

Review of Department of Labor First Response to PPA

Commissioned by Thornburg Investment Management
Prepared by DALBAR, Inc.

DOL's first response to the landmark Pension Protection Act of 2006 is a proposal to establish and alter regulations relating to automatic enrollments and default investments that have become the law of the land.

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REVIEW OF DOL FIRST RESPONSE TO PPA

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INTRODUCTION

On August 17th, 2006 President Bush signed the 2006 Pension Protection Act (PPA) that included directives to the Department of Labor (DOL) to establish and modify regulations regarding default investments by February 17, 2007. The DOL regulations must implement the law enacted by Congress, which states that:

...a participant in an individual account plan meeting the notice requirements of subparagraph (B) shall be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary [of Labor]. The regulations under this subparagraph shall provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. (See Note 1 for entire section)

On September 27, 2006 the DOL released its proposal (Proposal) in response to the PPA requirements. The Proposal offers that:

"A fiduciary of a plan that complies with this proposed regulation will not be liable for any loss, or by reason of any breach that occurs as a result of such [default] investments."

Under the Proposal, three types of investments are permitted as default investment alternatives. All three of these alternatives require allocations in equity and fixed income that change over time as needed:

- a. Multiple age, target date or life expectancy based funds.
- b. Single fund suitable for the average risk tolerance of participants based on employee demographics.
- c. Individual account management based on age, target retirement date or life expectancy.

The Proposal requires that plan fiduciaries remain responsible for the prudent selection and monitoring of these qualified default investment alternatives.

The Proposal offers relief on condition that participants are notified of:

- ✓ The circumstances under which contributions or other assets will be invested in a qualified default investment,
- ✓ The investment objectives of the default investment alternatives, and
- ✓ The right of participants and beneficiaries to direct investments out of the default investment alternative without penalty.

The DOL Proposal set five conditions for default investment alternatives:

- 1) Default investments may not include company stock as such, but company stock may be held inside a fund's portfolio.
- 2) Participant must be able to transfer out of default investment without restriction or financial penalty.
- 3) A qualified investment manager (such as an RIA or trust department) who accepts responsibility as a fiduciary is required to manage default investments.
- 4) Default investment must be diversified.
- 5) Only the permitted investment types may be used as a default investment.

The Proposal invited members of the public to offer comments by November 13, 2006, including specific invitations to comment on:

- ✓ Whether regulations adequately address concerns about conflicts with any State's law that might prohibit automatic enrollment.
- ✓ Administrative cost of complying with the proposed regulations and methods of minimizing costs.
- ✓ Any unintended consequences of the proposed regulation.
- ✓ Estimates made by DOL on the effect on plan assets.

OBSERVATIONS

Prospects for Growth

The qualified default investment is likely to be the fastest growing option in defined contribution plans since:

- ✓ Existing defaults (such as stable value funds) will likely be transferred into qualified default investments to obtain the protection offered by PPA.
- ✓ Plans with no default will adopt defaults to obtain the PPA protection and help the employee to make better investments. (Failure to do so may actually expose the fiduciary to litigation risk.)
- ✓ Current participants who are unsure of their investment selections will terminate investment elections to take advantage of the default so they can "set it and forget it".

While the Proposal relieves the plan sponsor of the risk of using a default investment, it adds certain burdens to the selection process and requires regular monitoring of the default investments. Default investments that protect the plan sponsor must either consist of a series of age appropriate investments or a single fund that is selected based on the average demographic of the employee base.

Age Appropriate Defaults

The DOL Proposal strongly endorses the idea of age appropriate defaults in two of its alternatives and puts the responsibility on the plan sponsor of determining what age appropriate arrangement is best for the plan. This raises the question of defining what age ranges to use and how is the appropriateness for that range determined.

These questions create the opportunity for investment managers to offer products that compete in a specific age range and for plan advisers to offer guidance on the selection of a default fund for each age range.

Single Fund Default

The single default option requires that plan sponsors use demographics of the employee base to select an appropriate default. This raises the question of whether the entire employee base is used in the determination or is it limited to those that will be defaulted.

Providers and plan advisers who recommend this alternative must have some means of determining and documenting the determination of the demographics used in selecting the default.

WHAT'S MISSING?

Retirement Default

Age based defaults proposed by the DOL address the accumulation of retirement assets but fails to include consideration for the critical pre-retirement stage. Employees that make no election are supported by the Proposal but face an abrupt end to this support at the important decision of using those assets for retirement income.

The Proposal is seriously flawed since the age based defaults are inappropriate for an employee at retirement, regardless of age. The alternative of using an average risk is equally inappropriate for the pre and post-retiree.

The PPA requires that the default arrangement address the contributions and earnings in the plan but the Proposal fails to address the needs of employees at retirement, the time when a default is needed most.

DOL should expand each of the three default alternatives proposed to require an automatic switch into an appropriate post-retirement fund or portfolio.

Employees Electing the Default

It can be expected that employees that currently have investment elections will want to use the default investment. The Proposal does not address the implications for the plan sponsor of employees "electing" the default or terminating existing elections. Clarification is needed as to whether the fiduciary protection for the default applies when employees make a conscious choice to use the default.

No Calculation to Be Understood

The Proposal leaves the question of what is "calculated to be understood" open to interpretation and litigation. There is no guidance provided as to what methods should be used to determine if a notice or disclosure has been "calculated to be understood".

This omission is particularly significant since the requirement is for the "average plan participant" and this average varies widely across employers. Can the notice "calculated to be understood" by employees of an investment firm also be used for academic institutions and for employees at a manufacturing plant?

The Proposal reinforces the PPA requirement but does not address what might constitute adequate steps that would afford the statutes' protection.

Fiduciary Adviser Protection

The Proposal is explicit about the protection provided to the plan sponsor and the fiduciary responsibility of the investment manager but is silent about the responsibility of the fiduciary adviser that is engaged to advise plan participants:

- ✓ Does the fiduciary adviser who directs employees into default investments have the same protection as the plan sponsor?
- ✓ If not, what control does the fiduciary adviser have in the selection of the default investment?

IMPACT OF PROPOSAL

The Proposal details the ways in which the DOL intends to implement the directive of the Pension Protection Act of 2006 to provide guidance regarding default investments to be used if plan participants do not make investment elections. The following summary highlights some of the major effects of what DOL has proposed.

EMPLOYEES AND PARTICIPANTS

Employees who are currently defaulted into stable value or other limited investments are immediately upgraded into a diversified portfolio. This upgrade will add to the investment risk and require additional disclosures.

Employees enrolling in the plan, automatically or by explicit enrollment have guidance, without the need to understand the various investment options in the plan. This ease of making investment choices can be expected to increase retirement savings from those employees who find it difficult to do their own fund selection and allocation.

The default avoids the most costly mistake that investors make by switching among funds at inappropriate times.

In the long term, the default investment is expected to produce substantially higher returns than the participant would otherwise have.

EMPLOYER AND PLAN SPONSOR

The employer's burden is relieved; employees complaining about not being able to figure out what investment choices to make and lose productivity while struggling to make the right decisions.

The plan sponsor can select default investments for employees without the liability for potential losses. In order to get this protection the plan sponsor must prudently select and monitor the default investment and make changes when appropriate.

PROVIDERS

Providers realize cost savings from discontinued enrollment and education programs as well as lowered need to support employees who will use the pre-packaged default investment.

The increased contribution levels from the default options will accelerate growth in assets. Revenues are also increased by the use of default investments that have higher management fees.

Providers will potentially introduce new investment options that comply with one or more of the DOL Proposal default alternatives.

PLAN ADVISER (ADVISING PLAN SPONSOR)

The plan adviser will have the additional responsibility for due diligence of default investments. The plan adviser will be required to review various qualified default investment and support the plan sponsor in determining:

- ✓ Ranges for age based options.
- ✓ Demographics for single fund alternative.
- ✓ Which fund is appropriate for each range and demographic.
- ✓ Whether the fees and expenses associated with the default investment are fair and reasonable.

FIDUCIARY ADVISER (ADVISING PARTICIPANTS)

The fiduciary adviser will be required to determine when it may be or may not be appropriate for a participant to use the default investment. The fiduciary adviser must document and use criteria such as age, plan balances, household investments, financial situation, etc. in making this determination.

One on one advice is provided to participants who are not well served by the default investment.

RECAP OF DOL PROPOSAL

WHAT CAN BE DEFAULTED?

The Proposal identifies the following circumstances to which the defaults can apply when no investment selection is made:

- ✓ Automatic enrollment
- ✓ Following the elimination of an investment alternative
- ✓ Change in service provider
- ✓ Following a rollover from another plan

WHAT NOTICE IS REQUIRED?

Employees must be given notice of the default, describe the default investment and given the option to reject the default. This notice must:

- ✓ Be “calculated to be understood” by the average participant.
- ✓ Describe the circumstances when the default investment will be used;
- ✓ Contain a description of the default investment, including investment objectives, risk and return characteristics (if applicable), and fees and expenses.
- ✓ Disclose the right to direct the assets in the default investment into any other investment alternative under the plan, without financial penalty
- ✓ Explain where to obtain investment information concerning the other investment alternatives available under the plan.

WHAT ARE THE THREE DEFAULT ALTERNATIVES?

Age, Target Date Or Life Expectancy Based Funds

This alternative provides 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.

These products and portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age.

Asset allocation decisions for these products and portfolios are not required to take risk tolerances, investments or other preferences of an individual participant into account.

An example of such a fund or portfolio may be a "life-cycle" or "targeted-retirement-date" fund or account. This alternative might be a "stand alone" product or a "fund of funds" comprised of various investment options otherwise available under the plan for participant investments.

In the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures.

Single Fund Suitable For The Average Risk

The second alternative is an investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole.

For purposes of this alternative, asset allocation decisions for such products and portfolios are not required to take into account the age of an individual participant, but rather focus on the demographics of the participant population as a whole.

An example of such a fund or portfolio may be a "balanced" fund. As with the first alternative, the reference to "an investment fund product or model portfolio" is intended to make clear that this alternative might be a "stand alone" product or a "fund of funds" comprised of various investment options otherwise available under the plan for participant investments.

In the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures for this alternative.

Unlike the first alternative, which focuses on the age, target retirement date (such as normal retirement age under the plan) or life expectancy of an individual participant, the second alternative requires a fiduciary to take into account the demographics of the plan's participants, similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction. For this reason, a fiduciary has the duty to monitor investment alternatives available under the plan and may conclude that a new or additional investment fund product or model portfolio is required to take into account significant changes in the demographics (e.g., age) of the plan's participant population.

Individual Account Management

The third alternative is an investment management service in which an investment manager allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy.

Such portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. As with the first alternative, the proposed regulation makes clear that, as with the other alternatives described in the regulation, asset allocation decisions are not required to take into account risk tolerances, other investments or other preferences of an individual participant.

An example of such a service may be a “managed account.”

WHAT ARE THE PLAN FIDUCIARY OBLIGATIONS AND RELIEF?

Plan sponsors remain responsible for the prudent selection and monitoring of the qualified default investment alternatives. As plan fiduciaries, sponsors remain liable for any resulting losses if there is a failure to satisfy these duties.

The relief from liability by the proposed regulation is conditioned on the use of certain investment alternatives, but the use of other alternatives may also be prudent. For example, the Department recognizes that investments in money market funds, stable value products and similarly performing investment vehicles may be prudent for some participants or beneficiaries.

A fiduciary qualifies for relief from liability for the investment of assets in the individual account if:

- 1) Assets are invested in a “qualified default investment alternative”;
- 2) The participant had the opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets;
- 3) The participant is furnished with appropriate notice at least 30 days before the first investment and 30 days before the start of each subsequent plan year;
- 4) Any material provided to the plan relating to a participant's investment (e.g., account statements, prospectuses, proxy voting material) will also be provided to the participant;
- 5) Any participant may transfer default investment assets to any other investment alternative available under the plan without financial penalty; and
- 6) The plan offers a “broad range of investment alternatives”.

REFERENCES

NOTE 1 -PPA DEFAULT INVESTMENT ARRANGEMENTS

SEC. 624. TREATMENT OF INVESTMENT OF ASSETS BY PLAN WHERE PARTICIPANT FAILS TO EXERCISE INVESTMENT ELECTION.

(a) In General- Section 404(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1104(c)), as amended by section 622, is amended by adding at the end the following new paragraph:

ˆ (5) DEFAULT INVESTMENT ARRANGEMENTS-

ˆ (A) IN GENERAL- For purposes of paragraph (1), a participant in an individual account plan meeting the notice requirements of subparagraph (B) shall be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary. The regulations under this subparagraph shall provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.

ˆ (B) NOTICE REQUIREMENTS-

ˆ (i) IN GENERAL- The requirements of this subparagraph are met if each participant--

ˆ (I) receives, within a reasonable period of time before each plan year, a notice explaining the employee's right under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election by the participant, such contributions and earnings will be invested, and

ˆ (II) has a reasonable period of time after receipt of such notice and before the beginning of the plan year to make such designation.

ˆ (ii) FORM OF NOTICE- The requirements of clauses (i) and (ii) of section 401(k)(12)(D) of the Internal Revenue Code of 1986 shall apply with respect to the notices described in this subparagraph.'

(b) Effective Date-

(1) IN GENERAL- The amendments made by this section shall apply to plan years beginning after December 31, 2006.

(2) REGULATIONS- Final regulations under section 404(c)(5)(A) of the Employee Retirement Income Security Act of 1974 (as added by this section) shall be issued no later than 6 months after the date of the enactment of this Act.

NOTE 2 -SENDING COMMENTS TO DOL

DATES: Written comments on the proposed regulation should be received by the Department of Labor on or before November 13, 2006.

ADDRESSES: Comments should be addressed to:

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

Attn: Default Investment Regulation.

Commenters are encouraged to submit comments electronically to e-ORI@dol.gov or <http://www.regulations.gov> (follow instructions for submission).

Comments will be available to the public at <http://www.dol.gov/ebsa> and www.regulations.gov.

Comments also will be available for public inspection at the Public Disclosure Room, N-1513, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Washington, DC 20210.

FOR FURTHER INFORMATION CONTACT: Erin M. Sweeney or Lisa M. Alexander, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500.

APPENDIX -DALBAR COMMENT LETTER TO DOL

October 10, 2006

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

Attn: Default Investment Regulation

E-mail to e-ORI@dol.gov

Ladies and Gentlemen:

DALBAR appreciates the opportunity to submit comments regarding the proposed regulations regarding default investment alternatives under participant directed individual account plans.

DALBAR has analyzed and measured investor behavior, starting in 1994. The purpose of this work has been to focus attention on the causes and effect of imprudent investor actions or inactions with the goal of improving financial results for investors. Our work (Quantitative Analysis of Investor Behavior -www.QAIB.com) has been widely used by most major financial institutions and often quoted in the press. This work has led to DALBAR's evaluations and industry forums focused on effective communications and practices in participant directed defined contribution retirement plans. In 2004 DALBAR published the report "Quality versus Quantity" which was highly critical of the current ERISA regulations and industry practices.

The comments offered here reflect this deep understanding of the causes and effects of investor behavior.

In our opinion, the proposed regulations represent an enormous improvement in the effectiveness of ERISA to meet the defined goal of employee retirement income security. The Default Investment Alternatives present an approach that will eliminate the greatest hurdle to participant directed plans. This hurdle has been the difficulty that most employees (estimated at 70%) have in making investment choices. The Default Investment Alternative regulation as proposed would address this issue for a large proportion of employees that face this difficulty.

In our review of the proposed regulation, we have identified four areas that need additional attention, within the context of what has been proposed. These areas are described, the rationale provided and suggested amendments to the proposal offered.

The four areas needing attention are:

- ✓ Inappropriate default alternative at retirement

- ✓ Employees “electing” the default create exposure to plan sponsor
- ✓ The term “calculated to be understood” is a condition for protection but remains undefined.
- ✓ Fiduciary adviser is not explicitly protected when using default

Inappropriate Retirement Default

The proposed age based defaults address the accumulation of retirement assets but fails to include consideration for the critical pre-retirement employment stage. Employees that make no election are supported by the proposed regulation during working years but face an abrupt end to this support at the important decision of using those assets for retirement income.

The proposed regulation is seriously flawed since the age based defaults are inappropriate for an employee at retirement. The most important need at retirement is for long-term income and this is true whether the employee is retiring at 40 or at 80 years old.

Employees relying on the default will find that their retirement portfolio is very poorly structured to replace a paycheck for the rest of their lives.

The proposed alternative of using an average risk is equally inappropriate for the pre and post-retiree. The demographic of the employee base is not applicable to the employee that enters retirement.

The Pension Protection Act requires that the default arrangement address the contributions and earnings in the plan but the proposed regulation fails to address the needs of employees at retirement, the time when a default is most urgently needed.

The three proposed default alternatives should be amended to require an automatic switch into an appropriate post-retirement fund or portfolio at the time employees are retired.

We suggest the following amendment to correct this problem:

Proposed Sec. 2550.404c-5(e) sets forth five requirements for qualified default investments, which should be amended by adding a sixth:

(6) A qualified default investment alternative must include at least one investment product, portfolio or service that is designed to produce maximum income for the purpose of replacing employment income at retirement.

Employees who have made no election must be automatically transferred into a maximum income investment product, portfolio or service upon retirement.

Employees Electing the Default

Based on the large number of employees that have difficulty with making investment choices, it can be expected that many employees that currently have investment elections will want to use the default investment. The Proposal does not address the implications for the plan sponsor of employees “electing” the default or removing existing elections. Clarification is needed as to whether the fiduciary protection for the default applies when employees make a conscious choice to use the default.

Plan sponsors remain exposed to the risk of employees who make a conscious choice to use the default.

We suggest the following amendment to correct this problem:

Proposed Sec. 2550.404c-5(a) contains the phrase “in the absence of an investment election by the participant,”, which should be replaced by:

“in the absence of an investment selection or election of a default investment or removal or withdrawal of a previous election,”

No Definition of “Calculated to Be Understood”

The Proposal leaves the question of what is “calculated to be understood” open to interpretation and litigation. There is no guidance provided as to what methods should be used to determine if a notice or disclosure has been “calculated to be understood”.

This omission is particularly significant since the requirement is for the “average plan participant” and this average varies widely across employers. Can the notice “calculated to be understood” by employees of an investment firm also be used for academic institutions and for employees at a manufacturing plant?

Plan sponsors are exposed to litigation that could claim that no calculation was performed and therefore notice of default was inadequate.

We suggest the following amendment to correct this problem:

Proposed Sec. 2550.404c-5(d) contains the sentence “The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant and contain the following:”, which should be replaced by:

“The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant. This notice must be tested for understanding by average participants and tests documented to provide evidence of understanding by typical participants in the plan or others that can reasonably be expected to have similar reading and comprehension skills. This notice shall contain the following:”

Fiduciary Adviser Protection

The Proposal is explicit about the protection provided to the plan sponsor and the fiduciary responsibility of the investment manager but is silent about the responsibility of the fiduciary adviser that is engaged to advise plan participants:

- ✓ Does the fiduciary adviser who directs employees into default investments have the same protection as the plan sponsor?
- ✓ If not, what control does the fiduciary adviser have in the selection of the default investment?

Fiduciary advisers are exposed to liability if they confirm that the default is appropriate for a participant. This creates a perverse disincentive to use the investment alternative that is most appropriate for the largest number of participants in the plan.

We suggest the following amendment to correct this problem:

Proposed Sec. 2550.404c-5(a)(1) contains the phrase "in order for a plan fiduciary to obtain the relief under this section", which should be replaced by:

"in order for a plan fiduciary or fiduciary adviser to obtain relief under this section"

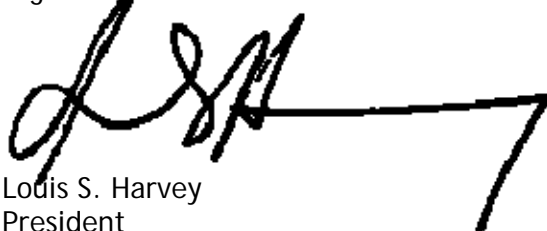
Proposed Sec. 2550.404c-5(b)(1) contains the phrase "fiduciary of an individual account plan", which should be replaced by:

"fiduciary of an individual account plan or fiduciary adviser"

Proposed Sec. 2550.404c-5(b)(2) contains the phrase "Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA", which should be replaced by:

"Nothing in this section shall relieve a plan fiduciary from his or her duties under part 4 of title I of ERISA"

Thank you for your consideration of these comments in developing the final regulations.



Louis S. Harvey
President
DALBAR, Inc.
The Measurement of Success