The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

October 15, 2000

Comment Letter on IRS Proposed Plan Loan Regulations, October 2000

October 30, 2000

CC: MSP:RU (REG-116495-99)
Courier's Desk
Internal Revenue Service
1111Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Plan Loan Regulations

Ladies and Gentlemen:

The Investment Company Institute[1] is writing to comment on the proposed regulations on plan loans issued under section 72(p) of the Internal Revenue Code. This guidance is of great interest to Institute members that offer recordkeeping services to 401(k) and other defined contribution plans and that are 403(b) contract providers. According to Institute statistics, about $ 777 billion, or 45% of 401(k) plan assets was invested in mutual funds as of year-end 1999; approximately $281 billion in 403(b) assets and $38 billion in 457 plan assets was invested in mutual funds.

Our comment letter is organized as follows. First, we comment generally on the applicability of electronic signature legislation to loan processing. Second, we make several comments regarding the proposed guidance on multiple loans and loan refinancing. Specifically, we question the need for the proposed rules regarding the treatment of loans issued to a participant after default on a previously issued loan; seek clarification of the scope of the proposed "two loan per year" limitation; and note our concerns regarding the complexity of the loan refinancing rules proposed. Additionally, we request that the Service clarify that governmental employers are permitted to offer loans to employees participating in section 457(b) plans in a manner consistent with section 72(p).

I. E-SIGN Legislation

The final regulations that were published July 31, 2000 permit plan loans to be formed and administered electronically. Although the regulations adopt the standards for paperless transactions set forth previously by the Service in section 1.411(a)-11(f)(2) of the regulations, as promulgated on February 8, 2000, the Service has recognized the need to

assess whether the Electronic Signatures in Global and National Commerce Act (E-SIGN) would require revisions to those standards as applied to plan loans. We agree with the Service that the impact of E-SIGN on the plan loan regulations, and more generally on the regulations addressing paperless technologies, must be assessed.

Because the impact of E-SIGN extends well beyond the scope of the plan loan regulations, however, we limit our comments here to some preliminary remarks. As a practical matter, Institute members generally were pleased with the standards for various paperless transactions that the Service set forth in February 2000, and believe that those standards both enable the electronic formation and administration of plan loans and protect plan participants who may seek to obtain a loan via electronic media. Furthermore, we believe it is important that the Service has adopted the same standards for plan loans as it has applied to other paperless activities. Imposing different standards for each electronic/paperless activity or transaction type would be cumbersome to implement, confusing for both plan sponsors and their participants and beneficiaries, and needlessly increase the cost of plan administration.

E-SIGN generally provides that signatures, contracts and other records that relate to transactions may not be denied legal effect or validity solely because they are in electronic form. It thus enables any commercial transaction to be conducted electronically at the election of the parties to the transaction. In addition, to the extent a state or federal law or regulation applicable to a transaction requires by its terms a traditional writing on paper or "pen and ink" signature, E-SIGN enables parties to the transaction to satisfy those requirements by using electronic media, rather than paper, pen and ink. E-SIGN section 101(a). Furthermore, the legislation enables parties to agree to produce, deliver, receive and retain all documents and records related to the transaction electronically. Moreover, only certain specified transactions are excluded from the reach of the statute. E-SIGN section 103. Thus, E-SIGN should enable entities acting on behalf of a plan and participants to produce, execute and process all necessary loan documentation electronically, including any required spousal consents and related notarizations that may be required.2

To the extent that a law or regulation requires notices, disclosures or other information to be provided to a "consumer" in writing, E-SIGN requires an affirmative consent from the consumer in order to provide such information electronically. E-SIGN section 101(c). If a participant seeking a plan loan is a "consumer" under E-SIGN,3 to the extent that consumer credit or other laws require such written disclosures or notices, the plan may be required to obtain such consent in a manner conforming to the requirements of E-SIGN section 101(c). E-SIGN, however, also provides that federal agencies may unconditionally exempt specified categories or types of records from the consumer consent provision. E-SIGN section 104(d)(1). Given that the Service's paperless transaction rules were designed to facilitate electronic transactions while maintaining sufficient protections for plan participants, the Service may find it appropriate to exercise its exemptive authority under E-SIGN.4 Alternatively, we recommend that the Service consider the extent to which the consumer consent provision may not apply to activities that the Service has permitted to be conducted electronically.5

As noted above, these are preliminary remarks and we would hope that the Service will seek further, more comprehensive comments on the applicability of E-SIGN to retirement plans at a later date.

II. Multiple Loans and Loan Refinancing

A. Loans Issued After Previous Loan Default

The proposed regulations would impose new requirements on loans issued to a plan participant or beneficiary who had defaulted on a previously issued loan. Specifically, for any loan issued subsequent to a loan deemed distributed and not repaid, the plan either must (1) receive "adequate security" in addition to the participant's or beneficiary's accrued benefit under the plan, or (2) arrange for repayment of the loan by payroll withholding. Proposed Reg. Section 1.72(p)-1 at A-19(b)(2).

We agree with the intent of the proposal: a loan program should provide bona fide loans and not become a mechanism to obtain, in effect, in-service distributions. We believe, however, that the rules the Service proposes to prevent loan program abuse would be impractical to implement and may be unnecessary to address the perceived abuse.

The alternative requirement that a plan obtain adequate security would be impractical and unlikely to be used. Obtaining security is a burden that few plan fiduciaries will want to undertake. Rather than obtaining additional security or collateral, it is more likely that, faced with this requirement, plan fiduciaries and 403(b) providers will opt to require payroll withholding or simply refuse to allow any additional loan.[6]

Issuers of 403(b) contracts will have particularly difficult problems in complying with the proposed regulations, because they have a more attenuated relationship with the individual contract owner's employer, especially in the case of 403(b) arrangements involving only salary deferrals. In these cases, employers frequently are intent on abstaining from any activity that might cause them to acquire fiduciary status under ERISA. Most employers, therefore, may be unwilling to assist in monitoring the status of any outstanding loans, obtaining additional security, or implementing and policing payroll withholding to assure loan repayment. Notably, employers that provide employee access to 403(b) programs, unlike employers in the ERISA plan environment, typically do not permit the use of payroll withholding for loan repayment. As a result, loans are frequently repaid after the 403(b) provider bills the individual contract holder (either by sending a monthly bill or by providing a payment booklet).

To the extent the Service retains this proposed rule, it should clarify that it applies to 403(b) contracts on a provider-by-provider basis. An individual may have multiple 403(b) contracts with more than one provider. Each provider will be able to determine whether there is a loan in default only with respect to its own 403(b) contract; a provider has no way of knowing whether or not the individual has defaulted on a loan issued under a contract with another provider.[7]

Finally, notwithstanding the intent of the proposed regulations, we are uncertain whether these rules – or any additional rules – are necessary to address loans issued after default on a previously issued loan. First, the statute clearly limits the total amount of assets that a participant or beneficiary can obtain in loans. Section 72(p)(2)(A). Second, the Service, in the final regulations issued together with these proposed regulations, specifically identified the manner in which deemed distributions are taken into account for purposes of applying section 72(p)(2)(A) to determine the maximum amount of any subsequent loan to the participant or beneficiary. Reg. Section 1.72(p)-1 A-19(b)(1). These rules sufficiently limit loan activity. Moreover, as the Service recognizes in footnote 3 of the preamble to the proposed regulations, for ERISA-covered plans, a participant loan program involves the

management of plan assets and is therefore subject to the prudence requirements of Title I, which would impose an obligation on plan fiduciaries to maintain a bona fide loan program.

B. Multiple Loan Limitations

The proposed regulations also would impose limits on the number of loan transactions a participant or beneficiary may complete in a single 12-month period. Specifically, the proposed regulations would treat a loan as a deemed distribution if two or more loans have previously been made from the plan to a participant or beneficiary during the 12-month period. We have four comments on this proposal.

First, as a practical matter, many plans already limit the number of loans that may be obtained by a participant. Plans do so in a variety of ways. For example, some plans permit participants to have only one or two outstanding loans at a time; others allow a participant to obtain only one loan per year; and some plans limit participants to only one loan plus one 'principal residence' loan. Plan sponsors establish such limitations for two reasons. First, they may limit loans based on their own judgment about how much access to retirement plan assets is appropriate for a participant to have prior to retirement. Second, loan processing can be burdensome, labor intensive and therefore, very costly. Thus, plan sponsor decisions and the administrative burdens and costs of loan administration already serve to encourage limits on loans.8 Arguably, in light of these practices, the proposed limitation, which appears to have little statutory basis, is unnecessary. At a minimum, the rule should be more flexible: plans with provisions such as those we have described should not be required to comply with an additional two-loan limit.9

Second, the manner in which the proposed rule is drafted seems to indicate that the Service intends the rule to apply on a plan-by-plan basis. The Service should clarify that this is the case. 10 Similarly, the Service should clarify that the proposed limitation applies to 403(b) arrangements on a contract-by-contract basis. As noted above, 403(b) providers are able to identify only loans made under the contracts that they have issued.

Third, the Service should clarify whether or not a loan refinancing counts as a loan for purposes of the two-loan limit, assuming that such a limit is adopted. One approach would differentiate a loan refinancing that does not extend the repayment period of the loan being refinanced, which would not count against the limit, from a refinancing that does extend the repayment period, which would count against the limit. Another approach would distinguish a loan refinancing that increases the outstanding loan amount from one that does not. A third – and the simplest – approach would treat any loan refinancing, regardless of circumstance, in the same manner for purposes of the two-loan limit.

Fourth, the proposed rule provides that plans may implement the loan limitation on a calendar year basis, a plan year basis or another consistently applied 12-month period. We recommend that the 12-month period be limited to either a calendar year or plan year. This change would make the rule easier to implement and result in less likelihood of error to the extent a third party recordkeeper is monitoring compliance across a number of different plans.

C. Loan Refinancing

We agree that it is important to establish rules that would enable certain loan refinancings to occur, while preventing loan refinancings to be used to extend the loan repayment period of a loan beyond the statutory five-year amortization period. The rules proposed by the Service, however, are complex – perhaps an inevitable outcome of balancing the desire to allow loan refinancings that would be appropriate and beneficial to participants and the

need to assure that the 5-year repayment period is not circumvented. Because of the complexity, however, there is a greater likelihood that employers and participants may unwittingly violate the rules. We encourage the Service to seek ways to simplify them.

Service providers will face some significant challenges implementing these proposed rules. They will need to develop operational mechanisms to distinguish a permitted loan refinancing from an impermissible one and to track loan repayments properly. Additionally, they must develop effective communications materials that clearly explain the refinancing rules to both employers and participants. Both tasks will be difficult given the complex nature of the rules. For instance, we interpret the proposed regulations to require that where a refinanced loan extends beyond the original repayment period, either the original loan and the total refinanced loan must meet the limitations of sections 72(p)(2)(B) and (C), or the outstanding amount of the original loan must be repaid within the original repayment period. Based on our discussions with Institute members, we are concerned that recordkeepers will have difficulty programming their recordkeeping systems to allocate the repayments properly between the original and refinanced loans, in accordance with the second 'prong' of the proposed rules.

In light of these concerns, we request that the Service delay the effective date of the final regulations to assure that employers and their service providers have adequate time to appropriately implement the regulations.

Finally, the Service should note that the proposed rules may have the unintended consequence of encouraging participants to over-borrow by obtaining a loan for a longer repayment period than they need. There is no incentive under this rule for a participant to obtain a short-term loan, rather than one for the full five-year amortization period.

III. Plan Loans Under Governmental 457(b)

Deferred Compensation Plans

We request that the Service clarify that governmental employers are permitted to offer loans to employees participating in section 457(b) plans in a manner consistent with section 72(p). The Small Business Job Protection Act of 1996 ("SBJPA") required governmental employer section 457(b) deferred compensation plans to hold their assets in section 457(g) trusts. In making this legislative change, Congress made clear its intent that employers sponsoring these plans could establish loan programs.[11] Furthermore, there is a clear legal basis in section 72(p) for such loans.[12] However, many public employers interested in implementing a 457(b) plan loan program are hesitant to do so, given the lack of clear regulatory guidance.[13]

* * *

The Institute appreciates the opportunity to comment on these proposed regulations, and would be happy to meet with the Service staff to discuss our comments. We note again that we have provided you with only preliminary comments regarding the applicability of E-SIGN to plan loan processing, and look forward to addressing the applicability of E-SIGN to retirement plans more generally. If you have any questions regarding this comment letter, please contact me at (202) 326-5835.

Sincerely,

Russell G. Galer

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,242 open-end investment companies ("mutual funds"), 488 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.453 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

2 E-SIGN expressly permits electronic notarization or similar verification of a signature, provided that it includes the electronic signature of the notary or other authorized person and all of the other information required by the notarization statute or other underlying, applicable law. Further, it requires that the electronic notarization be attached to or logically associated with a record of all information that is required to be provided under the applicable law. E-SIGN section 101(g).

3 It is unclear whether the consumer consent provision is applicable to plan participants. E-SIGN defines "consumer" as an individual who obtains through a transaction products or services which are used primarily for personal, family or household purposes. E-SIGN section 106(1).

4 Of course, the Service's authority to waive the consumer consent requirement may be applicable only to written notice and disclosure requirements that arise under the Internal Revenue Code, and not to any such requirements that arise under laws and regulations not within its jurisdiction. If the Service determines that consumer consent requirements are not necessary within the context of plan loans, and therefore seeks to use its waiver authority, we would recommend that it seek similar, coordinated determinations from other federal agencies.

5 The E-SIGN consumer consent provision apparently applies only to the extent a law or regulation requires a (paper) writing. Because the Service's regulations in many instances do not require a writing, but rather provide alternatives to paper delivery, it is unclear whether the provision would be applicable at all.

6 Indeed, many plan documents and 403(b) contracts already provide that an individual in default on one loan may not obtain an additional loan until the loan in default is repaid.

7 Similarly, as we discuss below, the proposed "two loan per year" limitation can be enforced by a provider only with respect to its own product.

8 Thus, abuses such as that demonstrated in Example 3 of the proposed regulations are unlikely to occur. In cases where loans are repaid by payroll withholding, payments are usually withheld from every payroll. Most employers pay employees no less frequently than monthly and often process payrolls to pay employees biweekly, semi-monthly or weekly. As a result, it is unlikely that an individual would be permitted or practically able to abuse a plan loan program by continuously obtaining multiple loans to repay ongoing loan repayment obligations in the manner demonstrated in Example 3.

9 The rule also may be too inflexible for many participants. There are legitimate reasons why a participant may need to obtain a loan more than twice in a 12-month period, including the need to pay for school tuition on a trimester basis or unanticipated medical or other emergencies. Indeed, the proposed multiple loan limitation may have an unintended consequence: it may cause participants to try to anticipate their borrowing needs for the coming year and withdraw more from their retirement plan account than they would

actually need, or force more participants than necessary to take a hardship withdrawal, rather than a plan loan.

10 Presumably, if an individual participates in two different plans at two different employers, each employer would be responsible for applying the proposed rule only with respect to its own plan. As a result, assuming each plan applied the limitation on a calendar year basis, the individual would be able to obtain four loans in that calendar year, two from each plan.

11 H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 251 (1996).

12 Section 72(p) is applies to loans from "qualified employer plan[s]." Section 72(p)(4)(A)(ii) states, "qualified employer plan shall include any plan which was (or was determined to be) a qualified employer plan or government plan." Section 72(p)(4)(B) defines government plan as "any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." Under this definition, an eligible governmental 457(b) plan is considered a government plan.

13 The issuance of IRS Revenue Procedure 98-40, which reopened the 457(b) plan private letter ruling process, created additional ambiguity by stating that a private letter ruling would not be issued for plan documents containing a loan feature.
