similarly, if a plan permits daily investment direction, participants and beneficiaries with investments in a qualified default investment alternative must be permitted to direct their investments on a daily basis.

The Department notes that this proposal does not address or provide relief with respect to the direction of investments out of a qualified default investment alternative into another investment alternative available under the plan. See generally section 404(c)(1) of ERISA and 29 CFR 2550.404c-1.

The last condition requires that the plan offer participants and beneficiaries the opportunity to invest in a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).[9] See § 2550.404c-5(c)(6). For purposes of the proposed regulation, the Department believes that participants and beneficiaries should be afforded a sufficient range of investment alternatives to achieve a diversified portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the pension plan participant or beneficiary. The Department believes that the application of the "broad range of investment alternatives" standard of the section 404(c) regulation accomplishes this objective. Moreover, the Department believes that virtually all individual account plans that provide for participant direction, without regard to whether such plans meet all the requirements for an ERISA section 404(c) plan, likely will meet this standard without having to undertake significant changes in available investment alternatives.

[9] 29 CFR 2550.404c-1(b)(3) provides that "[a] plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to: (A) Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; (B) Choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics; (3) which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio; . . ."

Notices

As discussed above, relief under the proposed regulation is conditioned on furnishing participants and beneficiaries advance notification concerning the default investment provisions of their plan. See § 2550.404c-5(c)(3). The specific information required to be contained in the notice is set forth in paragraph (d) of the regulation.

Paragraph (d) of § 2550.404c-5 requires that the notice to participants and beneficiaries be written in a manner calculated to be understood by the average plan participant and contain the following information: (1) a description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant and beneficiary in a qualified default investment alternative; (2) a description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative; (3) a description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, without financial penalty; and (4) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

It is the view of the Department that the notice requirements of this proposed regulation are consistent with the notice requirements added to section 404(c)(5) of ERISA by section 624 of the Pension Protection Act. The Department believes the required information is sufficient to put participants and beneficiaries on notice as to the consequences of failing to direct investment of the assets in their account, and encourages active decisionmaking by participants and beneficiaries. The Department invites suggestions as to whether additional information should be considered for inclusion in the notice.

Qualified default investment alternatives

Under the proposal, relief from fiduciary liability is provided with respect to only those assets invested on behalf of a participant or beneficiary in a "qualified default investment alternative." See § 2550.404c-5(c)(1). Paragraph (e) of § 2550.404c-5 sets forth five requirements for a qualified default investment alternative.

The first requirement is intended to limit investment in employer securities as part of a qualified default investment alternative's investment strategy. Subject to two exceptions, the proposal provides that a qualified default investment alternative shall not hold or permit the acquisition of employer securities. See § 2550.404c-5(e)(1)(i).

The first exception to this general prohibition is applicable to employer securities held or acquired by an investment company registered under the Investment Company

Act of 1940, 15 U.S.C. 80a-1, et seq., or a similar pooled investment vehicle regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof. While the Department does not believe it is appropriate for a qualified default investment alternative to encourage investments in employer securities, the Department also recognizes that an absolute prohibition against holding or investing in employer securities may unnecessarily complicate the selection and monitoring of qualified default investment alternatives by publicly traded companies, the stock of which may be held or acquired pursuant to an investment strategy wholly independent of the employer. The Department believes that the foregoing exception is sufficiently broad to accommodate publicly traded companies and pooled investment vehicles that may invest in such companies.

The second exception is for employer securities acquired as a matching contribution from the employer/plan sponsor or at the direction of the participant or beneficiary. This exception is intended to make clear that an investment management service will not be precluded from serving as a qualified default investment alternative under § 2550.404c-5(e)(5)(iii) merely because the account of a participant or beneficiary holds employer securities acquired as matching contributions from the employer/plan sponsor, or acquired as a result of prior direction by the participant or beneficiary, provided that the investment management service has the authority to dispose of such securities.

In the case of employer securities acquired as matching contributions that are subject to a restriction on transferability, relief would not be available until the investment management service can exercise discretion over such securities, at the expiration of the restriction. Although an investment management service would be responsible for determining whether and to what extent the account should continue to hold investments in employer securities, the investment management service could not, except as part of an investment company or similar pooled investment vehicle, exercise its discretion to acquire additional employer securities on behalf of an individual account without violating § 2550.404c-5(e)(1).

In the case of prior direction by a participant or beneficiary, if the participant or beneficiary provided investment direction with respect to employer securities, but failed to provide investment direction following an event, such as a change in investment alternatives, and the terms of the plan provide that in such circumstances the account's assets are invested in a default investment alternative, the proposed regulation would permit an investment management service to hold and manage those employer securities in the absence of participant or beneficiary direction. While the investment management service may not acquire additional employer securities using participant contributions, the investment management service may reduce the amount of employer securities held by the account of the participant or beneficiary.

The second requirement provides that, except as otherwise provided in paragraph (c)(5), a qualified default investment alternative may not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer, in whole or in part, his or her investment from the qualified default investment alternative to any other investment alternative available under the plan. The Department does not believe that limits on the ability of a participant or beneficiary to move from a qualified default investment alternative should be permitted by the plan or the qualified default investment alternative.

The third requirement is that a qualified default investment alternative be either managed by an investment manager, as defined in section 3(38) of the Act, or an investment company registered under the Investment Company Act of 1940. The Department believes that when plan fiduciaries are relieved of liability for underlying investment management/asset allocation decisions, those responsible for the investment management/asset allocation decisions must be investment professionals who acknowledge their fiduciary responsibilities and liability under ERISA. For this reason, the proposed regulation requires that, except in the case of registered investment companies, those responsible for the management of a qualified default investment alternative be "investment managers" within the meaning of section 3(38) of ERISA.[10]

[10] Section 3(38) of ERISA defines the term "investment manager" to mean "any fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2) [29 U.S.C. 1102(a)(2)]) - (A) who has the power to manage, acquire, or dispose of any asset of a plan; (B) who (i) is registered as an investment adviser under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq.*]; (ii) is not registered as an investment adviser under such Act by reason of paragraph (1) of section 203A(a) of such Act, is registered as an investment adviser under the laws of the State (referred to in such paragraph (1)) in which it maintains its principal office and place of business, and, at the time the fiduciary last filed the registration form most recently filed by the fiduciary with such State in order to maintain the fiduciary's registration under the laws of such State, also filed a copy of such form with the Secretary; (iii) is a bank, as defined in that Act [15 U.S.C. 80b-1 *et seq.*] ; or (iv) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and (C) has acknowledged in writing that he is

Inasmuch as the assets of an investment company registered under the Investment Company Act of 1940 do include plan assets solely by virtue of a plan's investment in securities issued by such investment company[11] and such investment companies are subject to Federal and State regulation and oversight, the proposal permits an investment company registered under the Investment Company Act of 1940 to constitute a "qualified default investment alternative" provided that the other conditions of the proposed regulation are satisfied.

The fourth requirement provides that a qualified default investment alternative is diversified so as to minimize the risk of large losses.

The last requirement for a qualified default investment alternative conditions relief on the use of one of three types of investment products, portfolios or services. See § 2550.404c-5(e)(5). In defining qualified default investment alternatives, the Department presumes that, in those instances when a participant or beneficiary chooses not to direct the investment of the assets in their account, the only objective and readily available information relevant to making an investment decision on behalf of the participant is age. For this reason, the investment objectives of the qualified default investment alternatives are not required to take into account other factors, such as risk tolerances, other investment assets, etc.

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a fiduciary with respect to the plan."

[11] See ERISA section 401(b)(1).

The first alternative is 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. Such products and portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. As noted above, asset allocation decisions for eligible products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account. See § 2550.404c-5(e)(5)(i). The reference to "an investment fund product or model portfolio" is intended to make clear that this alternative might be a "stand alone" product or a "fund of funds" comprised of various investment options otherwise available under the plan for participant investments. In the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures.

The second alternative is an investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this alternative, asset allocation decisions for such products and portfolios are not required to take into account the age of an individual participant, but rather focus on the demographics of the participant population as a whole. An example of such a fund or portfolio may be a "balanced" fund. As with the preceding alternative, the reference to "an investment fund product or model portfolio" is intended to make clear that this alternative might be a "stand alone" product or a "fund of funds" comprised of various investment options otherwise available under the plan for participant investments. In the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures for this alternative.

Unlike the first alternative, which focuses on the age, target retirement date (such as normal retirement age under the plan) or life expectancy of an individual participant, the second alternative requires a fiduciary to take into account the demographics of the plan's participants, similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction. For this reason, a fiduciary may, in connection with the duty to monitor investment alternatives available under the plan, conclude that a new or additional investment fund product or model portfolio is required to take into account significant changes in the demographics (e.g., age) of the plan's participant population.

The third alternative is an investment management service with respect to which an investment manager 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 alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. As with the first alternative, the proposed regulation makes clear that, as with the other alternatives described in the regulation, asset allocation decisions are not required to take into account risk tolerances, other investments or other preferences of an individual participant. An example of such a service may be a "managed account." [12]

Although investment management services are included within the scope of relief, the Department notes that relief similar to that provided by this proposed regulation is available to plan fiduciaries under the statute. Specifically, section 402(c)(3) of ERISA provides that "a person who is a named fiduciary with respect to control or management of the assets of a plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan." Section 405(d) of ERISA provides that "[i]f an investment manager or managers have been appointed under section 402(c)(3), then . . .no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager." The Department included investment management services within the scope

[12] With regard to this alternative, the Department notes that in 2003, a working group of the Advisory Council on Employee Welfare and Pension Benefit Plans submitted a report on optional professional management in defined contribution plans. While the Advisory Council report focused on the use of managed account services in which participants played an active role in preparing an investment profile, the report nonetheless provides support for including such services within the definition of a qualified default investment alternative. This report may be accessed at www.dol.gov/ebsa/publications/AC_1107b03_report.html.

of fiduciary relief in order to avoid any ambiguity concerning the scope of relief available to plan fiduciaries in the context of participant directed individual account plans.

D. Miscellaneous Issues

Preemption

Section 902 of the Pension Protection Act added a new section 514(e)(1) to ERISA providing that notwithstanding any other provision of section 514, title I of ERISA shall supersede any State law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. Section 902 further added section 514(e)(2) to ERISA defining the term “automatic contribution arrangement” as an arrangement under which a participant: may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash; is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage); and under which such contributions are invested in accordance with regulations prescribed by the Secretary of Labor under section 404(c)(5) of ERISA. The Department specifically requests comments on whether and to what extent regulations would be helpful in addressing the preemption provisions of section 514(e) of ERISA.

Enforcement

Section 902 of the Pension Protection Act amended section 502(c)(4) of ERISA to provide that the Secretary of Labor may assess a civil penalty against any person of up to $1,100 a day for each violation by any person of section 302(b)(7)(F)(vi) or section 514(e)(3) of ERISA. Implementing regulations will be developed in a separate rulemaking.

E. Request for comments

The Department invites comments from interested persons on all aspects of the proposed regulation. Comments should be addressed to the 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. Commenters are encouraged to submit comments electronically to e-ORI@dol.gov or www.regulations.gov. All comments received will be available to the public at www.dol.gov/ebsa and www.regulations.gov. Comments also will be available for public inspection at the Public Disclosure Room, N-1513, Employee Benefits Security Administration, 200 Constitution Avenue, NW, Washington, DC 20210.

Comments on this proposal should be submitted to the Department on or before [ENTER DATE THAT IS 45 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER].

F. Effective Date

The Department proposes to make this regulation effective 60 days after the date of publication of the final rule in the FEDERAL REGISTER.

G. Regulatory Impact Analysis

Summary

This proposed regulation is expected to have two major, positive economic consequences. First, default investments will be directed toward higher-return portfolios boosting average account performance. Second, automatic enrollment provisions will become more common boosting participation in retirement savings plans. Both of these effects will tend on average and on aggregate to increase retirement savings, especially among younger workers with low earnings and frequent job changes. A substantial number of individuals will enjoy significant increases in retirement income.[13] The magnitude of these effects will be large in absolute terms and proportionately large for

[13] In rare cases, retirement income may decrease slightly. A few individuals may wind up contributing for some period of time at a default rate that is lower than the rate they otherwise would have elected (this risk will be minimized in plans that automatically escalate default contribution rates). A few may realize lower returns in a qualified default investment alternative than they would otherwise have realized.

many directly affected individuals, but will be modest relative to overall aggregate retirement savings.

The magnitude of the proposed regulation's effects will depend on plan sponsor and participant choices. The effects will be cumulative and will become fully realized only after workers beginning their careers today reach retirement. For these reasons, any estimates of the regulation's effects are subject to substantial uncertainty. The Department has developed low- and high-impact estimates, to illustrate a range of potential long-term effects.

In the very long run the proposed regulation is predicted to increase aggregate 401(k) plan account balances by between 2 percent and 5 percent, or approximately $45 billion and $90 billion if represented at 2005 levels. The portion invested in equity will increase by between 3 percent and 5 percent, or $27 billion and $48 billon.

For individuals born in 1985 and surviving to age 67, holding other factors constant, low-impact estimates suggest that the proposed regulation will increase pension income by an average of $2,010 per year (in 2005 dollars) for 10 percent, but decrease it by $1,120 per year on average for 5 percent. Pension income would be unchanged for the remaining 85 percent. High-impact estimates suggest that average annual pension income will increase by $2,740 for 14 percent, fall by $1,460 for 6 percent, and be unchanged for 80 percent.

The costs and benefits of the proposed regulation are not simple, direct functions of the foregoing gross dollar estimates. Increases in retirement savings due to automatic enrollment will be offset by either decreases in current consumption or reductions in other savings, so net benefits will be smaller than the predicted increases in retirement savings. The proposed regulation may also have macroeconomic consequences, which are likely to be small but positive. An increase in retirement saving is likely to promote investment and long-term economic productivity and growth. The Department therefore concludes that the benefits of this proposed regulation will exceed its costs by a wide margin.

In accordance with OMB Circular A-4(available at www.whitehouse.gov/omb/circulars/a004/a-4.pdf), Table 1 below depicts an accounting statement showing the annualized benefits and transfers associated with the provisions of this proposed rule.

Table 1	**Estimates**		**Units**		
Category	**Low Estimate**	**High Estimate**	**Year Dollar**	**Discount Rate**	**Period Covered**
Benefits					
Annualized Quantified ($millions/year)	1,900.0	3,800.0	2005	n/a	2007 and later
Note:	Annual contributions to 401(k) plans are expected to grow by between $1.9 billion and $3.8 billion, expressed at 2005 levels. As explained below, these estimates were derived from the simulated experience of a 1985 birth cohort. Each individual in the cohort was sampled once at a random age from 21 to 65. Their observed contributions were aggregated to produce a proxy for a level annuity equivalent of aggregate contributions over time. (This proxy approach, which is not derived by discounting future levels, is explained below under the heading "Basis of Estimates.") Some participants will benefit additionally from an increase in average investment returns. Pension income will increase substantially. The benefits of the proposed regulation are not simple, direct functions of its gross dollar impacts. Increases in retirement savings will be offset by either decreases in current consumption or reductions in other savings. The proposed regulation will have distributional consequences. Increases in pension income will be proportionately larger for those with lower career earnings. The proposed regulation may also have macroeconomic consequences, which are likely to be small but positive.				

Costs					
Qualitative	Plan sponsors may incur some administrative cost in order to meet the conditions of the proposed regulation. The Department generally expects such cost to be low. Adverse consequences are not expected because the adoption of automatic enrollment programs, reliance on the proposed regulation and, therefore, compliance with its provisions, are voluntary on the part of the plan sponsor.				
Transfers					
Other Annualized Monetized ($millions/year)	700.0	1,300.0	2005	n/a	2007 and later
From/To	From: Private employers			To: Employees	
Note:	Increase in aggregate employer matching contributions. For discussion of derivation, see note to “Benefits” immediately above in this table.				
Effects					
State, Local, and/or Tribal Government	Not applicable				
Small Business	Significant impacts are expected to be limited to plan sponsors that adopt automatic enrollment programs as a result of the proposed regulation: approximately 28,000 to 56,000 plans or between 10 percent and 20 percent of all small 401(k) plans. Employer matching contributions to these plans are estimated to increase by between $100 million and $300 million annually (expressed at 2005 levels), constituting a transfer from employers to plan participants. Adverse consequences are not expected because the adoption of automatic enrollment programs, the provision of matching contributions, and reliance on the proposed regulation and compliance with its provisions are voluntary on the part of the plan sponsor.				
Wages	The proposed regulation is expected to increase some plan sponsors’ matching contributions. These increases have been characterized here as transfers from plan sponsors to participants. It is possible, however, that the increases will be offset in part or whole by corresponding decreases in wages or other compensation.				
Growth	The proposed regulation may also have macroeconomic consequences, which are likely to be small but positive. An increase in retirement saving is likely to promote investment and long-term economic productivity and growth.				

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is “significant” and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f) of the Executive Order, a “significant regulatory action” is an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as "economically significant"); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. OMB has determined that this action is significant under section 3(f)(1) because it is likely to have an annual effect on the economy of $100 million or more. Accordingly, the Department has undertaken, as described below, an analysis of the costs and benefits of the proposed regulation. The Department believes that the proposed regulation's benefits justify its costs.

Alternatives Considered by the Department

Prior to the enactment of the Pension Protection Act, the Department considered providing relief under section 404(a) of ERISA, rather than section 404(c), in response to concerns that conditioning relief on compliance with the Department's regulations under section 404(c), 29 CFR 2550.404c-1, may deter adoption of automatic enrollment provisions. Inasmuch as the relief provided by recently enacted section 404(c)(5) of ERISA does not condition relief on compliance with the Department's regulations under section 404(c), the Department concluded that adopting a regulation under section 404(c)(5) effectively provided the same relief it considered providing under section 404(a).

In defining the three types of investment products, portfolios or services that may be used as a qualified default investment alternative, the Department applied certain criteria. These criteria included consistency with market trends and mainstream financial planning practices. The Department entertained including as an additional type of investment product near risk-free fixed income instruments. Such instruments might have been defined so as to include money market mutual funds, certain bank deposits, and stable value insurance products. Including such instruments might yield some benefits. It is possible that at least some plan sponsors strongly prefer to use as default investments such instruments rather than any of the three types embraced by the proposed rule. It is further possible that some such sponsors would adopt automatic enrollment programs if and only if the fiduciary relief afforded by the proposed regulation was extended to include such instruments. In that case, including such instruments in the proposed regulation might boost participation and net retirement income for some individuals. The Department believes such cases would be rare, however. The proposed rule, by providing relief from fiduciary liability, is both intended and expected to tilt plan sponsors' default investment preferences away from such instruments and toward the three types it embraces. Moreover, many plan sponsors currently use such instruments as default investments under automatic enrollment programs, and they and others might continue to do so after adoption of the proposed rule. The proposed rule leaves intact the current legal provisions applicable to the use of such instruments as default investments.

On the other hand, including such instruments might erode benefits. Consider plan sponsors that under the proposed rule will adopt automatic enrollment programs and use as default investments one of the three types defined in the proposed rule. If such near-risk-free instruments were included as a fourth type, some of these plan sponsors might instead use such instruments as default investments, thereby reducing average investment performance and retirement income for some individuals. The Department therefore believes that including such instruments would be more likely to erode benefits than to increase them. Accordingly, the Department omitted such instruments from the types defined in the proposed rule.

The Department also considered whether to include or omit an investment fund product or model portfolio that establishes a uniform mix of equity and fixed income exposures for all affected participants, ultimately deciding to include such a type as the second of the three types defined in the proposed rule. Such a product or model portfolio has some drawbacks relative to the other two types of investment products, portfolios or services that may be used as a qualified default investment alternative. Unlike the latter types, its target level of risk must be appropriate for participants of the plan as a whole but cannot be separately calibrated for each participant or for particular classes of participants. Therefore, while its risk level may be appropriate for all affected participants it is unlikely to be optimal for all. However, such a product or model portfolio may also have relative advantages. Compared with the other two types such a product or portfolio may be simpler, less expensive and easier to explain and understand. These advantages may outweigh the potential advantage of more customized risk levels, especially for plans covering relatively homogenous populations. And the inclusion of such products or model portfolios along with the other two types of investment products, portfolios or services might help heighten competition in the market and thereby enhance product quality and affordability across all three types.

Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 et seq.) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 et seq.) and are likely to have a significant economic impact on a substantial number of small entities. Small entities include small businesses, organizations, and governmental jurisdictions.

For purposes of analysis under the RFA, the Department proposes to continue to consider a small entity to be an employee benefit plan with fewer than 100 participants. The basis of this definition is found in section 104(a)(2) of ERISA, which permits the Secretary to prescribe simplified annual reports for pension plans that cover fewer than 100 participants. Under section 104(a)(3) of ERISA, the Secretary may also provide for exemptions or simplified annual reporting and disclosure for welfare benefit plans. Pursuant to the authority of section 104(a)(3) of ERISA, the Department has previously issued at 29 CFR 2520.104-20, 2520.104-21, 2520.104-41, 2520.104-46, and 2520.104b-10 certain simplified reporting provisions and limited exemptions from reporting and disclosure requirements for small plans, including unfunded or insured welfare plans that cover fewer than 100 participants and satisfy certain other requirements.

Further, while some large employers may have small plans, in general small employers maintain most small plans. Thus, the Department believes that assessing the impact of these proposed rules on small plans is an appropriate substitute for evaluating the effect on small entities. The definition of small entity considered appropriate for this purpose differs, however, from a definition of small business that is based on size standards promulgated by the Small Business Administration (SBA) (13 CFR 121.201) pursuant to the Small Business Act (15 U.S.C. 631 et seq.). The Department therefore requests comments on the appropriateness of the size standard used in evaluating the impact of these proposed rules on small entities.

The reasons the Department is proposing this regulation, and the objectives of and legal basis for the proposed regulation, are discussed earlier in this preamble.

The Department has concluded that the primary effects of this proposed regulation will be to increase retirement savings and pension incomes for participants and beneficiaries by directing default investments to higher-performing portfolios and by promoting the implementation of automatic enrollment programs in participant directed individual account pension plans. Applying this assessment under the standards of the RFA, the Department believes that the impact of this proposed regulation will fall primarily on participants in participant directed individual account pension plans, and not on the plans themselves or on the employers that sponsor the plans. By promoting automatic enrollment programs and thereby increasing aggregate participant contributions, the proposed regulation may also increase some employers' matching contributions, including matching contributions made by small plans. For reasons explained below, however, the Department has concluded that this effect is not a sufficient basis for concluding that the proposed regulation will have a significant impact on a substantial number of small entities.[14]

Many plan sponsors provide matching contributions. The Department estimates that, if the proposed regulation is finalized, approximately 10 to 20 percent of all small participant directed defined contribution plans, or as many as 28,000 to 56,000 small plans, may adopt automatic enrollment programs and, consequently, may incur additional matching contributions. Such an increase in automatic enrollment programs could have the indirect effect of increasing aggregate matching contributions in small plans by between $100 million and $300 million annually (expressed at 2005 levels). The effect of increased matching contributions is expected to be proportionately similar for small and large entities. However, adverse consequences are not expected, for either large or small plans, because the adoption of automatic enrollment programs and the provision of matching contributions are, generally, voluntary and at the discretion of the plan sponsor. Reliance on the proposed regulation and, therefore, compliance with its provisions are also voluntary on the part of the plan sponsor. Accordingly, it is highly unlikely that the

[14] The proposed regulation requires affected plans to disclose to participants and beneficiaries certain information related to default investment provisions and default investments. As discussed below in connection with the Paperwork Reduction Act, the burden of compliance with the information collection provisions, which will be borne by plan sponsors and plans, will be minor, relative to the anticipated benefits of the regulation.

proposed regulation would have a significant impact on a substantial number of small entities. Therefore, the head of the Employee Benefits Security Administration hereby certifies, as required under section 605(b) of the RFA, that this proposed regulation will not, if promulgated, have a significant economic impact on a substantial number of small entities.

The Department is unaware of any duplicative, overlapping or conflicting federal rules.

Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA 95) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that the public understands the Department's collection instructions, respondents can provide the requested data in the desired format, the reporting burden (time and financial resources) is minimized, and the Department can properly assess the impact of collection requirements on respondents.

Currently, the Department is soliciting comments concerning the information collection request (ICR) included in the Proposed Regulation on Default Investment Alternatives under Participant Directed Individual Account Plans. A copy of the ICR may be obtained by contacting the person listed in the PRA Addressee section below.

The Department has submitted a copy of the proposed regulation to OMB in accordance with 44 U.S.C. 3507(d) for review of its information collections. The Department and OMB are particularly interested in comments that:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., by permitting electronic submission of responses.

Comments should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for the Employee Benefits Security Administration. Although comments may be submitted through [INSERT DATE WHICH IS 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], OMB requests that comments be received within 30 days of publication of the Notice of Proposed Rulemaking to ensure their consideration.

PRA ADDRESSEE: Address requests for copies of the ICR to Susan G. Lahne, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue, NW, Room N-5718, Washington, DC 20210. Telephone: (202) 693-8410; Fax: (202) 219-5333. These are not toll-free numbers.

The proposed Regulation on Default Investment Alternatives under Participant Directed Individual Account Plans (29 CFR 2550.404c-5) would provide certain relief for fiduciaries who make investment decisions on behalf of participants and beneficiaries in individual account pension plans that provide for participant direction of investments when such participants and beneficiaries fail to direct the investment of their account assets. The regulation describes conditions under which a participant who fails to provide investment direction will be treated as having exercised control over assets in his or her account under an individual account plan as provided in section 404(c)(5)(A) of ERISA. The proposed regulation would require that the assets of non-directing participants be invested in one of the qualified default investment alternatives described in the proposed regulation and that certain other specified conditions be met.

This ICR pertains to two separate disclosure requirements that are conditions to the relief created by the proposed regulation, as follows: (1) an annual notice containing specified information that must be provided to any individual whose assets may in the future be invested in a qualified default investment alternative at least 30 days prior to the fiduciary's initial investment, and thereafter at least 30 days before the beginning of each plan year; and (2) pass-through to participants and beneficiaries of any material (such as account statements, prospectuses, and proxy voting material) provided to the plan relating to the participant's or beneficiary's investment in a qualified default investment alternative. The information collection provisions of this proposed regulation are intended to ensure that participants and beneficiaries who are provided the opportunity to direct the investment of their account balances, but who do not do so, are adequately informed about the plan's provisions for default investment and about investments made on their behalf under the plan's default provisions.

The estimates of respondents and responses are derived primarily from the Form 5500 Series filings for the 2003 plan year, which is the most recent reliable data available to the Department. The burden for the preparation and distribution of the disclosures is treated as an hour burden. Additional cost burden derives solely from materials and postage. It is assumed that electronic means of communication will be used in 38 percent of the responses pertaining to annual notices and that such communications will make use of existing systems. Accordingly, no cost has been attributed to the electronic distribution of information.

<u>Annual Notice -- 29 CFR 2550.404c-5(c)(3).</u> The proposed regulation requires that a notice be provided at least 30 days before any portion of a participant's or beneficiary's account balance is initially invested in a qualified default investment alternative and annually thereafter. The notice must describe (1) the circumstances under which assets in a participant's individual account may be invested in a qualified default investment alternative; (2) the qualified default investment alternative, including its investment objectives, risk and return characteristics (if applicable), and fees and expenses; (3) the participants' and beneficiaries' right to direct the investment of the assets to any other investment alternative offered under the plan, without financial penalty; and (4) where participants and beneficiaries can obtain information about the other investment alternatives available under the plan. The proposed regulation states that the initial notice may be included in the plan's summary plan description or a summary of material modifications, or it may be provided as a separate notice.

The Department estimates that 418,000[15] participant directed individual account pension plans will prepare and distribute annual notices to 61,612,000 eligible workers, participants and beneficiaries in the first year in which this proposed regulation (if finalized) becomes applicable. Preparation of the annual notice in the first year is estimated to require one-half hour of legal professional time for each plan, for a total aggregate estimate of 209,000 burden hours. For the 62 percent of participants and

[15] All numbers used in this paperwork burden estimate have been rounded to the nearest thousand.

beneficiaries who will receive the annual notice by mail (38,200,000 individuals), distribution of the annual notice is estimated to require an additional 306,000 hours of clerical time, based on an estimate of one-half minute of clerical time per notice. No additional burden hours are attributed to the distribution of the annual notice to the remaining 38 percent of participants and beneficiaries who will receive this notice electronically (23,413,000 individuals). The total annual burden hours estimated for the annual notice in the first year, therefore, are 515,000. The equivalent cost for this burden hour estimate is $22,548,000 (legal professional time is valued at $83 per hour, and clerical time is valued at $17 per hour).[16]

In addition to burden hours, the Department has estimated annual costs attributable to the annual notice for the first year, based on materials and postage, at $18,718,000. This comprises the material cost for a two-page annual notice ($.10 per notice) to 38,200,000 participants and beneficiaries (62 percent of 61,612,000 participants and beneficiaries), which equals $3,820,000, plus postage at $0.39 per mailing, which equals $14,898,000. Total annual costs for the annual notice in the first year are therefore estimated at $18,718,000.

In years subsequent to the first year of applicability, the Department estimates that annual notices will be prepared only by newly established participant directed individual account pension plans and plans that changed their choice of qualified default investment alternative. For purposes of burden analysis, the Department has assumed that one-third

[16] Hourly wage estimates are based on data from the Bureau of Labor Statistics 2000 Occupational Employment Survey and data from the 2001 Employment Cost Index, and overhead assumptions by EBSA.

(1/3) of all participant directed individual account plans (139,000 plans) will prepare and distribute new or updated initial notices to all participants and beneficiaries, requiring 24 minutes of legal professional time per notice. The preparation of the initial notice in each subsequent year is estimated to require 56,000 hours. However, the number of participants receiving initial notices stays the same. As in the calculation for the initial year, distribution to the 62 percent of participants and beneficiaries who will receive the initial notice by mail (38,200,000 individuals) will require 306,000 hours and $18,718,000 additional materials and postage cost. (As for the first year, the Department has assumed that electronic distribution of the initial notice in subsequent years will not add any significant additional paperwork burden.)

Based on those assumptions, the Department estimates that the total burden hours for annual notices in each year after the first year of applicability will fall to 361,000 hours. The equivalent cost of such an hour burden (using the same assumptions as for the first year) is $9,823,000. The total cost burden estimated for subsequent years for the annual notice will stay at $18,718,000.

Pass-through Material – 29 CFR 2550.404c-5(c)(4). Under the proposed regulation, any material received by a plan (such as account statements, prospectuses, and proxy voting material) that relates to a default investment must be passed through to the participant or beneficiary on whose behalf the default investment was made. The proposed regulation imposes this requirement only with respect to participants and beneficiaries who have an investment in a qualified default investment alternative that was made by default. In conformity with the assumptions underlying the other economic analyses in this preamble, the Department has assumed that, at any given time, 5.3 percent of participants and beneficiaries in participant directed individual account pension plans (2,351,000 individuals) will have default investments. For purposes of this burden analysis, the Department has also assumed that plans will receive materials that must be passed through the participants and beneficiaries on a quarterly basis. This assumption takes into account that many, although not all, plans will receive quarterly account statements and prospectuses, and that plans will also receive other pass-through materials on occasion. These two factors result in an estimate of 9,405,000 responses (distributions of pass-through materials) per year. Duplication and packaging of the pass-through material is estimated to require 1.5 minutes of clerical time per distribution, for an annual hour burden estimate of 235,000 hours of clerical time. The equivalent cost of this hour burden is estimated at $3,997,000. Additional cost burden for the pass-through of material is estimated to include paper cost (40 pages of material yearly per participant or beneficiary) and postage ($.58 per mailing) at $10,157,000 annually for 4 distributions per participant or beneficiary with a default investment.

These paperwork burden estimates are summarized as follows:

Type of Review: New collection

Agency: Employee Benefits Security Administration, Department of Labor

Title: Default Investment Alternatives under Participant Directed Individual Account Plans

OMB Number: 1210-NEW

Affected Public: Business or other for-profit; not-for-profit institutions

Respondents: 417,000

Responses: 71,017,000

Frequency of Response: Annually; occasionally

Estimated Total Annual Burden Hours: 750,000 (first year)

Estimated Total Annual Burden Cost: $28,875,000

Congressional Review Act

This notice of proposed rulemaking is subject to the provisions of the Congressional Review Act provisions of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 et seq.) and, if finalized, will be transmitted to the Congress and the Comptroller General for review.

Unfunded Mandates Reform Act

Pursuant to provisions of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4), this rule does not include any Federal mandate that may result in expenditures by

State, local, or tribal governments, or the private sector, which may impose an annual burden of $100 million or more.

Discussion of Economic Impacts

Default Investments

A majority[17] of 401(k) plans with automatic enrollment offer as default investment vehicles money market or stable value funds or similarly-performing vehicles. The proposed regulation is expected to reduce this proportion by encouraging plans to offer default investment vehicles that include a mix of equity and fixed income instruments.

As a result of this proposed regulation, it is estimated that in the long run 401(k) plan equity holdings expressed at 2005 levels will increase by between $27 billion and $48 billion. The portion of this estimated increase that is attributable directly to the direction of a larger share of default investments into equity is between $11 billion and $14 billion.[18] The rest is attributable to increased contributions, which are discussed below under the heading "Participation and Contribution Behavior."

[17] Various surveys estimate the proportion at 50 percent (*48th Annual Survey of Profit Sharing/401(k) Plans*, *supra* note 2, at 37, Table 64), 58 percent (*2004 Annual 401(k) Benchmarking Survey*, *supra* note 2, at 7, Exhibit 20), and 81 percent (Utkus, *supra* note 4, at 3).

[18] It should be noted that these estimates pertain only to default investments made on behalf of default participants under automatic enrollment programs. The default investment proposed regulation is not so limited. Therefore, these estimates are likely to omit some of the direction of a larger share of default investments into equity that will occur under the proposed regulation. The Department lacks data on the amount of default investment activity occurring outside the default participation context, or any basis for predicting whether or how much such activity might increase as a result of the proposed regulation. The Department invites comments on these questions.

Account Performance

Historically, over long time horizons, diversified portfolios that include equities have tended to outperform those consisting only of very low risk, short term debt instruments, often by large amounts. From 1926 to 2004, large company stocks returned 10.4 percent annually on average, long-term corporate bonds 5.9 percent, and U.S. Treasury bills 3.7 percent.[19] Stocks are also riskier, however: the standard deviations in annual returns for these three securities classes over this period were 20.3 percent, 8.6 percent and 3.1 percent.[20] One-year large company stock returns ranged from -43 percent to 54 percent, long-term corporate bond returns from -8 percent to 43 percent, and U.S. Treasury bill returns from 0 percent to 15 percent.[21] But 20-year returns on these classes of securities ranged respectively from 3 percent to 18 percent, 1 percent to 12 percent, and from 0.4 percent to 8 percent.[22] Based on this history, it is widely believed to be advantageous for long-term savers, such as workers saving for retirement, to invest a substantial portion of their assets in equity.[23]

As noted above, this proposed regulation is expected to result in the direction of default investments from very low-risk instruments such as money market funds to diversified portfolios that include a substantial proportion of equities. If historical patterns hold, this in turn is expected to improve investment results for a large majority of

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[19] *Stocks, Bonds, Bills and Inflation 2005 Yearbook,* Ibbotson Assocs., at 117, Table 6-7 (2005).
[20] Id.
[21] Id. at 38-39, Table 2-5.
[22] Id. at 50-51, Table 2-11.
[23] See, *e.g.*, Utkus, *supra* note 4.

affected individuals. As a result of this proposed regulation, in the long run aggregate 401(k) account balances are estimated to increase by between $45 billion and $89 billion, expressed at 2005 levels. The portion of this estimated increase directly attributable to direction of default investments from very low-risk instruments into higher-performing portfolios is between $7 billion and $9 billion; the remainder is attributable to expected increases in contributions, discussed below under the heading "Participation and Contribution Behavior."

Automatic Enrollment

Automatic enrollment programs are growing in popularity. These programs covered only about 5 percent of workers eligible for 401(k) plans in 2002,[24] but the number may have increased to 18 percent today[25] and could reach 25 percent in the near future. The Department expects and intends that this proposed regulation, by alleviating some fiduciary concerns that might otherwise discourage implementation of automatic enrollment programs, will promote wider implementation of such programs. As a result of the proposed regulation, in the near future such programs may cover 35 percent to 45 percent of eligible workers rather than 25 percent.[26]

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[24] Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002-2003, Bulletin 2573, at 109 (2005).

[25] EBSA estimate. The proportion of plans in various size classes that provide automatic enrollment was taken from *48th Annual Survey of Profit Sharing/401(k) Plans*, *supra* note 2, at 36, Table 61. EBSA took a weighted average of these proportions, reflecting the distribution of 401(k) participants across the plan size classes, as estimated by EBSA based on annual reports filed by plans with EBSA.

[26] The incidence of automatic enrollment appears to be growing, by one estimate from 8.4 percent of plans in 2003 to 10.5 percent in 2004 (Id. at 36), by another from 14 percent in 2003 to 19 percent in 2005 (*Survey Findings: Trends and Experiences in 401(k) Plans, 2005*, *supra* note 2, at 1, 13). Another survey found no growth between 2003 and 2004. *2004 Annual 401(k) Benchmarking Survey*, *supra* note 2, at 6. Indicators of future growth are mixed. Most point to a potential for large growth, but it is unclear how much of this growth will be realized. The same survey that found no growth between 2003 and 2004 also found that, in 2004, 14 percent of plan sponsors had not yet implemented but were considering

Participation and Contribution Behavior

Analyses of automatic enrollment programs demonstrate that such programs increase participation. The increase is most pronounced among employees whose participation rates otherwise tend to be lowest, namely lower-paid, younger and shorter-tenure employees. Automatic enrollment programs increase many such employees' contribution rates from zero to the default rate, often supplemented by some employer matching contribution. These additional contributions tend to come early in the employees' careers and therefore can add disproportionately to retirement income as investment returns accumulate over a long period.[27]

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implementing automatic enrollment. Id. at 6, Exhibit 17. By another estimate, in 2005, 28 percent of plan sponsors indicated that they were likely to implement automatic enrollment over the next year. See *Survey Findings: Hot Topics in Retirement 2005*, (Hewitt Associates LLC) 2005, at 11. But 53 percent indicated they were unlikely to implement any automatic plan features, including 28 percent that cited concern about assuming additional fiduciary responsibility. Id. at 12. To estimate the impact of this proposed regulation on account balances and pension income, EBSA adopted the following assumptions. If current trends and concerns continued, the incidence of automatic enrollment would soon reach 25 percent of eligible employees, and then remain at that level. The proposed regulation, by relieving fiduciary concerns that discourage implementation of automatic enrollment, would increase that incidence to between 35 percent (low impact estimates) and 45 percent (high impact estimates). In addition, new provisions for a nondiscrimination safe harbor under the Code for "qualified automatic contribution arrangements," added by section 902 of the Pension Protection Act, are likely to affect the future incidence of automatic enrollment. These assumptions are highly uncertain and EBSA invites comments on their validity and suggestions as to how to develop more reliable estimates of the future incidence of automatic enrollment programs.

[27] However, there is also evidence that automatic enrollment programs can have the effect of lowering contribution rates for a few employees below the level that they would have elected absent automatic enrollment. At present, surveys indicate that the default contribution rate is usually either 2 percent or 3 percent of salary. Some employees who might otherwise have enrolled (either at first eligibility or later) and elected a higher contribution rate may instead permit themselves to be enrolled at the default rate. Once contributing at the default rate they may continue at that rate for some time. See, *e.g.*, James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Saving for Retirement on the Path of Least Resistance*, (July 19, 2004); see also Choi, Laibson & Madrian, *supra* note 1. The potential for lowering of contribution rates will be minimized in plans that provide for automatic escalation of default contribution rates, such as will be required under new tax nondiscrimination safe harbor provisions for "qualified automatic contribution arrangements," added by section 902 of the Pension Protection Act.

Plans implementing automatic enrollment programs may increase their participation rates on average from approximately 70 percent to perhaps 90 percent. Consequently, the Department estimates that this proposed regulation will increase overall 401(k) participation rates from 72 percent to between 75 percent and 77 percent. Aggregate annual contributions are expected to grow on net by between $1.9 billion and $3.8 billion, expressed at 2005 levels. These and related estimates are summarized Table 2 below.

Table 2
Estimated Effect of Proposed Regulation on 401(k) Participation and Contributions

	Low Impact	High Impact
Percentage point increase in participation rate of eligible employees	3%	5%
Added annual contributions ($billions, 2005 level)	$2.7	$5.2
Discouraged annual contributions ($billions, 2005 level)	$0.8	$1.4
Net growth in contributions ($billions, 2005 level)	$1.9	$3.8
Long-term increase in aggregate account balances ($billions, 2005 level)	$45	$90

Retirement Income from 401(k) Plans

For all individuals born in 1985 and surviving to age 67, holding other factors constant, low-impact estimates suggest that the proposed regulation may increase pension income by an average of $2,010 per year (in 2005 dollars) for 10 percent, but could decrease it by $1,120 per year on average for 5 percent. Pension income would be unchanged for the remaining 85 percent. High-impact estimates suggest that average annual pension income may increase by $2,740 for 14 percent, fall by $1,460 for 6 percent, and be unchanged for 80 percent. The number of individuals experiencing increases in retirement income is estimated to be approximately twice the number experiencing decreases, and the average gains are estimated to be approximately twice the size of average losses. These estimates are summarized Table 3 below. (The incidence and size of gains are likely to be larger than estimated here, and those of any losses are likely to be smaller, if plans provide for escalating default contribution rates or higher default contribution rates than assumed here.)

Table 3
Long-Term Effect of Proposed Regulation on Annual Pension Income at Age 67 (Expressed at 2005 Levels) – Incidence and Magnitude of Gains and Losses

Career Earnings	With Gain	Mean Gain	With Loss	Mean Loss
Low Impact				
All	9.9%	$2,010	4.5%	$1,120
Q1	5.6%	$1,030	2.5%	$490
Q2	10.0%	$1,630	4.3%	$680
Q3	11.6%	$1,960	5.4%	$1,200
Q4	12.5%	$2,800	5.9%	$1,630
High Impact				
All	13.7%	$2,740	5.9%	$1,460
Q1	7.9%	$1,420	3.3%	$600
Q2	13.6%	$2,250	5.7%	$950
Q3	16.1%	$2,780	7.0%	$1,500
Q4	17.2%	$3,690	7.7%	$2,180

Cost

Plan sponsors may incur some administrative cost in order to meet the conditions of the proposed regulation. The Department generally expects such cost to be low. The annual notice provision can be satisfied by adding information to existing notices and disclosures, such as the Summary Plan Description, the annual investment election form, or by adapting information provided to the plan by the investment manager of a qualified default investment alternative. The requirement to pass through investment material to participants and beneficiaries does not impose extensive costs. These revisions may be no more extensive than those associated with other amendments that plans implement from time to time. The boundaries of the proposed regulation are sufficiently broad to encompass a wide range of readily available and competitively priced investment products and services. It is likely that a large majority of participant directed plans already offer one or more investment options that would fall within the proposed regulation. For these reasons, it is likely that the administrative cost for a plan sponsor to take advantage of the relief afforded by the proposed regulation will be low. The Department invites comments on the administrative cost of this proposed regulation, and suggestions as to how to minimize that cost.

The proposed regulation may indirectly prompt some plan sponsors to shoulder additional costs in terms of increased retirement benefits paid to employees. For example, it is expected that the proposed regulation, by promoting the adoption of automatic enrollment programs, will have the indirect affect of increasing aggregate employer matching contributions by between $700 million and $1.3 billion annually (expressed at 2005 levels). Adverse consequences are not expected because the adoption of automatic enrollment programs and the provision of matching contributions generally are at the discretion of the plan sponsor. Use of the proposed regulation and, therefore, compliance with its provisions are also voluntary on the part of the plan sponsor.

Additional Potential Consequences

The Department anticipates that this proposed regulation will have two major economic consequences. Default investments will be directed toward higher-return instruments boosting average account performance, and automatic enrollment provisions will become more common boosting participation. However, it is possible that the proposed regulation will have additional, indirect consequences, which could affect future retirement income levels. The Department invites public comment on the likelihood and implications of any such consequences, including comments addressing the following questions.

- Will plan sponsors that direct default investments from very low-risk instruments into higher-performing portfolios make other changes to investment options or undertake new efforts to inform or influence participants' investment decisions? Will those plan sponsors that implement automatic enrollment programs change other provisions of their plans as well? For example, might they change matching contribution formulas, eligibility or vesting provisions, loan programs, or distribution policies?
- More than one-half of all participant directed individual account plans recently reported compliance with ERISA section 404(c)(1) and associated regulations. While the fiduciary protections afforded by this proposed regulation for default investments are intended to be similar to those afforded by the regulation under section 404(c)(1) of ERISA for participants' active

investment elections, it is possible that some fiduciaries who are covered by the proposed regulation in connection with default investments will not be covered by the regulation under section 404(c)(1) in connection with participant directed investments out of default investments. If so, how might the proposed regulation's incentives interact with those associated with the existing ERISA section 404(c) regulation, and to what effect?

- Will employees who make additional contributions as a result of new automatic enrollment programs reduce their current consumption or other types of current saving, or some of each? Will they be more or less likely than otherwise similar participants to retain or roll over their accounts, preserving them into retirement?

Changes such as these could either augment or offset the effects of this proposed regulation on retirement saving and pension income. For example, by one estimate, among employees eligible for a 401(k) plan with automatic enrollment and a life cycle fund investment default, moving the default contribution up from 3 percent to 6 percent could increase the median earnings replacement rate from 401(k) savings in each of the four earnings quartiles by between 6 and 10 percentage points.[28]

Cost-Benefit Assessment

[28] Holden & VanDerhei, *supra* note 1, at 15, Figure 10.

The costs and benefits of the proposed regulation are not simple, direct functions of the foregoing gross dollar estimates. For example, increases in retirement savings due to automatic enrollment will be offset by either decreases in current consumption or reductions in other savings. Increases due to higher returns will entail additional risk. Therefore, net benefits will be smaller than the predicted increases in retirement savings. The Department did not attempt to quantify these welfare effects, believing that there is insufficient data on the time preference for consumption and level of risk aversion in the affected population.[29]

The proposed regulation will have distributional consequences, the costs and benefits of which are open to different interpretations. Average increases in pension income will be larger for individuals with higher career earnings, but they will be proportionately larger for those with lower career earnings (see Table 4 below). Moreover, while average pension incomes will rise in each of the four career earnings quarterlies, a small minority of individuals in each quartile could lose some pension income (see Table 3).

The proposed regulation may also have macroeconomic consequences, which are likely to be small but positive. An increase in retirement saving is likely to promote investment and long-term economic productivity and growth. The increase in retirement saving will be very small relative to overall market capitalization, and may be offset in

[29] As noted below, peer reviewers raised questions about welfare effects in connection with peer review.

part by reductions in other saving. Therefore macroeconomic benefits are likely to be small.[30]

Based on the foregoing analysis and estimates, the Department is confident that the proposed regulation will increase aggregate retirement savings and pension income substantially. The Department therefore concludes that the benefits of this proposed regulation will exceed its costs by a wide margin, and invites comments on this conclusion.

Table 4
Long-Term Effect of Proposed Regulation on Annual Pension Income at Age 67 (Expressed at 2005 Levels) – Absolute and Proportional Average Increase

Career Earnings	Low impact		High Impact	
	$	%	$	%
All	$150	1.1%	$290	2.1%
Q1	$50	1.8%	$90	3.2%
Q2	$130	1.6%	$250	3.0%
Q3	$160	1.0%	$340	2.1%
Q4	$250	0.9%	$470	1.6%

Basis of Estimates

The Department estimated the effect of the proposed regulation on 401(k) plan participation, contributions, account balances, and investment mix, and its effect on pension incomes at age 67, using a microsimulation model of lifetime pension

[30] Insofar as the Department expects contributions to increase, the Department expects taxes on income to be correspondingly deferred. The magnitude of this effect would depend on the timing of contributions and withdrawals and the tax rates applicable at those times.

accumulations for a birth cohort, known as PENSIM.[31] To produce the low and high impact estimates presented here, PENSIM was parameterized and applied as follows.

First, automatic enrollment was assigned randomly to achieve incidences of 25 percent (baseline), 35 percent (low impact) and 45 percent (high impact) of 401(k) plan eligible employees. Next, participation and default participation rates were adjusted to reflect available research findings on these rates at various tenures in the presence and absence of automatic enrollment programs.[32] The default contribution rate was assumed to be 3 percent, which surveys indicate is the most common rate currently in use.[33] The investment of contributions made by default was directed as follows:[34] in the baseline

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[31] PENSIM was developed for the Department by the Policy Simulation Group as a tool for examining the macroeconomic and distributional implications of private pension trends and policies. Detailed information on PENSIM is available at http://www.polsim.com/PENSIM.html. Examples of PENSIM applications include comparisons of retirement income prospects for different generations contained in U.S. Government Accountability Office, Report No. 03-429, Retirement Income: Intergenerational Comparisons of Wealth and Future Income (2003) and comparisons of pension income produced by traditional defined benefit pension plans and cash balance pension plans contained in U.S. Government Accountability Office, Report No. 06-42, Private Pensions: Information on Cash Balance Pension Plans (2005). As noted below, the choice of PENSIM as the basis for these estimates was questioned in the context of peer review.

[32] These findings were drawn from Choi, Laibson & Madrian, *supra* note 1. The overall participation rate under automatic enrollment was adjusted upward to 90 percent.

[33] See, *e.g.,* *2004 Annual 401(k) Benchmarking Survey*; *supra* note 2, at 6; see also *Survey Findings: Trends and Experiences in 401(k) Plans, supra* note 2, at 16;" see also *48th Annual Survey of Profit Sharing/401(k) Plans*, *supra* note 2, at 36.

[34] These estimates assume complete correspondence between default participation in 401(k) plans and default investing. Participants contributing by default are assumed to invest by default, while those who actively elect to contribute or who are in plans without elective contributions are assumed to actively invest. In practice neither of these assumptions will hold all of the time. Some participants contributing by default may actively direct their investments. Perhaps more important, some active contributors or participants in plans without elective contributions may invest by default – and this proposed regulation may affect the incidence of such default investing. The Department did not attempt to estimate the extent or effect of default investing not associated with default contributing. The Department was unable to locate data on the extent of such default investing, but believes it is likely to be small relative to that of default investing of default contributions. The Department is likewise uncertain how much the proposed regulation might affect the incidence of such default investing, but believes that the economic effects of changes in that incidence will be modest insofar as the asset allocation of the active investments such default investments would replace are likely on average and aggregate to not differ much from the asset allocation of the defaults. The Department also notes that a large majority of the estimated economic effects of the proposed regulation derive from increased contributions rather than increased equity investment, so the omission from the estimates of some default investment effects may have only a modest effect on the total. The Department invites comments on its assumptions and estimates relating to the incidence of default investments.

estimates, to U.S. Treasury bonds;[35] in the low- and high-impact estimates, to a mix resembling a life cycle fund, with 100 percent minus the participant's age in equity and the remainder in U.S. Treasury bonds. Returns to equity were determined stochastically. The distribution was lognormal with a nominal mean of 9.48 percent[36] and standard deviation of 16.54 percent.[37]

To estimate the effects of the proposed regulation, the Department compared the baseline estimates with the low- and high-impact estimates. Because the proposed regulation's effects will be cumulative and gradual, estimates were prepared for the 1985 birth cohort, whose working lives would almost entirely follow implementation of the proposed regulation. To estimate participation rates, contributions, account balances and investment mixes, the cohort was sampled at random ages from 21 to 65, and results for individuals participating in 401(k) plans when sampled were aggregated, with all dollar amounts adjusted to 2005 levels. This roughly illustrates a point-in-time snapshot of plans in the future.[38] To estimate effects on pension incomes, account balances available

[35] On the risk return spectrum, Treasury bonds generally fall between money market and stable value funds on one side and balanced and life cycle funds on the other. They serve here as a proxy for the current default investments connected with automatic enrollment programs, which are mostly money market and stable value funds but include a substantial proportion of balanced and life cycle funds.

[36] This is the rate used by the Office of the Actuary, U.S. Social Security Administration, to estimate returns to proposed personal accounts in the Social Security program.

[37] This is parallel to volatility assumed by Vanguard in illustrating the effects of alternative default investments. See Utkus, *supra* note 4, at 17.

[38] Because PENSIM is a birth cohort-based model (rather than a panel-based model that simulates the experience of an entire population from year to year) it does not directly provide point-in-time aggregate estimates for the overall population. These PENSIM-derived estimates serve as a proxy for such panel-derived point-in-time estimates. The PENSIM-based estimates in effect blend the experience of younger workers in the nearer future with that of older workers in the more distant future, producing a sort of longitudinal central tendency. The estimated participation and contribution rates serve as proxies for the average across many future years (reflecting near-immediate, ongoing effects). The estimated account balances serve as proxies for some point in the distant future (reflecting cumulative effects). Actual aggregate participation rates and contribution amounts will vary over time because of changes in certain population variables such as birth rates, age-specific labor force participation rates, and productivity and compensation levels. Any long-term forecasts of such changes are highly uncertain, however. The Department therefore did not attempt to adjust its estimates for such changes, believing such adjustments

at retirement[39] were converted into lifetime annuities, and pension incomes of cohort members surviving to age 67 were measured and compared.

The estimates are highly uncertain. The long time horizon compounds the uncertainty. One of the greatest uncertainties relates to the default contribution rate, which is assumed to be fixed at 3 percent.[40] Higher initial default contribution rates, or default provisions that increase contribution rates as tenure and/or pay increases, might enlarge the positive effects on pension income and reduce the negative effects. But it is unclear whether plan sponsors will adopt such approaches, or if they do, whether they might make other changes to their plans or whether more eligible employees might decline automatic participation. The Department therefore has no reliable basis for estimating the effects of such changes in automatic enrollment programs.[41] The Department invites comments on this and other areas of uncertainty in its estimates.

Peer Review

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would be of questionable analytic value. Because the PENSIM-derived contribution estimates blend experience at different points in time and do not represent changes in population contributions over time or the timing of those changes, they do not lend themselves to discounting, conversion to net present values or level annuity equivalents. Rather, they can be interpreted as proxies for level annuity equivalents, albeit proxies which neglect the aforementioned changes in population variables.

[39] Taking into account individuals' propensities to cash out their accounts prior to retirement.

[40] As noted below, other areas of uncertainty, including rates of return, the rate of adoption of automatic enrollment, participation rates under automatic enrollment, and other savings decisions, were raised in connection with peer review.

[41] Nonetheless, to illustrate the potential impact of higher default contribution rates, the Department estimated the effect of the proposed regulation where the default contribution rate in automatic enrollment programs is 5 percent rather than 3 percent. The estimate holds constant other plan characteristics and participants' default rates and elective behaviors. In this scenario, in the very long run the proposed regulation is predicted to increase aggregate 401(k) plan account balances by between 3 percent and 6 percent, or approximately $60 billion and $114 billion if represented at 2005 levels. For individuals born in 1985 and surviving to age 67, holding other factors constant, low-impact estimates suggest that the proposed regulation will increase pension income by an average of $2,200 per year (in 2005 dollars) for 11 percent, and decrease it by $810 per year on average for 4 percent. Pension income would be unchanged for the remaining 85 percent. High-impact estimates suggest that average annual pension income will increase by $2,880 for 15 percent, fall by $1,040 for 5 percent, and be unchanged for 80 percent.

The "Final Information Quality Bulletin for Peer Review" issued by the Office of Management and Budget on December 16, 2004 (the Bulletin) establishes that important scientific information shall be peer reviewed by qualified specialists before it is disseminated by the federal government. Collectively, the PENSIM model, the data and methods underlying it, the surveys and literature used to parameterize it, and the Department's interpretation of these and application of them to produce the estimates presented in this regulatory impact analysis (RIA) constitute a "highly influential scientific assessment" under the Bulletin. Therefore, pursuant to the Bulletin, the Department arranged for review of this assessment by three highly qualified independent reviewers. The Department provided each reviewer with instructions for review pursuant to the Bulletin, a draft of the Notice of Proposed Rulemaking (NPRM) including a draft RIA, technical documentation of PENSIM and its application in support of the RIA, and detailed tables of related PENSIM estimates. The instructions directed the reviewers to focus on the technical and scientific issues in the assessment rather than the policy proposed in the NPRM. Each reviewer separately reviewed the assessment embodied in these materials and submitted to the Department a peer review report. All of the aforementioned materials are being published together with the Department's written response to the peer reviews on the Department's website, concurrent with the publication of this NPRM *[add url when known]*.

The reviews offer both praise for and criticism of the assessment. They question numerous specific modeling assumptions and identify potential indirect effects that were not estimated. They note that welfare effects (as distinguished from simple dollar impacts on retirement saving), which the Department did not estimate, may be negative if consumers are risk averse or prefer current to future consumption. One review criticizes PENSIM's reduced form modeling approach as lacking the structural, behavioral foundation necessary to predict results and evaluate welfare effects, finds the PENSIM estimates "unconvincing," and concludes that the Department has failed to provide a scientific rationale for the policy initiative contained in the NPRM.

While many of the reviews' criticisms have merit, the Department does not believe that they cast serious doubt on the RIA's primary conclusions: that the proposed rule on net will increase retirement savings and thereby benefit consumers. The Department's written response to the reviews qualifies and tempers some of the RIA's conclusions. It answers, to the extent possible, major questions raised in the reviews, including questions about welfare effects. It defends the Department's reliance on PENSIM as a basis for its estimates and explains why the Department did not estimate net welfare effects but believes such effects to be positive. It also offers a tentative, prioritized plan for conducting sensitivity tests and otherwise refining its assessment and RIA in connection with a possible final rulemaking.

Federalism Statement

Executive Order 13132 (August 4, 1999) outlines fundamental principles of federalism and requires federal agencies to adhere to specific criteria in the process of their formulation and implementation of policies that have substantial direct effects on the States, the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. The proposed rule does not have federalism implications because it has no substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the States as they relate to any employee benefit plan covered under ERISA. The requirements implemented in the proposed rule do not alter the fundamental provisions of the statute with respect to employee benefit plans, and as such would have no implications for the States or the relationship or distribution of power between the national government and the States.

List of Subjects in 29 CFR Part 2550

Employee benefit plans, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Real estate, Securities, Surety bonds, Trusts and trustees.

For the reasons set forth in the preamble, the Department proposes to amend Subchapter F, Part 2550 of Title 29 of the Code of Federal Regulations as follows:

SUBCHAPTER F--FIDUCIARY RESPONSIBILITY UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2550--RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

1. The authority citation for part 2550 is revised to read as follows:

Authority: 29 U.S.C. 1135; sec. 657, Pub. L. 107-16, 115 Stat.38; and Secretary of Labor's Order No. 1-2003, 68 FR 5374 (Feb. 3, 2003). Sec. 2550.401b-1 also issued under sec. 102, Reorganization Plan No. 4 of 1978, 43 FR 47713 (Oct. 17, 1978), 3 CFR, 1978 Comp. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), 3 CFR, 1978 Comp. 332. Sec. 2550.401c-1 also issued under 29 U.S.C. 1101. Sections 2550.404c-1 and 2550.404c-5 also issued under 29 U.S.C. 1104. Sec. 2550.407c-3 also issued under 29 U.S.C. 1107. Sec. 2550.408b-1 also issued under 29 U.S.C. 1108(b)(1) and sec. 102, Reorganization Plan No. 4 of 1978, 3 CFR, 1978 Comp. p. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), and 3 CFR, 1978 Comp. 332. Sec. 2550.412-1 also issued under 29 U.S.C. 1112.

2. Add Sec. 2550.404c-5 to read as follows:

§ 2550.404c-5 Fiduciary relief for investments in qualified default investment alternatives.

(a) In general. (1) This section implements the fiduciary relief provided under section 404(c)(5) of the Employee Retirement Income Security Act of 1974, as amended (ERISA or the Act), 29 U.S.C. 1001 et seq., under which a participant or beneficiary in an individual account plan will be treated as exercising control over the assets in his or her account for purposes of ERISA section 404(c)(1) with respect to the amount of contributions and earnings that, in the absence of an investment election by the participant, are invested by the plan in accordance with this regulation. If a participant or beneficiary is treated as exercising control over the assets in his or her account in accordance with ERISA § 404(c)(1) no person who is otherwise a fiduciary shall be liable under part 4 of title I of ERISA for any loss or by reason of any breach which results from such participant's or beneficiary's exercise of control. Except as specifically provided in paragraph (c)(6) a plan need not meet the requirements for an ERISA section 404(c) plan under 29 CFR 2550.404c-1 in order for a plan fiduciary to obtain the relief under this section.

(2) The standards set forth in this section apply solely for purposes of determining whether a fiduciary meets the requirements of this proposed regulation. Such standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under the Act with respect to the investment of assets in the individual account of a participant or beneficiary.

(b) Fiduciary relief. (1) Except as provided in paragraphs (2), (3), and (4), a fiduciary of an individual account plan that permits participants or beneficiaries to direct the investment of assets in their accounts and that meets the conditions of paragraph (c) of this section shall not be liable for any loss, or by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of—(i) investing all or part of a participant's or beneficiary's account in a qualified default investment alternative, or (ii) investment decisions made by the entity described in paragraph (e)(3) in connection with the management of a qualified default investment alternative.

(2) Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any qualified default investment alternative under the plan or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses.

(3) Nothing in this section shall relieve an investment manager described in paragraph (e)(3)(i) from its fiduciary duties under part 4 of title I of ERISA or from any

liability that results from a failure to satisfy these duties, including liability for any resulting losses.

(4) Nothing in this section shall provide relief from the prohibited transaction provisions of section 406 of ERISA, or from any liability that results from a violation of those provisions, including liability for any resulting losses.

(c) Conditions. With respect to the investment of assets in the individual account of a participant or beneficiary, a fiduciary shall qualify for the relief described in paragraph (b)(1) of this section if:

(1) Assets are invested in a “qualified default investment alternative” within the meaning of paragraph (e) of this section;

(2) The participant or beneficiary on whose behalf the investment is made had the opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets;

(3) The participant or beneficiary on whose behalf an investment in a qualified default investment alternative may be made is furnished within a reasonable period of time of at least 30 days in advance of the first such investment and within a reasonable period of time of at least 30 days in advance of each subsequent plan year, a summary

plan description, summary of material modification, or other notice that meets the requirements of paragraph (d) of this section;

(4) Under the terms of the plan any material provided to the plan relating to a participant's or beneficiary's investment in a qualified default investment alternative (e.g., account statements, prospectuses, proxy voting material) will be provided to the participant or beneficiary;

(5) Any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative may, consistent with the terms of the plan (but in no event less frequently than once within any three month period), transfer, in whole or in part, such assets to any other investment alternative available under the plan without financial penalty; and

(6) The plan offers a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3).

(d) Notice. The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant and contain the following:

(1) A description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant and beneficiary in a qualified default investment alternative;

(2) A description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative;

(3) A description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, without financial penalty; and

(4) An explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

(e) Qualified default investment alternative. For purposes of this section, a qualified default investment alternative means an investment alternative that:

(1)(i) Does not hold or permit the acquisition of employer securities, except as provided in paragraph (ii).

(ii) Paragraph (i) shall not apply to: (A) employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof; or (B) with respect to a qualified default investment alternative described in paragraph (e)(5)(iii), employer securities acquired as a matching contribution from the employer/plan sponsor, or employer securities acquired prior to management by the investment management service;

(2) Except as otherwise provided in paragraph (c)(5), does not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer, in whole or in part, his or her investment from the qualified default investment alternative to any other investment alternative available under the plan;

(3) Is (i) managed by an investment manager, as defined in section 3(38) of the Act, or (ii) an investment company registered under the Investment Company Act of 1940;

(4) Is diversified so as to minimize the risk of large losses; and

(5) Constitutes one of the following:

(i) 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. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(5)(i), asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account.

(ii) An investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this paragraph (e)(5)(ii), asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a "balanced" fund.

(iii) An investment management service with respect to which an investment manager 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 alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(5)(iii), asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a service may be a "managed account."

Signed at Washington, DC, this ______ day of _________________

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Ann L. Combs, Assistant Secretary, Employee Benefits
Security Administration, Department of Labor