The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

February 6, 2008

ICI Letter on Proposed IRS Rules on Automatic Contribution Arrangements, February 2008

Via Email

February 6, 2008

Internal Revenue Service
CC:PA:LPD:PR (REG-133300-07)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulations Relating to Automatic Contribution Arrangements

Ladies and Gentlemen:

The Investment Company Institute, on behalf of its members, submits these comments concerning regulations proposed by the Internal Revenue Service and the Treasury Department to implement provisions of the Internal Revenue Code added by the Pension Protection Act of 2006 to encourage employers to offer plans with automatic enrollment.[1] Our comments relate to automatic contribution arrangements that qualify for safe-harbor treatment for purposes of non-discrimination testing under sections 401(k)(13) and 401(m)(12) of the Code (qualified automatic contribution arrangements, or QACAs) and automatic contribution arrangements under section 414(w) of the Code that may permit participants to withdraw their automatic contributions without violating the Code's distribution rules (eligible automatic contribution arrangements, or EACAs). We make suggestions on how the Service can clarify the proposed rules by making them more flexible and cost-efficient to further the Congressional purpose of encouraging employers to offer plans with automatic enrollment.[2]

The Investment Company Institute is the national association of U.S. investment companies (including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts), which manage more than half of 401(k) assets and assets of other defined contribution plans.[3] Mutual fund firms and their affiliates also serve as recordkeepers and other service providers to 401(k), 403(b), 457, and other defined contribution plans.

Institute members have a significant interest in workable and cost-effective regulations that ensure secure and adequate retirement savings for participants and their beneficiaries. The Institute strongly supports policies that facilitate automatic enrollment in retirement plans and we commend the Service for clarifying many issues through this proposal.

The majority of our comments relate to the operation of EACAs, including how the plan year requirement should be applied, how current employees with pre-EACA plan elections on file should be treated, and what is required by the condition that assets be invested in accordance with regulations issued by the Department of Labor for default investments. We request clarification on a number of issues related to the operation of permissible withdrawals and the notice requirements for EACAs. Our letter also requests additional guidance on the notice timing requirement for both QACAs and EACAs for plans with immediate eligibility, and transitional relief for sponsors of calendar year plans that wish to implement automatic contribution arrangements during the 2008 plan year.

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I . EACA Comments

A. Plan Year Requirement

The proposed regulation is not clear as to whether EACAs must be implemented for full plan years only. The proposal states that an arrangement is an EACA "under an applicable employer plan that, for the plan year, satisfies the uniformity requirement …, the notice requirement …, and the default investment requirement" (emphasis added). 4 While the emphasized language may suggest a requirement that EACAs must be implemented for full plan years only, we do not believe that the PPA requires it. We believe a plan should be permitted to implement an EACA at mid-year so that employees could begin saving for their retirement earlier, and we urge the Service to clarify this point in the final regulation.

B. Employees with Pre-EACA Plan Elections for Deferral Rates

An eligible employee will be enrolled in his or her plan at an EACA deferral rate and in an EACA investment alternative only in the absence of his or her affirmative election. 5 We recommend that plans be allowed to have discretion to decide whether the term "affirmative election" would include an affirmative election for a deferral amount (including zero) that predates the EACA's effective date. This flexibility would allow employers to design automatic contribution arrangements that are most suitable for their work force.

C. Investment in Accordance with ERISA Section 404(c)(5)

Under Code section 414(w)(3)(C), an arrangement qualifies as an EACA only if, among other requirements, in the absence of an investment election by the participant, EACA contributions are invested in accordance with regulations prescribed by the Secretary of Labor under section 404(c)(5) of ERISA ("DOL Qualified Default Investment Alternative Regulation"). The proposed regulation clarifies that this investment condition applies only to plans subject to Title I of ERISA. 6

The Institute recommends that the Service further clarify that the investment condition relates only to the types of investment vehicles (qualified default investment alternatives, or "QDIAs") permitted by the DOL QDIA Regulation, and not to any other conditions of the DOL QDIA Regulation. 7 In addition, because the Code makes it clear that a participant may make his or her own investment election for EACA contributions and still remain an EACA participant, we recommend that the Service make clear that the EACA investment condition applies only in the absence of an investment election by the participant. 8

D. Permissible Withdrawals

A plan with an EACA may permit participants to withdraw EACA contributions, subject to certain conditions. We ask the Service to clarify a number of interpretive issues with respect to permissible withdrawals.

1. Identifying Permissible Withdrawals ¾ Date of First EACA Contribution

Employers and their service providers need to be able to readily distinguish permissible withdrawals from other distribution and withdrawal requests, because these withdrawals are subject to special rules under the Code. The fact that many EACAs also will be structured to comply with the DOL QDIA Regulation, which imposes its own rules on withdrawals of defaulted contributions, further increases the importance of a workable permissible withdrawal definition.

One condition for a permissible withdrawal is that an election to withdraw EACA

contributions be made during the prescribed 90-day election period that begins with the date of the first EACA contribution. 9 The proposed regulation defines the date of the first EACA contribution as "the date the compensation that is subject to the cash or deferred election would otherwise have been included in gross income." 10 This "income date" definition may be unworkable for many plans because in many cases EACA rules will be administered by service providers that generally may have plan-level payroll information but not participant-specific "income date" information. 11

In addition, the DOL QDIA Regulation generally prohibits imposition of any restrictions, fees or expenses on EACA permissible withdrawals. 12 If the 90-day election period for permissible withdrawals begins with the "income date," many service providers would not know when a participant-specific election period begins or ends, and therefore they would not easily be able to determine whether a participant's withdrawal may be charged certain fees.

The Institute recommends that the Service adopt a more flexible definition for the date of the first contribution to ensure smooth functioning of the overlapping regulatory schemes of ERISA and the Code with respect to permissible withdrawals. Under the DOL QDIA Regulation, in some cases, plans use the date of first investment in a QDIA for calculating the 90-day period for transfers out of a QDIA. 13 We recommend that the Service allow employers to decide which definition (e.g., income date or first investment date) works best for them in calculating the 90-day election period.

2. "Grace" Pay Period For Ceasing Contributions Pursuant to a Participant's Election

The proposed regulation clarifies that the effective date of a participant's election cannot be later than the last day of the payroll period that begins after the election is made. 14 By allowing the effective date of the election to be as late as the last day of the payroll period that begins after the election is made, the proposed regulation allows EACA contributions to continue for an extra payroll period before they are stopped. Allowing this "grace period" to stop EACA contributions is important for plans and their service providers, and we urge the Service to retain this grace period provision in the final regulation. The Service should also clarify that EACA contributions made through the end of this grace period must be included in a permissible withdrawal distribution.

The proposed regulation is silent on the issue of who will set the "effective date" of the election. We suggest that the Service clarify that the effective date of an election should be set by the plan administrator (e.g., "as determined by the plan administrator") and not by a plan participant.

3. Partial Withdrawals

We recommend that the Service make clear in the final regulation that partial withdrawals are not permissible. This conclusion is consistent with the Code, which states that a distribution amount must be "equal to" the amount of the first EACA contribution and any succeeding EACA contributions (and earnings attributable thereto) through the effective date of the election. As a practical matter, partial withdrawals may be complicated and expensive to administer. While a request for a flat dollar amount presents fewer difficulties, calculations will be complex and expensive if a participant wishes to withdraw EACA contributions above a certain deferral rate (with earnings) going back to the first EACA contribution. If the Service permits partial withdrawals in the final regulation, we strongly

recommend that plans be allowed discretion whether to permit partial withdrawals and under what conditions.

4. Relationship Between an Employee's Change in the EACA Deferral Rate and the Withdrawal Right

The Service should clarify the relationship between an employee's change in the EACA deferral rate and his or her right to a permissible withdrawal, and also clarify the effect of the permissible withdrawal on the employee's ability to change deferral rates in the future. An employee has a right to change his or her deferral percentage from the EACA-prescribed percentage at any time, but he or she has ninety days from the date of the first EACA contribution to make an election for a permissible withdrawal. 15 The Service should confirm that a participant's change from the EACA-prescribed deferral percentage during the 90-day election period would not affect the participant's ability to elect to withdraw his or her EACA contributions made before he or she changed the deferral rate.

It is also important that the Service confirm that once an employee withdraws all his or her EACA contributions, the employee is no longer a participant in the plan and, therefore, that employee will have to re-enroll in the plan under the plan's general enrollment rules to make any new deferral elections.

5. Forfeiture of Related Matching Contributions

Both the Code and the proposal address what happens to matching contributions related to participants' elective contributions that are subsequently withdrawn as permissible withdrawals. The Code provides that, with respect to permissible withdrawal distributions, the related employer contributions "shall be forfeited or subject to such other treatment as the Secretary may prescribe." 16 The proposed EACA regulation mandates that "employer matching contributions with respect to the amount withdrawn must be forfeited." 17

Some employers make their matching contributions on different cycles than payroll periods, quarterly, semi-annually or even annually. 18 We recommend that the Service clarify that only matching contributions actually made and posted to participants' accounts in connection with EACA contributions are required to be forfeited.

6. Right to Re-Enroll and Investment Restrictions of General Applicability

The Service stated in the preamble that an employer may not condition the right to take the permissible withdrawal on an employee making an election to have no future elective contributions made on the employee's behalf because such a condition would violate the contingent benefit rule under Code section 401(k)(4)(A) or the universal availability requirement under Code section 403(b)(12)(A)(ii). 19

We request clarification that this rule would not prevent the application of reinvestment or "round-trip" restrictions used in certain mutual funds. Some mutual funds restrict investors from reinvesting in the fund within a specified period of time (e.g., 30 days) after redeeming shares of the fund, to prevent abusive trading practices. Many funds implemented round-trip restrictions in the aftermath of the discovery of market timing involving mutual funds, in which frequent trading by certain fund shareholders operated to disadvantage long-term fund shareholders. A mutual fund with this type of restriction may serve as the plan's default investment (or may be part of a model portfolio that serves as the default investment). When an employee elects to make a permissible withdrawal, but

decides to make future elective contributions to the plan, the employee may not be permitted to reinvest in the default fund (or certain funds in the default model portfolio) for a period of time. In light of the important investor protections “round-trip” restrictions provide to long-term investors, we ask the Service to confirm that restrictions of this type, which would apply to any participant moving assets out of the fund (not just participants making permissible withdrawals), would not constitute a restriction on the right to make future elective contributions to the plan.

7. Implications for Sections 402(g) and 415

Sections 402(g) and 415 of the Code set annual limits on the amount of contributions to a retirement plan. The Service should confirm that amounts withdrawn as EACA permissible withdrawals should not be counted towards these annual contribution limits if a participant re-enrolls in the plan in the year in which the permissible withdrawal is made. In other contexts (e.g., ADP testing), EACA contributions that are withdrawn as permissible withdrawals are treated as never made. We recommend that the same approach apply in determining whether a participant exceeds his or her annual contribution limits.

8. Six-Month Extension under Code Section 4979(f)

Section 4979 of the Code imposes a tax on certain excess plan contributions, unless they are distributed within a specified period of time. The PPA modified this Code section to extend the distribution deadline of excess contributions made to EACAs from two and a half months to six months. 20 While some EACAs may offer a permissible withdrawal feature, others may not. 21 We ask the Service to clarify that the six-month extension would apply equally to all EACAs, regardless of whether or not the plan includes a permissible withdrawal feature.

E. EACA Notices

1. Required Recipients

We ask the Service to clarify with respect to EACA notices that, while the notices may be distributed to the entire plan population, they must be provided only to employees eligible for automatic enrollment under EACAs. Under this rule, an existing plan implementing an EACA would be required to provide notices only to employees who in fact would be enrolled in the plan under the new EACA. The plan may, but would not be required, to provide notices to employees who are already enrolled in the plan or had affirmatively elected not to participate in the plan.

This interpretation is consistent with the Code, which only requires that notices be provided to each employee eligible for the arrangement. 22 While some employers may prefer to send the notice to the entire plan population, other employers may prefer to give notices to EACA-eligible employees only, because a broader distribution might confuse employees who will not be affected by the EACA. 23 Allowing employers to decide which approach works best for them may help encourage implementation of automatic contribution arrangements.

2. Content of Notices

The requirements for an EACA notice include two main components. First, the proposed regulation lists specific information that should be included in the notice, such as the level

of EACA contributions, the employee's right to elect to opt-out, how EACA contributions will be invested, and the employee's right to make a permissible withdrawal, if applicable. 24 Second, the proposal requires the inclusion of other, more detailed plan information, to the extent applicable to EACAs (e.g., employer contributions that may apply to EACA contributions, a plan's withdrawal and vesting rules). 25

Some information required by the second component may crowd the notice with information and may detract from the basic information employees need to know about their immediate rights with respect to EACAs. Adding too much information to a basic EACA notice also will increase the costs of providing notices, which will be borne by plans and their participants. We recommend that the Service permit employers discretion on how much additional information to include in the notice from this second component. At the least, the Service should consider allowing the notice to cross-reference other documents (e.g., SPDs).

II. Timing of Initial Notices in Plans With Immediate Eligibility

In the proposals, the Service has provided helpful clarification on the timing requirement for initial notices for both QACAs and EACAs. 26 As we discuss below, we believe more guidance is needed on the timing of initial notices in plans with immediate eligibility.

As clarified by the proposal, the initial notice must be provided within a reasonable period before the employee becomes an eligible employee, 27 and must be provided sufficiently early so that the employee has a reasonable period of time after receipt of the notice and before the first elective contribution is made under the arrangement to opt out from the automatic contribution arrangement. 28 The timing requirement may be satisfied through the "deemed satisfaction" approach, which is generally the same as the rule currently used for providing standard safe harbor non-discrimination notices. 29 The deemed satisfaction approach is a bright-line test for when the notice is deemed to be timely. 30 In explaining the deemed satisfaction approach, the Service stated that, for new hires, the deadline for the notice is the first day of employment in plans with immediate eligibility. 31

The problem under both the general rule and the deemed satisfaction rule is that for plans with immediate eligibility, there is no lead time to provide notices to new hires. The due date is the eligibility date, which means the first date of employment. This simply may not be possible for many employers and their service providers. For example, some employers provide benefits information packages at the start of employment but they may not be certain that the packages are provided on the first day of employment. As a result, plans with immediate eligibility are most vulnerable to violating the timing notice rules of QACAs and EACAs, which may lead to plan disqualifications. This risk may discourage plans from adopting QACAs and EACAs or from permitting immediate eligibility in their plans, which is the opposite of what the PPA intended to accomplish.

We recommend that the Service remove the eligibility date deadline, which is not present in the Code, from notice requirements with respect to newly-eligible employees for plans with immediate eligibility. The Service should state that a notice would be timely if it is provided as soon as practicable on or after the employee becomes an eligible employee, as long as the employee is given an opportunity to make his or her election prior to the first elective contribution under the respective arrangement.

Alternatively, we recommend that the final regulations allow a plan with immediate eligibility to set eligibility dates for QACAs and EACAs that are different from the plan's eligibility date, but that do not extend past the last day of the full payroll period that begins after the employee becomes eligible to participate in the plan. We believe this approach strikes a balance between an employer's need for extra implementation time for plans with immediate eligibility and facilitating automatic enrollments that begin with an employee's first "full" pay check.

We believe the changes we recommend would provide needed flexibility to ensure that employers (especially smaller employers) are not discouraged from offering immediate plan eligibility or automatic enrollment in their plans because of concerns that they cannot set up payroll systems and provide notices on an employee's first date of employment.

III. Transitional Relief for 2008

Under the proposed regulation, QACAs must be effective as of the first day of the plan year and must remain in effect for an entire 12-month plan year. 32 For plans with calendar years that wish to implement a QACA beginning in 2008, this requirement means that the first QACA notices must have been provided no later than January 1, 2008. 33 Because the proposed QACA regulations and the Sample Automatic Enrollment and Default Investment Notice were issued late in 2007, many plans were not able to provide notices by January 1, 2008. The Institute urges the Service to provide transitional relief for 2008 so that plans that did not provide QACA notices by January 1, 2008 may still implement QACAs for a partial year in 2008.

In the event the Service applies the full plan year requirement to EACAs, we request that similar transitional relief be provided for EACAs.

* * *

The Institute would welcome the opportunity to provide further assistance to the Service in developing the regulations and any additional guidance. Please feel free to contact the undersigned at (202) 326-5826 or Anna Driggs at 202/218-3573.

Sincerely,

Mary S. Podesta
Senior Counsel – Pension Regulations

ENDNOTES

1 The proposal was published in 72 Fed. Reg. 63144 (Nov. 8, 2007).

2 Academic research finds that automatic enrollment increases participation and savings among lower income workers. See Choi, Laibson, Madrian, and Metrick, "For Better or For Worse: Default Effects and 401(k) Savings Behavior," NBER Working Paper, No. 8651, Cambridge, MA: National Bureau of Economic Research, December 2001; and Choi, Laibson, Madrian, and Metrick, "Saving For Retirement on the Path of Least Resistance," originally prepared for Tax Policy and the Economy, 2001, updated draft: July 19, 2004. The EBRI/ICI 401(k) Accumulation Projection Model incorporates the results from the academic research and applies them to all 401(k) plans for each worker's full career. The EBRI/ICI model finds that automatic enrollment increases participation rates, particularly among

lower income participants.

3 The Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of the Institute manage total assets of $12.68 trillion and serve almost 90 million shareholders.

4 Prop. Reg. § 1.414(w)-1(b)(1).

5 Prop. Reg. § 1.414(w)-1(b)(1) (EACA definition); Prop. Reg. § 1.414(w)-1(e)(2) (definition of automatic contribution arrangement).

6 Prop. Reg. § 1.414(w)-1(b)(4).

7 For example, the DOL QDIA Regulation contains requirements for additional participant disclosures. 29 C.F.R. § 2550.404c-5(c)(4).

8 In general, it is clear that under the Code, if an automatically enrolled participant changes his or her investment elections (but does not change the "automatic" deferral rate), he or she is still treated as an automatically enrolled participant subject to the requirements of the applicable arrangement (e.g., annual notices, automatic increases in the deferral rates for QACAs, the right to a permissible withdrawal for EACAs, etc.).

9 IRC § 414(w)(2)(B).

10 Prop. Reg. § 1.414(w)-1(c)(2).

11 Because Roth contributions are included in a participant's gross income, the "income date" definition also would not work for Roth contributions.

12 29 C.F.R. § 2550.404c-5(c)(5)(ii).

13 29 C.F.R. § 2550.404c-5(c)(5)(ii).

14 Prop. Reg. § 1.414(w)-1(c)(2).

15 IRC § 414(w)(2)(B); Prop. Reg. § 1.414(w)-1(c)(2).

16 IRC § 414(w)(1).

17 Prop. Reg. §1.414(w)-1(d)(2).

18 If a match is made on an annual basis and a participant makes a permissible withdrawal in the first quarter of the year, the match related to that participant's EACA contribution should not be considered as forfeited, but should be treated as never made.

19 Preamble to Prop. Reg., 72 Fed. Reg. 63144, 63147.

20 IRC § 4979(f)(1).

21 72 Fed. Reg. 63144, 63147.

22 IRC § 414(w)(4)(A)(EACA).

23 The Sample Automatic Enrollment and Default Investment Notice issued by the Service appears to be addressed to the entire plan population, but it explains that the new automatic enrollment features would not, for example, apply to participants with elections on file.

24 Prop. Reg. § 1.414(w)-1(b)(3)(ii)(A)-(D).

25 Treas. Reg. § 1.401(k)-3(d)(2)(ii).

26 IRC § 414(w)(4)(A)(EACA); IRC § 401(k)(13)(E)(i)(QACA); Prop. Reg. § 1.414(w)-1(b)(3)(iii)(EACA); Prop. Reg. §§ 1.401(k)-3(k)(4)(iii) and 1.401(k)-3(d)(3)(QACA).

27 Prop. Reg. § 1.414(w)-1(b)(3)(iii)(A)(EACA); § 1.401(k)-3(d)(3)(i)(QACA).

28 Prop. Reg. § 1.414(w)-1(b)(3)(iii)(A)(EACA); Prop. Reg. § 1.401(k)-3(k)(4)(iii)(QACA).

29 Prop. Reg. § 1.414(w)-1(b)(3)(iii)(EACA); Prop. Reg. §§ 1.401(k)-3(k)(4)(iii) and 1.401(k)-3(d)(3)(QACA); Preamble to Prop. Reg., 72 Fed. Reg. 63144, 63147 (QACA) and 72 Fed. Reg. 63144, 63148 (EACA).

30 Under this rule, the timing requirement is deemed satisfied if the notice is provided at least 30 days (but no more than 90 days) before the beginning of each plan year; for employees who become eligible after the 90th day before the beginning of the plan year, the notice must be provided no later than the date the employee becomes eligible. Prop. Reg. § 1.414(w)-1(b)(3)(iii)(B)(EACA); § 1.401(k)-3(d)(3)(ii)(QACA).

31 72 Fed. Reg. 63144, 63147 (discussing deemed satisfaction approach in a context of QACAs).

32 Prop. Reg. § 1.401(k)-3(e).

33 Prop. Reg. § 1.401(k)-3(k)(4)(iii); Preamble to Prop. Reg., 72 Fed. Reg. 63144, 63147 (for the first plan year, the notice must be provided no later than the date the employee becomes eligible).

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