

**DEPARTMENT OF LABOR****Employee Benefits Security Administration****29 CFR Part 2550**

RIN 1210-AB10

**Default Investment Alternatives Under Participant Directed Individual Account Plans**

AGENCY: Employee Benefits Security Administration.

ACTION: Final rule.

**SUMMARY:** This document contains a final regulation that implements 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 in 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 final regulation will not be liable for any loss, or by reason of any breach, that occurs as a result of such investments. This regulation describes the types of investments that qualify as default investment alternatives under section 404(c)(5) of ERISA. Plan fiduciaries remain responsible for the prudent selection and monitoring of the qualified default investment alternative. The regulation conditions relief upon advance notice to participants and beneficiaries describing 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 qualified default investment alternative, and the right of participants and beneficiaries to direct investments out of the qualified default investment alternative. This regulation 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:** This final rule is effective on December 24, 2007.

**FOR FURTHER INFORMATION CONTACT:** Lisa M. Alexander, Kristen L. Zarenko, or Katherine D. Lewis, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500. This is not a toll-free number.

**SUPPLEMENTARY INFORMATION:****A. Background**

With the enactment of the Pension Protection Act of 2006 (Pension Protection Act), section 404(c) of ERISA was amended to provide relief afforded 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 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 regulation under section 404(c)(5) of ERISA. The relief afforded by section 404(c)(5), 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. The amendments made by section 624 of the Pension Protection Act apply to plan years beginning after December 31, 2006.

On September 27, 2006, the Department, exercising its authority under section 505 of ERISA and consistent with section 624 of the Pension Protection Act, published a notice of proposed rulemaking in the **Federal Register** (71 FR 56806) that, upon adoption, would implement the provisions of ERISA section 404(c)(5). The notice included an invitation to interested persons to comment on the proposal. In response to this invitation, the Department received over 120 written comments from a variety of parties, including plan sponsors and fiduciaries, plan service providers, financial institutions, and employee benefit plan industry representatives. Submissions are available for review under Public Comments on the Laws &

Regulations page of the Department's Employee Benefits Security Administration Web site at <http://www.dol.gov/ebsa>.

Set forth below is an overview of the final regulation, along with a discussion of the public comments received on the proposal.

**B. Overview of Final Rule***Scope of the Fiduciary Relief*

Paragraph (a)(1) of § 2550.404c-5, like the proposal, generally describes the scope of the regulation and 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. Paragraph (a)(2) of § 2550.404c-5, also like the proposal, makes clear that the standards set forth in the regulation apply solely for purposes of determining whether a fiduciary meets the requirements of the regulation. These standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under ERISA with respect to the investment of assets on behalf of a participant or beneficiary in an individual account plan who fails to give investment directions. As recognized by the Department in the preamble to the proposal, investments in money market funds, stable value products and other capital preservation investment vehicles may be prudent for some participants or beneficiaries even though such investments themselves may not generally constitute qualified default investment alternatives for purposes of the regulation. The Department further notes that such investments, while not themselves qualified default investment alternatives for purposes of investments made following the effective date of this regulation, may nonetheless constitute part of the investment portfolio of a qualified default investment alternative.

Paragraph (b) of § 2550.404c-5 defines the scope of the fiduciary relief provided. Paragraph (b)(1) of the proposal provided 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, or by reason of any breach under part 4 of title I of ERISA, 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 Department has revised paragraph (b)(1) of the final regulation to clarify that 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 any qualified default investment alternative within the meaning of paragraph (e), 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 phrase "any qualified default investment alternative" in the final regulation is intended to make clear that a fiduciary will be afforded relief without regard to which type of qualified default investment alternative the fiduciary selects, provided that the fiduciary prudently selects the particular product, portfolio or service, and meets the other conditions of the regulation.

Some commenters asked whether the relief provided by the final regulation covers a plan fiduciary's decision regarding which of the qualified default investment alternatives will be available to a plan's participants and beneficiaries who fail to direct their investments. As long as a plan fiduciary selects any of the qualified default investment alternatives, and otherwise complies with the conditions of the rule, the plan fiduciary will obtain the fiduciary relief described in the rule. The Department believes that each of these qualified default investment alternatives is appropriate for participants and beneficiaries who fail to provide investment direction; accordingly, the rule does not require a plan fiduciary to undertake an evaluation as to which of the qualified default investment alternatives provided for in the regulation is the most prudent for a participant or the plan. However, the plan fiduciary must prudently select and monitor an investment fund, model portfolio, or investment management service within any category of qualified default investment alternatives in accordance with ERISA's general fiduciary rules. For example, a plan

fiduciary that chooses an investment management service that is intended to comply with paragraph (e)(4)(iii) of the final regulation must undertake a careful evaluation to prudently select among different investment management services.

#### *Application of General Fiduciary Standards*

The scope of fiduciary relief provided by this regulation 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 regulation. As with section 404(c)(1) of the Act and the regulation issued thereunder (29 CFR 2550.404c-1), the final regulation does not provide relief from the general fiduciary rules applicable to the selection and monitoring of a particular qualified 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.

Several commenters asked the Department to provide additional guidance concerning the general fiduciary obligations of these plan fiduciaries in selecting a qualified default investment alternative. The selection of a particular qualified default investment alternative (i.e. a specific product, portfolio or service) is a fiduciary act and, therefore, ERISA obligates fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries. A fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate. As with other investment alternatives made available under the plan, fiduciaries must carefully consider investment fees and expenses when choosing a qualified default investment alternative. See paragraph (b)(2) of § 2550.404c-5.

Paragraph (b)(3) of the final regulation has been modified to reflect changes to paragraph (e)(3)(i) regarding persons responsible for the management of a qualified default investment alternative's assets. Paragraph (b)(3) of § 2550.404c-5 makes clear that nothing in the regulation relieves any such fiduciaries from their general fiduciary duties or from any liability that results from a failure to satisfy these duties,

including liability for any resulting losses. As proposed, paragraph (b)(3) was limited to investment managers. The final regulation, at paragraph (e)(3)(i) of § 2550.404c-5, broadens the category of persons who can manage the assets of a qualified default investment alternative, thereby requiring a conforming change to paragraph (b)(3). The changes to paragraph (e)(3)(i) are discussed in detail below.

Finally, the regulation also 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. Therefore, plan fiduciaries must avoid self-dealing, conflicts of interest, and other improper influences when selecting a qualified default investment alternative. See paragraph (b)(4) of § 2550.404c-5.

#### *Application of Final Rule to Circumstances Other Than Automatic Enrollment*

Several commenters requested clarification on the extent to which the fiduciary relief provided by the final regulation will be available to plan fiduciaries for assets that are invested in a qualified default investment alternative on behalf of participants and beneficiaries in circumstances other than automatic enrollment. Consistent with the views expressed concerning the scope of the relief provided by the proposed regulation, it is the view of the Department that nothing in the final regulation limits the application of the fiduciary relief to investments made only on behalf of participants who are automatically enrolled in their plan. Like the proposal, the final regulation applies to situations beyond automatic enrollment. Examples of such situations include: The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant to provide investment instruction. Whenever a participant or beneficiary has the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation, so long as all of its conditions have been satisfied.

#### *Conditions for the Fiduciary Relief*

Like the proposal, the final regulation contains six conditions for relief. These

conditions are set forth in paragraph (c) of the regulation.

The first condition of the final regulation, consistent with the Department's proposal, requires that assets invested on behalf of participants or beneficiaries under the final regulation be invested in a "qualified default investment alternative." See § 2550.404c-5(c)(1). This condition is unchanged from the proposal.

The second condition also is unchanged from the proposal. The participant or beneficiary on whose behalf assets are being invested in a qualified default investment alternative must have had the opportunity to direct the investment of assets in his or her account but did not direct the investment of 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 continues to require that participants or beneficiaries receive information concerning the investments that may be made on their behalf. As in the proposal, the final regulation requires both an initial notice and an annual notice. The proposed regulation required an initial notice within a reasonable period of time of at least 30 days in advance of the first investment. A number of commenters explained that requiring 30 days' advance notice would preclude plans with immediate eligibility and automatic enrollment from withholding of contributions as of the first pay period. Commenters argued that plan sponsors should not be discouraged from enrolling employees in their plan on the earliest possible date.

The Department agrees that plan sponsors should not be discouraged from enrolling employees on the earliest possible date. To address this issue, the Department has modified the advance notice requirements that appeared in the proposed regulation. For purposes of the initial notification requirement, the final regulation, at paragraph (c)(3)(i), provides that the notice must be provided (A) at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of any first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2), or (B) on or before the date of plan eligibility, provided the participant has the opportunity to make a permissible withdrawal (as determined under section 414(w) of the Internal Revenue Code of 1986 (Code)).

With regard to the foregoing, the Department notes that, unlike the proposal, the final regulation measures the time period for the 30-day advance notice requirement from the date of plan eligibility to better coordinate the notice requirements with the Code provisions governing permissible withdrawals. The Department also notes that if a fiduciary fails to comply with the final regulation for a participant's first elective contribution because a notice is not provided at least 30 days in advance of plan eligibility, the fiduciary may obtain relief for later contributions with respect to which the 30-day advance notice requirement is satisfied.

In addition, while retaining the general 30-day advance notice requirement, the final regulation also permits notice "on or before" the date of plan eligibility if the participant is permitted to make a permissible withdrawal in accordance with 414(w) of the Code. In this regard, the Department believes that if participants are not going to be afforded the option of withdrawing their contributions without additional tax, such participants should be given notice sufficiently in advance of the contribution to enable them to opt out of plan participation.

The Department notes that the phrase in paragraph (c)(3)(i)—"or at least 30 days in advance of any first investment in a qualified default investment alternative"—is intended to accommodate circumstances other than elective contributions. For example, although fiduciary relief would not be available with respect to a fiduciary's investment of a participant or beneficiary's rollover amount from another plan into a qualified default investment alternative if the 30-day advance notice requirement is not satisfied, relief may be available when a fiduciary invests the rollover amount into a qualified default investment alternative after satisfying the notice requirement in paragraph (c)(3)(i)(A) as well as the regulation's other conditions.

Finally, the phrase—"in advance of the date of plan eligibility \* \* \* or any first investment in a qualified default investment alternative"—is not intended to foreclose availability of relief to fiduciaries that, prior to the adoption of the 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 date of plan eligibility \* \* \* or any first

investment"—should be read to mean the first investment with respect to which relief under the final regulation is intended to apply after the effective date of the regulation.

The timing of the annual notice requirement contained in the final regulation has not changed from the proposal. Notice must be provided within a reasonable period of time of at least 30 days in advance of each subsequent plan year. See § 2550.404c-5(c)(3)(ii). One commenter requested that the Department eliminate the annual notice requirement. The Department retained the annual notice requirement because the Pension Protection Act specifically amended ERISA to require an annual notice. Further, the Department believes that it is important to provide regular and ongoing notice to participants and beneficiaries whose assets are invested in a qualified default investment alternative to ensure that they are in a position to make informed decisions concerning their participation in their employer's plan. Several commenters supported the furnishing of an annual reminder to participants and beneficiaries that their assets have been invested in a qualified default investment alternative and that participants and beneficiaries may direct their contributions into other investment alternatives available under the plan.

Paragraph (c)(3), as proposed, provided that the required disclosures could be included in a summary plan description, summary of material modification or other notice meeting the requirements of paragraph (d), which described the content required in the notice. Some commenters expressed concern that permitting the notice requirement to be satisfied through a plan's summary plan description or summary of material modification may result in participants overlooking or ignoring information relating to their participation and the investment of contributions on their behalf. The Department is persuaded that, given the potential length and complexity of summary plan descriptions and summaries of material modifications, the furnishing of the required disclosures through a separate notice will reduce the likelihood of a participant or beneficiary missing or ignoring information about his or her plan participation and the investment of the assets in his or her account in a qualified default investment alternative. Accordingly, the final regulation, at paragraph (c)(3), has been modified to eliminate references to providing notice through a summary plan description or

summary of material modifications. The Department notes that the notice requirements of ERISA section 404(c)(5)(B) and this regulation, and the notice requirements of sections 401(k)(13)(E) and 414(w)(4) of the Code, as amended by the Pension Protection Act, are similar. Accordingly, while the final regulation provides for disclosure through a separate notice, the Department anticipates that the notice requirements of this final regulation and the notice requirements of sections 401(k)(13)(E) and 414(w)(4) of the Code could be satisfied in a single disclosure document. Further, the Department notes that nothing in the regulation should be construed to preclude the distribution of the initial or annual notices with other materials being furnished to participants and beneficiaries. In this regard, the Department recognizes that there may be cost savings that result from distributing multiple disclosures simultaneously and, to the extent that distribution costs may be charged to the accounts of individual participants and beneficiaries, efforts to minimize such costs should be encouraged.

The fourth condition of the proposed regulation required that, 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) would be provided to the participant or beneficiary. See proposed regulation § 2550.404c-5(c)(4). Several commenters asked the Department to clarify whether the phrase "under the terms of the plan" would require plan amendments to explicitly incorporate the proposed rule's disclosure provision. Commenters suggested that paragraph (c)(4) of the proposal could be read to require that the disclosure provisions be described in the formal plan document, and the commenters suggested that it is unclear what documents would suffice to meet this condition. The phrase "under the terms of the plan" was merely intended to ensure that plans provide for the required pass-through of information. Taking into account both the fact that a pass-through of information is a specific condition of the regulation and the comments on this provision, the Department has concluded that the phrase is confusing and not necessary. Accordingly, the phrase "under the terms of the plan" has been removed from paragraph (c)(4) of the final regulation. See § 2550.404c-5(c)(4).

Commenters also requested clarification as to the material intended to be included in the reference to

"material provided to the plan" in paragraph (c)(4). Specifically, commenters inquired whether material provided to the plan includes information within the custody of a plan service provider or the fiduciary responsible for selecting a qualified default investment alternative, and whether "material provided to the plan" includes aggregate, plan-level information received by the plan. Commenters also asked for clarification regarding the manner in which information shall be "provided to the participant or beneficiary" in paragraph (c)(4) of the proposed regulation. A number of commenters suggested that the final regulation permit disclosure of information upon request; others recommended that the disclosure requirement should be satisfied by including a statement in the notice required by paragraph (c)(3) of the proposed regulation that provides direction to a participant or beneficiary regarding where he or she can find information about the qualified default investment alternatives. Other commenters asked whether plans could make materials available to a participant or beneficiary instead of affirmatively providing materials to them.

Other commenters suggested that a participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative should not be required to be furnished more material than is required to be furnished to those individuals who direct their investments. In this regard, commenters recommended that the Department apply the same standard set forth in the section 404(c) regulation for the pass-through of information to both participants who fail to direct their investments and participants who elect to direct their investments.

The Department believes that participants who fail to direct their investments should be furnished no less information than is required to be passed through to participants who elect to direct their investments under the plan. The Department also believes there is little, if any, basis for requiring defaulted participants to be furnished more information than is required to be passed through to other participants. For this reason, the Department has adopted the recommendation of those commenters that the pass-through disclosure requirements applicable to section 404(c) plans be applied to the pass-through of information under the final regulation. The Department, therefore, has modified paragraph (c)(4) to provide that a fiduciary shall qualify for the relief described in paragraph (b)(1) of the final regulation if a

fiduciary provides material to participants and beneficiaries as set forth in paragraphs (b)(2)(i)(B)(1)(viii) and (ix), and paragraph (b)(2)(i)(B)(2) of the 404(c) regulation, relating to a participant's or beneficiary's investment in a qualified default investment alternative. The Department notes that, as part of a separate regulatory initiative, it is reviewing the disclosure requirements applicable to participants and beneficiaries in participant-directed individual account plans and that, to the extent that the pass-through disclosure requirements contained in § 2550.404c-1 are amended, the language of paragraph (c)(4), as modified, will ensure such amendments automatically extend to § 2550.404c-5. The Department notes, in responding to one commenter's request for clarification, that the plan's obligation to pass through information to participants or beneficiaries would be considered satisfied if the required information is furnished directly to the participant or beneficiary by the provider of the investment alternative or other third-party.

The fifth condition of the proposal required 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 proposed regulation § 2550.404c-5(c)(5). This provision was intended to ensure 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 was not intended to confer greater rights on participants or beneficiaries whose accounts the plan invests in qualified default investment alternatives than are otherwise available under the plan. 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 received many comments requesting clarification on this requirement, most often concerning what the Department considers to be a financial penalty. Commenters asked whether investment-level fees and restrictions, as opposed to fees or other restrictions that are imposed by the plan or the plan sponsor, would be considered impermissible restrictions or "financial penalties." Commenters explained that fees and limitations that are part of the investment product are beyond the control of the plan sponsor and should not be considered financial penalties for purposes of the final regulation. The comment letters provided many examples of investment-level fees or restrictions that commenters believed should not be considered punitive, including redemption fees, back-end sales loads, reinvestment timing restrictions, market value adjustments, equity "wash" restrictions, and surrender charges.

In response to these and other comments, the Department has modified and restructured paragraph (c)(5) of the final regulation to provide more clarity with respect to limitations that may or may not be imposed on participants and beneficiaries who are defaulted into a qualified default investment alternative. As modified and restructured, paragraph (c)(5) of the final regulation includes three conditions applicable to a defaulted participant's or beneficiary's ability to move assets out of a qualified default investment alternative.

The first condition, as in the proposal, is intended to ensure that defaulted participants and beneficiaries have the same rights as other participants and beneficiaries under the plan regarding the frequency with which they may direct an investment out of a qualified default investment alternative. In this regard, paragraph (c)(5)(i) provides that any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative must be able to transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded participants and beneficiaries who elect to invest in the qualified default investment alternative, but not less frequently than once within any three month period. The Department received no substantive comments on

this provision and it is being adopted unchanged from the proposal.

The second and third conditions, at paragraphs (c)(5)(ii) and (iii), relate to limitations (i.e., restrictions, fees, etc.) other than those relating to the frequency with which participants may direct their investment out of a qualified default investment alternative, which are addressed in paragraph (c)(5)(i). Unlike the proposal, which limited the imposition of financial penalties for the period of a defaulted participant's or beneficiary's investment, the regulation, as modified, precludes the imposition of any restrictions, fees or expenses (other than investment management and similar types of fees and expenses) during the first 90 days of a defaulted participant's or beneficiary's investment in the qualified default investment alternative. At the end of the 90-day period, defaulted participants and beneficiaries may be subject to the restrictions, fees or expenses that are otherwise applicable to participants and beneficiaries under the plan who elected to invest in that qualified default investment alternative. While the condition on restrictions, fees and expenses is limited to 90 days, the condition, as explained below, is broad in its application, thereby providing defaulted participants and beneficiaries an opportunity to redirect or withdraw their contributions. Also, the Department believes that restrictions or fees on qualified default investment alternatives are more likely to be waived if this period is shortened to 90 days. The 90-day period is defined by reference to the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, thereby enabling participants, if their plan permits, to make a permissible withdrawal without being subject to the 10 percent additional tax under section 72(t) of the Code.

Specifically, paragraph (c)(5)(ii) of the regulation provides that any transfer or permissible withdrawal described in paragraph (c)(5) resulting from a participant's or beneficiary's election to make such a transfer or withdrawal during the 90-day period beginning on the date of the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, or other first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2), shall not be subject to any restrictions, fees or expenses (except those fees and expenses that are charged on an ongoing basis for the investment itself, such as investment management and similar fees, and are not imposed, or do not vary, based on

a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the investment alternative). Accordingly, no restriction, fee, or expense may be imposed on any transfer or permissible withdrawal of assets, whether assessed by the plan, the plan sponsor, or as part of an underlying investment product or portfolio, and regardless of whether or not the restriction, fee, or expense is considered to be a "penalty." This provision, therefore, would prevent the imposition of any surrender charge, liquidation or exchange fee, or redemption fee. It also would prohibit any market value adjustment or "round-trip" restriction on the ability of the participant or beneficiary to reinvest within a defined period of time. As long as the participant's or beneficiary's election is made within the applicable 90-day period, no such charges may be imposed even if, due to administrative or other delays, the actual transfer or withdrawal does not take place until after the 90-day period.

Paragraph (c)(5)(ii)(B) makes clear that the limitations of paragraph (c)(5)(ii)(A) do not apply to fees and expenses that are charged on an ongoing basis for the operation of the investment itself, such as investment management fees, distribution and/or service fees ("12b-1" fees), and administrative-type fees (legal, accounting, transfer agent expenses, etc.), and are not imposed, or do not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the investment alternative. In response to a request for a clarification, the Department further notes that to the extent that a participant or beneficiary loses the right to elect an annuity as a result of a transfer out of a qualified default investment alternative with an annuity feature, such loss would not constitute an impermissible restriction for purposes of paragraph (c)(5)(ii) inasmuch as the annuity feature is a component of the investment alternative itself.

Paragraph (c)(5)(iii) of the final regulation provides that, following the end of the 90-day period described in paragraph (c)(5)(ii)(A), any transfer or permissible withdrawal described in paragraph (c)(5) shall not be subject to any restrictions, fees or expenses not otherwise applicable to a participant or beneficiary who elected to invest in that qualified default investment alternative. This provision is intended to ensure that defaulted participants and beneficiaries are not subject to restrictions, fees or penalties that would serve to create a greater disincentive for defaulted participants and beneficiaries, than for other participants and

beneficiaries under the plan, to withdraw or transfer assets from a qualified default investment alternative.

The Department notes that the final rule does not otherwise 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 of paragraph (c) of the regulation adopts, without modification from the proposal, the requirement that plans 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).<sup>1</sup> See § 2550.404c-5(c)(6). 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. The Department received no substantive objections to this provision and, as indicated, is adopting the provision without change.

#### Notices

As discussed above, relief under the final 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.

As proposed, paragraph (d) of § 2550.404c-5 required 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, including a description of any applicable restrictions, fees, or expenses in connection with such transfer; and (4) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

A few commenters suggested expanding the content of the notice to include procedures for electing other investment options, a description of the right to request additional information, a description of any right to obtain investment advice (if available), a description of fees associated with the qualified default investment alternatives, information about other investment options under the plan, etc. While the Department did not adopt all of the changes suggested by the commenters, the Department has modified the notice content requirements to broaden the required disclosures. As modified, the Department intends that the furnishing of a notice in accordance with the timing and content requirements of this regulation will not only satisfy the notice requirements of section 404(c)(5)(B) of ERISA but also the notice requirements under the preemption provisions of ERISA section 514 applicable to an "automatic contribution arrangement," within the meaning of ERISA section 514(e)(2).

ERISA section 404(c)(5)(B)(i)(I) provides for the furnishing of 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." ERISA section 514(e)(1) provides for the preemption of State laws that would directly or indirectly prohibit or restrict the inclusion in any

plan of an automatic contribution arrangement. Section 514(e)(3) provides that a plan administrator of an automatic contribution arrangement shall provide a notice describing the rights and obligations of participants under the arrangement and such notice shall include "an explanation of the participant's right under the arrangement not to have elective contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage)" and an explanation of "how contributions made under the arrangement will be invested in the absence of any investment election by the participant."

In addition to broadening the required disclosures, the Department revised the disclosures relating to restrictions, fees and expenses to conform the notice requirements to the changes in paragraph (c)(5) relating to restrictions, fees or expenses. As modified, paragraph (d) of the final regulation provides that the notices required by paragraph (c)(3) shall include: (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 or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contribution, and the right of the participant to elect not to have such contributions made on his or her behalf (or to elect to have such contributions made at a different percentage); (2) an explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts; (3) 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; (4) 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, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and (5) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

Other commenters suggested that the Department provide a model notice.

<sup>1</sup> 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; \* \* \*

Because applicable plan provisions and qualified default investment alternatives may vary considerably from plan to plan, the Department believes it would be difficult to provide model language that is general enough to accommodate different plans and different investment products and portfolios and that would allow sufficient flexibility to plan sponsors. Accordingly, the final regulation does not include model language for plan sponsors. However, the Department will explore this concept in the future in coordination with the Department of Treasury concerning the similar notice requirements contained in sections 401(k)(13)(E) and 414(w) of the Code.

Commenters also requested guidance concerning the extent to which the final regulation's notice requirements could be satisfied by electronic distribution. The Department currently is reviewing its rules relating to the use of electronic media for disclosures under title I of ERISA. In the absence of guidance to the contrary, it is the view of the Department that plans that wish to use electronic means by which to satisfy their notice requirements may rely on either guidance issued by the Department of Labor at 29 CFR 2520.104b-1(c) or the guidance issued by the Department of the Treasury and Internal Revenue Service at 26 CFR 1.401(a)-21 relating to the use of electronic media.

#### *Qualified Default Investment Alternatives*

Under the final regulation, as in 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 four requirements for a "qualified default investment alternative."

The first requirement, at paragraph (e)(1), addresses investments in employer securities. As indicated in the preamble to the proposal, 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 be unnecessarily limiting and complicated. Accordingly, the proposal, in addition to establishing a general prohibition against qualified default investment alternatives holding or permitting acquisition of employer securities, provided two exceptions to the rule. While, as discussed below, the

Department did receive comments generally requesting different or expanded exceptions to the general prohibition, the Department has determined it appropriate to adopt paragraph (e)(1) without modification from the proposal.

The two exceptions to the general prohibition are set forth in paragraph (e)(1)(ii). The first exception applies 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 (e.g., a common or collective trust fund or pooled investment fund) 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.

Several commenters suggested that the exception to investments in employer securities should extend to circumstances when the plan sponsor delegates investment responsibilities to an ERISA section 3(38) investment manager and with respect to which the plan sponsor has no discretion regarding the acquisition or holding of employer securities. The Department did not adopt this suggestion because in such instances the investment manager may be following the investment policies established by the plan sponsor, and, while the plan sponsor may not be directly exercising discretion with respect to the acquisition or holding of employer securities, the plan sponsor might indirectly be influencing such decision through an investment policy that requires the investment manager to acquire or hold various amounts of employer securities. In the Department's view, limiting the exception to regulated financial institutions avoids this type of problem.

Another commenter suggested that the Department limit qualified default investment alternatives to a 10% investment in employer securities. The Department did not adopt this suggestion because it believes that a percentage limit test would effectively require that a plan sponsor or other fiduciary monitor on a daily, if not more frequent, basis the specific holdings of the qualified default investment alternative and fluctuations in the value of the assets in the qualified default investment alternative to determine compliance with a percentage limit. Such a test would, in the Department's view, result in considerable uncertainty as to whether at any given time the intended designated qualified default

investment alternative actually met the requirements of the regulation. The Department believes that the approach it has taken to limiting employer securities provides both flexibility and certainty.

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)(4)(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; however, an investment management service will be considered to be serving as a qualified default investment alternative only with respect to assets of a participant's or beneficiary's account over which the investment management service has authority to exercise discretion.

In the case of employer securities acquired as matching contributions that are subject to a restriction on transferability, relief would not be available with respect to such securities until the investment management service has an unrestricted right to transfer the securities. 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 qualified default investment alternative, the final regulation continues to permit an investment management service to hold and manage those employer securities in the absence of participant or beneficiary direction. Although 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.

One commenter suggested that the exception be extended to qualified default investment alternatives other than the investment management service described in paragraph (e)(4)(iii). An employer securities match can only constitute part of a qualified default investment alternative if the fiduciary selects an investment management service as the qualified default investment alternative, because only in the investment management service context is the responsible fiduciary undertaking the duty to evaluate the appropriate exposure to employer securities for a particular participant or beneficiary and undertaking the obligation to sell employer securities until the participant's or beneficiary's account reflects that appropriate exposure. Accordingly, the Department declines to adopt the commenter's suggestion to expand the second employer securities exception to other qualified default investment alternatives. The Department further notes that this regulation does not provide relief for the acquisition of employer securities by an investment service.

The second requirement, at paragraph (e)(2), is intended to ensure that the qualified default investment alternative itself does not impose any restrictions, fees or expenses inconsistent with the requirements of paragraph (c)(5) of § 2550.404c-5. While the provision has been redrafted for clarity, it is substantively the same as in the proposal and, therefore, is being adopted without substantive change.

The third requirement, at paragraph (e)(3), addresses the management of a qualified default investment option. As proposed, the regulation required 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. Several commenters suggested that requiring a qualified default investment alternative to be managed by an investment manager, or to be an investment company, is too restrictive.

A number of commenters noted that section 3(38) of ERISA excludes from the definition of the term "investment manager" named fiduciaries, as defined in section 402(a)(2) of ERISA<sup>2</sup> and

trustees.<sup>3</sup> With regard to named fiduciaries, commenters pointed out that a number of employers serve as named fiduciaries and manage their plan investments in-house, resulting in reduced administrative and investment management costs. Commenters also noted that implementation of the requirement as proposed would eliminate the ability of plan sponsors who are named fiduciaries to directly manage a qualified default investment alternative, use asset allocation models, develop asset allocations themselves, or engage investment consultants (who may or may not be fiduciaries) to assist in the development of asset allocations. Other commenters, however, suggested that the final regulation retain the requirement that only investment managers within the meaning of section 3(38) of ERISA or registered investment companies be permitted to manage qualified default investment alternatives. Commenters suggested that investment management decisions should be made by investment professionals who are investment managers within the meaning of section 3(38) of ERISA; they asserted that requiring a 3(38) manager is safer and more prudent than other alternatives, and such requirement is administratively feasible.

With regard to permitting plan sponsors to manage a qualified default investment alternative, the Department is persuaded that a plan sponsor's willingness to serve as a named fiduciary responsible for the management of the plan's investment options in conjunction with the potential cost savings to plan

named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary by a person who is an employer or employee organization with respect to the plan, or by such an employer and such an employee organization acting jointly.

<sup>3</sup> Section 3(38) defines the term "investment manager" to mean any fiduciary (other than a trustee or named fiduciary, as defined in section 402(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 [15 U.S.C. 80b-3a(a)], 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; 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 a fiduciary with respect to the plan.

participants that can result from such management, is a sufficient basis to expand the regulation to permit plan sponsors that are named fiduciaries to manage a qualified default investment alternative. This modification is reflected in paragraph (e)(3)(i)(C).

A number of commenters also indicated that, under the proposal, investment consultants engaged by plan sponsors would have to assume fiduciary responsibility for asset allocations in order to obtain relief under the proposal. These commenters suggested that requiring an investment consultant to assume fiduciary responsibility for asset allocation would increase costs for the provision of such consulting services, and that these costs inevitably would be passed along to participants. Commenters also asserted that the use of asset allocation models is well-established and is often an effective way to lower costs and to provide a clean structure and process for the formation, selection and monitoring of all elements of a prudent default investment alternative. The commenters also noted that many plan sponsors develop generic asset allocations and select particular funds, tailored to a particular plan, with the input of an investment consultant who may be an investment adviser under the Investment Advisers Act of 1940. With regard to these comments, the Department continues to believe 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 fiduciaries and those fiduciaries must acknowledge their fiduciary responsibility and liability under the ERISA. The Department notes, however, that plan sponsors who serve as named fiduciaries of a qualified default investment alternative may, to the extent they consider it prudent, engage investment consultants, utilize asset allocation models (computer-based or otherwise), etc. to carry out their investment management/asset allocation responsibilities. Accordingly, the Department does not believe the regulation in this regard should to any significant degree alter the availability or cost of such services.

With regard to the exclusion of trustees from the "investment manager" definition, commenters suggested that the final regulation make clear that bank trustees of collective investment funds are permitted to manage a qualified default investment alternative. In this regard, commenters noted that the definition of "investment managers" recognizes that banks and other

<sup>2</sup> Section 402(a)(2) of ERISA provides that the term "named fiduciary" means a fiduciary who is



institutions can be investment managers, citing ERISA section 3(38)(B)(ii) and (iii), and should not be foreclosed from managing a qualified default investment alternative solely on the basis that the institution might otherwise serve as a trustee. These commenters noted that, similar to investment managers, banks as trustees of collective funds have fiduciary responsibility and liability under ERISA with respect to the funds they maintain. The Department is persuaded that an entity that meets the requirements of section 3(38)(A), (B) and (C) should not be precluded from assuming fiduciary responsibility and liability for the underlying investment management/asset allocation decisions of a qualified default investment alternative solely because that entity serves in a trustee capacity for the plan.<sup>4</sup> The Department has modified the final regulation accordingly. This modification is reflected in paragraph (e)(3)(i)(B).

In response to a request from one commenter, the Department confirms that the provisions of the regulation do not preclude a qualified default investment alternative from having more than one fiduciary (e.g., investment manager) responsible for the investment management/asset allocation decisions of the investment alternative, as would be the case in an arrangement utilizing a "fund of funds" approach to designing a qualified default investment alternative.

As with the proposal, the regulation permits a qualified default investment alternative to be an investment company registered under the Investment Company Act of 1940. See paragraph (e)(3)(ii) of § 2550.404c-5.

In addition to the foregoing, paragraph (e)(3) has been expanded to include certain capital preservation products and funds described in paragraph (e)(4)(iv) and (v) of § 2550.404c-5. These products and funds are discussed below.

The last requirement for a qualified default investment alternative conditions relief on the use of specified types of investment fund products, model portfolios or services. See § 2550.404c-5(e)(4). In the proposal, the Department identified three categories of investment alternatives that it determined appropriate for achieving meaningful retirement savings over the long-term for those participants and

beneficiaries who, for one reason or another, do not elect to direct the investment of their pension plan assets. After careful consideration of all the comments concerning the nature and type of the investment alternatives that should be included as qualified default investment alternatives under the regulation, the Department, as discussed below, has decided to retain the three proposed categories of investment alternatives, essentially unchanged from the proposal, as the type of alternatives appropriate for default investments under the regulation. However, in recognition of the fact that some plan sponsors may find it desirable to reduce investment risks for all or part of their workforce following employees' initial enrollment in the plan, the Department has added a limited capital preservation option that would constitute a qualified default investment alternative under the regulation for purposes of contributions made on behalf of a participant for a 120-day period following the date of the participant's first elective contribution. See paragraph (e)(4)(iv). In addition, the Department has modified the regulation to include a "grandfather"-like provision pursuant to which stable value products and funds will constitute a qualified default investment alternative under the regulation for purposes of investments made prior to the effective date of the regulation. See paragraph (e)(4)(v).

As noted above, the three categories of investment alternatives set forth in the proposal are being adopted essentially unchanged from the proposal. One organizational change appearing in the final regulation involves the inclusion of diversification language in each of three categories, rather than as a separate requirement of general applicability as in the proposal (see paragraph (e)(4) of proposed regulation § 2550.404c-5). This change accommodates the addition of the capital preservation investment alternatives mentioned above that may not, given the nature of the investment, satisfy a diversification standard.

Some commenters expressed concern that the Department's approach to defining qualified default investment alternatives takes into account only products currently available in the marketplace and that the defining of qualified default investment alternatives should be based on more general criteria. These commenters emphasized that the regulation should not stifle creativity in the development of the next generation of retirement products. While the Department does provide examples of products, portfolios and services that would fall within the

framework of the various definitions of products, portfolios and services set forth in the regulation, these examples are provided solely for the purpose of providing the benefits community with guidance as to what might be included within the defined categories and are not intended in any way to limit the application of the definitions to such vehicles. The Department believes that, on the basis of the information it has at this time and the comments on the proposal generally, the approach it is taking to defining qualified default investment alternatives for purposes of the regulation is sufficiently flexible to accommodate future innovations and developments in retirement products.

A number of commenters requested clarification concerning application of the regulation to possible qualified default investment alternatives that are offered through variable annuity contracts. Commenters explained that variable annuity contracts typically permit participants to invest in a variety of investments through one or more separate accounts (or sub-accounts within the separate account) that would qualify as qualified default investment alternatives under the regulation. Commenters also requested confirmation that the availability of annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts would not themselves affect the status of a variable annuity contract that otherwise met the requirements for a qualified default investment alternative. Consistent with providing flexibility and encouraging innovation in the development and offering of retirement products, model portfolios or services, the Department intends that the definition of "qualified default investment alternative" be construed to include products and portfolios offered through variable annuity and similar contracts, as well as through common and collective trust funds or other pooled investment funds, where the qualified default investment alternative satisfies all of the conditions of the regulation. For purposes of identifying the entity responsible for the management of the qualified default investment alternative in such arrangements pursuant to paragraph (e)(3) of § 2550.404c-5, it is the view of the Department that such a determination is made by reference to the entity (e.g., separate account, sub-account, or similar entity) that is responsible for carrying out the day-to-day investment management/asset allocation responsibilities. Finally, with regard to such products and portfolios,

<sup>4</sup> This position is consistent with the Department's long-held view that the parenthetical language of section 3(38) was merely intended to indicate that in order for a person to be an investment manager for a plan, that person must be more than a mere trustee or named fiduciary. See Advisory Opinion No. 77-69/70A

it is the view of the Department that the availability of annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts will not themselves affect the status of a fund, product or portfolio as a qualified default investment alternative when the conditions of the regulation are satisfied. A new paragraph (e)(4)(vi) was added to the regulation to clarify these principles.

A number of commenters submitted questions or comments concerning the specific investment alternatives described in the regulation.

The first investment alternative set forth in the regulation, at paragraph (e)(4)(i), is an investment fund, product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and 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. Consistent with the proposal, the description provides that 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. Also like the proposal, the description makes clear that 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.

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. As noted in the proposal, the Department believes that, 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.

Several commenters asked the Department to clarify whether a plan fiduciary must, or may, consider demographic or other factors in addition to a participant's age or target retirement date when selecting an investment product intended to satisfy the first category of qualified default investment

alternatives. For example, commenters suggested that a plan fiduciary may wish to take into account an employer-provided defined benefit plan or an employer stock contribution when selecting the plan's default investment product. Although the final regulation does not preclude consideration of factors other than a participant's age or target retirement date in these circumstances, the regulation is clear that such considerations are neither required nor necessary as a condition to a fiduciary obtaining relief under the regulation. The Department intended to provide plan fiduciaries with certainty that they have complied with the requirements of the regulation; accordingly, as long as a plan fiduciary satisfies its general obligations under ERISA when selecting any qualified default investment alternative, the fiduciary will not lose the relief provided by the regulation if he or she selects a product, portfolio or service described in the regulation.

One commenter requested clarification concerning the status of "lifestyle" funds. "Lifestyle" funds were defined as being similar to "lifecycle" funds, except that the allocation in a given lifestyle fund does not change over time to become more conservative. That is, the investment manager of a lifestyle fund invests the fund's assets to achieve a predetermined level of risk, such as "conservative," "moderate," or "aggressive." While it does not appear that a lifestyle fund, as defined by the commenter, would by itself satisfy the requirements for a product or portfolio within the meaning of paragraph (e)(4)(i), such a fund could, in the Department's view, constitute part of a qualified default investment alternative within the meaning of paragraph (e)(4)(i). Similarly, nothing in the final regulation precludes an investment manager from allocating a portion of a participant's assets to such a fund as part of a qualified default investment alternative within the meaning of paragraph (e)(4)(iii). It is also possible that a lifestyle fund, as defined by the commenter, might be able to constitute an investment within the meaning of paragraph (e)(4)(ii), an example of which is a "balanced" fund.

With respect to the language requiring that the investment fund, product or model portfolio provide varying degrees of long-term appreciation and capital preservation through "a mix of equity and fixed income exposures," one commenter inquired whether the Department intended to exclude funds that had no fixed income exposure, which, according to the commenter, might be appropriate for young

individuals many years away from retirement. While the Department believes that such an investment option may be appropriate for individuals actively electing to direct their own investments, the Department believes that when an investment is a default investment, the investment should provide for some level of capital preservation through fixed income investments. Accordingly, the final regulation, like the proposal, continues to require that the qualified default investment alternatives, defined in paragraph (e)(4)(i), (ii) and (iii), be designed to provide degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

The second investment alternative set forth in the regulation, at paragraph (e)(4)(ii), is an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and 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 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.

Although commenters generally supported inclusion of a balanced investment option as a qualified default investment alternative, a number of commenters had questions or expressed concern regarding the requirement that the investment alternative define its investment objectives by reference to "a target level of risk appropriate for participants of the plan as a whole." Commenters indicated that having to take into account the "participants of the plan as a whole" would result in uncertainty as to whether the plan sponsor properly matched the chosen fund to its participant population. In

addition, commenters asserted that the on-going monitoring necessary for the plan fiduciary to ensure the continued appropriateness of the match would likely result in unnecessary burdens and costs. One commenter explained that balanced funds as a group hold approximately 60–65% percent of their portfolios in equity investments,<sup>5</sup> and that the typical balanced fund would be somewhat more conservatively invested than most targeted-retirement-date funds; hence, the commenter argued that balanced funds are an appropriate default for all workers. The commenter further noted that periodic monitoring, while adding unnecessary costs, will likely never produce an impetus for changing to a different balanced fund option. After careful consideration of the comments, the Department has decided to retain the requirement that, for purposes of paragraph (e)(4)(ii), the selected qualified default investment alternative reflect “a target level of risk appropriate for participants of the plan as a whole.” The Department recognizes that, to the extent that a particular investment fund product or model portfolio does not itself consider or adjust its balance of fixed income and equity exposures to take into account a target level of risk appropriate for the participants of the plan as a whole, plan fiduciaries will retain that responsibility. The Department believes that, as a practical matter, this responsibility would be discharged by the fiduciary in connection with the prudent selection and monitoring of the investment fund product.<sup>6</sup> Specifically, fiduciaries would take into account the diversification of the portfolio, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to funding objectives of the plan, and the fees and expenses attendant to the investment.<sup>7</sup>

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, and would be similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction. A number of commenters asked the

Department to clarify the demographic factors that should be considered by the fiduciary. The Department understands that the only information a plan fiduciary may know about its participant population is age. Thus, when determining a target level of risk appropriate for participants of a plan as a whole, a plan fiduciary is required to consider the age of the participant population. However, a plan fiduciary is not foreclosed from considering other factors relevant to the participant population, if the fiduciary so chooses.

The third alternative set forth in the regulation, at paragraph (e)(4)(iii), 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.<sup>8</sup> 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. Similar to the first two alternatives, these portfolios must be structured in accordance with generally accepted investment theories and diversified so as to minimize the risk of large losses. The final regulation also clarifies 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.”

One commenter requested clarification that, with regard to a

<sup>8</sup> Although investment management services are included within the scope of relief, the Department notes that relief similar to that provided by this 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 the 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)(1) 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 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.

participant’s account holding employer securities with restrictions on transferability, the investment management service could serve as a qualified default investment alternative for purposes of all other assets in the participant’s account with respect to which the managed account has investment discretion. As discussed earlier, the mere fact that 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, will not preclude an investment management service from serving as a qualified default investment alternative. However, an investment management service will be considered to be serving as a qualified default investment alternative only with respect to the assets of a participant’s or beneficiary’s account over which the investment management service has authority to exercise discretion. If the investment management service does not have the authority to exercise discretion over investments in employer securities, the investment management service will not be a qualified default investment alternative with respect to those securities. See discussion of paragraph (e)(1)(ii) of § 2550.404c–5, above.

Another commenter expressed concern that requiring the manager of a managed account qualified default investment alternative to be an investment manager may prevent plan sponsors from using existing managed account programs, such as that addressed in Advisory Opinion 2001–09A (the “SunAmerica Opinion”). The Department believes these concerns are addressed by the modifications to paragraph (e)(3)(i)(C), pursuant to which plan sponsors who are named fiduciaries may manage qualified default investment alternatives.

Many commenters expressed concern that the Department did not include capital preservation, in particular stable value, products as qualified default investment alternatives on a stand alone basis. These commenters pointed out that stable value funds are utilized by a large number of plans as default investment funds. These funds are often chosen by plan sponsors because they provide: Safety of principal; bond-like returns without the volatility associated with bonds; stability and steady growth of principal and earned income; and benefit-responsive liquidity, so that plan participants may transact at “book value.” Commenters supporting stable value funds argued that stable value funds are superior to money market

<sup>5</sup> Investment Company Institute, Quarterly Supplementary Data for Quarter Ending June 30, 2006.

<sup>6</sup> See paragraph (b)(2) of 29 CFR 2550.404c–5.

<sup>7</sup> See 29 CFR 2550.404a–(b).

funds and other cash-equivalent products because stable value investments earn higher rates of return than money market funds and other cash-equivalent products. A number of these commenters also suggested that stable value funds are appropriate for plans with different demographics, including, for example, plans that cover younger, higher turnover employees who are likely to elect lump sum payments, or plans that cover older, near-retirement employees.

Commenters in support of the inclusion of stable value products also indicated that stable value funds have relatively low costs compared to life-cycle, targeted-retirement-date and balanced funds, particularly those that use a "fund of funds" structure. These commenters expressed the view that, because stable value returns are comparable to intermediate corporate bond returns, the premium, if any, of equity investments over stable value investments has been overstated. Many of the commenters argued that the exclusion of stable value funds would unduly discourage plan sponsors from using stable value funds as a default option, to the detriment of plan participants. These commenters argued that limiting default investment alternative choices discourages plans from implementing automatic enrollment. In addition, some commenters suggest that if participants whose account balances are invested in qualified default investment alternatives react negatively to volatile equity performance by opting out of plan participation when losses occur, the regulation may ultimately decrease retirement savings, and the potential gains expected from funds with higher historical long-term performance records will not materialize. Some of the comments supporting the inclusion of capital preservation products also argued that the Congress, in referencing "a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both" in section 624 of the Pension Protection Act, intended the Department to include capital preservation products as a separate stand alone qualified default investment alternative.

The Department also received comments in support of its determination that capital preservation products, such as money market funds, stable value funds and similarly performing investment vehicles, should not themselves constitute qualified default investment alternatives under the regulation.

After careful consideration of the comments addressing this issue and

assessment of related economic impacts, the Department has determined, except as otherwise discussed below, not to include capital preservation products, such as money market or stable value funds, as a separate long-term investment option under the regulation. As a short-term investment, money market or stable value funds may not, in the Department's view, significantly affect retirement savings. The Department recognizes, however, that such investments can, and in many instances will, play an important role as a component of a diversified portfolio that constitutes a qualified default investment alternative. It is the view of the Department that investments made on behalf of defaulted participants ought to and often will be long-term investments and that investment of defaulted participants' contributions and earnings in money market and stable value funds will not over the long-term produce rates of return as favorable as those generated by products, portfolios and services included as qualified default investment alternatives, thereby decreasing the likelihood that participants invested in capital preservation products will have adequate retirement savings.

The Department also is concerned that including capital preservation and stable value products as a qualified default investment alternative for future contributions on behalf of defaulted participants may impede, or even reverse, the current trend away from the use of such products as default investments. The Department understands that, because account balances invested in capital preservation products are unlikely to show a nominal loss, a number of employers, if given a choice between capital preservation products and more diversified investment options, may be more likely to opt for capital preservation products because they are perceived as presenting less litigation risk for employers. If so, inclusion of a capital preservation option without limitation may increase utilization of capital preservation products as default investments and, thereby, increase the number of participants likely to have inadequate retirement savings, as compared with savings that would be generated through investments in the established qualified default investment alternatives.

Lastly, the Department is concerned that inclusion of a capital preservation product as a qualified default investment alternative, without limitation, may be perceived by participants and beneficiaries as an endorsement by the government, by

virtue of its inclusion in the regulation, or as an endorsement by the employer, by virtue of its selection as the qualified default investment alternative, as an appropriate investment for long-term retirement savings. Although the Department recognizes that such perceptions on the part of some participants and beneficiaries might be addressed with investment education and investment advice, the Department nonetheless is concerned that, overall, the potentially adverse effect on long-term retirement savings may be significant.

In light of these concerns, the Department, as indicated above, has not included a capital preservation investment alternative as a long-term stand alone investment option for future contributions under the final regulation. The Department, however, has added two exceptions to the regulation that accommodate limited investments in capital preservation products as qualified default investment alternatives. The first exception is at paragraph (e)(4)(iv). In general, this exception treats investments in capital preservation products or funds as an investment in a qualified default investment alternative for a 120-day period following a participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code).

Specifically, paragraph (e)(4)(iv)(A) recognizes, subject to the limitations of paragraph (e)(4)(iv)(B), as a qualified default investment alternative an investment product that is designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, consistent with liquidity. The product description and applicable standards are similar to the standards adopted for purposes of automatic rollovers of mandatory distributions at 29 CFR 2550.404a-2. The Department believes it is appropriate to include capital preservation products as a limited-duration qualified default investment alternative to afford plan sponsors the flexibility of utilizing a near risk-free investment alternative for the investment of contributions during the period of time when employees are most likely to opt out of plan participation. The use of capital preservation products in these circumstances will enable plan sponsors to return contributed amounts to participants who opt out without concern about loss of principal. In this regard, the limitation set forth in paragraph (e)(4)(iv)(B) provides that capital preservation products described in paragraph (e)(4)(iv)(A) shall, with respect to any given participant, be treated as a qualified default investment

alternative for a 120-day period following the participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code). At the end of the 120-day period, capital preservation products would cease to be a qualified default investment alternative with respect to any assets of the participant that continue to be invested in such products. In order to avail itself of the relief afforded by the regulation, the plan fiduciary must redirect the participant's investment in the capital preservation product to another qualified default investment alternative prior to the end of the 120-day period. As previously stated, such alternative may include an appropriate capital preservation component in the context of a diversified portfolio.

The 120-day time frame is intended to provide plans that allow an employee to elect to make a permissible withdrawal, consistent with section 414(w) of the Code, a reasonable amount of time following the end of the 90-day period provided in section 414(w)(2)(B) (i.e., the period during which employees may elect to make a permissible withdrawal) to effectuate a transfer of a participant's assets to another qualified default investment alternative.

The second exception relating to capital preservation products and funds is at paragraph (e)(4)(v). This exception, unlike the first, is intended to be limited to stable value products and funds with respect to which plan sponsors are typically limited by the terms of the investment contracts from unilaterally reinvesting assets on behalf of participants who fail to give investment direction without triggering a surrender charge or other fees that could directly and adversely affect participant account balances. Under the exception, stable value products and funds will be treated as a qualified default investment alternative solely for purposes of investments in such products or funds made prior to the effective date of this regulation. The Department believes that this "grandfather"-type provision accommodates the concerns of commenters regarding the utilization of stable value products and funds by plan sponsors as their default investment option in the absence of guidance concerning fiduciary responsibilities attendant to default investments generally, guidance like that provided by this regulation. At the same time, by limiting the exception to pre-effective date contributions, plan sponsors are encouraged to assess whether and under what circumstances they wish to avail themselves of the relief provided under the regulation by utilizing a qualified default investment alternative that

extends to participant contributions made after the effective date of this regulation. It is important to note, however, that, as indicated in the regulation itself, the standards applicable to qualified default investment alternatives set forth in the regulation 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. Accordingly, fiduciaries may, without regard to this regulation, conclude that a stable value product or fund is an appropriate default investment for their employees and use such product or fund for contributions on behalf of defaulted employees after the effective date of this regulation.

It also is important to note with regard to both of the exceptions discussed above that the relief afforded by the regulation for investments in the covered products or funds on behalf of defaulted participants is contingent on compliance with all the requirements of the regulation.

Finally, the Department disagrees with commenters' assertion that the Department's decision not to include capital preservation products as a qualified default investment alternative is inconsistent with Congressional intent. The Department believes that Congress, in enacting section 624 of the Pension Protection Act, provided the Department broad discretion in framing a regulation that would permit the Department to include or exclude capital preservation products as a separate qualified default investment alternative. The Department also notes that, pursuant to section 505 of ERISA, the Secretary may prescribe such regulations as are necessary or appropriate to carry out the provisions title I of ERISA.

### C. Miscellaneous Issues

#### *Transition Issues*

A number of commenters raised issues concerning the status of existing default investments and transfers to default investments that would meet the requirements of the regulation. Specifically, commenters requested guidance on what steps should be taken to ensure that a plan's current default investments, which also meet the requirements of the regulation, will be treated as qualified default investment alternatives after the effective date of the regulation. Other commenters requested guidance on what steps should be taken when a plan is moving from default investments that do not meet the

requirements of the regulation to qualified default investment alternatives. In both scenarios, commenters noted that plans often will not have the records necessary to distinguish participants who were defaulted into a default investment from those who affirmatively elected to invest in that investment. Some commenters requested retroactive relief for investments that would not otherwise constitute qualified default investment alternatives because a plan's determination to transfer assets out of such investments could trigger a market value adjustment or similar withdrawal penalty.

To ensure that an existing or a new default investment constitutes a qualified default investment alternative with respect to both existing assets and new contributions of participants or beneficiaries, plan fiduciaries must comply with the notice requirements of the regulation. It is the view of the Department that any participant or beneficiary, following receipt of a notice in accordance with the requirements of this regulation, may be treated as failing to give investment direction for purposes of paragraph (c)(2) of § 2550.404c-5, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle of the plan. Under such circumstances, and assuming all other conditions of the regulation are satisfied, fiduciaries would obtain relief with respect to investments on behalf of those participants and beneficiaries in existing or new default investments that constitute qualified default investment alternatives.

Several commenters requested guidance on the effective date of the regulation. While section 404(c)(5) of ERISA is effective for plan years beginning after December 31, 2006, relief under section 404(c)(5) is conditioned on, among other things, the investment of a participant's contributions and earnings "in accordance with regulations issued by the Secretary." See section 404(c)(5)(A). Accordingly, relief under section 404(c)(5) is conditioned on compliance with the provisions of this final regulation, which provide relief only for investments on behalf of participants and beneficiaries who were furnished a notice in accordance with paragraphs (c)(3) and (d) of § 2550.404c-5 and who did not give investment directions to the plan after the effective date of the regulation. Although the regulation only provides relief for investments in qualified default investment alternatives when participants and beneficiaries do

not give investment directions after the effective date of the regulation, compliance with the notice requirements may be achieved by providing notice in accordance with the regulation before its effective date.

With regard to the possible assessment of market value adjustments or similar withdrawal penalties that may result from a fiduciary's decision to move assets to a qualified default investment alternative, the Department reminds fiduciaries that such decisions must be made in compliance with ERISA's prudence and exclusive purpose requirements. These decisions cannot be based solely on a fiduciary's desire to take advantage of the limited liability afforded by this regulation, without regard to the financial consequences to the plan's participants and beneficiaries. In this regard, the Department notes that the final regulation does not change the status of an otherwise prudent default investment into an imprudent default investment. The Department has attempted to make clear in both the preamble and the operative language of the final regulation that the standards set forth therein are not intended to be the exclusive means by which fiduciaries might satisfy their responsibilities under the Act with respect to the investment of assets on behalf of participants and beneficiaries who do not give investment directions.

Further, as discussed above under Qualified Default Investment Alternatives, the Department modified the regulation to provide relief for investments made in stable value products or funds prior to the effective date of the regulation. This modification is intended to assist plan fiduciaries who may be limited by the terms of investment contracts for such products or funds from unilaterally reinvesting assets on behalf of participants who fail to direct their investments.

One commenter requested that the Department make clear that once a participant or beneficiary directs any portion of his or her account balance, the participant or beneficiary is considered to have directed the investment of the entire account. The Department agrees that investment direction by a participant or beneficiary with respect to a portion of his or her account balance may be treated as a decision to retain the remainder of the account balance as currently invested, thus permitting the responsible fiduciary to consider the entire account balance as directed by the participant or beneficiary.

A number of commenters requested that the Department clarify the

interrelationship between ERISA section 404(c)(4)(A)—the “mapping” provisions—and section 404(c)(5) and this regulation. The most obvious difference between the two sections is the circumstances under which relief is available. The relief provided by section 404(c)(4) is limited to circumstances when a plan undertakes a “qualified change in investment options” within the meaning of section 404(c)(4)(B). In contrast, section 404(c)(5) and this regulation can apply to changes in investment options and to the selection of initial plan investments when participants or beneficiaries do not give investment directions. Section 404(c)(4) applies only when the investment option from which assets are being transferred was chosen by the participant or beneficiary (see section 404(c)(4)(C)(iii)). Section 404(c)(5), unlike 404(c)(4), can apply to the selection of an investment alternative by the plan fiduciary in the absence of any affirmative direction by the participant or beneficiary. While the fiduciary relief afforded by section 404(c)(4) and section 404(c)(5) is similar, relief under section 404(c)(4) requires that new investments be reasonably similar to the investments of the participant or beneficiary immediately before the change, whereas relief under section 404(c)(5) requires investment to be made in qualified default investment alternatives. In the context of changing investment options under the plan, ERISA sections 404(c)(4) and 404(c)(5) provide fiduciaries flexibility in implementing such changes.

#### *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. In the preamble to the proposed regulation, the Department specifically invited comment on whether, and to what extent, regulations would be helpful in addressing the preemption provision of section 514(e).

In response to the Department's invitation, commenters indicated that, while the application of the preemption provisions should be clarified, they did not believe it was necessary at this time for the Department to prescribe regulations establishing minimum standards for automatic contribution arrangements. Commenters also argued that ERISA preemption should extend to all prudent investments under an automatic contribution arrangement, not just those determined to be qualified default investment alternatives under the Department's regulation. In addition, commenters argued that preemption should not depend on compliance with all the requirements of the regulation under section 404(c)(5), noting that section 514(e) has an independent notice requirement. See section 514(e)(3).

In an effort to clarify the application of the preemption provisions of section 514(e), the final regulation includes a new paragraph (f). As set forth in the regulation, section 514(e) broadly preempts any State law that would restrict the use of an automatic contribution arrangement. After reviewing the text and purpose of section 514(e), the Department concluded that Congress intended to supersede the application of such laws to any pension plan that provides for an automatic contribution arrangement, regardless of whether such plan includes an automatic contribution arrangement as defined in the regulation. This conclusion is reflected in paragraph (f)(2) of the final regulation.

With the enactment of section 514(e), Congress intended to occupy the field with respect to automatic contribution arrangements.<sup>9</sup> Thus, section 514(e) of ERISA does not merely supersede State laws “insofar” as any particular plan complies with this final regulation, but rather generally supersedes any law “which would directly or indirectly

<sup>9</sup> This interpretation of section 514(e) is consistent with the Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, a document prepared by the staff of the Joint Committee on Taxation. That document states, on page 230: “The State preemption rules under the bill are not limited to arrangements that meet the requirements of a qualified enrollment feature.”

prohibit or restrict the inclusion in any plan of an automatic contribution arrangement." This language stands in marked contrast to the familiar language of section 514(a) of ERISA, which supersedes State laws only "insofar" as they satisfy the "relates to" standard set forth in that section.<sup>10</sup>

Additionally, Congress gave the Department discretion in section 514(e)(1) to determine whether and to what extent preemption should be conditioned on plan compliance with minimum standards, stating that "[t]he Secretary may prescribe regulations which would establish minimum standards that such an arrangement would be required to satisfy in order for this subsection [on preemption] to apply in the case of such arrangement."

Pursuant to this grant of discretionary authority, the Department has concluded, at this time, that it should not tie preemption to minimum standards for default investments. The Department, therefore, specifically provides in paragraph (f)(4) that nothing in the final regulation precludes a pension plan from including an automatic contribution arrangement that does not meet the conditions of paragraph (a) through (e) of the regulation. While relief under ERISA section 404(c)(5) is available only to plans that comply with the regulation, the Department has determined that it would be inappropriate to discourage plan fiduciaries from selecting default investments that are not identified in the regulation. State laws that hinder the use of any other default investments would be inconsistent with this determination, and with the discretionary authority Congress vested in the Department over the scope of ERISA preemption.

Finally, in an effort to eliminate the need for multiple notices by plan administrators of automatic contribution arrangements, paragraph (f)(3) of the final regulation specifically provides that the administrator of an automatic contribution arrangement within the meaning of paragraph (f)(1) shall be considered to have satisfied the notice requirements of section 514(e)(3) if notices are furnished in accordance with paragraphs (c)(3) and (d) of the regulation. Accordingly, satisfaction of the notice requirements under section 404(c)(5) and this regulation also will serve to satisfy the separate notice requirements set forth in section

514(e)(3) for automatic contribution arrangements.

#### *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 for each violation of section 514(e)(3) of ERISA. Implementing regulations will be developed in a separate rulemaking.

#### **D. Effective Date**

This final regulation will be effective 60 days after the date of its publication in the **Federal Register**.

#### **E. Regulatory Impact Analysis**

##### *Summary*

This regulation is expected to have two major economic consequences. Default investments will be directed more toward higher-return portfolios, boosting average investment returns, and automatic enrollment provisions will become more common, boosting participation. Both of these effects will increase average retirement savings, especially among workers who are younger, have lower earnings and/or more frequent job changes. A substantial number of individuals will enjoy significant increases in retirement income, while a few may experience decreases if the introduction of automatic enrollment slows their saving or if their default investment returns are particularly poor. The magnitude of these effects will be large in absolute terms and proportionately large for many directly affected individuals.

The regulation's effects will be cumulative and gradual, and their magnitude will depend on plan sponsor and participant choices. The Department has developed low- and high-impact estimates to illustrate a range of potential long-term effects.

By 2034 the regulation (together with the automatic enrollment provisions of the Pension Protection Act) is predicted to increase aggregate annual 401(k) plan contributions by between 2.6 percent and 5.1 percent, or by \$5.7 billion to \$11.3 billion (expressed in 2006 dollars). It is predicted to increase aggregate account balances by between 2.8 percent and 5.4 percent, or by \$70 billion to \$134 billion. Between 83 percent and 77 percent of net new 401(k) accumulations will be preserved for retirement rather than cashed out early.

Low-impact estimates indicate that the regulation will increase pension income by \$1.3 billion per year on aggregate for 1.6 million individuals age

65 and older in 2034, but decrease it by \$0.3 billion per year for 0.6 million. High-impact estimates suggest that pension income will increase by \$2.5 billion for 2.5 million and fall by \$0.6 billion for 0.9 million. Impacts on retirement income will be larger farther in the future, reflecting the fact that automatic enrollment and default investing disproportionately affect young workers.

A substantial portion of the increase in retirement savings will be attributable directly to the movement of default investments away from stand-alone, fixed income capital preservation vehicles and toward qualified default investment alternatives that provide for capital appreciation as well as capital preservation. The majority of the increase, however, will be attributable to the proliferation of automatic enrollment.

The Department believes that the net increase in retirement savings will translate into a net improvement in welfare. There is substantial risk that savings will fall short relative to many workers' retirement income expectations, especially in light of increasing health costs and stresses on defined benefit pension plans and the Social Security program. The regulation will help reduce that risk. An increase in retirement savings additionally is likely to promote investment and long-term economic productivity and growth. The Department therefore concludes that the benefits of this regulation will justify its costs.

##### *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). Section 3(f) of the Executive Order defines a "significant regulatory action" as 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

<sup>10</sup> Section 514(a) of ERISA provides, in pertinent part, that "the provisions of this title and title IV shall supersede any and all State laws *insofar* as they may now or hereafter relate to any employee benefit plan \* \* \*." Emphasis added.



mandates, the President's priorities, or the principles set forth in the Executive Order. 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 regulation. The Department believes that the regulation's benefits justify its costs.

#### *Regulatory Flexibility Act*

The Department certified that the proposed regulation, if adopted, would not have a significant economic impact on a substantial number of small entities. 71 FR 56806, 56815 (Sept. 27, 2006). In explaining the basis for this certification, the Department noted that 10 to 20 percent of small participant directed defined contribution plans (28,000 to 56,000 plans) might adopt automatic enrollment programs as a result of the regulation. Consequently, some of the employers sponsoring such plans may have to make additional matching contributions (up to \$100 million to \$300 million annually). The Department expects that the amount of such additional contributions to small plans would be proportionately similar to those to large plans. The Department did not expect the proposed regulation to have any adverse consequences for small plans or their sponsors because all the factors at issue, including the payment of matching contributions, the adoption of automatic enrollment programs, and compliance with the regulation are voluntary on the part of the plan sponsor.

The Department received one comment regarding the proposed regulation's potential effect on small entities. The commenter believes that certain types of mutual funds that would be qualified default investment alternatives under paragraph (e)(4)(i) (e.g., life-cycle or target-retirement date funds) sometimes invest in other types of mutual funds. According to the commenter, the investment advisers for the life-cycle or target-retirement-date funds may have an incentive to skew the fund's allocation toward sub funds that generate higher fees than to funds that would be most appropriate for the age or expected retirement date of the affected participants. The commenter stated that fiduciaries of small plans wishing to use the safe harbor would need to expend disproportionately more resources than large plan fiduciaries in making sure that the asset allocations (and thus, the corresponding fee structures) are not tainted by conflicts of interest. Specifically, the commenter was concerned that unlike larger plans

which could conduct analyses of the neutrality of asset allocations in-house, small plans would have to expend resources on using outside consultants to conduct such analyses or face potential liability for a failure to do so. The commenter mentioned that some funds are willing to indemnify fiduciaries of large plans from any liability associated with choosing such funds. The commenter suggested that the Department add measures to mitigate the likelihood of conflicts, such as requiring that such funds allocate assets pursuant to independent algorithms and require equal treatment for small plan fiduciaries with regard to indemnification.

Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not. This obligation flows from the fiduciary duties of prudence and loyalty to the participants set out in ERISA section 404(a)(1). The regulation imposes no new requirements for selecting qualified default investment alternatives. For large or small plans, the duty to evaluate a plan investment option exists regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary is seeking to comply with this regulation. Thus, the Department continues to believe that this regulation would not have a significant effect on a substantial number of small entities.

The Department considered the commenter's suggestions. Adopting them, however, could limit plans' choices or increase the cost of qualified default investment alternatives. The regulation does not prevent plan fiduciaries from taking features such as independent algorithms into account in choosing qualified default investment alternatives. If it determines that a widespread need for such assistance exists, the Department may consider providing guidance for small plans regarding prudent selection of qualified default investment alternatives.

The Department has also considered the changes made in this document from the proposed regulation. These changes, including the modified notice requirement, allowing trustees and certain plan sponsors to manage qualified default investment alternatives, and the addition of a temporary qualified default investment alternative are discussed more fully earlier in this document. They do not affect the Department's determination regarding the regulation's impact on small entities. Therefore, the

Department recertifies its earlier conclusion that this regulation will not have a significant economic impact on a substantial number of small entities.

#### *Paperwork Reduction Act*

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)), the proposed regulation solicited comments on the information collections included in the proposed regulation. The Department also submitted an information collection request (ICR) to OMB in accordance with 44 U.S.C. 3507(d), contemporaneously with the publication of the proposed regulation, for OMB's review.<sup>11</sup> Although no public comments were received that specifically addressed the paperwork burden analysis of the information collections, the comments that were submitted, and which are described earlier in this preamble, contained information relevant to the costs and administrative burdens attendant to the proposals. The Department took into account such public comments in connection with making changes to the proposal, analyzing the economic impact of the proposals, and developing the revised paperwork burden analysis summarized below.

In connection with publication of this final rule, the Department has submitted an ICR to OMB for its request of a new collection. The public is advised that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The Department intends to publish a notice announcing OMB's decision upon review of the Department's ICR.

A copy of the ICR may be obtained by contacting the PRA addressee shown below or at <http://www.RegInfo.gov>. PRA ADDRESSEE: Gerald B. Lindrew, 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) 219-4745. These are not toll-free numbers.

The regulation provides certain specified relief from fiduciary liability for fiduciaries who make investment decisions on behalf of participants and beneficiaries in individual account

<sup>11</sup> On Nov. 20, 2006, OMB issued a notice (ICR Reference No. 200608-1210-003) that it would not approve the Department's request for approval of the information collection provisions until after consideration of public comment on the proposed regulation and promulgation of a final rule, describing any changes.

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 or beneficiary 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 regulation requires that the assets of non-directing participants or beneficiaries be invested in one of the qualified default investment alternatives described in the regulation and that certain other specified conditions be met.

The regulation imposes two separate disclosure requirements to participants and beneficiaries that are conditions to the relief created by the final regulation, as follows: (1) The plan must provide an initial notice containing specified information to any individual whose assets may be invested in a qualified default investment alternative generally at least 30 days prior to the date of plan eligibility (or on or before the date of plan eligibility if the participant is permitted to make a withdrawal under Code section 414(w)) and thereafter annually at least 30 days before the beginning of each plan year; and (2) the plan must provide certain materials that it receives relating to participants' and beneficiaries' investments in a qualified default investment alternative. The "pass-through" materials that must be provided are those specified in the Department's regulation under ERISA section 404(c) at 29 CFR 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix) and 29 CFR 404c-1(b)(2)(i)(B)(2). The information collection provisions of this 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 on which the Department's burden analysis is based are derived primarily from the Form 5500 Series filings for the 2004 plan year, which are the most recent reliable data available to the Department.<sup>12</sup> 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 the initial and annual notices and that such communications will make use of existing systems. Accordingly, no cost has been attributed to the electronic distribution of information.

*Annual Notice—29 CFR 2550.404c-5(c)(3).* The regulation requires that notice be provided initially, before any portion of a participant's or beneficiary's account balance is invested in a qualified default investment alternative, and annually thereafter. The notice generally must describe: (1) The circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage); (2) the right of participants and beneficiaries to direct the investment of assets in their accounts; (3) the qualified default investment alternative, including its investment objectives, risk and return characteristics (if applicable), and fees and expenses; (4) the participants' and beneficiaries' right to direct the investment of the assets to any other investment alternative offered under the plan, including a description of any applicable restrictions, fees or expenses in connection with such a transfer; and (5) where participants and beneficiaries can obtain information about the other investment alternatives available under the plan.

The Department estimates that 424,000<sup>13</sup> participant directed individual account pension plans will prepare and distribute notices to 62,544,000 eligible workers, participants and beneficiaries in the first year in which this regulation becomes applicable. Preparation of the 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 212,000 burden hours. For the 62 percent of participants and beneficiaries who will receive the notice by mail (38,777,000 individuals), distribution of

the notice is estimated to require an additional 310,000 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 notice to the remaining 38 percent of participants and beneficiaries who will receive this notice electronically (23,767,000 individuals). The total annual burden hours estimated for the notice in the first year, therefore, are 522,000. The equivalent cost for this burden hour estimate is \$30,232,000 (legal professional time is valued at \$106 per hour, and clerical time is valued at \$25 per hour).<sup>14</sup>

In addition to burden hours, the Department has estimated annual costs attributable to the notice for the first year, based on materials and postage, at \$19,776,000. This comprises the material cost for a two-page notice (\$.10 per notice) to 38,777,000 participants and beneficiaries (62 percent of 62,544,000 participants and beneficiaries), which equals \$3,878,000, plus postage at \$0.41 per mailing, which equals \$15,899,000. Total annual costs for the notice in the first year are therefore estimated at \$19,776,000.

In years subsequent to the first year of applicability, the Department estimates that notices will be prepared only by newly established participant directed individual account pension plans and plans that change their choice of qualified default investment alternative. For purposes of burden analysis, the Department has assumed that one-third (1/3) of all participant directed individual account plans (141,000 plans) will prepare and distribute new or updated notices to all participants and beneficiaries, requiring 24 minutes of legal professional time per notice. The preparation of these notices in each subsequent year is estimated to require 57,000 hours. However, the number of participants receiving 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 notice by mail (38,777,000 individuals) will require 310,000 hours and \$19,776,000 additional materials and postage cost. (As for the first year, the Department has assumed that electronic distribution of the notice in subsequent years will not add any significant additional paperwork burden.)

Based on those assumptions, the Department estimates that the total

<sup>12</sup> The Department does not anticipate an increase in the number of Form 5500 filings merely due to the changes to the Form 5500 for 2007 to 2009.

<sup>13</sup> All numbers used in this paperwork burden estimate have been rounded to the nearest thousand.

<sup>14</sup> EBSA estimates based on the Bureau of Labor Statistics, National Occupational Employment Survey (May 2005) and the Bureau of Labor Statistics, Employment Cost Index (Sept. 2006).

burden hours for notices under this regulation in each year after the first year of applicability will fall to 367,000 hours. The equivalent cost of such an hour burden (using the same assumptions as for the first year) is \$13,749,000. The total cost burden estimated for subsequent years for the notice will remain at \$19,776,000.

*Pass-through Material—29 CFR 2550.404c-5(c)(4).* Under the regulation, the fiduciary shall qualify for the relief described in paragraph (b)(1) of the final regulation if a fiduciary provides material to participants and beneficiaries as set forth in paragraphs (b)(2)(i)(B)(1)(viii) and (ix), and paragraph (b)(2)(i)(B)(2) of the 404(c) regulation. In addition, plans must be prepared to provide certain information on request and must therefore maintain such information in updated form in order to comply. The paperwork burden for the pass-through disclosure requirements calculated here does not include pass-through disclosure burden for section 404(c) plans, as these disclosures for section 404(c) plans were considered in the renewal to OMB Control No. 1210-0090.<sup>15</sup>

The 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 (3,794,000 individuals) will have default investments. Of these, 1,072,000 individuals are invested in participant directed individual account pension plans that are not section 404(c) plans. 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 financial statements and prospectuses, and that plans will also receive other pass-through materials on occasion. These two factors result in an estimate of 4,286,000 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 107,000 hours of clerical time. The equivalent cost of this hour burden is estimated at \$2,679,000. 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 \$4,629,000 annually for 4 distributions per participant or beneficiary with a default investment.

Plans also need to maintain information in order to provide certain information on request. This preparation is estimated to require one hour of clerical time for each of the 162,000 newly affected plans, for a total of 162,000 burden hours. The Department assumes that, on average, plans will make one disclosure upon request every year and that it takes one-half minute of clerical time per disclosure to send out the materials, requiring about 4,000 hours of clerical time. In total, the preparation and sending of information upon request requires 166,000 burden hours with equivalent costs of \$4,145,000. Additional cost burden for the material is estimated to include paper cost (20 pages of material yearly per information request) and postage (\$.89 per mailing) at \$306,000.<sup>16</sup>

In total, the Department estimates that providing pass-through disclosures to non-directing participants and beneficiaries under this regulation will require annual burden hours of approximately 273,000 hours (with equivalent costs of \$6,824,000) and total costs of \$4,935,000.

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-AB10.

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

*Respondents:* 424,000.

*Responses:* 66,991,000.

*Frequency of Response:* Annually; occasionally.

*Estimated Total Annual Burden Hours:* 795,000 (first year).

*Estimated Total Annual Burden Cost:* \$24,711,000 (first year).

#### *Congressional Review Act*

This notice of final rulemaking is subject to the Congressional Review Act provisions of the Small Business

Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*) and therefore has been transmitted to the Congress and the Comptroller General for review.

#### *Unfunded Mandates Reform Act*

Pursuant to the 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, that may impose an annual burden of \$100 million or more, adjusted for inflation.

#### *Economic Impacts*

By 2034 the regulation (together with the automatic enrollment provisions of the Pension Protection Act) is predicted to increase aggregate account balances by between 2.8 percent and 5.4 percent, or by \$70 billion to \$134 billion.

#### *Investment Mix*

A large but declining proportion<sup>17</sup> of 401(k) plans currently direct default investments exclusively to fixed income capital preservation vehicles such as money market or stable value funds. By reducing risks attendant to fiduciary responsibility and liability, this regulation is expected to encourage more plans to direct default investments to vehicles that include a mix of equity and fixed income instruments and thereby provide the potential for capital appreciation as well as capital preservation.

As a result of this regulation, it is estimated that in 2034, 401(k) plan investments in qualified default investment alternative-type vehicles (expressed in 2006 dollars) will increase by between \$65 billion and \$116 billion. The portion of this estimated increase that is attributable directly to the redirection of default investments is between \$18 billion and \$24 billion. The rest is attributable to increased contributions, which are discussed below.<sup>18</sup>

<sup>17</sup> Various surveys estimate the proportion at 40 percent (Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 39), 41 percent (Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 7), and 21 percent (Vanguard, How America Saves 2006 (Sept. 2006) at 26). Surveys also reveal a trend away from capital preservation defaults toward investment vehicles like those included as qualified default investment alternatives for future contributions under this regulation.

<sup>18</sup> These estimates pertain only to default investments made on behalf of defaulted participants under automatic enrollment programs. The default investment regulation is not so limited. Therefore, these estimates are likely to omit some of the redirection of default investments that will occur under the regulation.

<sup>15</sup> See 71 FR 64564 (Nov. 2, 2006). The paperwork burden as calculated for section 404(c) plans assumes that plans send pass-through disclosures to all participants and beneficiaries in section 404(c) plans, not only to the ones that are actively directing their investments.

<sup>16</sup> The burden arising from these disclosure requirements will be the same in subsequent years.

## Investment Performance

Historically, over long time horizons, diversified portfolios that include equities have tended to deliver higher returns than those consisting only of lower risk debt instruments.<sup>19</sup> It therefore is widely believed to be advantageous to invest retirement savings in diversified portfolios that include equity.<sup>20</sup>

As noted above, this regulation is expected to encourage the redirection of default investments from stand-alone, low-risk capital preservation instruments to diversified portfolios that include equities. This in turn is expected to improve investment results for a large majority of affected individuals, increasing aggregate account balances by an estimated \$5 billion to \$7 billion in 2034.

In deriving these estimates, in response to public and peer reviewer comments, the Department refined its assumptions regarding investment performance relative to those relied on in its estimates of the proposed regulation's effects. This is explained further below under headings "Basis of Estimates" and "Peer Review."

## 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,<sup>21</sup> but the number may now be as high as 24 percent<sup>22</sup> and could reach 35 percent in the near future, absent this final rule.<sup>23</sup>

<sup>19</sup> See, e.g., Ibbotson Associates, *Stocks, Bonds, Bills and Inflation, 2006 Yearbook* (2006).

<sup>20</sup> See, e.g., U.S. Securities and Exchange Commission, *Beginners' Guide to Asset Allocation, Diversification, and Rebalancing* (May 2007), at <http://www.sec.gov/investor/pubs/assetallocation.htm>; and Stephen P. Utkus, *Selecting a Default Fund for a Defined Contribution Plan*, Vanguard Center for Retirement Research, Volume 14 (June 2005) at 6.

<sup>21</sup> U.S. Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002–2003*, Bulletin 2573 (Jan. 2005).

<sup>22</sup> EBSA estimate. The proportion of plans in various size classes that provide automatic enrollment was taken from Profit Sharing/401(k) Council of America, *49th Annual Survey of Profit Sharing and 401(k) Plans* (2006) at 38. 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.

<sup>23</sup> The incidence of automatic enrollment appears to be growing. According to one series of surveys automatic enrollment spread from 8.4 percent of plans in 2003 to 16.9 percent in 2005 (Profit Sharing/401(k) Council of America, *49th Annual Survey of Profit Sharing and 401(k) Plans* (2006) at

The Department expects and intends that this regulation, together with the automatic enrollment provisions of the Pension Protection Act, will promote wider implementation of automatic enrollment programs. The regulation will help alleviate fiduciary concerns that might otherwise discourage implementation of automatic enrollment programs. It will also make it possible for plan sponsors to take advantage of Pension Protection Act provisions that waive certain Internal Revenue Code bars against discrimination in favor of highly compensated employees and that preempt state laws unfriendly to automatic enrollment programs. As a result of the regulation, in the near future automatic enrollment programs may cover 50 percent to 65 percent of 401(k)-eligible workers rather than 35 percent.<sup>24</sup>

## Participation

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.<sup>25</sup> Automatic enrollment

38). Another found that automatic enrollment spread from 15 percent of plans in 2003 to 23 percent in 2005 with an additional 29 percent considering it for the future (Deloitte Consulting, *2003 Annual 401(k) Benchmarking Survey* (2004) at 25 and Deloitte Consulting, *Annual 401(k) Benchmarking Survey 2005/2006 Edition* (2006) at 7). According to yet another, it grew from 14 percent in 2003 to 24 percent in 2006, with 23 percent of the remainder "very likely" and 25 percent "somewhat likely" to begin automatic enrollment within the year (Hewitt Associates LLC, *Survey Findings: Trends and Experiences in 401(k) Plans, 2005* (2005) at 13, and Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement, 2006* (2006) at 3).

<sup>24</sup> The Department believes these figures reasonably illustrate a range of possible outcomes. The Department is confident that the regulation will increase the incidence of automatic enrollment. According to one survey, among plans that currently are somewhat or very unlikely to offer automatic enrollment in the future, 36 percent cite the need for the Department to identify appropriate default investments, 33 percent cite the need for preemption of unfriendly state laws, and 30 percent cite the need for relief from nondiscrimination requirements (Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement, 2006* (2006) at 5).

<sup>25</sup> According to the Department's low- and high-impact estimates (respectively), under the regulation, active (non-defaulted) participants will number between 32 million and 33 million in 2034. Their ages will average between 44.2 and 44.1 years, and their pay will average between 160 percent and 158 percent of average earnings calculated by the Social Security Administration.

programs increase many such employees' contribution rates from zero to the default rate, often supplemented by some employer matching contributions. 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. However, there is also evidence that automatic enrollment programs can have the effect of lowering contribution rates for some employees below the level that they would have elected absent automatic enrollment. Current surveys indicate that the default contribution rates are typically set at 3 percent of salary.<sup>26</sup> Some employees who might otherwise have actively enrolled in a plan (either at first eligibility or later) and elected a higher contribution rate may instead permit themselves to be enrolled at the default rate.<sup>27</sup>

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 regulation will increase overall 401(k) participation rates from 73 percent to between 77 percent and 80 percent.<sup>28</sup> Aggregate annual contributions in 2034 are expected to grow on net by between \$5.7 billion and \$11.3 billion (expressed in 2006 dollars). These and related estimates are summarized in Table 1 below.

Defaulted participants will number between 4.2 million and 5.4 million. In contrast to active participants, their ages will average between 34.0 and 34.1 years, and their pay will average between 109 percent and 108 percent of average pay in Social Security covered employment.

<sup>26</sup> It is possible that in the future more plans will provide for higher or escalating default contribution rates. The Pension Protection Act waives certain bars against discrimination in favor of highly compensated employees for 401(k) plans with automatic enrollment that satisfy certain conditions. One such condition generally provides that a participant's default contribution rate must escalate to at least 6 percent not later than his fourth year of participation.

<sup>27</sup> See, e.g., James J. Choi, David Laibson, Brigitte C. Madrian and Andrew Metrick, *Saving for Retirement on the Path of Least Resistance* (updated draft analysis, July 19, 2004) at 56–57, Figures 2A–2D; and James J. Choi, David Laibson and Brigitte C. Madrian, *Plan Design and 401(k) Savings Outcomes* (written for the National Tax Journal Forum on Pensions, June 2004) at 11.

<sup>28</sup> These numbers are rounded to the nearest percentage point.

**Table 1: Estimated Effect of Regulation on 401(k) Participation and Contributions in 2034**  
(Dollar amounts expressed in billions of 2006 dollars)

	Low Impact	High Impact
Percentage point increase in participation rate of 401(k)-eligible employees	4%	8%
Added annual contributions	\$8.9	\$17.4
Discouraged annual contributions	\$3.2	\$6.0
Net additional contributions	\$5.7	\$11.3
Increase in aggregate account balances	\$70	\$134

#### Preservation

New employee contributions attributable to automatic enrollment will be attributable disproportionately to younger, lower-paid, shorter-tenure workers.

Some such workers, who absent automatic enrollment would have delayed participation, will begin contributing earlier and thereby accumulate larger balances. The investment of these contributions in qualified default investment alternatives, rather than in capital preservation vehicles, will further enlarge account balances on average. Larger balances are more likely to be preserved for retirement. Therefore it is possible that the regulation will increase the proportion of 401(k) accounts that are preserved.<sup>29</sup>

On the other hand, other such workers may accumulate only small accounts before leaving their jobs. Historically, younger, lower-paid workers with small accounts have tended disproportionately to cash out their accounts upon job change rather

than preserve them in tax-deferred retirement accounts. It is therefore also possible that, by encouraging automatic enrollment, the proportion (but not the total amount) of 401(k) accounts preserved for retirement could decrease.

The Department estimates that these effects will nearly offset one another. Workers will leave an estimated 4.3 million 401(k)-eligible jobs in 2033. As a result of this regulation (together with the automatic enrollment provisions of the Pension Protection Act), the number leaving with positive account balances will grow from 2.30 million to between 2.45 million and 2.61 million. The proportion of those leaving with positive accounts that preserve their accounts for retirement will fall slightly from 61.0 percent to between 60.4 percent and 59.7 percent, and the proportion of the account balances preserved will fall from 85.9 percent to between 85.8 percent and 85.4 percent. The regulation's marginal effect on the preservation of account balances can be illustrated by comparing estimated net increases in account-holding job leavers

and their account balances with estimated net increases in preserved accounts. The proportion of net new job leavers with account balances that preserve their accounts is estimated to be approximately 50 percent, while the proportion of net new job-leaver accounts that is preserved is estimated to be 83 percent to 77 percent.

#### Retirement Income

Low-impact estimates suggest that the regulation will increase pension income by \$1.3 billion per year on aggregate for 1.6 million individuals age 65 and older in 2034 (expressed in 2006 dollars), but decrease it by \$0.3 billion per year for 0.6 million. High-impact estimates suggest that average annual pension income will increase by \$2.5 billion for 2.5 million and fall by \$0.6 billion for 0.9 million. These estimates are summarized in Table 2 below. Impacts on retirement income will be larger farther in the future, reflecting the fact that automatic enrollment and default investing disproportionately affect young workers.

<sup>29</sup> There will be other, smaller effects. Because larger accounts are more likely to be preserved, any effect of the regulation on account balances may also affect the preservation rate. As noted below, while automatic enrollment increases contributions

for many workers, it may decrease them for a few. Likewise, while movement from capital preservation investments to qualified default investment alternatives will boost investment returns for many, it may reduce returns for a few.

All of these effects in turn affect account balances and preservation rates. The Department's estimates account for all of these effects.

**Table 2: Effect of Regulation on Annual Pension Income of Individuals Age 65+ in 2034 (Expressed in 2006 Dollars)**

Career Pay Quartile	Number with Gains (000s)	Aggregate Gain (\$Millions)	Number with Losses (000s)	Aggregate Loss (\$Millions)
<b>Low Impact</b>				
All	1,594	\$1,330	589	\$328
Q1	285	\$111	100	\$18
Q2	390	\$226	142	\$52
Q3	434	\$343	164	\$84
Q4	485	\$650	183	\$174
<b>High Impact</b>				
All	2,541	\$2,465	856	\$637
Q1	457	\$206	145	\$41
Q2	635	\$451	206	\$97
Q3	686	\$611	240	\$163
Q4	763	\$1,198	265	\$336

The regulation is estimated to have distributional consequences, narrowing somewhat the distribution of pension income across earnings groups. Among all individuals age 65 or older in 2034,

for example, those in the lowest lifetime earnings quartile would receive just 5 percent of pension income absent the regulation, but they will receive 9 percent of net gains from the regulation.

The amount they gain will exceed the amount lost by a factor of five or six (see Table 3 below).

**Table 3: Distributional Effect of Regulation on Annual Pension Income of Individuals Age 65+ in 2034 (Expressed in 2006 Dollars)**

Career Pay Quartile	Low Impact				High Impact			
	Pension Income Shares		Gain/Loss Ratios		Pension Income Shares		Gain/Loss Ratios	
	Base-line	Net Gain	#	\$	Base-line	Net Gain	#	\$
Q1	5%	9%	2.8	6.1	5%	9%	3.2	5.1
Q2	12%	17%	2.8	4.3	12%	19%	3.1	4.6
Q3	23%	26%	2.6	4.1	23%	24%	2.9	3.7
Q4	60%	48%	2.7	3.7	60%	47%	2.9	3.6

**Administrative Cost**

Plan sponsors may incur some administrative costs in order to meet the conditions of the regulation. The Department generally expects such costs to be low. Any changes to plan provisions or procedures necessary to satisfy the regulation's conditions are likely to be no more extensive than those associated with changes that plans implement from time to time in the normal course of business. The boundaries of the 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 safe harbor. Costs attendant to the regulation's notice provisions can be mitigated by furnishing the notices together with other plan disclosures and/or through the use of electronic media. The requirement to pass through certain investment materials to participants and beneficiaries is the same as that already applicable to

participant directed individual account plans operating in accordance with ERISA section 404(c). The Department's estimates of these costs are presented above under the heading Paperwork Reduction Act.

The regulation may indirectly prompt some plan sponsors to shoulder additional benefit costs. For example, it is expected that the regulation, by promoting the adoption of automatic enrollment programs, will have the indirect effect of increasing aggregate employer matching contributions in 2034 by between \$1.7 billion and \$3.4

billion (expressed in 2006 dollars). 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. Reliance on the regulation and, therefore, compliance with its provisions are also voluntary on the part of the plan sponsor.

#### Cost-Benefit Assessment

The Department believes that, by increasing average retirement income, the regulation will improve overall social welfare. There is mounting concern that many Americans have been preparing inadequately for retirement. Most workers are on track to have more retirement wealth than most current retirees, and recent declines in reported savings rates may not be cause for alarm in light of offsetting capital gains. Nonetheless, savings may fall short relative to workers' retirement income expectations, especially in light of increasing health costs and stresses on defined benefit pension plans and the Social Security program.<sup>30</sup> Because of these real risks, the Department believes that policies that increase retirement savings can increase welfare by helping workers secure retirement living standards that meet their expectations.

The regulation may also have macroeconomic consequences, which are likely to be small but positive. An increase in retirement savings is likely to promote investment and long-term economic productivity and growth. The increase in retirement savings will be very small relative to overall market capitalization. Therefore macroeconomic benefits are likely to be small. Based on the foregoing analysis and estimates, the Department believes that the benefits of this regulation will justify its costs.

#### Basis of Estimates

The Department estimated the effect of the regulation on 401(k) plan participation, contributions, account balances, investment mix, and early cash outs, and its effect on pension incomes in retirement, using a microsimulation model of lifetime pension accumulations known as PENSIM.<sup>31</sup> To produce the low and high

impact estimates presented here, PENSIM was parameterized and applied as follows.

First, automatic enrollment was assigned randomly to 401(k) plan eligible employees to achieve incidences of 35 percent (baseline), 50 percent (low impact) and 65 percent. 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.<sup>32</sup> The default contribution rate was assumed to be 3 percent, which surveys indicate is the most common rate currently in use.<sup>33</sup>

Defaulted participants were assumed to invest their contributions as follows:<sup>34</sup> in the baseline estimates, either in a money market fund<sup>35</sup> (50

generations contained in U.S. Government Accountability Office, Retirement Income: Intergenerational Comparisons of Wealth and Future Income, GAO-03-429 (Apr. 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, Pension Plans: Information on Cash Balance Pension Plans, GAO-06-42 (Oct. 2006).

<sup>32</sup> These findings were drawn from James J. Choi, David Laibson and Brigitte C. Madrian, Plan Design and 401(k) Savings Outcomes (written for the National Tax Journal Forum on Pensions, June 2004). The overall participation rate under automatic enrollment was adjusted upward to 90 percent.

<sup>33</sup> See e.g., Vanguard, How America Saves 2006 (Sept. 2006) at 26, Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 7; Hewitt Associates LLC, Survey Findings: Trends and Experiences in 401(k) Plans, 2005 (2005) at 16; and Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 38.

<sup>34</sup> These estimates assume complete correspondence between automatic enrollment in 401(k) plans and default investing. Participants contributing by automatic enrollment are assumed to invest in the plan's default investment, 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 who are automatically enrolled may nonetheless actively direct their investments. Some active contributors or participants in plans without elective contributions may choose to invest in the plan's default investment " and this 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 automatic enrollment.

<sup>35</sup> Some comments on the proposed regulation suggested that money market funds may not accurately represent the range of capital preservation instruments that might serve as default investments. In particular, according to some comments, stable value funds, relative to money market funds, offer higher returns with similarly low risk. The Department's estimates of the effects of the proposed regulation did not reflect this possibility. The Department agrees that stable value funds, if they perform as projected by their proponents, would outperform money market funds and thereby narrow (but not eliminate) the gains in average account balances and retirement income estimated to result from the shift toward qualified

percent) or a qualified default investment alternative (50 percent); in the low- and high-impact estimates of the regulation's effects, all entirely to a qualified default investment alternative.<sup>36</sup> Active contributors were assumed to invest their contributions either in a qualified default investment alternative (75 percent), a U.S. Treasury bond fund (15 percent), or an even mix of the two (10 percent). Some employer contributions were assumed to be invested in company stock. Price inflation and real returns were estimated stochastically. Mean price inflation was assumed to be 2.8 percent, and mean real returns to money market funds, Treasury bond funds, and equity funds, respectively, were assumed to be 1.3 percent, 2.9 percent, and 4.9 percent. Deducted respectively from

default investment alternatives. However, the Department believes that this possibility should be assessed with caution. Economic theory suggests that if financial markets are efficient, financial instruments with similar risk characteristics will provide similar returns. It therefore seems likely that there are important differences between money market and stable value funds beyond any difference in average returns. The Department understands that stable value products may come with a variety of features that may sometimes erode actual returns in response, for example, to certain plan sponsor actions that have the effect of shifting participant account allocations away from such products. Such stable value product features may sometimes dissuade plans or participants from making investment changes that they otherwise would, thereby imposing opportunity costs. The Department also understands that stable value products may expose investors to the credit risk of the fund vendor in ways that money market funds do not. This credit risk may be sensitive to changes in interest rates. In light of these considerations the Department continues to believe that, for purposes of assessing the impact of this regulation, money market funds reasonably represent available near risk-free investment instruments.

Nonetheless, in an effort to fully consider the potential implications of representations made in the comments, the Department tested the sensitivity of its low-impact estimates to representations regarding the investment performance of stable value products and assuming stable value products would be a substantial part of qualified default investments in the future. The sensitivity test puts aside the above considerations, and replaces money market fund performance with stylized stable value performance that is 200 basis points higher and equally variable. Under this test scenario, the regulation would increase aggregate account balances in 2034 by \$68 billion (for comparison the Department's primary estimate is \$70 billion), of which \$3 billion (compared with \$5 billion) is attributable to the shift of default investments from near risk-free instruments to qualified default investment alternatives. Among individuals age 65 and older in 2034, the number gaining retirement income would exceed the number losing by a ratio of 2.2 to 1 (compared with 2.7 to 1) and the aggregate amount gained would exceed that lost by a ratio of 3.8 to 1 (compared with 4.1 to 1).

<sup>36</sup> The qualified default investment alternative is represented by a portfolio resembling a life cycle fund, with 100 percent minus the participant's age in equity and the remainder in U.S. Treasury bonds.

<sup>30</sup> See generally U.S. Council of Economic Advisors, Economic Report of the President, February 2006 (2006).

<sup>31</sup> 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



these returns were assumed fees of 45, 45 and 75 basis points.

To estimate the effects of the regulation, the Department compared the baseline estimates to the low- and high-impact estimates.

For a more detailed explanation of the basis of these estimates, see Martin R. Holmer, "PENSIM Analysis of Impact of Final Regulation on Defined—Contribution Default Investments" (Policy Simulation Group, February 12, 2007). For additional estimation results, see Holmer, "EBSA Automatic Enrollment RIA: Final Estimates" (Policy Simulation Group, February 7, 2007). Both are available as part of the public docket associated with this regulation. Additional information on the Department's use of PENSIM in connection with this regulation is provided below, under the heading "Peer Review."

#### *Sensitivity Tests*

As noted above, the Department anticipates that this regulation (together with the automatic enrollment provisions of the Pension Protection Act) will have two major, beneficial 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. In reaching its conclusion that the regulation will increase retirement income and improve social welfare, the Department took into account the potential sensitivity of its estimates to important economic and behavioral variables.

One variable involves the future incidence of automatic enrollment programs. As noted above the Department assessed this variable by comparing both low- and high-impact estimates with a common baseline. This variable affects the magnitude but not the net positive direction of the regulation's estimated effects.

The specific characteristics of future automatic enrollment programs constitute additional variables. For example, will new automatic enrollment programs cover only new employees, or existing non-participating employees as well?<sup>37</sup> The Department's estimates reflect automatic enrollment of new employees only. If plan sponsors automatically enroll existing employees the regulation's effects will be larger

<sup>37</sup> According to one survey, 24 percent of employers with automatic enrollment programs extended initial automatic enrollment beyond new hires to include the entire eligible population (Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 8).

than estimated, especially in the near term. What default contribution rates will prevail?<sup>38</sup> The Department's primary estimates assume a uniform 3 percent default contribution rate. Higher contribution rates would increase the size of default participants' contributions, but might also discourage some from participating. To illustrate these potential effects the Department produced two alternative low-impact estimates substituting a 4.5-percent default contribution rate. One estimate assumed that the impact of automatic enrollment on participation was undiminished by the higher default contribution rate, the other that it was diminished by half. These were compared with the primary baseline estimate. Where the Department's primary low-impact estimate placed the increase in aggregate account balances in 2034 at \$70 billion, the first alternative placed it at \$123 billion, the second at \$40 billion.

Additional variables concern what other changes plan sponsors might make to their plans. Plan sponsors implementing qualified default investment alternatives may make other changes to investment options or undertake new efforts to inform or influence participants' investment decisions. Plan sponsors that maintain or begin automatic enrollment programs may change other provisions of their plans, such as matching contribution formulas, eligibility or vesting provisions, loan programs, or distribution policies. Changes such as these could either augment or offset the effects of this regulation.

The investment advice and automatic enrollment provisions of the Pension Protection Act will promote activities and plan designs that are likely to augment the regulation's positive effects on retirement savings. Those provisions will help make investment advice available to more participants and will promote automatic enrollment programs with escalating default contribution rates, generous employer matching contributions and short vesting periods.

Default participants may make other changes in their savings behavior. Default participation might foster

<sup>38</sup> According to one survey, 14 percent of plans with automatic enrollment provided for escalating default contributions in 2005, up from 7 percent in 2004 (Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 39). According to another, among the 24 percent of surveyed employers offering automatic enrollment in 2006, 17 percent planned to introduce escalating default contributions and 6 percent intended to increase the default contribution rate; none planned to lower it (Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement, 2006 (2006) at 4).

financial literacy or a taste for saving, which could augment the regulation's effect. Alternatively, default participants might offset their default savings by reducing other savings or taking on debt. In particular, they may be less likely than active participants to preserve their accounts for retirement when leaving a job.<sup>39</sup> To assess the implications of this possibility the Department produced alternative baseline and low-impact estimates, which assume that participants who leave their jobs while in default status never preserve their accounts. (Default participants who become active participants before leaving their jobs are assumed to preserve their accounts at the same rate as other active participants.) The alternative estimates represent a worst case outer bound. As noted above, comparing its primary baseline and low-impact estimates, the Department found that in 2033, 50 percent of net new job leavers with account balances preserve 83 percent of all net new job-leaver account balances. Comparing the respective alternative estimates, the Department found that the corresponding figures are 25 percent and 72 percent. Based on the Department's primary baseline and low-impact estimates, the regulation is expected to reduce the proportion of account holding job leavers that preserve their accounts from 61.0 percent to 60.4 percent and the proportion of their accounts that is preserved from 85.9 percent to 85.8 percent. Based on the alternative estimates, the corresponding reductions are from 56.9 percent to 54.7 percent and from 85.3 percent to 84.9 percent. Both the primary and alternative estimates strongly suggest that most new retirement saving resulting from this regulation (together with the automatic enrollment provisions of the Pension

<sup>39</sup> A number of factors may diminish this possibility. First, participants who contribute and invest by default may also tend to handle account distribution opportunities by default. Laws governing plans' default distribution provisions provide for the preservation of all but the smallest accounts. Absent participant direction to the contrary, accounts of \$5,000 or more must remain in the plan, and smaller accounts of \$1,000 or more must either remain in the plan or be rolled directly into an IRA. Second, some 401(k) plan sponsors reserve eligibility and automatic enrollment for employees who complete a specified period of service, such as one year. It is possible that sponsors with higher-turnover work forces and/or those offering automatic enrollment are or will be more likely to provide for such waiting periods for eligibility, perhaps in order to avoid the expense of churning very small accounts. Third, it is possible that the small fraction of employees who decline automatic enrollment (perhaps 10 percent) may be largely the same ones who would decline to preserve their accounts. In that case, participants added by automatic enrollment might be more likely to preserve them.

Protection Act) will be preserved for retirement. While one effect of the regulation will be to create many very small and short-lived accounts that participants never actively manage and may be unlikely to preserve, the Department expects that the larger effect will be to spur new, early default contributions by participants who later actively manage their accounts and are likely to preserve them.

The regulation may encourage active (in addition to default) investments in qualified default investment alternatives—a phenomenon sometimes referred to as an endorsement effect. If so, the impact of the regulation on asset allocation, and the attendant net positive effect on account balances and retirement income, will be amplified.<sup>40</sup>

<sup>40</sup> There is some evidence to suggest that qualified default investment alternatives, once established as plan defaults, may claim a disproportionate share of active investments as well. There is some evidence that participants may gravitate toward investment options that appear to be endorsed by their employers, such as by responding to employers' directing of matching contributions into company stock by investing more participant-directed funds in company stock as well (see, e.g., Jeffrey R. Brown, Nellie Liang and Scott Weisbenner, *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans*, (Sept. 2006) at 18). This paper summarizes some prior evidence and provides some new evidence of this effect, but also raises the possibility that this effect may be attributable instead to other factors. Participants have been found to exhibit inertia in their investment choices, being slow to rebalance or to respond to changes in the investment options offered to them (see, e.g., Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi, *The Inattentive Participant: Portfolio Trading Behavior in 401(k) Plans*, Pension Research Council Working Paper 2006-5 (2006) at 16, which finds a lack of rebalancing; see also Jeffrey R. Brown and Scott Weisbenner, *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans* (Dec. 2004) at 23, 37, Tables 8a, 8b, which finds inertia in participant response to the addition of new funds). Most on point, some early experience with automatic enrollment programs suggests that a previously available investment alternative, once established as a default in an automatic enrollment program, may attract an increased proportion of actively directed participant accounts (see, e.g., John Beshears, James J. Choi, David Laibson and Brigitte C. Madrian, *The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States*, National Bureau of Economic Research Working Paper 12009 (Jan. 2006), which provides some evidence of such an endorsement effect; see also Fidelity Investments, *Building Futures Volume VII: How Workplace Savings are Shaping the Future of Retirement*, (2006) at 124-138, for data on the concentration of participant accounts in default investment alternatives). To assess the potential implications of an endorsement effect for the impact of this regulation, the Department carried out a sensitivity test of its low-impact estimates of the regulation's effects. Where the Department's primary estimates take into account the default investment of defaulted participants' accounts only (no endorsement effect), the sensitivity test additionally assumes that 20 percent of actively directed accounts in plans with automatic enrollment will be directed to default investment

Because the regulation's effects will be cumulative and gradual, they will be fully realized only in the very long run, generally when workers beginning careers today have long since retired. This long time horizon introduces additional, longer-term variables, but most of these implicate less the regulation's effects than the baseline. For example, future investment results may vary.<sup>41</sup> Other variables, which the Department did not attempt to quantify, include future career patterns and compensation levels and mixes.

#### Peer Review

OMB's "Final Information Quality Bulletin for Peer Review" (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 estimate the effects of this regulation and the proposed regulation constitute a "highly influential scientific assessment" under the Bulletin. Pursuant to the Bulletin, the Department therefore subjected this assessment to peer review. All materials associated with that review, including the Department's full response to the peer review, are available to the public as part of the docket associated with this regulation.<sup>42</sup>

The analysis presented here has been refined in several ways in response to the peer review.

The review questioned whether default participants would cash out their accounts rather than preserve them for retirement. The Department's primary estimates assume that default accounts will be cashed out or preserved at the same rates as other similarly-sized accounts.<sup>43</sup> The results,

alternatives (20 percent endorsement effect). Compared with the primary estimates, the sensitivity test indicates that regulation will increase aggregate account balances in 2034, expressed in 2006 dollars, by \$87 billion (rather than \$70 billion), of which \$26 billion (rather than \$5 billion) will be directly attributable to the allocation of more assets to qualified default investment alternatives (the rest will be attributable to growth in automatic enrollment).

<sup>41</sup> The Department's estimates illustrate some of this as variation in results across individuals.

<sup>42</sup> Please see <http://www.dol.gov/ebsa/regs/peerreview.html>.

<sup>43</sup> The Department's estimate of the effect of the proposed regulation assigned uniform cash out probabilities (derived from an industry survey) to accounts within certain arbitrary size categories. For example, all accounts smaller than approximately \$11,000 (expressed at 2005 levels) were assigned the same cash out probability. This may have understated the propensity to cash out

as reported above, suggest that balances attributable to new default contributions will be nearly as likely as other balances to be preserved. It is possible, however, that default participants will be less likely to preserve their accounts than active participants with similar-sized accounts. The Department therefore prepared alternative estimates that account for this possibility. The results appear under the heading "Sensitivity Testing" above.

The review questioned whether lower-paid workers might be more risk averse and might therefore be susceptible to welfare losses if their default investments are redirected from capital preservation vehicles to qualified default investment alternatives. In response the Department more closely examined the regulation's impact on lower-paid workers, finding disproportionate gains in pension income, as described above. These gains may help offset any welfare losses due to sub-optimal risk exposure. In addition, the Department believes the required notice to participants regarding default investments will facilitate the ability of workers to easily choose to actively change their risk exposure if the qualified default investment alternatives do not meet their risk preferences.

The reviews questioned the Department's assumptions regarding investment returns, saying they exaggerated the equity premium, neglected fees, and neglected variation in inflation and returns to debt instruments. In response the Department has moderated its assumption regarding the equity premium,<sup>44</sup> accounted for fees, and incorporated stochastic variation in inflation and debt returns.

#### Alternatives Considered

##### Capital Preservation Products

In defining the types of investment products, portfolios or services that may be used as a long-term qualified default investment alternative, the Department, after careful consideration of the many comments supporting capital preservation products, and assessment of related economic impacts, determined not to include capital

very small accounts. The Department has since refined its estimation of cash out probabilities. These probabilities are now estimated as a continuous function of account size, based on household survey data.

<sup>44</sup> In its estimates of the effects of the proposed regulation the Department had assumed a real average equity return of 6.5 percent, which was consistent with long-term historical performance. The estimates presented here assume a real average return of 4.9 percent, which is more in line with recent performance and commenters' expectations of the future.

preservation products, such as money market or stable value funds, as a stand-alone long-term investment option for contributions made after the effective date of this regulation. However, the Department believes that such investments can play an important role as a component of a qualified default investment alternative. Further, it is important to note that the exclusion of such funds as a qualified default investment alternative does not preclude their use as a default investment option—fiduciaries are free to adopt default investments they deem to be prudent without availing themselves of the fiduciary relief afforded by this regulation.

Including such instruments for future contributions might have yielded some benefits if, for example, their inclusion would encourage more plan sponsors to implement automatic enrollment programs or fewer workers to opt out of them. The Department believes such cases would be rare, however. First, a decreasing proportion of plans already are designating such instruments as default investments.<sup>45</sup> Second, workers concerned that a default investment provides more risk than they prefer need not refuse or terminate<sup>46</sup> participation in response, but instead need only direct their contributions into a different investment option otherwise available in the plan.

Including such instruments might benefit some affected short-tenure participants who cash out and spend their accounts during downturns in equity prices. Historically, though, equity returns are positive more often than they are negative, so this potential benefit is likely to be outweighed by the opportunity cost to affected short-tenure

participants who cash out during upturns.<sup>47</sup> Moreover, the Department believes that this regulation should be calibrated to foster preservation of retirement accounts rather than to accommodate cashouts, consistent with other provisions of law, such as the mandatory withholding and additional tax provisions applicable to premature distributions.

Some comments on the proposed regulation expressed concern that qualified default investment alternatives would expose risk averse participants to excessive investment risk, and on that basis urged the Department to include stand-alone capital preservation instruments as qualified default investment alternatives. The Department is not persuaded by this argument, however, for three reasons. First, the regulation's primary goal is to promote default investments that enhance retirement saving, not to align default investments with individuals' levels of risk tolerance.<sup>48</sup> Second, the Department nonetheless believes that the qualified default investment alternatives included in the regulation can satisfy most affected individuals' risk preferences.<sup>49</sup> Finally, participants

<sup>47</sup> Such potential benefits would additionally be offset by reduced average returns to default investors who do not cash out early. As noted above, the Department estimates that most default contributions will be preserved for retirement. As discussed above, even the subset of short term workers who cash out their accounts will experience an overall aggregate increase in wealth from this regulation. Thus, the concern for fostering preservation of retirement accounts is not being weighed against aggregate losses to this subset of workers, but is instead being weighed against the added volatility their accounts might experience. In weighing these interests, the Department kept in mind that short term employees concerned about this volatility are always free to choose a different investment option.

<sup>48</sup> In theory individuals can optimize their investment mix over time to match their personal taste for risk and return. The regulation's provisions that establish participants' right to direct their investments out of qualified default alternatives give participants the opportunity to do so. But in practice investors sometimes do not optimize their investment alternatives. Some may lack clear, fixed and rational preferences for risk and return. Some investors' tastes for risky assets may be distorted by imperfect information, or by irrational and ineffectual behavioral phenomena such as naive diversification (a tendency to divide assets equally across available options), sub-optimal excessive concentration in company stock, market timing, mental accounting and framing, and reliance on peer examples (see, e.g., Richard H. Thaler and Shlomo Benartzi, *The Behavioral Economics of Retirement Savings Behavior*, AARP Public Policy Institute white paper #2007-02 (Jan. 2007) at 6-16), or inertia. This regulation promotes default investments that can enhance such investors' retirement savings prospects.

<sup>49</sup> One commenter on the proposed regulation called the Department's attention to a study of optimal investment mixes for investors with different levels of risk aversion. The study employed techniques known as stochastic

who find default investments too risky can opt out of them without opting out of plan participation entirely.

Some comments cautioned that the exclusion of stand-alone capital preservation products from the definition of qualified default investment alternatives would prompt a large, rapid movement of money across asset classes, with negative consequences for financial markets. In particular according to these comments, movement out of stable value products might repress those products' future interest crediting rates and thereby harm investors who continue to hold them. The Department believes, however, that movement away from stable value products and therefore any negative impact on forward crediting rates will be modest, as only a relatively small portion of current assets in stable value products appears to be attributable to defaulted participants.<sup>50</sup> Additionally,

dominance analysis of asset class performance and multi-period investor utility optimization, explaining that these techniques are in some ways superior to alternatives such as mean-variance analysis of asset class performance and single-period utility optimization. The commenter criticized the Department's use of the latter, potentially inferior techniques to assess the question of what mix of asset classes best matches investors' tastes. But in fact the Department did not assess this question, focusing instead on how different asset class mixes affect retirement savings accumulations. Interestingly the study, which utilized stable value product performance data supplied by the industry, concluded that for most investors most of the time, the optimal portfolio will include a mix of equity and stable value products rather than stable value products alone. This suggests to the Department that the qualified default investment alternatives included in this regulation encompass most investors' levels of risk tolerance. The Department also notes that most 401(k) plan participants who actively direct their investments include equity in their portfolios (see, e.g., Sarah Holden and Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005*, EBRI Issue Brief No. 296 (Aug. 2006) at 9, Figure 8; see also Fidelity Investments, *Building Futures Volume VII: How Workplace Savings are Shaping the Future of Retirement* (2006) at 128, Figure 130).

<sup>50</sup> There are several reasons to believe that asset allocation will not shift very abruptly, and that stable value products will continue to claim a large share of 401(k) plan assets. First, while this regulation generally does not extend fiduciary relief to default investments that consist solely of stable value products, it does not foreclose qualified default investment alternatives from including such products, and leaves intact general fiduciary provisions that may otherwise permit default investments that consist solely of such products. A significant number of plans currently utilize stable value products as their default investment option, reflecting determinations by a significant number of plan fiduciaries that stand-alone stable value products are a prudent investment for defaulted participants. Nothing in this regulation is intended to suggest or require that a plan fiduciary change an otherwise prudent selection of a stable value product for a plan's default investment option. The Department therefore anticipates that some plans will continue to direct all or a portion of default investments to stable value products. Second, the

<sup>45</sup> According to one survey, in 2006, 17 percent of sponsors with automatic enrollment programs were likely to change their default from such instruments to qualified default investment alternative-type instruments, while just 4 percent were likely to do the opposite (Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement 2006* (2006) at 4). According to another, between 1999 and 2005 the proportion designating such instruments as defaults decreased from 69 percent to 56 percent, while the proportion designating qualified default investment alternative-type instruments as defaults increased from 28 percent to 39 percent (Hewitt Associates LLC, *Survey Findings: Trends and Experiences in 401(k) Plans 2005*, (2005) at 15).

<sup>46</sup> Might a risk-averse participant, enrolled and invested by default, terminate participation in response to news that their account had suffered principal losses? Perhaps not. The same inertia that leads some participants to enroll and invest by default might also prevent them from terminating participation. The Department also observes that an early principal loss usually will not translate into a decline in the account balance reported in a quarterly statement, since quarterly contributions are likely to more than offset such losses during at least the first few years of participation.

according to these comments, movement out of stable value products might alter short-term conditions in the markets for debt securities that underlie such products. Decreased demand for stable value products might then repress the price of underlying debt instruments and increased demand for qualified default investment alternatives might drive up equity prices. The Department believes any such effects would be gradual and negligible.<sup>51</sup>

If included as a qualified default investment alternative and thereby promoted as a default investment, stand-alone capital preservation products' generally inferior long-term investment returns would almost certainly erode the regulation's beneficial effect on retirement income.

Department expects that stable value products will continue to be offered as an investment option by many participant-directed plans and selected by many participants. It is expected that participants will invest only a small fraction of assets by default, and will actively direct a large majority of assets. The Department's low- and high-impact estimates respectively suggest that between 1.2 percent and 1.5 percent of 401(k) plan assets will be invested by default in 2034. Viewed another way, absent this regulation, the Department estimates that just \$10 billion would be invested by default in capital preservation vehicles in 2034 (expressed in 2006 dollars). This compares with approximately \$400 billion of 401(k) assets invested in stable value products today. Third, there will be some offsetting effect, deriving from the increase in actively invested account balances expected to result from this regulation. The Department estimates that the regulation, by promoting automatic enrollment and higher average investment performance, will increase aggregate actively invested account balances in 2034 by between \$59 billion and \$114 billion (expressed in 2006 dollars), or between 2.4 percent and 4.6 percent, while aggregate default invested account balances will grow by just \$11 billion to \$20 billion. Stable value products will capture some share of the increase in actively invested account balances. Fourth, the extent to which some plans do move money out of stable value products may be additionally moderated by stable value product features that have the effect of discouraging large movements and by associated fiduciary considerations. Plan fiduciaries, in determining whether, how and under what circumstances a change should be made in the plan's default investment option, must assess, among other things, the potential economic consequences of such a change to participants' investments in such options. Finally, because this regulation includes a "grandfather"-like provision applicable to certain stable value products, it provides no direct incentive for plan fiduciaries to reallocate account balances heretofore invested by default in such products.

<sup>51</sup> As noted above, the Department expects that asset allocation will not shift very abruptly, and that stable value products will continue to claim a large share of 401(k) assets. In addition, while stable value products comprise a substantial fraction of all 401(k) assets (perhaps as much as 20 percent), their underlying portfolios hold only a small fraction (generally between 0.5 percent and 2 percent) of all debt and of major debt categories such as mortgages, corporate bonds and treasury and agency issues. These estimates are based on stable value product data provided by the Stable Value Industry Association and the U.S. Federal Reserve Board of Governors' Flow of Funds Accounts.

The Department estimates that including capital preservation instruments as a stand-alone qualified default investment alternative would reduce aggregate account balances in 2034 by between \$5 billion and \$7 billion (expressed in 2006 dollars).<sup>52</sup> This negative effect will be larger if there is an endorsement effect (\$26 billion under the low-impact estimate)—that is, if the instruments status as a qualified default investment alternative encourages active (in addition to default) investments in them.<sup>53</sup>

Finally, the Department believes it is desirable for a default investment vehicle to be diversified across asset classes, rather than to include only a single asset class. Such diversification can improve a portfolio's risk and return efficiency.

In summary, in weighing the merits of potential qualified default investment alternatives, the Department sought primarily to promote default investments that enhance retirement savings. The Department considered market trends, generally accepted investment theories, mainstream financial planning practices, and actual investor behavior, as well as the estimated effect of qualified default investment alternatives on retirement savings. All of these criteria suggest that it is desirable to invest retirement savings in vehicles that provide for the possibility of capital appreciation in addition to capital preservation.

Accordingly, the Department did not include stand-alone capital preservation instruments among the qualified default investment alternatives under the regulation. However, the Department has modified the regulation to include a "grandfather"-like provision pursuant to which stable value products and funds will constitute a qualified default investment alternative under the regulation for purposes of investments made prior to the effective date of the regulation.

#### Balanced Defaults

The Department also considered whether to include as a qualified default investment alternative an investment fund product or model portfolio that establishes a uniform mix of equity and fixed income exposures for all affected participants. Such a product or model portfolio 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 potential qualified default investment alternatives such a product or portfolio may be simpler, less expensive and easier to explain and understand. These advantages sometimes may outweigh the potential advantage of more customized risk levels. And the inclusion of such products or model portfolios might help heighten competition in the market and thereby enhance product quality and affordability across all qualified default investment alternatives. Accordingly, the Department has included such instruments as qualified default investment alternatives under this regulation.

#### Federalism Statement

Executive Order 13132 (August 4, 1998) outlines fundamental principles of federalism and requires Federal agencies to adhere to specific criteria in the formulation and implementation of policies that have a substantial direct effect on the States, the relationship between the national government and the States, or on the distributive power and responsibilities among the various levels of government. As noted above, section 902(f) of the Pension Protection Act adds a new provision to ERISA (section 514(e)) providing that notwithstanding any other provision of section 514, Title I of ERISA supersedes State laws that would directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in any plan. In the preamble to the notice of proposed rulemaking published on September 27, 2006, the Department specifically discussed the preemption provision enacted in the Pension Protection Act and requested comments on whether, and to what extent, addressing this provision in the regulations would be helpful. Although no States provided comments on the proposed regulation, other commenters requested that the Department use the regulation to clarify the application of the statutory preemption provision. As noted elsewhere in this preamble, paragraph (f) of the final regulation addresses those comments. In accordance with section 4 of the E.O. 13132, the Department of Labor has construed the preemptive effect of ERISA section 514(e) at the minimum level necessary to achieve the objectives of the statute.

<sup>52</sup> This assumes that, as under the baseline, 50 percent of default contributions will be directed to capital preservation products and 50 percent to (other) qualified default investment alternatives.

<sup>53</sup> For this calculation, the Department assumes a 20 percent endorsement effect.

In any event, the Department does not view the final rule, as distinct from the statute, as having a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power among the various levels of government. The statute preempts State laws and the regulation merely clarifies application of the statutory provision in a way that is consistent with the plain language and the legislative history. State wage withholding restrictions will not be affected except as they apply to automatic contribution arrangements of ERISA-covered plans. Moreover, the regulation imposes no compliance costs on State or local governments. As a result, the Department concludes that the final regulation does not have federalism implications.

#### 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 amends 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 § 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 section 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) of this section, 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 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 (b)(2), (3), and (4) of this section, 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 any qualified default investment alternative within the meaning of paragraph (e) of this section, or (ii) investment decisions made by the entity described in paragraph (e)(3) of this section 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 any fiduciary described in paragraph (e)(3)(i) of this section 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 a notice that meets the requirements of paragraph (d) of this section:

(i) (A) At least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the date of any first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2) of this section; or

(B) On or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal (as determined under section 414(w) of the Internal Revenue Code of 1986, as amended (Code)); and

(ii) Within a reasonable period of time of at least 30 days in advance of each subsequent plan year;

(4) A fiduciary provides to a participant or beneficiary the material set forth in 29 CFR 2550.404c–1(b)(2)(i)(B)(1)(viii) and (ix) and 29 CFR 404c–1(b)(2)(i)(B)(2) relating to a participant's or beneficiary's investment in a qualified default investment alternative;

(5)(i) Any participant or beneficiary on whose behalf assets are invested in

a qualified default investment alternative may transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elected to invest in the qualified default investment alternative, but not less frequently than once within any three month period;

(ii)(A) Except as provided in paragraph (c)(5)(ii)(B) of this section, any transfer described in paragraph (c)(5)(i), or any permissible withdrawal as determined under section 414(w)(2) of the Code, by a participant or beneficiary of assets invested in a qualified default investment alternative, in whole or in part, resulting from the participant's or beneficiary's election to make such a transfer or withdrawal during the 90-day period beginning on the date of the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, or other first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2) of this section, shall not be subject to any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment);

(B) Paragraph (c)(5)(ii)(A) of this section shall not apply to fees and expenses that are charged on an ongoing basis for the operation of the investment itself (such as investment management fees, distribution and/or service fees, "12b-1" fees, or legal, accounting, transfer agent and similar administrative expenses), and are not imposed, or do not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the qualified default investment alternative; and

(iii) Following the end of the 90-day period described in paragraph (c)(5)(ii)(A) of this section, any transfer or permissible withdrawal described in this paragraph (c)(5) of this section shall not be subject to any restrictions, fees or expenses not otherwise applicable to a participant or beneficiary who elected to invest in that qualified default investment alternative; 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 shall 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 or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);

(2) An explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts;

(3) 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;

(4) 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, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and

(5) 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 available to participants and beneficiaries that:

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

(ii) Paragraph (e)(1)(i) of this section 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)(4)(iii) of this section, employer securities acquired as a matching contribution from the employer/plan sponsor, or employer

securities acquired prior to management by the investment management service to the extent the investment management service has discretionary authority over the disposition of such employer securities;

(2) Satisfies the requirements of paragraph (c)(5) of this section regarding 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: (A) an investment manager, within the meaning of section 3(38) of the Act; (B) a trustee of the plan that meets the requirements of section 3(38)(A), (B) and (C) of the Act; or (C) the plan sponsor who is a named fiduciary, within the meaning of section 402(a)(2) of the Act;

(ii) An investment company registered under the Investment Company Act of 1940; or

(iii) An investment product or fund described in paragraph (e)(4)(iv) or (v) of this section; and

(4) Constitutes one of the following:

(i) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and 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)(4)(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 applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and 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)(4)(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 a fiduciary, within the meaning of paragraph (e)(3)(i) of this section, applying generally accepted investment theories, 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 are diversified so as to minimize the risk of large losses and 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)(4)(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."

(iv)(A) Subject to paragraph (e)(4)(iv)(B) of this section, an investment product or fund designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. Such investment product shall for purposes of this paragraph (e)(4)(iv):

(1) Seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product; and

(2) Be offered by a State or federally regulated financial institution.

(B) An investment product described in this paragraph (e)(4)(iv) shall constitute a qualified default investment alternative for purposes of paragraph (e)

of this section for not more than 120 days after the date of the participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code).

(v)(A) Subject to paragraph (e)(4)(v)(B) of this section, an investment product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, while providing liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives. Such investment product or fund shall, for purposes of this paragraph (e)(4)(v), meet the following requirements:

(1) There are no fees or surrender charges imposed in connection with withdrawals initiated by a participant or beneficiary; and

(2) Principal and rates of return are guaranteed by a State or federally regulated financial institution.

(B) An investment product or fund described in this paragraph (e)(4)(v) shall constitute a qualified default investment alternative for purposes of paragraph (e) of this section solely for purposes of assets invested in such product or fund before December 24, 2007.

(vi) An investment fund product or model portfolio that otherwise meets the requirements of this section shall not fail to constitute a product or portfolio for purposes of paragraph (e)(4)(i) or (ii) of this section solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio.

(f) *Preemption of State laws.* (1) Section 514(e)(1) of the Act provides that title I of the Act supersedes any State law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. For purposes

of section 514(e) of the Act and this paragraph (f), an automatic contribution arrangement is an arrangement (or the provisions of a plan) under which:

(i) A participant may elect to have the plan sponsor make payments as contributions under the plan on his or her behalf or receive such payments directly in cash;

(ii) A participant 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

(iii) Contributions are invested in accordance with paragraphs (a) through (e) of this section.

(2) A State law that would directly or indirectly prohibit or restrict the inclusion in any pension plan of an automatic contribution arrangement is superseded as to any pension plan, regardless of whether such plan includes an automatic contribution arrangement as defined in paragraph (f)(1) of this section.

(3) The administrator of an automatic contribution arrangement within the meaning of paragraph (f)(1) of this section shall be considered to have satisfied the notice requirements of section 514(e)(3) of the Act if notices are furnished in accordance with paragraphs (c)(3) and (d) of this section.

(4) Nothing in this paragraph (f) precludes a pension plan from including an automatic contribution arrangement that does not meet the conditions of paragraphs (a) through (e) of this section.

Signed at Washington, DC, this 15th day of October, 2007.

**Bradford P. Campbell,**

*Assistant Secretary, Employee Benefits Security Administration, Department of Labor.*

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