The ERISA Industry Committee

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Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Transitional Amendments to Satisfy the Market Rate of Return Rules for Hybrid Retirement Plans (RIN 1545–BL62) and Additional Rules Regarding Hybrid Retirement Plans (RIN 1545-BI16)

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to respond to the request of the Treasury Department and Internal Revenue Service (collectively, "Treasury") for comments on the Transitional Amendments to Satisfy the Market Rate of Return Rules for Hybrid Retirement Plans (the "proposed regulations")[1] and the Additional Rules Regarding Hybrid Retirement Plans (the "final regulations").[2] ERIC appreciates the Treasury's issuance of the final and proposed regulations on hybrid retirement plans.

ERIC'S INTEREST IN THE INFORMATION COLLECTION REQUEST

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals that would affect its members' ability to provide secure retirement benefits in a cost-effective manner.

SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in defined benefit plans in the United States.[3] They also account for

[1] Dep't of the Treasury and Internal Revenue Service, *Transitional Amendments to Satisfy the Market Rate of Return Rules for Hybrid Retirement Plans*, 79 Fed. Reg. 56305 (Sept. 19, 2014).
[2] Dep't of the Treasury and Internal Revenue Service, *Additional Rules Regarding Hybrid Retirement Plans*, 79 Fed. Reg. 56441 (Sept. 19, 2014).
[3] Dep't of Labor, *Private Pension Plan Bulletin: Abstract of 2012 Form 5500 Annual Reports*, p. 3 (Oct. 2014), *available at http://www.dol.gov/ebsa/pdf/2012pensionplanbulletin.pdf* (reporting that, in the private sector in 2012, cash balance plans had 11.8 million participants out of a total 39.8 million participants in defined benefit plans of all types).

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approximately one-third of the assets held in defined benefit plans nationwide.[4] As a result, these plans provide the primary source of retirement income for a significant number of American workers. Congress recognized the value of cash balance and pension equity plans, and in the Pension Protection Act of 2006 (the "PPA") adopted comprehensive legislation to encourage employers to adopt and maintain them. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury adopt regulations that reflect Congress' intent. The proposed and final regulations issued on September 19, 2014, make great progress toward achieving this goal. ERIC supports Treasury in this effort.

Toward that end, ERIC is pleased to present comments on the most recent package of proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. ERIC recognizes that the most recent package reflects many of our previous comments and appreciates the consideration Treasury has given them. Our present comments therefore focus on the important remaining areas where Treasury has requested comments, and/or where we believe work is still needed. Those comments fall under four general themes:

- The "silo" approach to transition in the proposed regulations is unnecessarily restrictive and fails to take account of the many variations in interest crediting rates among existing plans, resulting in arbitrary distinctions among plans.

- The final regulations for the first time penalize plans that calculate lump sums using the "whipsaw" method (even though the Internal Revenue Service ("IRS") previously required plans to use that method). There is no basis in the statute for denying these plans the protections Congress afforded hybrid plans in the PPA.

- The final regulations for the first time, and without statutory authority, establish a new definition of early retirement subsidy that differs markedly from the established definition embodied in the statute and regulations since the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"). Because early retirement subsidies are exempt from the age discrimination rules, the new definition will have unpredictable impacts on many existing hybrid plans previously approved by the IRS.

- Because critical regulations governing hybrid plans remain to be issued, plan sponsors will be required to make important plan design changes under the final regulations—potentially involving significant reductions in participants' already accrued benefits—on the basis of incomplete guidance. This problem is particularly acute for pension equity plans, participant-directed cash balance plans, and plans that credit an investment rate of return.

Because of the importance of these regulations to many ERIC members, ERIC supports the decision of Treasury to hold a public hearing on the regulations. ERIC has separately requested that it be permitted to testify at the hearing.

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[4] *Id.* (reporting that, in the private sector in 2012, cash balance plans held $855 billion out of a total $2.7 trillion in assets held by defined benefit plans of all types).

DETAILED COMMENTS

I. The "Silo Approach" to transition is unnecessarily restrictive and undermines the purpose of the PPA.

The proposed regulations would provide a way for a hybrid plan that credits a non-compliant interest crediting rate to become compliant using the so-called "silo approach." Under the silo approach, the non-compliant plan's interest crediting rate is classified in one of a limited set of categories, and the regulations would prescribe the precise amendment that must be made to bring the plan into compliance for each silo. For example, a plan that credits a fixed rate of return in excess of the maximum fixed rate of return permitted under the regulations would be required to lower the rate to the highest permissible fixed rate of return (6%), and a plan that credits an impermissible investment-based rate must select a similar investment rate that is compliant. The silo approach, however, is unnecessarily restrictive and inconsistent with the purpose of the rules it is supposed to implement.

The proposed rules provide transition relief regarding the hybrid plan provisions in the PPA. However, the rules telling plan sponsors how to transition their pension plans to the PPA are now expected to be finalized in 2015, nine years after the PPA was enacted. The PPA itself included broad anti-cutback relief, permitting sponsors of private plans to make amendments pursuant to the PPA until the end of 2009, three years after the PPA was enacted. Congress undoubtedly believed that guidance would be issued before the deadline for plan amendments so that plan sponsors would know how to amend their plans to conform to the PPA's new hybrid plan rules. This is made clear by Section 1107 of the PPA, which extended the anti-cutback relief to plan changes made pursuant to the PPA or "pursuant to any regulation issued" under the PPA. Given the intent that the rules would be clear before plans were required to make changes, and that broad anti-cutback relief would be available to make changes to comply with these rules, the final transition regulations should ensure that plan sponsors have as much flexibility as possible to make changes now required as they would have if the rules had been finalized before the end of the PPA's original deadline.

Notably, Congress did not mandate a narrow set of transition rules depending on a plan's design but instead granted plan sponsors broad discretion to amend their plans. This flexibility was necessary because the PPA authorized expressly in statute for the first time many hybrid plan designs including plans that credit a market rate of return. There is no single way for each plan sponsor to take advantage of the new design opportunities and to modify existing plans to fall within the new rules. Congress understood that it could not anticipate how plan sponsors would craft plans to meet the needs of the company and its workers under the design opportunities provided by, and requirements imposed under, the PPA.

Having not had final regulations under the PPA's hybrid plan provisions, plan sponsors could not take full advantage of the transition relief provided in the PPA. The deadline for plan amendments passed well before plan sponsors would and could know how to respond to the PPA. Accordingly, now is the time when the purpose of the PPA's hybrid plan provisions may be fulfilled, as plan sponsors finally receive the guidance necessary to amend plans with fuller knowledge of the new regulatory regime. Yet what Congress knew in 2006 remains true today: the government cannot anticipate with precision how each plan should be modified. Because the rules cannot effectively be implemented by mandating plan designs, it is necessary to provide more broad anti-cutback relief.

For example, if a plan credits the greater of an S&P 500 index fund and an annual minimum rate of return of 4%, the silo approach might require the minimum annual fixed rate to be converted to a 3% cumulative fixed rate, which would significantly increase the volatility of the combined rate of return for participants. A cumulative rate would rarely apply for long-term participants, leaving longer service employees (including many close to retirement) subject to the substantial volatility of an S&P 500 index fund in place of a much less volatile aggregation of the return on that fund with a 4% annual minimum return. A plan sponsor might reasonably determine that another rate of return, such as the third segment rate under Code section 417(e)[5] or the rate of return on a target date fund, is more similar to the existing characteristics of the plan. Alternatively, the plan sponsor might create an investment portfolio with a subset of plan assets that could more closely resemble the characteristics of the current interest crediting rate. Any of these approaches should be acceptable, and there is no reason to mandate one approach over the other.

The limited set of silos set forth in the regulations do not clearly cover all possible scenarios previously adopted by plans. For example, if a plan provides interest credits equal to 1.25 (or other multiple) multiplied by the greater of a fixed rate (e.g., 5%) and a permitted government bond rate, would the plan be considered to (1) have an impermissible bond-based rate or (2) an impermissible margin on a bond-based rate, or (3) a fixed minimum that is too high, or some combination of these three violations? At a minimum, it is an extremely complex undertaking to track through each of the possible "corrections" required by each of these silos to determine which (if any) would lead to a single required outcome. Undoubtedly there will be other existing rate structures not clearly addressed by a specific silo.

Another example of a rate not anticipated by the regulations is the greater of (a) the average of the S&P 500 return and the 30-year bond rate or (b) 4%. It is not clear if this is treated as a blended rate that needs to be converted to: (i) 50% of the account adjusted by an S&P 500 index fund subject to a 3% cumulative minimum and (ii) the other 50% of the account adjusted by the 30-year bond rate subject to a 4% annual minimum; if so, the resulting interest rate could have very different characteristics than the current interest rate. It would be no more reasonable to move to this approach than to move to the third segment rate or many other approaches. Treasury simply cannot consider each permutation of interest rates to set forth with precision every reasonable transition approach, nor should Treasury unnecessarily restrict plan sponsors because of this inability.

Not only might the silo approach get it wrong – by mandating a change that significantly alters the characteristics of the plan – but it also unnecessarily confines plan sponsors. One purpose of the PPA is to encourage new designs that more effectively provide benefits to workers. Employers should be encouraged to provide these benefits (rather than leaving the defined benefit system altogether), and broad transition relief is a key element of this process. For example, if a plan sponsor has been crediting 30-year Treasury rates, the sponsor should now be permitted to change the plan to any other market rate of return, including, for example, the rate of return on a subset of plan assets, which only just became available as a design option. Crediting interest based on the return on a subset of plan assets is undoubtedly one of the many designs Congress intended to allow when drafting the PPA, and the broad transition relief in the PPA itself would have allowed plans to transition to that rate of return for the entire plan had final regulations been promulgated within three

[5] All references to the Code are to the Internal Revenue Code of 1986, as amended.

years of the PPA's passage. The fact that eight years passed before final regulations were issued should not preclude plan sponsors from pursuing designs intended by the PPA.

Broad transition relief is consistent with the anti-cutback regulations permitting amendments "to the extent necessary" to comply with the law: Plan amendments are necessary now because the rules did not exist previously in a comprehensive final form. Moreover, if a plan sponsor provides the maximum rate of return in any category of rates (or silos), the plan will not reduce the value of the benefit provided. A dollar invested today in an S&P index fund, for example, has the same value today as a dollar invested today in a subaccount in a plan's trust. Volatility may differ among market rates of return, but the current value of the benefit is not reduced.[6] Accordingly, the silo approach should be converted into safe harbors or examples, but the final regulations should make clear that transition relief covers other plan amendments pursuant to the final regulations issued last September.

Should the silo approach be maintained in the final transition regulation, however, the transition rules should be modified in several respects. Some hybrid plans credit interest based on a Pension Benefit Guaranty Corporation ("PBGC") interest rate. Indeed, IRS Notice 96-8 permitted a plan to distribute lump sums equal to the participant's account balance if the plan credited a "variable index equal to the PBGC immediate rate." The final regulations should clarify how this rate is treated under the silo approach and, in particular, that a rate based on the PBGC rate could be replaced with (or capped by) the third segment rate.

In addition, if the silo approach is maintained, there should be certain "safe harbor" transition approaches permitted for any plan, or, at least for those plans with current interest rate provisions that do not clearly fit into a specific silo. These safe harbor approaches should include the maximum rate of return in any of the categories set out by the market-rate regulations, including the third segment 417(e) rate with the maximum permitted floor rate, the maximum 6% fixed rate, and any of the government-bond based rates with the maximum permitted margin and floor. In addition, if at least a portion of the current rate is investment-based, the plan should be permitted to convert to any permissible investment-based rate (including the rate on a subset of plan assets). Because this relief would apply only at this one time, before the extended regulatory relief period ends, any concerns about market-timing should be allayed – while one safe harbor rate might currently be lower than another safe harbor rate, there is no way to know how the rates will compare into the future, and the opportunity to make changes in the future will be restricted by the generally applicable anti-cutback rules.

The final regulations also should permit any investment-based rate to be amended to be based on a subset of plan assets. All investment rates have the same present value, and plans previously did not have the opportunity to offer a rate based on a subset of plan assets. This is particularly important for plans crediting rates based on a regulated investment company ("RIC"). The final regulation permits a change to a RIC only if it ceases to exist, but a RIC might otherwise increase fees, depart from its initial investment objectives, or otherwise experience poor performance. The way to preserve flexibility (unless other rules change) would be to, instead, credit interest based on a subset of plan assets.

[6] Treas. Reg. § 1.411(d)-3(c)(1)(iii)(B) (permitting reduction of redundant optional forms under certain circumstances when the form eliminated and the form retained have the same actuarial present value as of the date the plan is amended).

II. Plans that provide whipsaw should receive the same treatment under the age discrimination rules as plans that do not provide whipsaw.

One of the most surprising provisions in the PPA regulations imposes adverse consequences on plans that apply the so-called "whipsaw" calculation. This is particularly surprising because many plans include the whipsaw calculation only because the IRS required the plan to be amended to include it. Now, years later, the Treasury states—for the first time in final regulations and several years after the deadline passed for plans to voluntarily eliminate it—that whipsaw undermines the plan's ability to obtain the relief provided by the PPA.

"Whipsaw" refers to the IRS's prior administrative practice of requiring cash balance plans to pay out lump sums in excess of some participants' account balances if the plans credited interest in excess of relatively low rates set by the IRS. Under the whipsaw approach, an account balance is projected to normal retirement age at the plan's current interest crediting rate and then discounted back to the present using the statutory discount rate to determine the amount of the lump sum distribution. Depending on interest rates and the age of the participant, the lump sum could be significantly larger (sometimes several times larger) than the account balance. The PPA made clear that whipsaw is not required. Sponsors of private pension plans could have amended plans prior to 2009 to eliminate the whipsaw approach but have not been permitted to make those amendments since then. Given the lack of guidance from Treasury on how the market rate of return requirement would be applied, it is not surprising that some plans retained their whipsaw provisions until knowing whether or not their interest crediting rates would be permissible.

The final regulations penalize plans that continue to include the whipsaw approach. The regulations provide that, beginning in 2016, a plan will not be a "lump sum-based plan" unless the lump sum distribution equals the account balance. Furthermore, only a lump sum-based plan is eligible for the safe harbor age discrimination rules.[7] Accordingly, a plan that pays lump sums under the whipsaw approach is not eligible for the age discrimination safe harbor that would apply if the plan did not apply whipsaw.

There is no reason to exclude plans that provide whipsaw from the same treatment under the age discrimination rules as plans that do not provide whipsaw. There is simply no indication in the PPA that a plan that provides a whipsaw benefit would be treated differently under the age rules. (The regulations also provide that a plan applying whipsaw is not eligible for the whipsaw relief under Code § 411(a)(13); this is understandable because a plan applying whipsaw simply does not need relief from the IRS's pre-PPA whipsaw requirement.) The final regulations should be amended to apply the age discrimination safe harbor in Code § 411(b)(5) to a plan regardless of whether it applies whipsaw.

If, however, the final regulations continue to exclude plans with whipsaw from the age discrimination safe harbor, plan sponsors should be permitted to eliminate the whipsaw approach (either prospectively or with respect to benefits already accrued) as a necessary means to conform the plan to the safe harbor. Such relief would be consistent with the intention of Congress as reflected in PPA section 1107, which, as noted above, extended the anti-cutback relief to plan changes made pursuant to the PPA or "to any regulation issued" under the PPA, and would meet the existing

[7] 79 Fed. Reg. at 56460 (amending Treas. Reg. § 1.411(b)(5)-1 to add paragraph (b)(1)(ii)(F)).

regulatory standard of necessity as well. To now say that a primary benefit of the PPA for these plans, safe harbor compliance with age discrimination rules, is unavailable, would be an extremely unfair result. If whipsaw must be eliminated to comply with a primary benefit of the PPA, then the regulations should provide anti-cutback relief to allow a plan to eliminate whipsaw "to the extent necessary" to qualify for the PPA safe harbor. The regulations should also clarify the exception for lump sum-based plans for subsidies required by the anti-cutback rule: the final regulations should make clear that the exception covers both wear-away and A+B approaches to eliminating whipsaw.

If a plan with whipsaw is not considered a lump sum-based plan, the final regulations should make clear that the plan is an indexed plan. In addition, the final regulations should provide that indexed plans that don't qualify as lump sum-based plans and that provide interest credits in excess of a market rate of return will be permitted to reduce or change those rates to conform them to the market rate of return standard with full anti-cutback relief just like similarly situated lump sum-based plans. Indexed plans are equally deserving of transition relief as lump sum-based plans.

III. The age discrimination statutes exempt early retirement subsidies from their coverage, so any new definition of early retirement subsidy should be adopted only pursuant to full notice-and-comment rulemaking.

The final regulations, for the first time, would impose age discrimination rules on early retirement subsidies. The regulations state that an early retirement subsidy will violate the age discrimination rules if the periodic amount of the benefit exceeds the periodic amount of the benefit of a similarly situated, older participant.[8] However, Code section 411(b)(5)(A)(iii) states clearly that, for purposes of the hybrid plan age discrimination rules, early retirement subsidies are disregarded.[9]

Should Treasury wish to create a new definition of early retirement subsidy, this should be done in a proposed regulation applying not just to hybrid plans. While it is not clear whether the current approach is consistent with the statute, there is certainly no reason in the statute to have different definitions of early retirement subsidy, depending on whether the plan is a hybrid plan.

IV. Treasury should proactively anticipate and minimize the practical problems posed for plans and participants by incomplete guidance.

Treasury has said that additional regulations are still being prepared on several subjects of critical importance to hybrid retirement plans.[10] ERIC agrees that additional regulations are needed in these areas and applauds Treasury's continuing efforts to provide comprehensive guidance. Without it, hybrid plans cannot be structured with legal certainty in ways that comport with sound retirement design criteria, and that meet the needs of both plan sponsors and participants.

Finalizing regulations in stages with staggered effective dates does pose a number of practical problems, however. In particular, it will require plan sponsors to make fundamental plan design

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[8] *Id*. (amending Treas. Reg. § 1.411(b)(5)-1 to add paragraph (b)(1)(iii)).
[9] *See also* Code § 411(b)(1)(H)(iv).
[10] *See, e.g.*, IRS Field Guidance, *Explanation of PEP Plan Issues*, at 6 (rev. Sept. 9, 2014) (issuance of guidance on pension equity plans pending); 79 Fed. Reg. at 56455-56456 (preamble) (issues raised by participant-directed hybrid plans reserved for subsequent guidance); *id.* at 56448 (preamble) (final regulations provide rules for projecting investment rates of return for anti-backloading purposes under Code § 411(b)(1)(B)(iv) but not for other purposes).

changes—often involving cutbacks in participants' previously accrued benefits—on the basis of incomplete guidance. While sponsors can speculate on the shape of future guidance, they and their participants face the real prospect that changes required by the current round of final regulations will conflict with requirements imposed by subsequent rounds. In any event, subsequent regulations are likely to require additional plan changes and perhaps more cutbacks in participant benefits. The prospect of additional design changes—including modifying or even reversing earlier design changes adopted in response to the current final regulations—cannot but disrupt plan operations, sponsors' overall retirement arrangements, and, above all, participants' own retirement planning and preparation. It is incumbent upon Treasury to minimize these disruptions by proactively anticipating and avoiding inconsistent and repetitive plan design changes in its current and future hybrid plan guidance.

To address these concerns, ERIC has developed several proposals to mitigate these practical problems. While these concerns affect many hybrid plans, they are particularly acute for pension equity plans, participant-directed cash balance plans, and plans that credit investment-based rates of return. ERIC's specific proposals for these plans are described below.

A. Future PEP guidance must be crafted with care to avoid imposing repeated and/or inconsistent changes on pension equity plans and participants.

Treasury has indicated that it is developing proposed regulations to address fundamental questions about pension equity plans ("PEPs") that Treasury has previously identified. Despite the lack of even proposed guidance on these fundamental questions, pension equity plans would be required to be amended to conform to the current proposed and final hybrid plan regulations by no later than the opening of the first plan year to begin in 2016. As a result, PEP sponsors will be required to make important design changes to their plans—potentially including cuts to participants' previously accrued benefits—in the absence of guidance that Treasury considers fundamental to such plans. This places plan sponsors and participants in a quandary of making important plan design changes in 2016 without knowing how those changes will interact or even comply with further fundamental PEP guidance Treasury will issue in the future.

One possible way to address this quandary would be to provide a delay for pension equity plans in the effective date of the current proposed and final hybrid plan regulations until final PEP guidance is issued. However, ERIC does not support this approach. Rather, ERIC believes that the same effective date should continue to apply to pension equity plans as to other hybrid plans under the current proposed and final regulations. But Treasury must exercise care in crafting future PEP guidance to avoid requiring repetitive and inconsistent changes in PEPs as a result of such future guidance. Attempting to identify what those potentially repetitive and inconsistent changes might be would be pure speculation at this point. It is therefore incumbent upon Treasury to proactively think through and identify them when it reaches critical decisionmaking points in its development of future PEP guidance.

B. The current proposed and final regulations need to explain—with clarity—when and how participant-directed cash balance plans are to comply with the market rate of return rules.

The preamble to the September 19, 2014, final hybrid regulations states that Treasury continues to study whether participants should be permitted, in one degree or another, to direct the allocation of their hybrid plan accounts among investment options made available to them under the plan.[11] The preamble goes on to state:

> It is possible that the Treasury Department and the IRS will conclude that such plan designs are not permitted. In that event, it is anticipated that any statutory hybrid plans that permitted participant choice among a menu of investment options on September 18, 2014 pursuant to plan provisions that were adopted by September 18, 2014 would receive anti-cutback relief that would permit any such plans to be amended to provide for one or more appropriate alternative replacement interest crediting measures.

ERIC appreciates this promise of broad transition relief. However, in the interim it is unclear whether existing hybrid plans with self-directed investment options will be required to be amended to conform to the current proposed and final hybrid plan regulations by no later than the opening of the first plan year to begin in 2016. Specifically, must each investment option under a participant-directed hybrid plan—when viewed in isolation—offer to credit a rate that is approved as a permissible market rate of return under the current final regulations? If so, sponsors of participant-directed hybrid plans will need to amend their plans to eliminate or replace any noncompliant investment options they contain without knowing whether participant direction will even be permitted under regulations Treasury intends to issue at some point in the future.

1. Treasury should finalize its decisions on participant direction at the same time it finalizes the current transition guidance for other hybrid plans.

To avoid the disruption this two-step process would inevitably entail for plan sponsors and participants and the possibility that such plans would remain in regulatory limbo for an extended period, Treasury should finalize its decisions on participant direction at the same time they finalize the current transition guidance for other hybrid plans. Doing so would allow affected plans and participants to go through a single set of changes in 2016 (with full anti-cutback relief).

In the alternative, if guidance on participant direction is not finalized at the same time as other transition guidance, then Treasury should give consideration to extending the effective date of the market rate of return rules for participant-directed plans until such time as Treasury does finalize its guidance on participant direction, thus allowing participant-directed plans to continue to operate as currently structured in the interim.

Absent adoption by Treasury of either of the foregoing proposals, then pending the issuance of final guidance on participant direction, Treasury should at a minimum provide clear guidance and anti-cutback relief in the current round of final transition guidance to address whether a plan with participant direction is required to test each of its investment options independently under the

[11] *See* 79 Fed. Reg. at 56455-56.

regulations (*i.e.*, as if each option were the only investment option under the plan) for compliance with the market rate of return rules and is also required to transition any non-compliant options to compliant options by no later than the opening of the first plan year to begin in 2016. Assuming a plan with participant direction is required to take the foregoing steps, the final regulations should confirm that (1) if a non-compliant investment option is transitioned to the closest compliant option and the closest compliant option is a pre-existing option under the plan, the resulting reduction in the number of plan investment options is permissible, and (2) a plan that contains a menu of all individually compliant investment options as of the opening of the 2016 plan year will be deemed to comply with the market rate of return regulations until such time as the Treasury finalizes its guidance on participant direction (together with any related anti-cutback relief needed if such final guidance disallows or further restricts participant direction under the plan).

2. Treasury should provide additional guidance on employer stock funds.

Except in rare circumstances, an investment-based interest crediting rate tied to the rate of return on the stock of a single company would not comply with the market rate of return standard in the current final regulations. This raises concerns for participant-directed hybrid plans that include an employer stock fund among the investment options available to participants. Whichever approach outlined above is taken to transition for participant-directed plans generally, Treasury should confirm that, in the case of an employer stock fund of a company that is a member of the S&P 500, it is permissible for the sponsor to change the interest crediting rate on that option to the rate of return on the S&P 500, and to the extent the plan already offers an investment-based rate keyed to the S&P 500 through another plan investment option, the employer would not be required to create a new investment-based return option to replace the employer stock fund option in the menu of plan options.

In addition, Treasury should permit participant-directed plans that include an employer stock fund to apply a phase-in period for transitioning participant investments out of the fund and into a designated default replacement option that complies with the market rate of return standards (such as an S&P 500 fund). This approach would allow employees with account balances in the employer stock fund to switch gradually over a period of time to other compliant options rather than switching all at once. Participants who may have previously made long-term investment decisions to allocate part of their accounts to an employer stock fund with its inherent potential investment volatility should not be forced to liquidate their positions in that fund at a single fixed point in time. Instead, a transitional phase-in period should provide more time for the participant to exit the position in an orderly fashion without the risk of extreme volatility to which they would be exposed by liquidating on a single day. Under this proposal, participants would still retain discretion to liquidate their positions in employer stock more rapidly than the transitional phase-in period contemplates and to reallocate those positions to funds other than the default replacement fund, to the extent they choose to do so and any final regulations still permit.

3. The final regulations should be amended to include the rate of return on an investment option in the plan sponsor's 401(k) plan that is funded through a broadly diversified collective trust or separate account.

The current final regulations permit plans to credit the rate of return on a regulated investment company (within the meaning of Code section 851) that is reasonably expected to be not significantly more volatile than the broad United States equities market or a similarly broad international equities market (a "Qualified RIC"). Participant-directed cash balance plans frequently mirror the investment options available under the plan sponsor's 401(k) plan.[12] Those 401(k) plans, in turn, typically include investment options based on Qualified RICs, but also increasingly include investment options funded through collective trusts and separate accounts that, while not regulated investments companies within the meaning of section 851, do meet the broad diversification requirements applicable to Qualified RICs. Plan sponsors have been moving to collective trusts and separate accounts to fund investment options under 401(k) plans to reduce expenses and increase yields for participants in a way that simply cannot be achieved through the use of even institutional-class RICs.

The preamble to the current final regulations rejects the use of investment options under a plan sponsor's 401(k) plan as providing market rates of return because those options include funds that do not meet the broad diversification requirements applicable to Qualified RICs.[13] However, there is no reason why Treasury should not approve investment options under a plan sponsor's 401(k) plan funded through a collective trust or separate account that *does* meet the broad diversification requirements applicable to Qualified RICs (a "Qualified 401(k) Fund"). On the contrary, participants in hybrid plans would benefit enormously from the reduced expenses and increased yields available to them through such vehicles, and with none of the excess volatility concerns that trouble Treasury about other potential investment options. ERIC therefore recommends that Treasury amend the current final regulations to include among permitted market rates of return the rate of return on an investment option in the plan sponsor's 401(k) plan that is funded through a collective trust or separate account that meets the broad diversification requirements applicable to Qualified RICs. This is a much simpler alternative to setting up a subset of plan assets under section 1.411(b)(5)-1(d)(5)(ii)(B) of the final regulations, both for the plan to administer and for the Internal Revenue Service to verify and audit.

While this recommendation applies to market rates of return and hybrid plans generally, at the very least Treasury should permit participant-directed hybrid plans to continue to use Qualified 401(k) Funds either permanently or until final regulations on participant direction are issued. Participants are likely to react with consternation if Treasury forces an existing Qualified 401(k) Fund in a participant-directed hybrid plan to be replaced with a comparable Qualified RIC with higher expenses and lower yields, on the theory that the Qualified 401(k) Fund fails to provide a market rate of return.

4. Treasury should amend the final regulations to clarify that an interest crediting rate equal to the yield from time to time on a "stable value" fund under the employer's 401(k) plan is a permitted market rate of return.

The final regulations should clarify that an interest crediting rate equal to the yield from time to time on a "stable value" fund under the employer's 401(k) plan is a permitted market rate of return. By definition, such a return should never be deemed to be in excess of a market rate of return or subject to volatility in excess of that permitted a Qualified RIC. If the yield on the stable value fund is

[12] For simplicity, we use the term "401(k) plan" to refer to a defined contribution plan, including ones that do not include elective deferrals.
[13] *See* 79 Fed. Reg. at 56451.

not acceptable for some reason, Treasury should at least confirm that the stable value option could be transitioned to the yield on the first segment corporate bond rate.

C. Treasury should finish finalizing its guidance on projecting investment rates of return in a way that fairly reflects future rates of return participants are actually likely to earn, and that does not contradict key provisions of the PPA.

ERIC incorporates here by reference its earlier comments on projecting investment rates of return. We also note that the new final regulation on projecting investment rates of return for anti-backloading purposes[14] requires projections that violate the market rate of return standard. Specifically, while the rate of return on a specified investment (such as an S&P 500 mutual fund) clearly is a market rate of return, holding a given year's rate of return on that investment constant into the future clearly is *not* a market rate of return. In fact, in many years such a projection would produce returns far in excess of a market rate of return. Since hybrid plans are not permitted to credit returns in excess of a market rate of return, the projection methodology in the new final anti-backloading regulation fails to hold all relevant benefit computation factors constant,[15] since those factors require the plan to comply with the market rate of return standard. Just as the preservation of capital rule in Code section 411(b)(5)(B)(i)(II) prohibits cumulative projections below 0% (a benefit computation factor recognized and applied by the new regulation), the comparable requirement of section 411(b)(5)(B)(i)(I) that prohibits cumulative projections in excess of a market rate of return is ignored entirely. Treasury should amend its final regulations to correct this oversight.

ERIC appreciates the opportunity to submit our views on the proposed and final hybrid regulations and our recommendations on how the regulations should address the issues discussed above. We look forward to working with you to create workable rules that reflect the statutory language of the Pension Protection Act and fully effectuate Congress's intent in adopting it. If the Treasury and IRS have any questions concerning our comments, or if we can be of further assistance, please contact us at (202) 789-1400.

Sincerely,

Kathryn Ricard

Kathryn Ricard
Senior Vice President, Retirement Policy

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[14] 79 Fed. Reg. at 56459-60 (amending Treas. Reg. § 1.411(b)-1 to add paragraph (b)(2)(ii)(G)).
[15] Code § 411(b)(1)(B)(iv); Treas. Reg. § 1.411(b)-1(b)(2)(ii)(C).