DIVERSIFIED INVESTMENT ADVISORS, INC.

Partners in Retirement Solutions

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

Robert F. Colby
Sr. Vice President &
General Counsel

Atlanta
Baltimore
Boston
Cedar Rapids
Charlotte
Chicago
Cincinnati
Dallas
Detroit
Houston
Little Rock
Los Angeles
Milwaukee
New Orleans
New York
Philadelphia
Portland
San Francisco

Attn: Default Investment Regulation

Ladies and Gentlemen:

Diversified Investment Advisors, Inc. ("Diversified") appreciates this opportunity to comment on regulations for default investment alternatives under participant-directed individual account plans (the "Proposed Regulations") recently proposed by the U.S. Department of Labor's Employee Benefits Security Administration (the "Department").[1] The Proposed Regulations would implement provisions under the Pension Protection Act of 2006 (the "Pension Protection Act"), which added section 404(c)(5) under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Section 404(c)(5) provides fiduciary relief to plan sponsors and other fiduciaries who invest the account balances of participants who fail to provide investment elections in a "qualified default investment alternative" ("QDIA") in accordance with regulations issued by the Department.

Diversified is a national investment advisory firm specializing in retirement plans. The company services over $66 billion in retirement plan assets, helping more than 1.4 million participants save and invest for retirement. Its expertise covers the spectrum of defined benefit and defined contribution plans, including participant-directed 401(k) and similar plans.

We congratulate the Department on quickly proposing regulations for default investment alternatives in response to requirements under the Pension Protection Act, and we commend the Department's efforts to facilitate the use of default investment alternatives that are likely to increase retirement savings over long periods of time. However, we encourage the Department to address several issues in connection with the Proposed Regulations.

[1] 71 Fed. Reg. 56806 (Sept. 27, 2006). The Proposed Regulations are required by section 624(b)(2) of the Pension Protection Act of 2006, Public Law 109-280.

- *Modify "investment manager" condition.* Because it may exclude some commonly available investment products from qualifying as QDIAs, the Department should review the requirement that a QDIA must be either an investment company registered under the Investment Company Act of 1940 (a "registered investment company") or managed by an "investment manager" as defined by ERISA section 3(38). Specifically, without further clarification, the proposed definition of QDIA could exclude —

    - model asset allocation portfolios and balanced funds using a plan's available investment alternatives where maintained by a plan sponsor acting as the plan's "named fiduciary;"
    - "managed account" services based on asset allocation models and methodologies provided by an independent expert, in accordance with DOL Advisory Opinion 2001-09A (the "SunAmerica Opinion"); and
    - collective trust fund products, which are under management by a "trustee."

    Diversified believes that each of these would provide appropriate structures for QDIAs, and should not be excluded from relief available under ERISA section 404(c)(5).

- *Clarify that mutual fund redemption fees are not a "financial penalty."* The Department should confirm that redemption fees and other policies against frequent trading adopted by registered investment companies would not violate the condition prohibiting financial penalties and restrictions against the ability of a participant to transfer from a QDIA under § 2550.404c-5(e)(2) of the Proposed Regulations.

- *Clarify circumstances in which a participant "did not direct the investment of assets."* The Proposed Regulations should be clarified so that a participant who may have previously provided investment instructions will be deemed to have "had the opportunity to direct the investment of assets in his or her account but did not direct the investment of assets," as specified by § 2550.404c-5(c)(2), if the participant fails to respond within a reasonable time to a request for new affirmative investment instructions. This would provide plan sponsors important flexibility in initially transitioning participant investments from existing default alternatives to QDIAs to obtain relief under section 404(c)(5). It also would facilitate the use of appropriate default investments in a range of situations on an ongoing basis.

- *Modify timing for notice in the case of "immediate participation" plans.* The Proposed Regulations should be revised to allow less than 30 days advance notice concerning the investment of assets in a QDIA in the case of participants eligible for automatic enrollment under "immediate participation" plans, because it is not workable to require notice in advance of a participant's actual employment commencement date.

- *Revise participant investment information requirements.* The Department should reconsider the requirement proposed under § 2550.404c-5(c)(4) to provide to each participant any materials provided to the plan relating to the participant's QDIA investment, because this requirement would be administratively burdensome for plans and confusing rather than helpful to participants. Instead, participants should receive a simplified disclosure document, such as a "fact sheet" containing key information about the QDIA.

- *Include capital preservation products as QDIAs.* Diversified strongly agrees with comments that are being provided to the Department by others, including the American Council of Life Insurers and the American Benefits Council, urging the Department to include capital preservation products, including stable value and money market funds, among the types of investment products eligible to be QDIAs.

- *Coordinate the regulation with preemption relief under section 514(e).* Because preemption relief for automatic contribution arrangements under new ERISA section 514(e) includes reference to the Department's regulations under section 404(c)(5), we urge the Department to address several issues under section 514(e) as it finalizes the Proposed Regulations. As explained in more detail below, these include certain effective date issues, whether preemption will be available if a plan uses a default investment alternative other than a QDIA, and issues pertaining to notice requirements for automatic contribution arrangements under section 514(e)(3).

We discuss these comments in more detail below.

1. Modify "investment manager" condition.

As noted, the Proposed Regulations would require that a QDIA must (among other conditions[2]) be either (a) a registered investment company, or (b) managed by an investment manager as defined by ERISA section 3(38). Under ERISA section 3(38), an "investment manager" is a fiduciary (other than a trustee or named fiduciary) (A) who has the power to manage, acquire, or dispose of any asset of a plan; (B) who is registered as an investment adviser under the Investment Advisers Act of 1940 or under the laws of a state, or is a bank or an insurance company, and (C) has acknowledged in writing that it is a fiduciary with respect to the plan. Without further clarification, this condition could limit whether certain investment products commonly available to participant-directed plans would be eligible as QDIAs.

Named Fiduciary Managed Portfolios Some plan sponsors acting as named fiduciaries of their plans maintain plan level portfolios that incorporate existing plan investment alternatives, including "balanced funds" and "lifecycle" portfolios that would be the types of investment products allowed for a QDIA under the Proposed Regulations. The plan sponsor may maintain the portfolios using in-house expertise and/or advice from a plan adviser or consultant. As compared to the cost of engaging a professional investment manager, this approach may reduce the cost of these portfolios to plan participants while still providing prudent investment management of plan assets.

However, these named fiduciary managed portfolios would not satisfy requirements to be a QDIA under the Proposed Regulations because they generally are not managed by a registered investment adviser, bank or insurance company qualifying as an "investment manager" as defined by ERISA section 3(38). This result is not consistent with the general structure of ERISA, which generally allocates to the plan sponsor (or other named fiduciary of a plan) responsibility to determine when it is necessary for the plan

[2] The Proposed Regulations also require that (a) subject to certain limited exceptions, a QDIA may not hold or permit the acquisition of employer securities, (b) there generally may not be any penalties or restrictions on a participant's ability to transfer from a QDIA to another plan investment alternative, and (c) a QDIA must be diversified to minimize the risk of large losses. In addition, a QDIA must use one of three types of investment products — (a) a fund or portfolio designed to provide varying degrees of long-term capital appreciation and capital preservation based on a participant's age, retirement date or life expectancy, i.e., a so-called "lifecycle" or "target-retirement date" fund or portfolio; (b) a balanced fund or portfolio (mixing equity and fixed income) that is appropriate to all participants, based on participant demographics, or (c) an investment management or "managed account" service, through which a professional investment manager allocates the assets of a participant's account among equity and fixed income investments based solely on the participant's age, life expectancy or target retirement date.

to incur the expense of engaging investment managers and other professionals to provide plan services. Under current law, plan sponsors have authority to select plan investment alternatives and to exercise investment management authority with respect to plan assets. In this context, there is no reason why plan sponsors should be required to engage a professional asset manager or select a registered investment company for a QDIA, especially if a plan sponsor has in-house expertise to construct and maintain a plan's QDIA at lower cost to participants.

Diversified believes that such plan level portfolios maintained by a plan sponsor are especially appropriate as QDIA investments because they may provide a lifecycle or target retirement investment as contemplated by the Proposed Regulations and use the existing plan investment options as the underlying investments. Accordingly, such a QDIA would include only underlying investments with respect to which the plan sponsor/named fiduciary has already made an independent fiduciary decision to include in the plan's fund lineup. On the other hand, under the Department's current draft of the Proposed Regulations, plan sponsors will be required to either (i) incur the unnecessary cost of employing a third party as an "investment manager" to create such portfolios or, more likely, (ii) add a registered investment company lifecycle or lifestyle fund provided by a mutual fund sponsor. It is difficult to see how either of these alternatives is preferable to a default alternative that uses the plan's carefully selected investment options and for which a named fiduciary accepts fiduciary responsibility.

Accordingly, Diversified requests that the Proposed Regulations be revised to provide that a QDIA could also include a fund or portfolio under management by the plan sponsor or other named fiduciary of a plan.

Managed Account Services Based on the "SunAmerica Opinion" The SunAmerica Opinion permits a financial services firm to provide participant-level investment advice and "managed account" services based on models and methodologies under the control of an independent financial expert, and the financial services firm avoids violations of ERISA section 406(b) even if it may receive varying levels of fees from investment products that it provides to plans.[3] This approach to delivering participant advice and managed account

[3] As described by DOL Advisory Opinion 2001-09A, SunAmerica offered plans a combination of proprietary and non-proprietary investment products, which paid it different levels of fees. Although SunAmerica's own representatives actually administered the participant advice and managed account programs, the Department concluded that SunAmerica would not violate the self-dealing and anti-kickback prohibitions under ERISA section 406(b) by offering the program and receiving fees from the various investment products. An essential fact to the Department's opinion was that all recommendations were provided based solely on the financial expert's model portfolios and

services is widely used in the retirement services industry, and generally, may be priced more favorably for plan participants than engaging an investment manager for each participant's account. Therefore, it would be helpful to plan participants if this widely offered approach to providing managed account services could be used as a QDIA for 404(c)(5) purposes.

However, it is unclear whether a managed account service structured in accordance with the SunAmerica Opinion could serve as a QDIA because the "investment manager" condition might not be met. Although a financial services firm providing managed account services based on the SunAmerica Opinion may acknowledge that it will serve as a "fiduciary" to plans receiving managed account services, the financial services firm does not appear to have "power to manage, acquire or dispose of any asset of a plan" (in accordance with ERISA section 3(38)) where it only mechanically implements models and methodologies supplied by an independent financial expert. Further, independent financial experts offering these services generally are not appointed as an "investment manager" to plans receiving the services.

The Department should resolve this uncertainty and clarify the Proposed Regulations to provide that a managed account service based on models and methodologies provided by an independent expert in accordance with the SunAmerica Opinion may qualify as a QDIA. This important clarification would allow plans to use existing managed account services to implement ERISA section 404(c)(5), which will speed the ability of plans to implement the Proposed Regulation and may also reduce plan expenses as compared to engaging an investment manager to manage the plan's QDIA.

Collective Trust Fund Products Collective trust funds are frequently offered as investment alternatives under participant-directed plans. These products may include "life-cycle" or "target retirement date funds," which are one of the three types of investment products that could be used as a QDIA under the Proposed Regulations. However, because a collective trust fund typically is maintained by "trustee," there is a question about whether a collective trust fund would qualify as a QDIA.

We request that the Department confirm that a bank or trust company trustee of a collective trust fund maintained for the investment of plan assets qualifies as an "investment manager" of a QDIA under the Proposed Regulations, so long as the trustee is specifically appointed as an "investment manager" to plans participating in the collective trust fund in documents

methodologies — neither SunAmerica nor its representatives could change any of the financial expert's model portfolios or methodologies or any recommendations for a participant.

governing the collective trust fund or in a separate document approved by a plan's named fiduciary. This conclusion would be consistent with the Department's views, expressed in Advisory Opinion 77-69/70A (September 16, 1977). This opinion explains that the parenthetical language of ERISA section 3(38) does not prohibited a named fiduciary from serving as investment manager for plan assets, but rather only clarifies that a person who is a named fiduciary or trustee with respect to a plan is not an "investment manager" merely by virtue of meeting conditions under section 3(38), but must instead be specifically appointed as investment manager.

2. Clarify that mutual fund redemption fees are not a "financial penalty."

Under § 2550.404c-5(e)(2) of the Proposed Regulation, a QDIA may not impose a financial penalty or otherwise restrict the ability of participants to transfer their investments to other investment alternatives available under the plan. However, as a result of recent Securities and Exchange Commission rulemaking, many registered investment companies have adopted policies to deter frequent trading that may harm shareholders, including redemption fees and other policies restricting frequent trading by the investment company's shareholders, including plan participants. If redemption fees and other restrictions imposed by investment companies violate § 2550.404c-5(e)(2) of the Proposed Regulation, the universe of investments available as QDIAs could be unduly restricted. For example, some otherwise appropriate registered investment companies, including certain balanced and lifecycle funds, could not be used as a QDIA because of their redemption fee policies. Further, the "core" investment alternatives under many plans include investment companies that impose redemption fees and other restrictions on frequent trading — these plans would not be able to offer a QDIA that is constructed using the plan's investment alternatives, including a target retirement date or balanced portfolio or managed account service that would use the investment alternatives offered under a plan.

Accordingly, Diversified urges the Department to confirm that § 2550.404c-5(e)(2) of the Proposed Regulation does not prohibit the use of registered investment companies that impose redemption fees or other restrictions to address frequent trading as a QDIA, or in constructing a QDIA that uses the plan's current investment alternatives.

3. ***Clarify circumstances in which a participant "did not direct the investment of assets."***

The Proposed Regulations (at § 2550.404c-5(c)(2)) would require that a participant or beneficiary on whose behalf assets are being invested in a QDIA must have "had the opportunity to direct the investment of assets in his or her account *but did not direct the investment of assets" (emphasis added).* The Department explained that this requirement means that "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."[4] Diversified requests that the Department review and clarify the circumstances in which it may be determined that a participant "did not direct the investment of assets" under the Proposed Regulation. Following are examples of why this flexibility is needed.

- There are a number of questions raised with respect to the implementation of the Proposed Regulations for plans that already have designated default investment alternatives for auto-enrollment or for other reasons. The Department has explained that, if an already designated default is a QDIA, fiduciaries may obtain relief under section 404(c)(5) for participants' future investments in the QDIA by delivering notice as described by the Proposed Regulations. However, many plans may be required to transfer participants' balances in existing default alternatives (such as money market or stable value options) to new investment alternatives that qualify as a QDIA. Further, it may be appropriate to replace a plan's QDIA from time to time based on cost, performance or other criteria. The Proposed Regulations currently do not provide specific procedures for transitioning participant account balances to a QDIA so that fiduciaries may obtain relief under section 404(c)(5), or for replacing a QDIA if required in the future.

- The Department appears to agree that, where there is a complete change in plan investment options available to plan participants in connection with a change in plan service providers, participants' prior investment instructions would not be effective, so that relief under the Proposed Regulation would be available where accounts of participants who do not provide new investment instructions are invested in a QDIA.[5] However, the Proposed Regulations do not address whether, if only some plan investment options are deleted,

[4] 71 Fed. Reg. at 56808.

[5] 71 Fed. Reg. at 56806-07, n.5.

a plan may require participants to provide new instructions for their entire plan account, or if the portion of participants' accounts unaffected by deleting plan options must remain invested based on the participants' prior affirmative investment instructions. As the Department may be aware, investment products such as lifecycle funds and target date funds may not achieve an appropriate asset allocation for a participant unless the participant's entire account is allocated to the product.

- Some participants may initially provide affirmative investment instructions but then do not update their instructions or provide new instructions. For example, in DOL Advisory Opinion 96-02A (February 2, 1996), the Department addressed circumstances where plan fiduciaries were concerned about protecting plan assets in accounts of plan participants who could not be located to provide new investment instructions. The Department concluded that that a plan will not cease to be a "404(c)" plan merely because plan fiduciaries may override the last investment direction of a missing participant or beneficiary, where the fiduciaries determined that continuing to follow that last direction may not be prudent. It is unclear under the Proposed Regulations whether fiduciaries electing to override participants' prior instructions could obtain relief if the participants' accounts are invested in a QDIA.

- As a result of changes in service providers or for other administrative reasons, records of some participants' previous affirmative investment instructions may not have been preserved. For example, if a plan investment option was deleted in a prior years, some participants who failed to provide new instructions might have been defaulted to a stable value or money market fund, but there are no records to indicate whether a particular participant's investment in the plan's money market or stable value fund was based on the participant's affirmative direction or a plan sponsor's default investment direction. Diversified believes that the Proposed Regulations should provide a process by which plan sponsors may resolve this type of situation by requiring all participants to provide new investment instructions and then directing that the accounts of participants who do not provide new affirmative instructions are to be invested in a QDIA.

The Department could clarify the Proposed Regulation to address these and similar situations by adding a provision that would permit plan fiduciaries to conclude that a participant (even if the participant may have previously provided affirmative investment instructions) will have "had the opportunity to direct the investment of assets in his or her account but did not direct the investment of assets" for purposes of § 2550.404c-5(c)(2) if the participant fails to respond within a reasonable time to a plan request for new affirmative investment instructions (such a request would include a notice with the information required by § 2550.404c-5(d)). This approach would provide plan sponsors much needed flexibility to transition participant investments from a currently designated default alternative to a QDIA and obtain relief under section 404(c)(5), even if plan records do not specify which participants have previously provided investment directions. On an ongoing basis, this approach also would facilitate the investment of participants' individual accounts in appropriate default investments.

4. Modify timing for notice in the case of "immediate participation" plans.

Under § 2550.404c-5(c)(3), the Proposed Regulations require a participant or beneficiary to be furnished with a notice within a reasonable period of time of at least 30 days in advance of the first investment in a QDIA. However, this rule is unworkable for plans that provide for eligibility beginning on the employment commencement date. Accordingly, the Proposed Regulations should be revised to include a special rule for "immediate participation" plans, which would require notice to be provided as far as practicable in advance of the first investment in a QDIA but such notice need not be provided before the participant's actual employment commencement date.

5. Revise participant investment information requirements.

We respectfully request that the Department reconsider § 2550.404c-5(c)(4) of the Proposed Regulation, which would require that —

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

As an initial matter, it is unclear why the "terms of the plan" must require that information be provided to a participant. This type of requirement may be a "trap" for an unwary plan sponsor, but would not ensure that plan participants whose accounts are allocated to a QDIA receive information that is helpful to their review of how their plan accounts are invested.

More importantly, this disclosure requirement could be unduly burdensome for plans, but would not provide plan participants with the type of information that they may find helpful in reviewing how their plan account balances are invested.

- First, as drafted, the Proposed Regulation would require plans to deliver a substantial volume of materials. With respect to a QDIA that is a registered investment company, a plan may receive (and would have to deliver to each participant) an annual prospectus and any prospectus updates, the investment company's semi-annual report to shareholders, and proxy materials. If a plan's QDIA is a managed account or plan portfolio made up of individual plan investment options, plans would have to deliver all of these documents for each of the plan investment options incorporated in the QDIA.

- Second, participant-directed plans typically do not provide for the pass-through of proxy-voting responsibility for shares of investment companies held by the plan. Delivering proxy materials to participants who are not eligible to vote would be at best confusing.

- Third, the language of the requirement in the Proposed Regulation relating to account statements is confusing. It is unclear whether participants' account statements are required, or if an account statement received by the plan to show the plan's holdings in a QDIA must be provided to plan participants. In addition, because other provisions of the Pension Protection Act impose new participant statement requirements for participant-directed plans, it should not be necessary to require participant account statements in the Proposed Regulations.

We respectfully suggest that the Department review this requirement and consider a rule that would result in plans delivering materials that will be helpful to participants rather than providing participants an overwhelming amount of information. Diversified's experience is that plan participants who fail to provide investment elections for their plan account balances often do not have interest and/or expertise in investment matters. These participants are likely to find documents such as investment company prospectuses, semi-annual reports and proxy materials to be confusing rather than helpful.

Further, we believe that plan communications to participants are more effective if the communications are presented in a shorter disclosure format limited to key information, as compared to more extensive and complex disclosure that may overwhelm participants and encourage them to ignore everything that is provided.

Therefore, we suggest that the Department revise this provision under the Proposed Regulations to require plans to deliver a simplified disclosure with respect to the QDIA, such as a "fact sheet" containing key information about the QDIA (e.g., the name of the investment company or designated investment manager, investment objective, type of assets, fees and expenses, and investment performance) and how additional information (including prospectuses and other documents) may be obtained.

6. Include capital preservation products as QDIAs.

We understand that the Department is receiving comments requesting that capital preservation products, including stable value and money market funds, be among the types of investment products included as eligible to be QDIAs, including comments from the American Council of Life Insurers and the American Benefits Council. Diversified strongly agrees and urges the Department to include capital preservation products among the types of products allowed to be used as QDIAs.

7. Coordinate the regulation with preemption relief under section 514(e).

Congress included in the Pension Protection Act section 902(f), which provides preemption from conflicting state regulation for "automatic contribution arrangements" under new ERISA section 514(e). For this purpose, an automatic contribution arrangement is an arrangement under which "contributions are invested in accordance with regulations prescribed by the Secretary under section 404(c)(5)." Section 514(e) was effective as of August 17, 2006, the date of enactment of the Pension Protection Act.

Because new ERISA section 514(e) references the Department's regulations under section 404(c)(5), we request that the Department address several issues that are raised by new section 514(e) when finalizing the Proposed Regulations. In this regard, the preemption of state anti-wage garnishment laws, including certain criminal prohibitions against payroll withholding without employee consent, arguably may depend on whether a plan has complied with the Department's final regulations under section 404(c)(5).

First, we urge the Department to address an effective date issue. Specifically, although ERISA section 514(e) was effective as of August 17, 2006, it has not been possible for any employer to comply with its requirements because the Department has not issued final regulations under 404(c)(5). The Department can resolve this by specifying in its final regulations under 404(c)(5) that employers that adopt automatic contribution arrangements on or before the Proposed Regulations are final will be deemed to have complied with ERISA section 404(c)(5) effective as of August 17, 2006 (or the adoption date of the arrangement, if later) so long as contributions under the employer's automatic contribution arrangement are invested in accordance with the 404(c)(5) regulations after the regulations are effective, including a grace period. For this purpose, a grace period of at least one year would allow plan sponsors to incorporate an appropriate QDIA into their plans and comply with the notice and other conditions under final 404(c)(5) regulations.

Second, the Department has specifically recognized that its Proposed Regulations should not be construed to indicate that the use of investment alternatives not identified as a QDIA would be imprudent or not permissible.[6] If the Department agrees that investment alternatives other than QDIAs defined by the Proposed Regulations may be prudent, there is no reason to deny an employer the benefit of preemption for its automatic contribution arrangement if an alternative default is used. Therefore, we urge the Department to clarify in finalizing the Proposed Regulations that, for purposes of obtaining preemption relief under section 514(e), the default need not meet requirements under § 2550.404c-5(e) (which defines conditions for QDIAs), but other requirements of the final 404(c)(5) regulations must be met.

Finally, new ERISA section 514(e)(3) requires that the plan administrator of an automatic contribution arrangement must "within a reasonable period before such plan year, provide to each participant to whom the arrangement applies for such plan year notice of the participant's rights and obligations under the arrangement . . ." Diversified requests that the Department clarify several issues with respect to this requirement.

- We believe that this notice requirement is not a condition to obtain preemption relief under ERISA section 514(e) based on the specific language of section 514(e) as well as the fact that Congress

[6] 71 Fed. Reg. at 56907.

implemented a separate penalty under ERISA section 502(c)(4) that would apply if the notice is not provided. We request that the Department confirm this view.

- Because final regulations under 404(c)(5) have not been issued, we request that the Department clarify that any good faith effort to provide notice for plan years beginning as of August 17, 2006 and until the section 404(c)(5) regulations are effective, will meet the notice requirement under section 514(e)(3).

- The Department should clarify that notice under section 514(e)(3) may be included with any notice required under § 2550.404c-5(c)(3) and will meet the "reasonable period" requirement under section 514(e)(3) if provided within the time frames described by the Proposed Regulations.

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We appreciate the opportunity to comment and hope that these comments will be helpful to the Department as it finalizes the Proposed Regulations. We welcome any questions that you may have about these comments.

Sincerely,