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**IMPORTANT PENSION CHANGES FROM D.C.  
- WHAT DO YOU NEED TO KNOW?**

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## **IMPORTANT PENSION CHANGES FROM D.C. - WHAT DO YOU NEED TO KNOW?**

### **I. Transforming the Private Retirement System**

#### **A. General Outlook for DOL Rulemaking in 2012.**

The landscape for tax-qualified retirement plans is changing. Change can be accomplished by legislation, like the Pension Protection Act of 2006, which left a sizable footprint in the retirement market. But change can also be achieved through agency action, and that is what is happening right now. 2012 is going to be a big year for the U.S. Department of Labor (“DOL”), as its various rules go into effect. Covered providers will have to deliver 408(b)(2) fee disclosures to their plan clients for the first time by April 1, 2012. Plan sponsors and recordkeepers will need to furnish new participant-level fee disclosures by May 31, 2012 in the case of calendar year plans. The prohibited transaction exemption for providing investment advice to participants becomes effective at the end of 2011 (December 27, 2011).

In addition to launching its final rules, the DOL is moving ahead with its proposed rulemaking. A lot of people are still talking about the DOL’s announcement that it will be re-proposing a new “fiduciary” definition in the early part of 2012. And the DOL is expected to finalize its current proposals for target date funds and default investments. It should also be noted that the DOL is continuing to work closely with the White House and its Middle Class Task Force. Given the unprecedented involvement of the White House in the development of DOL regulations under ERISA, it is important to bear in mind that these rules are designed to make strategic improvements in the 401(k) plan arena, and that they not being issued haphazardly in isolation of one another. In sum, the DOL and the Administration are targeting these seven areas:

1. Fee disclosures to participants
2. Participant investment advice
3. 408(b)(2) disclosures from service providers
4. Broader “fiduciary” definition
5. Default investments
6. Lifetime income options
7. Automatic IRA legislation

### **II. Fee Disclosures to Participants**

On October 14, 2010, the DOL finalized its regulations concerning the fee and investment-related disclosures that must be provided to participants in 401(k) plans and other defined contribution plans with participant-directed investments. In its press release announcing the issuance of these final rules, the DOL explained that the previous laws did not require plans to provide workers with “the information they need to make informed investment decisions,” such as fee and expense information. However, the new rules would enable the estimated 72 million affected participants “to meaningfully compare the investment options under their plans.”

#### A. Types of Plans Covered

The new participant disclosure requirements only apply to participant-directed individual account plans, such as 401(k) plans, and they do not apply to defined contribution plans with employer-directed investments. The fiduciary obligation to provide the mandatory disclosures is generally imposed on the plan sponsor.

Many participant-directed plans are designed to comply with the requirements of ERISA Section 404(c), a provision which relieves plan sponsors of any fiduciary responsibility for the investment allocation decisions of individual participants. However, the new participant disclosure requirements cover all participant-directed plans, even if they are not designed to comply with ERISA Section 404(c). The 404(c) rules have been revised so that they cross-reference the new disclosure rules. That is to say, in order to comply with Section 404(c), the plan must now comply with the new participant disclosure rules as well as the other requirements under Section 404(c).

#### B. Coverage of Participants

The new disclosure requirement applies to all eligible employees, and not merely participants who have actually enrolled in the plan. Thus, the entire eligible employee population will need to receive the relevant disclosures on an ongoing basis. The required disclosures include both plan-related information and investment-related information.

#### C. Annual and Quarterly Disclosure of Plan-Related Information

Under the DOL's final regulations, participants must be furnished general information about the plan annually, including an explanation of how participants may give investment allocation instructions and information concerning the plan's investment menu. Plan participants must also receive an annual explanation of the *general administrative service fees* which may be charged against their accounts as well as any *individual expenses* charged for individualized services (*e.g.*, plan loan processing fee). With respect to new participants, this information must be provided before they can first direct investments under the plan.

Participants must also receive certain information on a quarterly basis. They must receive statements that include the quarterly dollar amounts actually charged to their plan accounts as general administrative service fees and as individual expenses, as well as a description of the relevant services.

The annual and quarterly fee disclosures for general administrative services and individual expenses only apply to the extent such fees are not already reflected in the total annual operating expenses of the plan's investments. For example, if a service provider is wholly

compensated through indirect compensation flowing from a plan's investment funds (*i.e.*, the provider's fees are already reflected in each fund's per-share market value or "NAV"), the provider's fees and services would not be subject to these annual and quarterly fee disclosures. However, if any portion of the fees for general administrative services are paid from the total annual operating expenses of any of the plan's investments (*e.g.*, through revenue sharing or 12b-1 fees), an explanation of this fact must be included in the quarterly statements.

D. Annual Disclosure of Investment-Related Information

Plan participants must receive certain fee and performance-related information relating to the plan's various investment alternatives in a comparative format, for which the DOL has created a "model comparative chart." This information must be provided on or before the date on which a participant can direct investments, and annually thereafter.

The comparative information which must be provided includes: (a) the name and type of investment option, (b) investment performance data, (c) benchmark performance data, (d) fee information, including both the *total annual operating expenses* of each investment alternative and any *shareholder-type fees* which are not reflected in the total annual operating expenses, such as commissions and account fees, and (e) the internet website address at which additional information is available.

E. Information That Must Be Available Upon Request

Upon request, participants must be provided copies of fund prospectuses (or other corresponding documents) as well as any shareholder reports and related financial statements provided to the plan.

F. Form of Disclosure

The annual disclosures required under the DOL's regulations may be provided separately or as part of the plan's summary plan description ("SPD") or participant benefit statements. The required quarterly statements may also be provided separately or as part of the plan's participant benefit statements. All disclosures must be written in a manner calculated to be understood by the average participant.

G. Impact on Plan Sponsor's Other Fiduciary Duties

As expressly provided in the new DOL regulations, a plan sponsor's compliance with the new disclosure rules will not relieve it of its fiduciary duty to prudently select and monitor the plan's providers and investments.

The new regulations modify the DOL's existing regulations under ERISA Section 404(c). A plan sponsor can be relieved of any responsibility over the investment allocation decisions of individual participants, provided that the regulatory conditions under Section 404(c) are satisfied. To comply with the applicable investment-disclosure requirements under the 404(c) regulations, as modified by the DOL's new rules, participants simply need to receive the annual and quarterly disclosures required under the new regulations.

#### H. Effective Date

Although the DOL's participant disclosure regulations have been finalized, they have a delayed application date. The new disclosure requirements will be imposed on plan sponsors for plan years beginning on or after November 1, 2011. In the case of calendar year plans, they will go into effect on January 1, 2012. Under the final regulation, plan administrators are not required to provide the first disclosure until 60 days after: (1) the effective date of the 408(b)(2) service provider fee disclosure rule (*i.e.*, April 1, 2012), or (2) the date the regulations apply (*i.e.*, plan years beginning on or after November 1, 2011). Thus, plan administrators of calendar year plans have until May 31, 2012, to provide the initial disclosure.

#### I. Potential Impact on Administrative Service Providers

The new regulations will clearly have the greatest impact on third party administrators ("TPAs") and bundled service providers. Given the fact that the DOL's final regulations are generally consistent with its 2008 proposed rulemaking, providers that have already modified their systems based on the DOL's proposed rules are likely to require modest changes only.

There will be one administrative advantage under the new participant disclosure regime. Under the prior version of the 404(c) regulations, participants generally had to receive a copy of a fund's prospectus prior to the participant's initial investment in such fund. As a practical matter, this burdensome requirement forced recordkeepers to deliver copies of all the plan's fund prospectuses to all new participants. However, as modified by the new rules, prospectuses will only need to be provided upon request by a participant.

#### J. Potential Impact on Financial Advisors

Under the new regulations, there is no special disclosure requirement for the fees and services of brokers receiving indirect compensation only (*e.g.*, 12b-1 fees and other types of revenue sharing payments). If the broker's compensation is fully reflected in the total annual operating expenses of the plan's investments, the annual and quarterly fee disclosures of plan-related information, as discussed above, would not apply. To the extent the broker's advisory services were deemed general administrative services, an explanation that a portion of the fees for such services were being paid from the total annual operating expenses of the plan's investments would have to be included in the quarterly statements. However, whether a broker's

advisory services should be characterized as general administrative services is somewhat unclear under the new regulations.

With respect to registered investment advisers (“RIAs”), it is similarly unclear if a RIA’s separate advisory fee (unrelated to the total annual operating expenses of the plan’s investments) should be characterized as a general administrative service fee or a shareholder-type fee. If the advisory fee is deemed to be a general administrative service fee, it would need to be reflected in both the annual and quarterly disclosures, although the RIA’s advisory fee would not have to be separately itemized. If the RIA’s advisory fee can be categorized as a shareholder-type fee, they presumably would not have to be reflected in the quarterly disclosures as a general administrative service fee.

Even if the impact of the new regulations on many financial advisors will be indirect, it is likely to be significant. Given the detailed level and comparative nature of the disclosures that will be provided to participants, many will scrutinize their respective plan’s investments and fees. The enhanced disclosures may also prompt them to pressure plan sponsors, asking “hard” questions about the performance of the plan’s investments as well as the size of plan fees. This pressure is likely to reinforce the heightened scrutiny of 401(k) fees that is already being applied in the retirement plan market.

### **III. Participant Investment Advice**

Many non-fiduciary providers of investment services to DC plans receive variable compensation from or through the plan’s investments. For example, a broker-dealer may receive different 12b-1 fees from a plan’s lineup of investments, or a mutual fund platform may receive different fees from the proprietary funds included in a plan’s menu. The fact that they receive variable rates of compensation from the plan’s investments makes it unlawful for them to provide fiduciary advice to participants (without a prohibited transaction exemption). A provider of participant advice cannot give fiduciary advice to a participant, if it can increase its compensation by steering participants to funds with higher payouts. Because of the strict nature of ERISA, the mere existence of the conflict would trigger a prohibited transaction. And so, even if a provider acts in good faith and its advice to participants does not cause an overconcentration in funds with the highest fees, the advice would be unlawful and would result in prohibited transactions.

#### **A. DOL Final Regulations for Participant Investment Advice**

Fortunately, there is a specific exemption from the prohibited transaction rules that allow these investment providers to offer advice to plan participants. This exemption was included as part of the Pension Protection Act of 2006. The DOL had finalized its first iteration of the investment advice regulations on January 21, 2009, during the last days of the Bush Administration. However, under the new Obama Administration, the DOL withdrew these

regulations, publishing new final regulations on October 25, 2011. Although various aspects of the DOL's rules have changed during the rulemaking process, the basic features remain consistent with the statutory framework from the Pension Protection Act.

A provider can take advantage of the statutory prohibited transaction exemption if it qualifies as a "Fiduciary Adviser". To be a Fiduciary Adviser, the provider must be either a registered investment adviser ("RIA"), a broker-dealer, a bank or an insurance company.

In addition, the participant advice must be provided through an "Eligible Investment Advice Arrangement". The final rules describe 2 different types of Eligible Investment Advice Arrangements: a "Fee-Leveling" arrangement" and a "Computer Model" arrangement. If the Eligible Investment Advice Arrangement is a Fee-Leveling arrangement, the fee earned by the Fiduciary Adviser must be level and cannot vary with the participants' investment allocation decisions. If the Eligible Investment Advice Arrangement is a Computer Model arrangement, the Fiduciary Adviser's advice to participants must be limited to the advice generated by a computer model certified by an expert.

The Eligible Investment advice Arrangement must meet a number of operational conditions. A plan's participation in the arrangement must be authorized by the plan sponsor or another fiduciary that is separate and unrelated to the Fiduciary Adviser. The arrangement must also be reviewed annually by an independent auditor. Furthermore, participants must receive an upfront notice with disclosures concerning the fees charged for investment advice as well as any material affiliations between the Fiduciary Adviser and any other involved parties.

#### B. Fee-Leveling Arrangement

If a Fiduciary Adviser provides advice to participants under a Fee-Leveling arrangement, the Fiduciary Adviser's compensation (and the compensation of the Fiduciary Adviser's employees and representatives) must be level. However, any plan-related fees earned by the Fiduciary Adviser's affiliates can vary.

For example, let's take a mutual fund platform maintained by the ABC Fund family. Let's further assume that a 401(k) plan on this platform invests in a mix of ABC Funds and third party funds. If the investment manager of the ABC Funds (ABC Fund Manager) were to give allocation advice to the plan participants, it would clearly have a conflict of interest because of its incentive to steer participants to the ABC Funds to increase its own flows and compensation. However, let's say that the ABC Fund family creates a brand new affiliated RIA called "ABC Fiduciary Adviser". So long as ABC Fiduciary Adviser receives level compensation for the advice provided to plan participants, ABC Fund Manager is permitted to receive compensation that varies with the participants' level of investment in the ABC Funds. Thus, the fee-leveling requirement is imposed on ABC Fiduciary Adviser alone, and ABC Fund Manager and any other affiliates are permitted to receive variable compensation from the plan's investments.



### C. Computer Model Arrangement

If a Fiduciary Adviser provides advice to participants under a Computer Model arrangement, the Fiduciary Adviser's investment advice must be provided through an objective computer model that is independently certified not to favor investment options that would result in greater fees for the Fiduciary Adviser. The Fiduciary Adviser must request risk profile information and other relevant participant data, and the Computer Model must take this information into account when providing participant advice. So long as the participant advice is based on the Computer Model advice, the Fiduciary Adviser is permitted to receive compensation that varies with the participants' investment allocation decisions under the plan.

During the rulemaking process, the DOL had made some comments that implied that Computer Models would need to recommend index funds over actively managed funds for fee-related reasons. However, the DOL has backed away from its comments, and the final rules do not favor passively or actively managed funds.

As a formal matter, the participant investment advice rules also apply to IRAs. However, as a practical matter, it is unclear if providers will be able to create Computer Models with the capability of advising IRA owners. Computer Models by their nature are typically only able to provide advice with respect to a finite menu of designated investment options. So they are well-suited for advising 401(k) plan participants, but not for advising IRA owners with the freedom to select investments from an entire universe of securities.

### D. Effective Date

The DOL's participant investment advice rules go into effect on December 27, 2011.

## IV. **408(b)(2) Disclosures from Service Providers**

### A. "Hidden" Fees and Conflicts of Interest

There has been a great deal of discussion surrounding the so-called "hidden" payments flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant). Plan sponsors are undoubtedly aware of the "hard dollar" fees invoiced directly to the plan or the employer, but they may not necessarily understand that the service provider can also receive indirect compensation from the plan's investment funds and the managers of such funds. The hidden payments made to a plan's service provider might include shareholder servicing fees (as well as 12b-1 fees and sub-transfer agency fees) paid from the plan's investment funds or revenue sharing payments made directly from the fund managers. Thus, a plan sponsor could conceivably select what appears to be a "free" administrative service for the

plan, without understanding that the provider's compensation was being passed on to plan participants in the form of higher embedded costs in the plan's investment funds.

A plan sponsor's ignorance of the fact that administrative service providers can receive such indirect compensation creates a potential conflict of interest for the administrative service provider. By steering plan clients to the arrangement with the highest level of indirect compensation, the provider is presumably able to receive fees in excess of what plan clients would otherwise agree to if they knew the true cost of services. Ironically, the arrangement with the highest level of indirect compensation may be the most attractive to an uninformed plan client, because it would have lower "hard dollar" fees, creating the false impression that this service arrangement was the cheapest for the plan.

For example, let's assume that an employer is looking for a provider of administrative services to its 401(k) plan. The provider offers the plan sponsor two options: (1) the employer can order services *a la carte* with no restriction on the combination of services and investment funds available for an annual fee of \$10,000, and (2) the employer may choose pre-packaged services with a limited investment menu for an annual fee of \$4,000. If the plan sponsor does not realize that the provider is receiving "hidden" compensation from the plan's investment funds and fund managers, the plan sponsor may prematurely conclude that the second option is the best choice for the plan and its participants. Unfortunately, the total compensation payable to the provider under the pre-packaged option may greatly exceed \$10,000 (*i.e.*, the cost of the first option), and the hidden cost would be directly or indirectly borne by the plan's participants.

Revenue sharing among a plan's investment and service providers is not prohibited under ERISA. But without full disclosure of the indirect compensation paid to the plan's service providers, the plan and its participants might end up paying fees that are unreasonable, resulting in a breach of its fiduciary duties under ERISA.

#### B. Retirement Security Initiative – Improving Transparency.

To address these concerns, the Obama Administration wants to improve "the transparency of 401(k) fees to help workers and plan sponsors make sure they are getting investment, record-keeping, and other services at a fair price."<sup>1</sup> Consistent with this policy objective, interim final regulations were published on July 16, 2010 requiring service providers to provide specific disclosures with respect to fees.

The DOL initiative to educate plan sponsors about 401(k) fees and to improve fee transparency actually began more than a decade ago. In 1997, the DOL held a hearing on 401(k) plan fees, which appeared to have been in response to several consumer magazines criticizing the

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<sup>1</sup> *Annual Report of the White House Task Force on the Middle Class*, February 2010.

size of such fees.<sup>2</sup> In 1998, the DOL published a booklet for plan participants called “A Look At 401(k) Plan Fees,” as well as a much more sizable 72-page report for plan sponsors (“Study of 401(k) Fees and Expenses”).<sup>3</sup> Unfortunately, the DOL’s informal efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees apparently failed. In light of that failure, the DOL is now requiring service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

### C. Background – Prohibited Transaction Rules Under ERISA.

The prohibited transaction rules under ERISA cover a broad spectrum of activities. In addition to banning transactions that involve fiduciary conflicts of interest, the prohibited transaction rules also prohibit the use of plan assets with respect to many other activities (other than the payment of benefits). Fortunately, there is a specific exemption that allows the use of plan assets to pay fees for reasonable services.

ERISA Section 408(b)(2) provides relief from ERISA’s prohibited transaction rules for the use of plan assets to pay for services between a plan and a party in interest (e.g., recordkeeper). The conditions of this statutory exemption are satisfied if:

- the contract or arrangement is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

Before the 408(b)(2) rules were adopted, ERISA did not impose a significant administrative burden on service providers that were paid with plan assets. Other than satisfying the plain meaning of the above requirements under the statute itself, the DOL merely imposed one other requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.<sup>4</sup>

### D. Interim Final 408(b)(2) Regulations

#### 1. Interim Final Regulations

On July 16, 2010, the DOL released its interim final regulations under ERISA Section 408(b)(2). If a service provider is paid directly or indirectly with plan assets,

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<sup>2</sup> “Protect Yourself against the Great Retirement Rip-off,” *Money Magazine* (April 1997). “Your 401(k)'s Dirty Little Secret,” *Bloomberg Personal* (September 1997).

<sup>3</sup> A Look at 401(k) Plan Fees” is posted at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html). The Study of 401(k) Fees and Expenses is posted at: <http://www.dol.gov/ebsa/pdf/401kRept.pdf>.

<sup>4</sup> 29 CFR 2550.408b-2(c).

such arrangement will trigger a prohibited transaction under ERISA, unless the plan sponsor receives certain fee disclosures required under the DOL's rules. The purpose of these rules is to ensure plan fiduciaries have sufficient information, to be able to assess the reasonableness of the compensation paid for plan services.

The effective date for these rules was recently pushed back from July 16, 2011 to January 1, 2012, and then to April 1, 2012.<sup>5</sup> Thus, the final regulations will apply to existing services arrangements as of April 1, 2012 as well as to new arrangements entered into on or after that date. The one-year lead time is intended to accommodate the costs and burden of transition to the new disclosure regime. However, because the regulations are interim as well as final, new requirements may be added before the effective date. It is not clear whether any additional changes will have an extended effective date for compliance.

## 2. Covered Plans

Under the proposed regulations, all employee benefit plans subject to Title I of ERISA were subject to the regulation's disclosure requirements. The final regulations retrench by defining a covered plan to mean an employee pension plan. Excluded from this definition and, therefore, not affected by the disclosure requirements of the final regulation are:

- a. IRAs,
- b. Simplified Employee Pension ("SEP") plans, and
- c. SIMPLE retirement accounts.

## 3. Covered Service Providers.

The final rule is limited to service providers that reasonably expect to receive \$1,000 or more in compensation (direct or indirect) from providing plan services that fall under one of the following categories:

- a. Services as a fiduciary under ERISA or as a registered investment adviser. Such services include:
  - i. Provider of Fiduciary Services. Services provided directly to a covered plan in the capacity of an ERISA fiduciary.

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<sup>5</sup> EBSA News Release, February 11, 2012 (announcing DOL's intent to delay effective date to January 1, 2012). IRS Employee Plans News, Issue 2011-5, June 22, 2011 (announcing DOL's proposed rule extending and aligning the applicability dates for its retirement plan fee disclosure rules).

- ii. Investment Product Fiduciary. Services provided as a fiduciary to an investment contract, product or entity that holds plan assets. To be included in this new category, the plan must have a direct equity investment in the contract, product or entity. Fiduciary services provided to underlying investments (i.e., to second tier investment vehicles) are not taken into account.
    - (A) Mutual funds are not considered to hold plan assets and, therefore, fund investment advisers are excluded from the definition of a covered service provider. Accordingly, mutual funds are not subject to the general disclosure obligation.
    - (B) Insurance products providing a fixed rate of return are generally considered not to hold plan assets. Thus, products, such as GICs, general account investments and deferred fixed annuities will not result in the insurer becoming a covered service provider. However, a variable annuity based on a separate account that may be treated as a plan asset could give rise to compensation subject to disclosure.
    - (C) Fiduciaries to plan asset vehicles, such as collective trusts, hedge funds and private equity funds are potentially subject to the fee disclosure rules.
  - iii. Registered Investment Adviser. Services provided directly to the covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or state law.
- b. Recordkeeping or brokerage services provided to individual account plans that permit participants to direct the investment of their accounts. This category assumes that one or more designated investment alternatives have been made available through an investment platform. As discussed, the final regulations expand the disclosure obligation of such recordkeepers and brokers to compensation information regarding each designated investment alternative.
  - c. Services within a broad list of categories that are reasonably expected to be paid for by indirect compensation or compensation paid among related parties. Service categories include investment consulting, accounting, auditing, actuarial, appraisal, development of investment policies, third party administration, legal, recordkeeping and valuation services.

#### 4. Required Disclosure

- a. General. A covered service provider must disclose in writing to the plan sponsor or similar plan fiduciary all services to be provided to the plan, not including nonfiduciary services. Service providers must also disclose whether they will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940.
  - i. Formal Contract No Longer Required. Unlike the proposed regulations, the final regulation does not require a formal written contract delineating the disclosure obligations.
  - ii. Disclosure of Conflicts No Longer Required. In addition, the final rule eliminates required disclosure of conflicts of interest on the part of service providers. The reasoning for this change is that the expanded disclosure of compensation arrangements with parties other than the plan will be a better tool to assess a service arrangement's reasonableness, as well as potential conflicts of interest.
- b. Distinction Based on Direct or Indirect Compensation. Different rules apply to the receipt of direct and indirect compensation, with the latter thought more likely to implicate conflicts of interest.
  - i. Direct compensation is defined as compensation received from the plan.
  - ii. Indirect compensation is defined as compensation received from a source other than the plan, the plan sponsor, the covered service provider or an affiliate or subcontractor in connection with the services arrangement. For example, indirect compensation generally includes fees received from an investment fund, such as 12b-1 fees, or from another service provider, such as a finder's fee.
  - iii. Non-monetary compensation valued at \$250 or less, in the aggregate, during the term of the contract, is disregarded.
- c. Disclosure of Compensation. Covered service providers are required to disclose all direct and indirect compensation that the service provider, an affiliate or a subcontractor expects to receive from the plan. In the case of indirect compensation, the service provider must identify the services for which the indirect compensation will be received as well as the payer of the indirect compensation.

- i. Format. Compensation may be expressed as a dollar amount, formula, percentage of covered plan assets, a per capita charge, or by any other reasonable method that allows a plan fiduciary to evaluate the reasonableness of the compensation.
  - ii. Manner of Receipt. Disclosure must include a description of the manner in which the compensation will be received, such as whether it will be billed or deducted directly from participants' accounts.
  - iii. Transaction-Based Fees Received by Affiliates or Subcontractors. Compensation set on a transaction basis (e.g., commissions or soft dollars) or charged directly against the plan's investment (e.g., 12b-1 fees) and paid among the covered service provider, an affiliate or a subcontractor must be separately disclosed. The services for which the compensation is to be paid, the recipient and the payer must be identified. Other types of compensation do not require separate disclosure.
  - iv. Bundled Services. Except for the special rules discussed below, there is no requirement to unbundle service pricing.
- d. Special Rules for Recordkeepers. A person who provides recordkeeping services must provide a description of the direct and indirect compensation that the service provider (and its affiliates and subcontractors) expects to receive for recordkeeping services.
- i. If there is no explicit fee for recordkeeping services, a reasonable, good faith estimate of the cost to the plan of such services must be provided. The estimate may take into account the rate that the service provider would charge to a third party or prevailing market rates for similar services.
  - ii. Disclosing a de minimis amount of compensation for recordkeeping when the amount has no relationship to cost will not be regarded as reasonable.
- e. Special Rule for Platform Providers. Recordkeepers and brokers that make designated investment alternatives available must provide basic fee information for each such alternative for which recordkeeping or brokerage services are provided. This information is in addition to information regarding the recordkeeper's or broker's own compensation. The information to be provided includes the expense ratio, ongoing expenses (e.g., wrap fees), as well as transaction fees (e.g. sales charges, redemption fees and surrender charges) that may be charged directly against the amount invested.

- i. Pass-Through of Information on Investment Products. A recordkeeper or broker may satisfy its disclosure obligations for unaffiliated mutual funds by passing through the fund prospectus without having the duty to review its accuracy, provided that the disclosure material is regulated by a state or federal agency.
- ii. Responsibility of Other Service Providers. If there is no recordkeeper or broker to provide the required information as to the fees associated with a designated investment alternative that holds plan assets, such responsibility passes to the fiduciary of the investment contract, product or entity.
- iii. Exclusion for Brokerage Windows. Open brokerage windows are not subject to the disclosure requirements for platform providers.

5. Timing of Disclosures

Disclosure of information regarding compensation or fees must be made reasonably in advance of entering into, renewing or extending the contract for services. All of the required disclosures need not be contained in the same document and may be provided in electronic format.

- a. During the term of the contract, any change to the previously furnished information must be disclosed within 60 days (expanded from 30 days under the proposed regulations) of the service provider's becoming informed of the change.
- b. In contrast to the proposed regulation, the final rule provides that a service contract will not fail to be reasonable (*i.e.*, there will not be a prohibited transaction) solely because the service provider makes an error, provided that the service provider has acted in good faith and with reasonable diligence. Errors or omissions must be disclosed within 30 days of the service provider's acquiring knowledge of the error or omission.
- c. When an investment contract, product or entity is initially determined not to hold plan assets but this fact changes, if the covered plan's investment continues, disclosures are required as soon as practicable, but not later than 30 days from the date on which the service provider acquires knowledge that the investment vehicle holds plan assets.



## 6. Curing Disclosure Failures: Prohibited Transaction Exemption

- a. Relief for Plan Sponsor. As under the proposed 408(b)(2) regulations, the final rule provides that a service provider's failure to comply with the disclosure obligations results in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL had proposed a separate class exemption that would have provided relief for the plan fiduciary. This exemption is now incorporated into the final regulation. There is no relief for a service provider that fails to comply with the disclosure requirements.
- b. Corrective Action. Relief would be provided if the plan sponsor or similar plan fiduciary enters into a service contract under the reasonable belief that the service provider has complied with its disclosure obligations under the final regulations. To qualify for relief, the plan sponsor or similar fiduciary must take corrective steps with the service provider after discovering the disclosure problem by requesting in writing the correct disclosure information. If the service provider fails to comply within 90 days of such request, the plan fiduciary must notify the DOL not later than 30 days following the earlier of the service provider's refusal to furnish the requested information; or the date which is 90 days after the date the written request is made.
- c. Termination of Service Contract. As under the proposed regulations, the plan sponsor or similar fiduciary must also determine whether to terminate or continue the service contract by evaluating the nature of the particular disclosure failure and determining the extent of the actions necessary under the facts and circumstances. Factors to consider, among others, include the responsiveness of the service provider in furnishing the missing information, and the availability, qualifications, and costs of potential replacement service providers.

## 7. Immediate Impact and Issues

Currently, service providers need not disclose specific types of information to plan sponsors or similar fiduciaries. The interim final disclosure regulations require service providers to disclose extensive amounts of information, including the identity of third parties from whom a service provider receives fees as a result of providing services to the plan.

While conflict of interest disclosures have been eliminated, required fee disclosure will present significant internal tracking and communication challenges for large/complex companies. The ongoing 60-day disclosure deadline for information changes will result in similar challenges.

The interim final regulation clarifies that the new rules will apply to contracts in place when the regulation becomes effective on April 1, 2012. Service providers should begin preparing now to meet the new disclosure requirements, but should be prepared for possible changes to the rules due to the interim status of the regulation.

## V. **Broader “Fiduciary” Definition**

The DOL is on a campaign to expose and minimize conflicts in the retirement plan industry. And they are accomplishing this goal, at least in part, through the new fee disclosure rules (*i.e.*, 408(b)(2) and participant-level fee disclosures). But the DOL is also seeking to implement rules that would address the problem of conflicts “head on”. Specifically, the DOL is in the process of proposing a new “investment advice fiduciary” definition. If the DOL stays on track with its proposal, many non-fiduciary advisors would become subject to the fiduciary standards under ERISA for the first time. Additionally, any advisors that do not want to become subject to the fiduciary requirements of ERISA would need to fess up to clients and make certain “in your face” disclaimers concerning their non-fiduciary status.

The DOL released its initial proposed regulations to modify the existing regulatory definition of a “fiduciary” on October 21, 2010. However, due to the high volume of comments submitted in connection with this proposal, including comments from members of Congress, the DOL announced on September 19, 2011 that it would be re-proposing this definition to take into account further input from the public.<sup>6</sup>

### A. **Overview of Existing Regulatory Definition**

ERISA has a functional definition of a fiduciary. If you provide “investment advice” within the meaning of ERISA, you are automatically deemed to be a fiduciary. Under the current regulation, a person is deemed to provide fiduciary investment advice if:

- (1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
- (2) on a regular basis,
- (3) pursuant to a mutual agreement or understanding (written or otherwise)
- (4) that such services will serve as a primary basis for investment decisions, and
- (5) that such person will render advice based on the particular needs of the plan.

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<sup>6</sup> <http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm>.

It should be noted that this 5-factor definition of “investment advice” is much more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

#### B. Two Specific Changes to Existing Regulatory Definition

Assuming that the DOL’s re-proposed rule will follow its initial proposal, two specific changes would be made to the existing definition of “investment advice.” Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

- there is a mutual understanding or agreement that the advice will serve as the "primary basis" for plan investment decisions, and
- the advice is provided on a "regular basis."

However, under the DOL's proposed rulemaking, an advisor would be deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Thus, casual advice or even one-time advice could trigger fiduciary status. Under both the existing and the initial proposed rules, advice would constitute "investment advice" only if it is individualized advice for the particular plan client.

#### C. Safe Harbor “Disclaimer” for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the DOL’s initial proposal introduced a safe harbor that advisors would need to follow to avoid fiduciary status. Generally, to avoid being characterized as an investment advice fiduciary, an advisor would have to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the advisor in its "capacity as a purchaser or seller" of securities or other property, (b) the interests of the advisor are adverse to those of the client, and (c) the advisor is not undertaking to provide "impartial investment advice." Although the initial proposed rule did not actually require the advisor to provide these disclaimers in writing, it clearly contemplated some type of notice or acknowledgment form for the plan client.

#### D. Potential Impact on Providers

If the proposed regulations were finalized in their current form, non-fiduciary advisors would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would effectively be forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance. Alternatively, a provider could accept its status as a plan fiduciary. However, as

a fiduciary, it would no longer be able to provide investment advice for any variable compensation (e.g., 12b-1 fees) and it would be subject to ERISA and the prohibited transaction rules.

#### E. Outlook for DOL Proposed Regulations

Since the DOL announcement that it would be re-proposing its “fiduciary” definition, it has clarified that its re-proposed rule would only impose fiduciary status on those advisors who provide “individualized” advice to plan clients. The DOL has informally indicated that the re-proposed rule will be substantially similar in approach to its initial proposal. Its rulemaking this time around will be coordinated with the U.S. Securities and Exchange Commission (the “SEC”), which is working on its own proposal to impose fiduciary status on broker-dealers as authorized under the Dodd-Frank Act.<sup>7</sup> The DOL’s re-proposed rule is expected in early 2012.

### VI. Default Investments: Target Date Funds

A. Performance Issues Concerning Target Date Funds. Target date funds are popular default investment vehicles for 401(k) plans. As a legal matter, these investment products are typically established as mutual funds (*i.e.*, open-end investment companies registered under the Investment Company Act of 1940), although these products can also be formed as bank collective funds and other pooled investment vehicles. Target date funds are a type of balanced fund, with investments in a mix of asset classes. They are designed to provide a convenient investment solution for individual investors who do not want to be burdened with the responsibility of finding the right mix of assets for their retirement investments. The defining characteristic of a target date fund is its “glide path,” which determines the overall asset mix of the fund over time. The fund’s asset allocation automatically becomes more conservative (*i.e.*, higher allocation to fixed income investments and lower allocation to equity investments) as the fund gets closer to its target date.

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<sup>7</sup> Under the powers conferred by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the SEC is authorized to issue regulations that will impose on broker-dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). As required under the Dodd-Frank Act, on January 21, 2011, the SEC’s staff published its study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff’s report recommended that the SEC create a uniform fiduciary standard that would apply to both brokers and investment advisers when they provide personalized investment advice to retail customers. Of the 5 commissioners serving on the SEC, the 2 Republican appointees released a separate statement, criticizing the report and making the following points: (i) the SEC staff’s report does not reflect the views of the SEC or its individual commissioners, (ii) the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

Despite the immense popularity of these financial products, Congress and regulators have voiced deep concerns regarding the design of target date funds, especially funds with near-term target dates. The average investment loss for funds with a target date of 2010 was roughly -25% due to the market turmoil in 2008, with individual fund losses running as high as -41%, according to an analysis by the SEC.<sup>8</sup>

B. Administration's Proposals for Target Date Funds.

1. Retirement Policy Objectives.

In light of the surprising level of volatility across a number of target date funds intended for the oldest of retirees, the Obama Administration now seeks to improve the “transparency of target date and other default retirement investments.”<sup>9</sup> Specifically, the Administration aims to require “clear disclosure regarding target-date funds, which automatically shift assets among a mix of stocks, bonds, and other investment over the course of an individual’s lifetime. Due to their rapidly growing popularity, these funds should be closely reviewed to help ensure that employers that offer them as part of 401(k) plans can better evaluate their suitability for their workforce and that workers have access to good choices in saving for retirement and receive clear disclosures about the risk of loss.”<sup>10</sup>

2. SEC and DOL Comments at Senate Hearing.

The Administration’s announcement is consistent with comments made by senior representatives of both the U.S. Securities and Exchange Commission and the DOL at a hearing before the Senate Special Committee on Aging on October 28, 2009.<sup>11</sup> At this hearing, the Director of the SEC’s Division of Investment Management reported that it was focusing on the regulation of target date funds, with a view towards making recommendations in 2 areas: (1) fund names (e.g., use of a target year in the name of the fund), and (2) fund sales materials. The Assistant Secretary of Labor of EBSA reported that the DOL was re-examining its regulations for “qualified default investment alternatives” (QDIAs) to ensure meaningful disclosure is provided to participants and that

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<sup>8</sup> Based on SEC staff analysis of data as of October 14, 2009, as presented in the testimony of Mr. Andrew J. Donohue, Director, SEC Division of Investment Management, before the United States Senate Special Committee on Aging on October 28, 2009.

<sup>9</sup> *Budget of the U.S. Government, Fiscal Year 2011*, Office of Management and Budget.

<sup>10</sup> *Annual Report of the White House Task Force on the Middle Class*, February 2010.

<sup>11</sup> Testimony Concerning Target Date Funds by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Before the United States Senate Special Committee on Aging, October 28, 2009; Testimony of Phyllis C Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration Before the Special Committee on Aging, United States Senate, October 28, 2009.

it was also considering more specific guidelines for selecting and monitoring target date funds as a default investment and as an investment option. Both agency representatives acknowledged that additional rules were necessary to protect plan participants, and both agencies appear to favor enhanced disclosure with respect to target date funds.

3. SEC / DOL Co-Publish Investor Bulletin on Target Date Funds.

On May 6, 2010, the DOL and the SEC issued joint guidance on target date funds entitled, “Investor Bulletin: Target Date Retirement Funds,” providing basic guidance concerning the features of target date funds, and the ways to evaluate a target date retirement fund that will help increase awareness of both the value and risks associated with these types of investments. As announced in its Regulatory Agenda and as recently confirmed by Assistant Secretary Borzi, the DOL will also be issuing a “best practices” fiduciary checklist later this year, which is designed to assist small and medium-sized plan sponsors evaluate and select target date funds

4. SEC Proposal to Change Advertising Rules for Target Date Funds.

The SEC voted unanimously on June 16, 2010, to propose rule amendments requiring target date funds to clarify the meaning of the date in a target date fund’s name and to enhance the information provided in advertisements to investors. Under the proposed rules, if adopted, marketing materials for target date funds that include a date in their name would also have to include the fund’s expected asset allocation at the target date as a “tag line” immediately adjacent to the fund’s name. The newly proposed rule would also require the marketing materials to include a visual depiction, such as a chart or graph, showing a fund’s glide path over time. Marketing materials would also have to include a statement of the target date fund’s asset allocation at the “landing point” (i.e., when the fund becomes most conservative) and when the fund will reach the landing point. In addition, the marketing materials would need to state that a target date should not be selected solely based on age or anticipated retirement date; that the fund is not a guaranteed investment and that asset allocations may be subject to change without a vote of shareholders

5. DOL Issues Proposed Rules on Target Date Disclosures.

On November 30, 2010, the DOL published its proposed regulations on target date disclosures. The proposed rule would amend its existing QDIA regulations (29 CFR 2550.404c-5) as well as its recently finalized participant-level fee disclosure regulations (29 CFR 2550.404a-5), requiring specificity as to the information that must be disclosed to participants concerning investments in target date funds.

a. Proposed Changes to QDIA Regulations.

*Background.* The QDIA regulations, which were issued pursuant to the Pension Protection Act of 2006, provide fiduciary relief to sponsors of 401(k)-style plans that feature a default investment choice for participants. If the applicable conditions are satisfied, the plan's automatic investment of a participant's account in a default investment choice (in the absence of actual investment directions from the participant) is deemed to be a participant-directed action. Thus, defaulted participants alone (and not the plan sponsor) are held responsible for the plan's automatic investments. Among other regulatory requirements necessary for the plan sponsor to obtain this relief, the default investment choice must meet the requirements of a QDIA, and the plan sponsor must furnish a QDIA notice to participants explaining the default arrangement.

*Proposed Changes for QDIA Notice.* Under the DOL's proposal, with respect to any target date fund series selected as the plan's QDIA, the QDIA notice would need to explain how its asset allocation changes over time and when its most conservative asset allocation is reached (*i.e.*, landing point), as well as include an illustration of the fund's glide path. If the name of the target date fund includes a reference to a particular date (*e.g.*, "Retirement 2050 Fund"), the QDIA notice would also need to explain the relevance of the date and the intended age group. If applicable, the QDIA notice would also need to include a disclaimer that the target date fund may lose money near and following retirement.

Although the DOL's proposal focuses on target date disclosures, it also proposes general changes to the QDIA notice requirement that would apply to any type of QDIA (*e.g.*, balanced fund). As proposed, with respect to any default investment choice selected as the plan's QDIA, the QDIA notice would need to describe the investment's objectives and principal strategies, including the types of assets held by the investment choice. The QDIA notice would also need to include historical investment performance and a disclaimer that past performance is not necessarily an indication of how the investment will perform in the future.

b. Proposed Changes to Participant-Level Fee Disclosure Regulations.

*Background.* As discussed above in section III, the DOL recently finalized its participant-level fee disclosure regulations on October 14, 2010. The regulations will require annual and quarterly disclosures of plan-related fee information and annual disclosures of investment-related information to participants, effective with plan years beginning on or after November 1, 2001. The annual investment-related disclosures are required to be provided in the form of a comparative chart.

Proposed Appendix for Annual Comparative Chart. Under the DOL’s proposed change to its participant-level fee disclosure regulations, the annual comparative chart with investment-related disclosures would need to be supplemented with an appendix that includes additional information about any target date fund series included in the plan’s menu of investment options. This appendix would be required, even if the target date fund series is not utilized as the plan’s default investment option. The information required in the appendix is substantially similar to the applicable information required under the proposed change to the QDIA notice, as described above (*i.e.*, explanation of glide path and any reference to a particular date in the fund’s name, disclaimer regarding investment losses near and following retirement).

- c. Informal Follow-Up Guidance. The DOL informally stated during its web chat on January 4, 2011 that a target date fund’s prospectus is unlikely to satisfy the proposed requirement for target date disclosures. Thus, once the target date disclosure rules are finalized, plan fiduciaries (or their administrative service providers) will need to develop customized disclosures for target date funds, which are expected to be roughly 2 pages in length. The DOL also informally stated that it does not intend to develop a “model” target date disclosure for a plan’s QDIA notice or the appendix to the annual comparative chart.

The comment period for the public to provide feedback on its proposed regulation ended on January 14, 2011, and the DOL has not yet indicated when it is likely to finalize its proposed rule. We anticipate that the DOL will prioritize finalization of the interim final regulations under ERISA Section 408(b)(2) and the participant investment advice regulations, and then pursue finalization of its target date disclosure regulations.

C. Conflicts of Interest in Fund-of-Funds Structure. Target date funds typically have a “fund of funds” tiered investment structure. Instead of investing in portfolio securities directly, the target date fund actually invests in other mutual funds, which in turn invest in portfolio securities. A conflict of interest arises in this fund-of-funds structure because many target date funds invest in affiliated mutual funds.

From a product development perspective, when a fund family creates a target date fund, it naturally has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers. Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. In the report prepared by the Senate Special Committee on Aging, it was reported that target date funds have higher expense ratios



than the rest of the core portfolio in 401(k) plans.<sup>12</sup> Furthermore, although many target date funds invest in affiliated underlying funds exclusively, the reality is that many fund families do not have “best in class” funds for each and every applicable asset class.

A related conflict arises with respect to the mix of funds that underlie the target date fund. Because equity funds typically pay higher fees than other funds, the fund family has an incentive to design the target date fund so that it has a higher exposure to equity, increasing its aggregate fees at the expense of plan participants and also increasing the product’s expected volatility. This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments. Thus, even in funds with a target date of 2010, underlying equity funds constituted up to 68% of assets, which in turn contributed to recent volatility and investment losses.

Although an investment manager for a target date fund is permitted to invest in affiliated underlying funds under the Company Act, it would not be permitted to manage the target date fund’s investment in this conflicted manner if it were actually subject to the fiduciary standards under ERISA.

D. DOL Advisory Opinion 2009-04A (Requested On Behalf of Avatar Associates).

1. Fiduciary Status of Asset Managers. Generally, when a person or firm manages the assets of an ERISA plan, the person or firm becomes a fiduciary with respect to the plan and is subject to the standard of care mandated under ERISA. However, there is a general exception that applies when a plan invests in shares of a mutual fund.

- Under Section 401(b)(1) of ERISA, when a plan invests in a security issued by a registered investment company, “the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company.” Thus, when a plan invests in shares of a mutual fund, the underlying assets of the mutual fund are not deemed to be plan assets.
- Under ERISA Section 3(21)(B), a plan’s investment in a registered investment company “shall not by itself cause such investment company or such investment company’s investment adviser” to be deemed to be a fiduciary.

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<sup>12</sup> *Target Date Retirement Funds: Lack of Clarity Among Structures and Fees Raises Concerns*, Summary of Committee Research, United States Senate Special Committee on Aging (October 2009).

Accordingly, the mutual fund's investment adviser is generally not deemed to be a fiduciary of the plan investing in such mutual fund.

The combined effect of these rules is to create a carve-out from ERISA's fiduciary rules for mutual fund investment managers. To illustrate its significance, let's assume that a plan sponsor has appointed a professional asset manager to invest a segment of the plan's portfolio in U.S. large cap securities. The appointed asset manager would clearly be a fiduciary subject to ERISA's fiduciary requirements. Similarly, if the plan sponsor decided to invest this segment of the plan's portfolio in a bank collective fund investing in U.S. large cap securities, the bank managing this collective fund would automatically be deemed a plan fiduciary. However, if the plan sponsor were to invest this segment of the plan's portfolio in a U.S. large cap mutual fund, the fund's manager would not be subject to any of ERISA's fiduciary requirements.

2. Are Mutual Fund Managers Ever Subject to ERISA? *The Wagner Law Group* believes that the managers of target date funds can as a matter of law be held responsible for their conduct as ERISA plan fiduciaries in certain instances. Section 3(21)(B) of ERISA provides that a plan's investment in a mutual fund "shall not by itself cause such [fund] or such [fund's] investment adviser or principal underwriter to be deemed to be a fiduciary (emphasis added)." This wording demonstrates that the exception whereby target date fund advisers escape fiduciary status does not apply in all instances and is not absolute.

In the firm's recent request to the DOL on behalf of Avatar Associates, it requested clarification on the scope of this exception as applied to target date funds investing in other affiliated mutual funds. In its response letter, Advisory Opinion 2009-04A, the DOL declined to rule that the investment advisers to such funds should be viewed as fiduciaries to investing plans.

3. Plan Sponsors Are Alone in Fiduciary Responsibility. The implications of the DOL ruling are clear and may be surprising to many plan sponsors. A participant who is defaulted into a QDIA is responsible for his or her passive decision, or "negative" election, to invest in this specific investment option. However, the preamble to the DOL's final regulations on QDIAs states that the plan fiduciary continues to have the obligation to prudently evaluate, select and monitor any investment option that will be made available to the plan's participants, including any option that is used as a default investment for a plan with an automatic enrollment feature. The Assistant Secretary of Labor of EBSA, in her testimony regarding QDIAs before the Senate Special Committee on Aging, stated that "[the plan sponsor] continues to have the obligation to prudently evaluate, select, and monitor any investment option that will be made available to the plan's participants and beneficiaries." In other words, the plan sponsor remains

responsible for ensuring that the QDIA, just like any other option in the plan's investment menu, is a prudent investment choice.

Since the managers of target date funds do not have any fiduciary duty under ERISA with respect to the plans investing in them, plan sponsors alone are responsible for the selection and monitoring of target date funds and the construction, management and oversight of their portfolios of underlying funds. Unfortunately many plan sponsors incorrectly believe that they do not need to evaluate the target date fund's underlying investments, and they wrongly assume that fund managers have accepted this responsibility as ERISA fiduciaries on their behalf.

#### E. Congressional Scrutiny of Target Date Funds.

On December 16, 2009, U.S. Senator Herb Kohl (D-WI), chairman of the Senate Special Committee on Aging, announced his intent to introduce legislation that would require target date fund managers to take on ERISA fiduciary responsibility in order for such funds to be eligible for designation as the plan's QDIA. Senator Kohl was quoted as taking issue with the fact that "[m]any target date funds are composed of hidden underlying funds that can have high fees, low performance, or excessive risk" and concluding that "there is no question that we need greater regulation and transparency of these products." Unlike the Obama Administration's regulatory proposal to improve disclosure with respect to target date funds, Senator Kohl's legislative proposal involves imposing ERISA's fiduciary standards on target date fund managers. Due to the nature of ERISA's prohibited transaction rules, Senator Kohl's proposal would require substantial changes to the current "fund of funds" structure and fee arrangements in many target date fund products.

### VII. Lifetime Income Options

One of the key retirement security goals of the Obama Administration is to "reduce barriers to annuitization of 401(k) plan assets" and promote "guaranteed lifetime income products, which transform at least a portion of retirees' savings into guaranteed future income, reducing the risks that retirees will outlive their savings or that their living standards will be eroded by investment losses or inflation."<sup>13</sup>

A. DOL and IRS Request for Information. In connection with the Administration's goals to promote DC plan annuitization, the DOL, Internal Revenue Service and the Treasury Department issued a joint release on February 2, 2010, requesting information regarding lifetime income options for participants in retirement plans. In this release, these agencies announced that they were currently reviewing the rules under ERISA and the related rules under the Internal

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<sup>13</sup> *Annual Report of the White House Task Force on the Middle Class*, February 2010.

Revenue Code, to determine whether and how they could enhance the retirement security of participants by facilitating access to lifetime income arrangements. The requests for information addressed a range of topics, including participant education, required disclosures, 401(k) plan and other tax-qualification rules, selection of annuity providers, ERISA Section 404(c) and QDIAs.

B. The Retirement Security Project. The Retirement Security Project, a joint venture of the Brookings Institution and the Urban Institute, has released two white papers regarding DC plan annuitization. These papers have generated a significant amount of interest, given the fact that they were co-authored by Mark Iwry, who was recently appointed by the Treasury Secretary to serve as the Deputy Assistant Secretary for Retirement and Health Policy. The white papers include proposals to encourage DC plan annuitization by using deferred annuities as the default investment for participants for certain purposes.

C. Legislative Proposals. A number of bills have been introduced in Congress, which are designed to provide tax incentives to save for retirement through annuities (e.g., Lifetime Pension Annuity for You Act, Retirement Security for Life Act). These bills typically encourage annuitization by exempting a percentage of annuity income up to a stated threshold (e.g., \$5,000 for individuals or \$10,000 for couples). Although they typically do not extend this exemption to annuity payments from defined benefit plans, they do exempt annuity payments made from DC plans.

In contrast to these tax-related measures, the Lifetime Income Disclosure Act puts a different spin on the subject of lifetime income and 401(k) plans.<sup>14</sup> Under this proposed legislation, 401(k) plan sponsors would be required to inform participants annually of how their account balances would translate into guaranteed monthly payments – a "retirement paycheck for life." The goal of this legislation is to give participants an understanding of how much projected retirement income they can expect from their savings. The legislation directs the DOL to issue tables that employers may use in calculating an annuity equivalent and model disclosures. Employers and service providers who use the model disclosure and guideline assumptions would be insulated from liability under ERISA.

D. Tax Requirements. The IRS addressed various tax-qualification requirements for DC plans with variable group annuity investment options for participants in PLR 200951039. This private letter ruling was helpful to the benefits community since it illustrated how these plans were viewed with respect to the age 70 ½ minimum distribution requirements and for purposes of the QJSA rules. In sum, DC plans with annuity investment options were not subject to any "surprise" interpretations with respect to these rules.

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<sup>14</sup> U.S. Senators Jeff Bingaman (D-NM), Johnny Isakson (R-GA), and Herb Kohl (D-WI) introduced this bill in December 2009.

E. Lifetime Income Hearing by Senate Special Committee on Aging. On June 16, 2010, the U.S. Senate Special Committee on Aging convened a hearing entitled, “The Retirement Challenge: Making Savings Last a Lifetime.” The hearing explored options to help retirees transform their retirement savings into lifetime income, taking a close look at 401(k) plan participants in particular. According to Senator Kohl, chairman of the Senate Special Committee on Aging, the hearing was the start of a legislative debate about how the government can help Americans make their retirement savings last a lifetime. In his opening statement, he stated that, “[o]ur goal is to find ways to ensure retirees have access to lifetime income options that provide adequate consumer protections at a reasonable cost.” In his view, the focus of most education efforts have been on encouraging people to save, and not about how to make their savings last.

At the hearing, Phyllis Borzi (Assistant Secretary of Labor) and Mark Iwry (Deputy Assistant Secretary for Retirement and Health Policy at the Treasury Department) presented their early analysis of the responses they received to the RFI on lifetime income options, jointly released by the DOL, IRS and Treasury on February 2, 2010. The RFI attracted more than 780 responses from the public. Many of the comments were submitted by individuals who said they were worried that the RFI was the first step in a government plan to take over 401(k) plans. However, Assistant Secretary Borzi clarified that the DOL and the Obama administration had no intention of taking over workers’ 401(k) plans. She indicated that the agencies simply wanted to know if promoting lifetime income vehicles were a good idea, and, if so, if there were ways for the government to improve access to them. These comments from the DOL were consistent with Senator Kohl’s opening statement, in which he had also clarified that he was in favor of making lifetime income options available at a fair price, and that he did not advocate any type of mandate that would force people to purchase lifetime income products.

F. Joint Hearing by DOL, IRS and Treasury in September 2010. On September 14<sup>th</sup> and September 15, 2010, the DOL, IRS and the Treasury Department held a 2-day joint hearing to consider the specific issues raised in the various comments submitted by the public in response to the RFI regarding lifetime income options.<sup>15</sup>

In contrast to the jointly released RFI on February 2, 2010, which solicited comments on a broad array of topics concerning lifetime income options, the September hearing focused on 5 specific areas of concern.

They included the following 2 areas of general policy-related interest:

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<sup>15</sup> The agency representatives involved in coordinating the hearing include (i) Mark Iwry, Senior Advisor to the Secretary, Deputy Assistant Secretary for Retirement and Health Benefits, Department of the Treasury, (ii) Nancy Marks, Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities, IRS, and (iii) Phyllis Borzi, Assistant Secretary, EBSA, DOL.

- Specific Concerns Raised by Participants. Participants and participant representative groups had expressed concern about lifetime income options in general (e.g., inflation risk, product complexity and fees, the long-term viability of issuers of annuity products, limited availability of death benefits and withdrawal options). The agencies heard testimony exploring and addressing these concerns.
- Alternative Designs of In-Plan and Distribution Lifetime Income Options. The respective agencies were also interested in exploring the different ways in which lifetime income options can be made available in plans, including both insurance and non-insurance design solutions (e.g., managed payout funds).

The hearing also focused on the following 3 areas of specific interest:

- Fostering Education to Help Participants Make Informed Retirement Income Decisions. The agencies were interested in hearing about the type of information that would help participants make better informed decisions regarding their retirement income. DOL Interpretive Bulletin 96-1 provides guidance on how plan sponsors can provide “investment education” to participants without fiduciary liability, and the DOL appears to be interested in expanding it to cover “retirement income education.”
- Disclosure of Account Balances as Monthly Income Streams. Along the lines of various legislative proposals such as the *Lifetime Income Disclosure Act*, the agencies were interested in hearing how participants may be more likely to choose lifetime income options if their benefit statements were to include disclosures noting what their individual accounts are worth when converted to a hypothetical monthly benefit.
- Modifying Fiduciary Safe Harbor for Selection of Issuer or Product. Under current law, a DOL regulatory “safe harbor” provides guidelines on how a plan fiduciary can prudently select an annuity provider for its DC plan.<sup>16</sup> This safe harbor is largely procedural, requiring an objective, analytical search for an annuity provider, in consultation with an expert as necessary. The agencies heard testimony on whether these safe harbor standards should be modified, and whether they should apply more broadly to other types of lifetime income products.

Given the specificity of these 3 areas, it appears that the DOL and Treasury Department (and IRS) have narrowed their areas of focus, which could signal that these agencies are preparing to move ahead with rulemaking in these areas.

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<sup>16</sup> 29 CFR 2550.404a-4.

## **VIII. Automatic IRA Act Introduced in Both Senate and House**

Substantially similar pieces of legislation, both entitled the “Automatic IRA Act,” were introduced in both chambers of Congress in 2010, and this bill was re-introduced to the Senate in 2011. If enacted, this law would require employers to deduct a portion of their employees’ paychecks in order to make IRA contributions on their behalf, unless the individual employees affirmatively opt out or make different elections. The concept of automatic IRAs was also proposed in President Obama’s 2011 fiscal year budget and supported by the Middle Class Task Force chaired by Vice President Joe Biden. Vice President Biden has applauded both versions of the bill, confirming the White House’s support for automatic IRAs.

### **A. Senate Version (S. 1557) Introduced by Senator Bingaman**

Senator Jeff Bingaman (D-NM) introduced the “Automatic IRA Act of 2011” legislation to the Senate on September 14, 2011. In the first year after enactment, employers with 100 or more employees would be subject to the automatic IRA requirement. It would apply to employers with 50 or more in the second year, and employers with 25 or more in the third year. In the fourth year and beyond, any employer with 10 or more employees would be subject to the automatic IRA requirement.

Employers that already maintain a qualified retirement plan would be exempt from the automatic IRA requirement. However, if the plan does not cover employees in a division, subsidiary or other major business unit, the employer would have to provide automatic IRAs to the excluded employees.

The Senate bill has the following features:

- Automatic IRAs must be provided to each employee who has been employed for at least 3 months and attained age 18 as of the beginning of the year.
- Employees have the choice of contributing to either a traditional pre-tax IRA or Roth (post-tax) IRA. If no choice is made, Roth IRA accounts are the default vehicle.
- The bill sets the default contribution at 3% of compensation. Employees can raise or lower their contribution percentage, or can opt out entirely from the program.
- Investment firms are not be required to accept automatic IRA accounts. An employer can select an IRA provider to which all automatic IRA contributions will be sent, using a central online resource developed by the Treasury Department.
- All Automatic IRAs will offer the same three 3 standardized investment options (to be developed by Treasury and DOL): (1) a principal preservation fund, or a special,

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new Treasury Retirement Bond (“R Bond”); (2) a life-cycle or other blended investment option; or (3) an alternative investment option with a somewhat higher concentration in equities than the life-cycle or other blended investment option.

- The investment options must be based on low-cost investments, which may include index funds.
- An employer that fails to offer an automatic IRA for its employees is subject to an excise tax of \$100 for each employee.
- To help offset startup costs for an automatic IRA arrangement, small employers (with no more than 100 employees) may receive a tax credit of up to \$250 for each of the first 2 years of automatic IRA operation.
- To encourage the adoption of qualified plans, the existing tax credit to help offset the startup costs for small employers adopting qualified plans will be adjusted by increasing the maximum tax credit to \$1,000 (from the current limit of \$500) for each of the first 3 years of plan operation.<sup>17</sup>

B. Outlook for Automatic IRA Legislation

Automatic IRAs were originally proposed in President Obama’s 2011 fiscal year budget under the label of the “Automatic Workplace Pensions” initiative. This same initiative appears once again in the 2012 fiscal year budget. The inclusion of this initiative in the 2012 budget confirms the White House’s ongoing push for automatic IRAs and that this legislation is a high priority for the Obama Administration.

**IX. Establishing A Game Plan for Clients**

The DOL’s new rules on 408(b)(2) fee disclosures and participant-level fee disclosures will go into effect shortly, and it is likely that the DOL’s proposed rules will be finalized before the Obama Administration ends its current term on January 13, 2013. Given the likelihood that these changes will impact many (if not all) plans, financial advisors should strongly consider developing a “game plan” to help plan clients make sense of these rule changes.

A. 408(b)(2) Fee Disclosures

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<sup>17</sup> Under the current provisions of IRC Section 45E, the annual tax credit to help offset the startup costs of a qualified plan adopted by a small employer with no more than 100 employees, which can apply for up to 3 years, is equal to the lesser of 50% of the start up costs, or \$500. The legislation, if enacted, would increase the \$500 limit to \$1,000.



The new 408(b)(2) fee disclosure rules will require covered service providers to furnish detailed information about their compensation to plan sponsors by April 1, 2012. Although the 408(b)(2) fee disclosure rules will have an obvious impact on providers, it will also have a direct impact on plan sponsors. Plan fiduciaries have always had a duty to prudently monitor each provider's compensation and to ensure that the plan's fees are reasonable. Thus, once plan sponsors begin to receive the newly mandated fee disclosures, they will have a duty to review such information and to prudently evaluate both the direct and indirect compensation disclosed. Unfortunately, due to the complexity of many plan arrangements (which involve multiple parties, subcontractors and different types of indirect compensation), plan sponsors will need help understanding this information. Financial advisors can play a key role, helping plan sponsors "interpret" the disclosures included in their providers' 408(b)(2) fee disclosures. A qualified advisor can help a plan sponsor determine if its fees are unreasonably high in light of the quality of the services provided, and the advisor can assist the plan sponsor investigate alternatives plan service and investment arrangements, as necessary or appropriate.

#### B. Fee Disclosures to Participants

There is a good chance that a significant number of plan participants will be "caught off guard" by the new fee disclosures delivered to them, once the new rules go into effect. Additionally, as a result of the anticipated feedback from participants and their ongoing scrutiny of the plan's fees, plan sponsors may also become more sensitive to the level of the plan's fees. Fortunately, plan sponsors still have some time to prepare for the new disclosure regime. For calendar year plans, the DOL's participant disclosure rules will not take effect until May 31, 2012. During this critical interim period, advisors should help plan sponsors prepare for this change. Advisors can discuss the new disclosure rules with the plan's recordkeeper, to determine the extent to which the newly mandated fee disclosures are (or are not) already being provided to participants. The advisor can also meet with participants to discuss the new fee disclosures, and integrate a review of this information into investment education sessions with participants. If the plan sponsor is concerned with the potential reaction and scrutiny from participants, advisors can remind the sponsor that a prudent review of the plan's investments and services is the best defense against fiduciary liability, and that the sponsor can always strengthen its fiduciary review process if it has any concerns.

C. Target Date Disclosures. Although the DOL has not yet finalized its proposal concerning the required disclosures for target date funds, it is clear that there is a concern that participants are not getting the appropriate information and education. As a "best practice," advisors can help provide meaningful information about the plan's target date funds to participants right now. Participants need to focus on the key features of a target date investment, such as its glide path, landing point and its potential volatility. While educating participants about target date funds, advisors should also work with plan sponsors to ensure that they are prudently evaluating the target date fund series in the plan's menu, especially if it is being

utilized as a QDIA. In light of the level of investment losses sustained by all types of target date funds in recent years, plan sponsors should pay particular attention to the expected volatility and equity/fixed income mix of target date funds intended for participants who are already in or nearing retirement (*e.g.*, 2015 Retirement Fund).

D. Broader “Fiduciary” Definition. The DOL’s pending proposal to broaden its “investment advice fiduciary” definition is likely to “shake up” the retirement plan industry, pressuring many retirement plan advisors to provide their services in a fiduciary capacity for a level fee. If the DOL’s re-proposed rule is similar to its initial proposal, any advisor that is unwilling to advise plan clients on these terms may, as a practical matter, be forced out of the retirement plan business in its entirety. Given the significance of this anticipated change, financial advisors should evaluate and re-consider their business model for ERISA plan clients, especially those who do not currently hold themselves out as plan fiduciaries.

Recordkeepers are constantly adapting and developing new types of arrangements, and they may be able to offer assistance with the problems associated with variable compensation (which is prohibited under ERISA’s prohibited transaction rules in the case of a fiduciary advisor). For example, working with recordkeeping platforms that are able to offer level payouts may be one possible approach. Advisors can also explore the use of ERISA budget accounts (also known as ERISA fee recapture accounts) as a means for leveling the compensation payable to the advisor. Advisory firms that currently receive variable compensation may also wish to consider providing investment advice to ERISA plans as a dual-registered RIA, which would enable the firm to charge a level asset-based fee. There are no “one size fits all” solutions for all firms, especially since every advisor’s service model will need to be fully compliant with both ERISA and securities law. However, financial advisors and advisory firms should strongly consider the potential impact of the DOL’s proposal in the near future, and investigate potential and possible solutions in the days ahead.

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