Fund Democracy
Consumer Federation of America
Consumer Action

May 3, 2010

FILED ELECTRONICALLY

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

Dear Ms. Ward,

We are writing on behalf of Fund Democracy, Consumer Federation of America and Consumer Action in response to the Department's request for information on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (collectively, "401(k) plans"). We support the Department of Labor's efforts to improve Americans' retirement security and its recognition of the changing structure of our retirement system. Lifetime income options should be a core component of Americans' 401(k) plans.

We believe that the consideration of lifetime income options, which we will refer to as "annuities," is the kind of foundational inquiry that requires the Department to revisit the key principles that define its role in regulating 401(k) plans. The answers to virtually all of the Department's questions regarding annuities depend on fundamental assumptions about the Department's regulatory role. Our letter presents our views regarding what these fundamental assumptions are and, to a limited extent, provides initial answers to some of the Department's questions on the basis of these fundamental assumptions.

We cannot emphasize strongly enough the importance of the Department's developing a coherent conception of its role before developing policies and making detailed proposals regarding annuities in 401(k) plans. Regardless of whether the Department's conception of its regulatory role conforms to our understanding, it is imperative that whatever policies it implements reflect a coherent, sustainable approach. We believe that America's current and future

retirees are at risk[1] and that this risk results as much from the government's ambivalence in developing and implementing coherent policies as from the current structure of our retirement system itself.

The fundamental assumptions regarding the Department's role in the regulation of 401(k) plans that we believe should guide the Department's consideration of annuities are summarized as follows:

- Investment Theory. The Department's role in regulating 401(k) plans requires as a matter of law, practice and policy that it ensure that 401(k) plans operating under the Section 404(c)'s fiduciary safe harbor reflect generally accepted investment theories. The Department should ensure that any policies relating to annuities in 401(k) plans fulfill this role by expressly reflecting articulated general investment theories on which the policies are based.

- Low Income, Less Sophisticated Plan Participants. The Department should tailor is treatment of annuities in 401(k) plans to reflect the needs of less sophisticated, low income plan participants. These participants are most susceptible to sales abuses, are at greater risk of committing planning errors, and are most vulnerable to losses that leave them unprepared for retirement and dependent on government transfer payments.

- Variable Annuities. Variable annuities are more frequently the subject of abusive sales practice than any other investment. They impose higher fees and provide additional benefits of questionable value. We strongly encourage the Department to require heightened scrutiny by employers and/or product providers of variable annuity investment options.

We have also provided initial recommendations regarding the role of annuities in 401(k) plans that generally flow from the fundamental assumptions discussed above. We expect that we and other commenters will revisit detailed aspects of this issue as the Department's overall policy direction unfolds, and that our recommendations will evolve as well. Our initial recommendations are as follows:

- Employers should be required to provide standardized Simple Annuities, as defined *infra*;

- State guarantees of annuities should be strengthened and a federal role in this respect considered; and

[1] *See* Christine Dugas, *Retirement Overhaul: 401(k)s May Not be the Answer Now*, USA Today (Oct. 20, 2009).

- Employers and/or product providers should be required to demonstrate the net benefit provided by variable annuities relative to other investments.

The remainder of this letter is organized as follows:

I. Investment Theory

We believe that the Department is required by law to incorporate substantive investment theory into its rules regarding the operation of 401(k) plans. This assumption is based on explicit directions from Congress, the consistent evolution of the law since ERISA was enacted over thirty years ago, and the Department's rulemaking under that Act.

The most important element of the legal structure under which the Department has promulgated numerous 401(k)-related rules is the fiduciary duty to which plan sponsors, referred to herein as "employers," are subject under ERISA. The scope of an employer's fiduciary duty is set forth in Section 404(a) of ERISA, which incorporates a "then-prevailing" prudent person standard. The term "then-prevailing" means that this standard is to be applied consistently with evolving notions of prudential investment management. Congress also incorporated a specific requirement that the employer "diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." Congress chose to embed a specific, albeit somewhat crude, statement of investment theory in the statutory fiduciary duty that applies to employers under ERISA.

In Section 404(c), Congress also chose to insulate employers from liability with respect to participants' investment decisions, however, when participants exercise control over the assets in their accounts. It expressly delegated to the Department the responsibility for determining when participants would be deemed to "exercise control." Toward this end, the Department adopted Rule 404c-1, which provides that a plan does not qualify under Section 404(c) unless, among other things, the participant has "an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested."

Thus, the Department interpreted the "exercises control" standard to mean more than merely the participant's authority to choose the options in which his assets are invested. The Department incorporated a specific "diversify the investments" requirement, which Congress had included in Section 404(a), as a component of an employer's fiduciary duty under that provision.[2] ***The conditions that the Department deemed necessary to absolve employers of fiduciary liability for participants' investment choices included not just the employees' unrestricted freedom, but also the incorporation of general investment theory.***

The Department actually gave much greater content than that to Section 404(a). Rule 404c-1 also states that a "broad range of investment alternatives" has been provided only if the participant has 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;
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> (B) Choose from at least three investment alternatives:
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> (1) Each of which is diversified;
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> (2) Each of which has materially different risk and return characteristics;
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> (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
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> (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;
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> (C) Diversify the investment of that portion of his individual account with respect to which he is permitted to exercise control so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' or beneficiaries' accounts.

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[2] *See* Participant Directed Individual Account Plans, 56 FR 10724-01, 1991 WL 301434 (Mar. 13, 1991) ("This requirement was based on the statement of Congress in the Conference Report accompanying the enactment of ERISA that the regulations promulgated pursuant to section 404(c) 'generally will require that for there to be independent control by participants, a broad range of investments must be available to the individual participants and beneficiaries.'").

This set of requirements shows that what began with Congress's general directive to diversify plan investments to avoid "large losses" had evolved into a far more sophisticated, specific incorporation of investment theory, which itself was rapidly evolving in the world of financial economics. Modern portfolio theory, premised primarily on the relationship between risk and return, was founded by Harry Markovitz in the 1950s and continues to evolve today. The repeated references to risk and return in the foregoing parts of Rule 404c-1 reflect the parallel evolution of modern portfolio theory beginning in the 1950s to the present, and the law's incorporation of modern portfolio theory as reflected in the "diversify the investments" requirement in 1974, to Rule 404c-1's advanced standard quoted above that was adopted in 1992,[3] the qualified default investment alternatives adopted in 2006 that are discussed below.[4]

The Department expressly intended that Rule 404c-1's diversification standard incorporate general investment theory. In the adopting release, the Department stated:

> The Department believes that the criteria set forth in paragraph (b)(3)(i)(B) reflect ***well established investment principles*** which are appropriate to the defining of a broad range of investment alternatives. The Department also believes that adoption of these principles provides plan sponsors the design flexibility necessary to accommodate changes in participant needs and changes in investment products and markets.[5]

The Rule recognizes both the need for diversification within and across investment options, as well as the concept of risk/return characteristics that reflect "the range ***normally appropriate*** for the participant or beneficiary."[6] The Rule thereby reflects the investment theory that combining investments the performance of which is generally uncorrelated can reduce the overall risk of a portfolio, as well as the importance of matching particular risk/return characteristics to the needs of different participants.

In 2006, Congress created an additional safe harbor for qualified default investment alternatives ("QDIAs"). Interestingly, the safe harbor provides that a participant shall be deemed to exercise control over his account if he actually ***does not*** exercise control (*i.e.*, "in the absence of an investment election by the

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[3] *See* Final Regulation Regarding Participant Directed Individual Account Plans, 57 FR 46906-01, 1992 WL 277875 (Oct. 13, 1992) *(Participant Directed Adopting Release)*.

[4] *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 FR 60451 (Oct. 24, 2007) (*QDIA Adopting Release*).

[5] *See Participant Directed Adopting Release*, *supra* (emphasis added).

[6] *Id*.

participant,")[7] if the employer invests the participant's assets in a QDIA as prescribed by the Department. Here, the Department moved from the realm of imposing general investment theory to picking the specific types of investments into which employers could default participants under the Section 404(c) safe harbor. It became the arbiter of what specific risk/return characteristics were "normally appropriate" for the participant or beneficiary.

Under Congress's general instruction that QDIA's "include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both," the Department selected:

> 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.[8]

Each of these three categories of QDIAs must: apply "generally accepted investment theories," be diversified so as to minimize the risk of large losses," and achieve "long-term appreciation and capital preservation through a mix of equity and fixed income exposures."

The Department's guidance did not stop with these general statements of generally accepted investment theory. It required that life-cycle and target-date funds, for example, take into account a "participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy," but ***not*** the "risk tolerances, investments or other preferences of an individual participant." No reasonable financial planner would: (1) consider such a limited set of factors to be sufficient to determine the best investment choice for a client, or (2) willingly ignore the client's risk tolerances, investments or other preferences. In fact, a broker who provided a recommendation based solely on a client's "age, target retirement date (such as normal retirement age under the plan) or life expectancy" generally would violate his obligation under the federal securities laws to make suitable recommendations. In some cases, the law allows financial advisors to provide investment advice without adequate information, but only if the client refuses to provide it upon request.

We make this point not to criticize the Department for permitting employers to invest participants' assets based on inadequate information (we agree with that position), but rather to emphasize the extraordinary reach of its role in fashioning investment theory to fit the particular circumstances. The

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[7] The safe harbor applies even in the absence of decision by the participant to participate in the plan where an employer automatically enrolls employees.

[8] *QDIA Adopting Release*, *supra*.

Department could have required that the employer collect sufficient information to make a decision that was appropriate for that participant similar to the information that a financial advisor would be required to collect. It also could have permitted investment decisions without adequate information as long as the employer had attempted to obtain the information and documented that attempt. We agree, however, that such positions would have dissuaded employers from adopting automatic enrollment and/or encouraged them to direct participants' assets to overly conservative QDIAs.

Instead, the Department chose, to its credit, to permit employers to make investment decisions – ***within the parameters of generally accepted investment theory as determined by the Department*** – based on inadequate information about particular participants' investment needs. It made the tough call to fill the regulatory void created by the fiduciary safe harbor with what can only be described as a finely balanced application of specific, substantive investment theory. The Department decided that participants who decline to choose investment options in a plan into which they may have been placed automatically are better off being invested in an investment option that reflects an extremely crude estimate of the risk and return characteristics that would be most appropriate for a participant based solely on their age, target retirement date or life expectancy. We agree that the Department made the right call and, more importantly for purposes of this letter, this was a call that the Department was required to make.

The QDIAs approved by the Department also reflect a failure, however, on the Department's part regarding its recognition of its role in applying substantive investment theory in the context of 401(k) plans. As described above, the Department has a responsibility to apply generally accepted investment theories as a general matter, and that responsibility is especially pronounced where the theories it adopts will be applied to participants who, by definition, have declined to make an investment choice and where investment decisions will be made for them based on inadequate information. As discussed further below, the Department's unwillingness to accept the logical consequences of its QDIA policy illustrates the kind of incoherent policymaking that places participants at greater risk.

The Department authorized target-date funds as QDIAs on the condition that they 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.

It also expressly authorized employers to disregard participants' "risk tolerances" and "investments," when investing QDIA assets in a QDIA target-date fund. The

problem with this approach is that the Department did nothing to ensure that QDIA target-date funds accounted for the fact that they would not reflect anything about a participant's risk tolerance or other investments. Both of these factors would be critical to determining, for example, whether a target-date fund that was more or less aggressive than average might be the best fit for a particular participant. A more aggressive target-date fund would be appropriate for a participant, all other factors being equal, who had a high risk tolerance and/or substantial outside investments in low risk securities. A more aggressive target-date fund would not be appropriate for a participant, all other factors being equal, who had a low risk tolerance and/or no such risk-offsetting investments.

Note that this is not a question of what is the optimal equity/debt mix for a 50-year-old who plans to retire at age 65, for example. Rather, our point is that the optimal equity/debt mix for that 50-year-old when based solely on his age and expected retirement date is decidedly ***not*** an outlier debt/equity mix. Nor is our point that many target-date funds are overly aggressive.[9] Rather, it is the risk that permitting extremes when investment decisions are based on very little information creates an unacceptable level of risk for participants. Allowing target-date funds to use allocations that are more or less aggressive than average increases the risk created by making investment decisions without knowing the risk tolerances or investments of the investors. The Department cannot eliminate this risk because no target-date fund will meet every participant's particular needs and some degree of investment error is unavoidable, but it has a responsibility to minimize this risk by requiring that the unavoidable cost of investment error be minimized.

We recognize that this analysis would require that the Department provide some mechanism for determining what we have referred to as an "average" debt/equity mix. It is difficult for a government agency to take this step, especially in a political climate in which some influential commentators seem to reject even the possibility that financial services regulation benefits society. But it is a step that the Department is required to take as a matter of law, policy and practice. The Department should have followed the ineluctable logic of its authorization of informationally deprived decisions to invest participant assets in target-date funds, and limited the variance in their risk characteristics. The result of the Department's failure to do so was that, in 2008, "target date funds for 2010 suffered losses of as little as 4 percent to as much as 40 percent."[10]

The Department's current position continues to be, in effect, that it is appropriate for employers to place participants in high risk target-date funds even

[9] We disagree with the position expressed by some critics that target-date funds necessarily should assume very little risk.

[10] Remarks of SEC Chairman Mary Schapiro before the Solutions Forum on Fraud, Washington, DC (Oct. 22, 2009). Although this statement reflects all target-date funds, we have no reason to believe that the performance range of target-date funds in 401(k) plans was materially different.

if they have a low risk tolerance or other characteristics that would make a high risk target-date fund a particularly inappropriate investment selection. The Department has an obligation, having established the investment theory pursuant to which target-date funds qualify as QDIAs under the fiduciary safe harbor, to ensure that that investment theory is implemented consistent with the fact that investment decisions will be made without regard to important participant characteristics.

The target-date fund issue discussed above illustrates how, when the Department hesitates to act consistently with its own investment theories, the result can be investment decisions that are harmful to participants. It is the Department that has told employers that placing low risk tolerance participants in high risk target-date funds is permissible. Some might argue that forbearance by the Department in regulating the risk characteristics of target-date funds will allow more efficient free market forces to find the most efficient combination of investments, but this is a fantasy. The alternative to the Department's taking a position is not the free market. The fiduciary safe harbor eliminates the free market right of a low risk-tolerance participant to bring a fiduciary claim against the employer who defaults that participant into a high risk target-date fund. The natural constraints that are normally are present in the free market have been removed by the QDIA safe harbor.

To a large extent, it is the Department that decides what investments are appropriate for the 401(k) market. Employers are permitted, indeed, implicitly *encouraged* to place participant assets into target-date funds on the sole basis of the participant's age or expected retirement date, yet the range of asset allocations permitted in these funds will inevitably result in some participants, based on their risk tolerance or other investments, for example, being placed in extremely inappropriate investments. And the Department has expressly authorized employers to *ignore* risk tolerance and other investments, where other regulatory regimes *require* that advisers make a reasonable effort to incorporate these factors.

The Department cannot have it both ways. It must either:

- permit employers to make investment decisions based on what every financial professional would agree is inadequate information and, accordingly, narrowly circumscribe those investment decisions so as to minimize or eliminate the risk created by the inadequacy of information about participants on which the decisions are based, or

- require employers to collect information about participants' characteristics and afford employers greater freedom to use that information to make more tailored investment decisions for which they will be held fiduciarily responsible.

Each of these approaches is reasonable in theory, if not in practice. What is in no way reasonable, however, is for the Department to permit investment decisions that, for example, reflect a very high or very low risk tolerance where the participant's actual risk tolerance is permitted to have, and almost certainly will have, no bearing on the investment decision. This approach is internally inconsistent. The result is the kind of incoherent policymaking that creates significant risk for America's retirees.

This letter is not about target-date funds, however; nor is it intended to suggest that such incoherent policymaking has been a systemic problem at the Department in this area. To the contrary we believe that the Department's most recent initiatives regarding QDIAs, fee disclosure and conflicted investment advice demonstrate a laudable, implicit recognition of its role in applying substantive investment theory in the context of 401(k) plans.

One purpose of this letter is to encourage the Department to demonstrate a stronger commitment to this role. For example, we hope that the Department will respond directly to commenters who complain that the Department's actions represent excessive government interference by pointing out that the Department's role is necessarily intrusive. For example, the argument made in the context of the regulation of 401(k) plans that the "government should not dictate the solution or attempt to regulate exposure to investment risk" is either naïve or disingenuous.[11] A 401(k) plan is itself a form of government subsidy, which triggers a necessarily heightened public stake in its operations and structure. For decades, the public interest in 401(k) plans has been partly expressed by "regulating exposure to investment risk," including express statutory mandates that the Department to regulate "exposure to investment risk." To view the establishment of QDIAs as anything other than regulating "exposure to investment risk" shows an unwillingness to engage in serious debate about the appropriate scope of the Department's role in regulating 401(k) plans. ***The Department's ability to develop coherent 401(k) policies will depend partly on its commitment to expressly rejecting arguments that are fundamentally inconsistent with law, established public policy and decades of precedent as applied to the Department's role in regulating 401(k) plans.***

The Department should clarify that these commenters' complaints are with Congress and the fundamental structure of the Section 404(c) safe harbor (or, based on recent public debate, the very existence of a fiduciary duty under Section 404(a)) -- not with the Department. Their issue is not with how the Department does its job, but whether it does its job at all.

[11] Testimony of Paul Schott Stephens before the Committee on Education and Labor, U.S. House of Representatives, at 17 (Feb. 24, 2009) *available at* http://edlabor.house.gov/documents/111/pdf/testimony/20090224PaulSchottStevensTestimony.pdf.

That being said, we agree that the Department must exercise restraint and stay within its role, which is far from unbounded. What we object to is the absurdity of arguments, for example, that the Department should not be taking positions on what are generally accepted investment theories, and the Department's overly politic reluctance to meet these arguments head-on. It is imperative that the Department fully embrace its necessarily intrusive role in the context of evaluating annuities in 401(k) plans because a half-hearted policy on annuities, as illustrated by the target-date funds example discussed above, may leave America's retirees worse off than if the Department had never waded into this issue in the first place. ***When the Department takes action on the issue of annuities in 401(k) plans, its actions will necessarily be in the form of investment advice; the only question is whether that advice will be good or bad for Americans.***

II. Low Income Participants

We believe that the Department should tailor its approach to annuities in 401(k) plans to reflect particular concerns relating to low income workers. The participants with the lowest incomes have the most to lose if they make poor investment choices. We know that even if they make good investment choices, they are likely to rely heavily on Social Security and other transfer payments for their living expenses in retirement. Every dollar by which a low income worker's retirement income is reduced has a substantially greater impact than for a high income. The dollar lost to a low income worker is far more likely to reduce the worker's ability to afford food, shelter and medical care than it is likely to reduce a high income worker's ability to pay for these necessities.[12]

It is the inadequacy of low income workers' income to cover basic living expenses that presents the greater risk of undermining the viability of the Social Security system. The viability of the Social Security system depends on an inherently unstable political compromise. It is not, as popularly described, a "retirement system" in the sense of providing a mechanism for workers to save and invest current income that they then are paid in retirement.[13] Rather, it is structured as a current transfer of wealth from workers to retirees.[14] In contrast, a

[12] This principle is often referred to as the declining marginal utility of money. *See generally* Joshua Greene & Jonathan Baron, *Intuitions about Declining Marginal Utility* (June 2000) *available at* http://ssrn.com/abstract=231183.

[13] For example, the President's Commission to Strengthen Social Security describes Social Security as follows: "This 12.4 percent of wages paid into Social Security currently buys for these Americans an inflation indexed annuity upon retirement, as well as insurance against disability and protections for dependents and survivors." The Final Report of the President's Commission to Strengthen Social Security at 28 (Dec. 2001). While such rhetoric may itself "strengthen" the perception that Social Security has a strong foundation, Social Security taxes do not actually "buy" anything in the sense of taxpayers having purchased a contractual property right.

[14] Even this characterization gives excessive credence to Social Security as a bona fide "system" because current Social Security revenues (taxes) are not specifically earmarked for Social Security

401(k) plan represents a contractual property right that, while in a limited sense itself "political," is a far more politically viable structure for the long-term stability of our retirement system then Social Security. It is low income workers who are most dependent on Social Security, and the capacity of 401(k) plans generally and annuities specifically to place their retirement security on the politically and socially firmer ground of private, contractually protected arrangements should be a significant consideration as the regulation of 401(k) plans develops.

Private retirement plans also reflect a more coherent financial theory of retirement planning than government transfer payments. The statement above that Social Security represents a current transfer of wealth from workers to retirees is somewhat wishful because much of government spending is funded through borrowing, not current tax revenues. Thus, while the structure of a private retirement plan comprises a deferral of current consumption to fund future consumption, the structure of Social Security partly comprises current consumption funded by future deferral of consumption. We are not expressing a view on the Keynesian aspect of this observation, but rather on the different question of whether a pay-later approach, all things being equal, is more likely to enhance Americans' retirement security and promote a strong capitalist democracy than a pay-now approach. We believe that it is not.

Another way of making the same observation is to note that the much-debated privatization of Social Security has actually been well underway for decades in the form of a continuous expansion of tax-advantaged retirement funding mechanisms (*e.g.*, 401(k), 403(b), and 457 plans; IRAs; and Roth IRAs). The foregone tax revenues from tax-deferred investment vehicles are functionally no less transfer payments than are Social Security benefits. This privatization is structurally unsound, however, because it is used primarily by moderate and high income workers and does little to mitigate the transfer- and debt-based structure of our Social Security retirement system for low income workers. We believe that annuities have the potential to address this increasing structural segregation of retirement policy between a public system for low income workers funded through transfer payments and borrowing on the one hand, and a private, pre-funded system for other workers on the other hand.

The foregoing reinforces both the importance of considering regulation's affect on low income workers and the role of the Department in applying generally accepted investment theory through 401(k) regulation as discussed *supra* at pages 3 - 11. Indeed, the Department should be viewed not as fomenting intrusive government regulation, but as promoting free(er) markets. The practical alternative to heavily regulated 401(k) plans is not an unregulated retirement market, but an even more regulatory, and arguably unsustainable, Social Security

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payments (benefits). Social Security taxes fund the general treasury, where they provide one source for all federal government expenditures.

system. Indeed, one irony of criticisms of the Department for over-regulating 401(k) plans is that it is the Department's success or failure in fulfilling this role that will have a direct impact on the far more intrusive model of providing Americans' retirement income through current transfer payments and borrowing.[15] As long as Congress continues to abdicate its responsibility for addressing the long-term problems with Social Security, the Department will be the *de facto* lead policymaker on this issue.

To return to the primary focus on this discussion – low income workers – a variety of factors argue for focusing on concerns relating to low income workers in developing 401(k) regulations for annuities, including particularly the ameliorative effect on Social Security issues that the use of annuities in 401(k) plans could have. The social and individual cost of low income workers' not realizing the expected value of their retirement assets in retirement is far greater than for other workers. Low income workers who survive paycheck to paycheck already are at greater risk of unexpected expenses derailing their lives. In retirement and without the potential flexibility that earnings can provide, low income retirees are even more vulnerable to investment risk. Workers are and should be more risk averse at lower incomes.

Annuities have the potential to reduce or eliminate retirement income risk for low income workers. A low income worker who purchases a fixed, inflation-adjusted lifetime annuity at retirement can eliminate the retirement income risk that an investment portfolio that fluctuates in value presents.[16] Purchasing the

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[15] In other words, we reject the view that "true libertarians" should be expected to "object to restrictions on default portfolios." James Choi, David Laibson & Brigitte Madrian, *Are Empowerment and Education Enough? Under-Diversification in 401(k) Plans* at 24 (2005) *available at* http://www.brookings.edu/es/commentary/journals/bpea_macro/forum/200509bpea_laibson.pdf. This view assumes that the alternative to such restrictions is a libertarian marketplace when, in fact, the true alternative is a *more* intrusive government role, not less. By analogy, those who oppose federally insuring money market funds on libertarian grounds ignore the fact that their position may have the effect of directing cash to riskier, more heavily regulated banks. *See* Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (2009) *available at http://ssrn.com/abstract=1351987*. Unless it is a libertarian principle that public policy reforms must be modeled on theoretically perfect ideals, rather than practicable, incremental improvements, then Department policies that substitute default-option paternalism (401(k) default options) for coerced transfer payments (Social Security) should be supported by "true libertarians." We note that this is an argument that policies that reduce government intrusion into the marketplace are libertarian, in contrast with the argument that default options are inherently libertarian (or not paternalistic) if they reflect so-called "libertarian paternalism." *See*, *e.g.*, Cass Sunstein & Richard Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chic. L. Rev. 1159 (2003).

[16] *See generally* Wolfram J. Horneff, Raimond Maurer, Olivia S. Mitchell, & Ivica Dus, *Optimizing the Retirement Portfolio: Asset Allocation, Annuitization, and Risk Aversion* (July 2006) (quantifying risk aversion and finding fixed annuity a more appealing option for most risk averse); Ralph Koijen, Theo Nijman & Bas Werker, *Optimal Annuity Risk Management*, CentER Working Paper Series No. 2006-78 (Aug. 2009) (risk averse investors are less willing to bear inflation risk) *available at* http://ssrn.com/abstract=890730.

same annuity while working, where the income stream begins at retirement, has the added benefit of eliminating investment risk during the accumulation phase. This reduction in risk comes with an attendant reduction in potential returns, but the potential downside costs of negative performance are much greater for low income workers for the reasons discussed above.

We recognize that low income workers, as a group, might enjoy higher average incomes by investing in the securities markets during both the accumulation phase and retirement, but an individual retiree does not receive the average retirement income. An individual retiree can sink into poverty regardless of the average retirement income of his cohort, just as easily as a person can drown in a lake with an average depth of only six inches. The greater the variance in the investment success of low income workers, the higher their average income is likely to be, but the absolute number of low income retirees who fall below a fixed poverty line also will be greater. Greater variance may mean that more low income retirees will enjoy higher incomes that they would had they purchased an annuity, but it also may mean that more low income retirees will go hungry and rely on redistributional policies to survive.

Expressing this point in terms of a normal distribution curve, greater risk may move the average retirement income to the right, but it will also increase the length of the tail on the left. Greater variance in investment returns will create a larger absolute number of outliers and, importantly, a larger number of outliers that fall below a minimum income level. When one's position on the left tail is a matter of affording or not affording a nice vacation or cable television, the prospect of maximizing overall societal wealth through investment in the capital markets may justify greater risk-taking. We believe that, when a retiree's position on the left tail determines whether he can afford basic necessities, however, the individual and social costs of what may be a societally wealth-maximizing strategy exceed its potential benefits. The Department must recognize the rational basis for greater risk aversion among low income workers when considering the role of annuities in 401(k) plans.

III. Least Sophisticated Participants

The regulation of 401(k) plans also should be particularly tailored to the needs of the least sophisticated participants. Unsophisticated participants are most likely to make bad investment decisions and are most vulnerable to abusive sales practices. An annuity is at once both a greater and smaller risk with respect to unsophisticated participants. For example, a simple, inflation-adjusted, fixed annuity based on standardized terms and a fully disclosed, standardized price presents substantially less risk than does managing a pool of investments. Such an annuity would reduce an ongoing monitoring requirement to a single decision, and that decision would be far simpler than the process of selecting an appropriate mix of investments and planning and managing a schedule of withdrawals in

retirement ("withdrawal risk"). A fixed annuity eliminates behavioral risk, *i.e.*, the risk that worker will implement a good plan but fail to stay with it in practice.

An annuity need not comprise all of a worker's retirement portfolio to provide these advantages. It can provide these advantages even if it represents only a part of a worker's retirement portfolio. For example, an annuity might provide for a welfare-based minimum level of income, which would mitigate the complexity risk presented by the rest of a portfolio being invested in securities.

Unfortunately, annuities also have the potential to exacerbate the risk created by complexity. Insurance companies offer fixed annuities with a variety of features. Each additional feature makes an annuity more difficult to evaluate and to compare with other annuities. The greater the complexity, the greater the likelihood that the least sophisticated participants will make poor investment choices and/or pay excessive fees. Participants will be not able to correct their mistakes when the annuity purchase is irrevocable.

The problems encountered by the least sophisticated participants will also be exacerbated by the fact that this group overlaps disproportionately with low income participants. Low income participants are less likely to have the educational background, for example, that would provide them with greater sophistication and are definitionally less likely to have sufficient disposable income to retain a professional adviser. This latter point makes it likely that they will bear the brunt of conflicted advice that the Pension Protection Act permits employers to provide through a plan.

In summary, unsophisticated participants are more likely to make bad investment decisions, and, when they are also low income participants, the adverse effects of bad decisions will be magnified. We believe that the regulatory foundation on which the Department's approach to annuities should be principally based is the special concerns relating to low income, less sophisticated participants. The Department should consider investment risk, complexity risk and withdrawal risk as particular concerns. This may require, for example, that the Department promote or require the offering of simpler options that admittedly may not be perfectly aligned with each individual participant's needs but that would generate a net benefit when all risks are considered. The Department must not allow the perfect to be the enemy of the good. It must be realistic about the characteristics of the 401(k) plan participants who are most at risk.

IV. Variable Annuities

It is an unfortunate aspect of the regulatory context for annuities that they happen to be involved in more sales abuses than any other retail financial services product. Variable annuities are the most prominent repeat offenders in regulatory enforcement actions and are almost universally viewed negatively in the financial

press and in the academic literature.[17] For example, personal finance writer Liz Pulliam Weston has labeled variable annuities the "worst retirement investment you can make," and Investment Sense, LLC, has called them "one of the most overhyped, most oversold, and least understood investment products."[18] One analyst estimates that variable annuities transfer approximately $25.6 billion a year "of spendable investment returns" from vulnerable investors to the insurance industry and its sales force.[19] To be frank, we were stunned by the Department's request for comments on whether 404(c) regulations should "be amended to ***encourage*** use for these products" (emphasis added).

If anything, the Department should take steps to ***discourage*** the rampant overuse of variable annuities. Variable annuities are routinely the subject of antifraud enforcement actions. As has been noted elsewhere,

> While industry trade associations have argued that "there have been few concerns in the life insurance marketplace that would justify additional regulatory oversight," concerns over abusive practices involved in the marketing and sales of annuities and more particularly variable annuities have led NASAA to issue numerous warnings about the products to investors and were similarly identified as a problem area in the joint SEC-FINRA-NASAA Investor Alert on schemes to defraud senior investors.[20]

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[17] *See generally* Letter from AARP, North American Securities Administrators Association, Fund Democracy and Consumer Federation of America to Chairman Christopher Dodd and Ranking Member Richard Shelby, Committee on Banking, Housing and Urban Development, U.S. Senate (Feb. 2, 2010) (discussing abusive sales practices in sale of variable annuities to seniors) *(Variable Annuities Senior Citizen Letter*).

[18] Liz Pulliam Weston, *The Basics: The Worst Retirement Investment You Can Make* (updated January 2008); InvestSense, LLC, *Common Sense InvestSense™ … Variable Annuities* (2002); *see also*, Caroline Greer, *The Great Annuity Rip-Off*, Forbes (Feb. 9, 1998).

[19] Scott Burns, *Variable Annuity Watch, 2008*, *AssetBuilder – Registered Investment Adviser*.

[20] *Variable Annuities Senior Citizen Letter*, *supra*, citing: NASAA News Release, "NASAA Identifies Traps Likely to Burn Investors This Summer" (June 17, 2008); NASAA News Release, "State Securities Regulators Issue Senior Investor Alert" (Sep. 10, 2007); NASAA News Release, "State Securities Regulators Identify Top 10 Traps Facing Investors" (May 15, 2007); *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Seminars*, Securities and Exchange Commission, North American Securities Administrators Association and Financial Industry Regulatory Authority (2007); NASAA News Release, "State Securities Regulators Release 'Unlucky 13' Investor Traps" (Feb. 16, 2006). *See also* FINRA Investor Alert, "Should You Exchange Your Variable Annuity?" (last updated Mar. 2, 2006) (citing abusive sales practices); Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2003); FINRA Investor Alert, "Variable Annuities: Beyond the Hard Sell" (last updated May 27, 2003); NASD Regulatory and Compliance Alert, "Advertising of Bonus Credit Variable Annuities" (Summer 2000) (warning against misleading sales practices); NASD Notice to Members 99-35, "The NASD Reminds Members of their Responsibilities Regarding the Sales of Variable Annuities" (May 1999); NASD Notice to Members 96-86, "NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements" (Dec. 1996).

We encourage the Department to review carefully the materials produced by other regulators on variable annuities that are cited in the immediately preceding footnote before taking any steps that might promote the sale of variable annuities and thereby facilitating the perpetration of sales abuses upon America's investors.

At the heart of widespread sales abuses involving variable annuities is the fact that they are not really annuities at all. Functionally, variable annuities operate as investments rather than as lifetime income sources. The word "annuities" in the term "variable annuities" is principally a sales pitch. There is generally no meaningful advantage provided by the annuity option offered by variable annuities. This is partly reflected in the low incidence of variable annuity purchasers who actually annuitize their investments. One study found that less then 0.8% of variable annuity purchasers actually converted to a fixed income annuity.[21]

Variable annuities' primary practical advantage is tax deferral, yet that advantage is of no benefit to participants in already tax-deferred 401(k) plans. Variable annuities are extremely complex, which presents particular concerns for less sophisticated investors, and their fees are consistently higher than fees charged by other types of investment options. There are numerous studies that question whether the special features of variable annuities benefit more than a small number of purchasers.[22] The death benefits provided by variable annuities are generally considered to be overpriced, [23] as are their guaranteed withdrawal benefits.[24]

The Department should consider that any expansion of the role of annuities in 401(k) plans is likely to provide greater opportunities for insurance agents to advise client to buy insurance products under the conflicted advice safe harbor. History shows that it is variable annuities that are most likely to be the

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[21] *See* Jeffrey Brown, *Rational and Behavioral Perspectives on the Role of Annuities in Retirement Planning*, NBER Working Paper 13537 (2007) (less than 0.8% o variable annuities were converted to fixed life annuities, citing Dan Beatrice and Matthew Drinkwater, *The 2003 Individual Annuity Market: Sales and Assets*, LIMRA International (2004)).

[22] *See*, *e.g.*, William Reichenstein, *An Analysis of Non-Qualified Tax-Deferred Annuities*, 73 J. Invest. 9 (2000).

[23] *See*, *e.g.*, Moshe Arye Milevsky & Steven Posner, *The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds*, 68 J. Risk & Ins. 93 (2001) (estimating value of death benefit to be 1 to 10 basis points and median charge for death benefit as greater than 10 times that amount).

[24] *See*, *e.g.*, Benny Goodman & Seth Tanenbaum, *The 5% Guarantee Minimum Withdrawal Benefit: Paying Something for Nothing?* TIAA-CREF Research Institute (2008) (concluding that guaranteed minimum withdrawal benefit "does not offer much value") *available at* http://www.tiaa-crefinstitute.org/pdf/research/research_dialogue/89.pdf.

subject of self-serving recommendations under the Department's new conflicted advice rules, especially if the Department permits computer model recommendations to ignore these investment options. Over the last six months, the insurance industry has been the most vocal opponent of applying a fiduciary duty – which provides the bedrock of regulation under ERISA – to the sale of variable annuities. The Department should carefully review insurance lobbyists' recent arguments that the fiduciary duty is incompatible with the business of selling variable annuities in its evaluation of the compatibility of variable annuities with ERISA's fiduciary regulatory structure.

Rather than seeking ways to encourage the use of variable annuities in 401(k) plans, the Department should be seeking ways to protect participants against the sales abuses that are so frequently associated with these products. Variable annuity options, if allowed at all, should be subject to heightened scrutiny, with a heavy burden placed on plan sponsors who choose such inherently questionable products as 401(k) investment options and the insurance companies that sell them.

V. Initial Recommendations

Based on the foregoing discussion, we have the following initial recommendations regarding the role of annuities in 401(k) plans:

- Mandatory Annuities. We recommend that employers be required to offer two types of standardized annuities as 401(k) plan options. The Simple Annuity would provide retirees with an immediate contractual right to a fixed, inflation-adjusted income stream for the life of the retiree or the retiree and their spouse. It would have no investment or other features. Its only fee would be included in the lump sum purchase price. The Future Simple Annuity would be identical except that it could be purchased on an installment basis during a worker's career and would provide an immediate contractual right to a fixed, inflation-adjusted, lifetime income stream beginning at the age of retirement. The essential information about each Simple Annuity and Future Simple Annuity would be presented in a price/payout chart for different ages that would allow for easy comparison, and promote competition, among annuity providers.[25] Employers should be permitted to offer other types of annuities, provided that the standardized Annuities received greater prominence and subject to new requirements applicable to variable annuities discussed below.

- "Guaranteed" Annuities. The Department should consider requiring employers and/or annuity sellers to obtain reinsurance of annuities in excess of amounts recoverable from applicable state guaranty funds. Fixed annuities are routinely (and, we believe, falsely) advertised as

[25] *See* Mercer Bullard, *Annuities in Retirement Plans: Live Long and Prosper?* Morningstar.com (Mar. 18, 2010) *available at* http://news.morningstar.com/articlenet/article.aspx?id=329545.

providing a "guaranteed" source of income, although the seller's promise is only as certain as its own creditworthiness and the amount of the coverage limit of the applicable state guaranty fund. The greatest benefit offered by an annuity is the income security that it is held out as providing. Employers and/or sellers should be required to reinsure annuities up to a minimum income level. The maximum coverage for defined benefit obligations provided by the Pension Benefit Guaranty Corporation might be an appropriate benchmark ($4,500/mo in 2010), and the Department should consider recommending to Congress that the PBGC itself provide reinsurance at least for the mandatory Simple Annuities discussed above.

- Variable Annuities. The Department should not "encourage" the use of variable annuities. To the contrary, the Department should take steps that recognize the long-term, pernicious effect of variable annuity sales abuses on America's investors. We recommend that the Department consider special requirements to protect plan participants against these abuses. For example, the Department could require employers to obtain from sponsors of variable annuities that are offered as 401(k) plan investment options a plain English analysis of the sponsor's determination that the benefits of each non-investment feature of the variable annuity exceeds its cost and cannot be obtained at lower cost by other means. For example, the sponsor of a variable annuity that offers the option to convert to an income stream at a future date would be required to show that the additional benefit provided by that option exceeded its cost (with data on the actual frequency with which annuity options are selected being incorporated into this analysis). If a variable annuity offered a death benefit that guarantee a minimum account value upon the death of the owner, the sponsor should have to demonstrate that the relevant risk of loss could not have been achieved more efficiently by other means, such as through the purchase of a term life policy and/or a reduction in the risk of the assets underlying the variable annuity.

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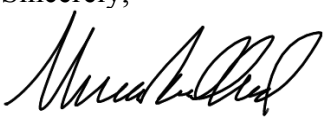
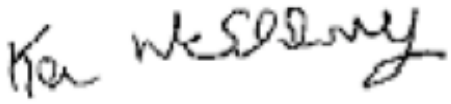
We strongly support the Department's evaluation of the role of annuities in 401(k) plans and sincerely hope that it will not refrain from the full exercise of its responsibilities in this area. The retirement security of Americans has entered a precarious period in which systematic planning errors may have disastrous individual and societal consequences. The Department has an obligation to act decisively to guide the investment decisions of the least sophisticated, most vulnerable 401(k) plan participants.

We look forward to working with the Department to strengthen Americans' retirement security by developing a coherent plan for the full integration of annuities into the 401(k) plan marketplace.

Sincerely,



Mercer Bullard
President and Founder
Fund Democracy, Inc.



Ken McEldowney
Executive Director
Consumer Action

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc by U.S. Mail:

Honorable Hilda Solis, Secretary of Labor
Phyllis C. Borzi, Assistant Secretary of Labor (EBSA)