KEEPING UP WITH DC

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I. Broader "Fiduciary" Definition

The fiduciary standards under ERISA are "the highest known to the law."[1] And unlike securities laws which generally allow you to mitigate conflicts of interest through disclosure, ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption.

In connection with the Obama Administration's campaign to reduce conflicts of interest in the 401(k) plan industry, the DOL is proposing new rules that would expand the definition of a "fiduciary" under ERISA to include pension consultants and other plan advisers that do not meet the current regulatory definition. This regulatory proposal is consistent with the Administration's aim to reduce conflicts in the 401(k) plan industry, and imposing ERISA's fiduciary standards on a large segment of plan consultants and retirement advisors who do not currently hold themselves out as fiduciaries would force them to eliminate their conflicts of interest or provide their advice in strict compliance with a prohibited transaction exemption.

A. Proposal to Amend "Definition of Fiduciary" Regulations. In its Unified Agenda of upcoming federal regulations released on December 7, 2009, the DOL announced that it would be publishing a proposed regulation (scheduled for release in June 2010) to amend the current regulatory definition of an "investment advice" fiduciary to include more persons, such as pension consultants and financial asset appraisers.

As announced in its Fact Sheet regarding this proposed regulation, the DOL believes there is a need to re-examine the types of advisory relationships that could give rise to fiduciary duties on the part of those providing advisory services. The Fact Sheet makes specific reference to pension consultants and financial asset appraisers. The DOL further stated that it had reached this conclusion based on its experience in implementing the current regulation, which has not been updated since its adoption in 1975. "The current regulation may inappropriately limit the types of investment advice relationships that should give rise to fiduciary duties on the part of the investment adviser."[2] The Assistant Secretary of Labor of EBSA, Phyllis Borzi, commented that the DOL is "concerned that it allows advisers from whom plans expect impartial advice to evade fiduciary responsibility."[3]

As detailed in its Fact Sheet, the DOL noted that the current regulatory definition of a fiduciary, which institutes a 5-part test, is more narrow than the statutory definition under Section 3(21)(A)(ii) of ERISA, which broadly provides that any person who renders investment advice for direct or indirect compensation is a fiduciary.

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[1] Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).
[2] EBSA Unified Agenda, Fall 2009
[3] Live Q&A Session with EBSA, December 9, 2009, available at http://www.dol.gov/regulations/chat-ebsa.htm.

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.

It should be noted that the DOL's regulatory definition of "investment advice" is more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a very broad view of the activity that is subject to regulation as investment advice.

B. Implications of a Broader "Fiduciary" Definition. The DOL's proposal to extend the reach of its "fiduciary" definition dovetails neatly with its much broader initiative to improve transparency in the 401(k) plan industry. By expanding the types of consultants and advisors who will be viewed as fiduciaries, the DOL will be ensuring that its other regulations and pronouncements, including its prohibited transaction rules, will have the greatest possible impact. The DOL's proposed rulemaking may be a game-changer for a large segment of plan providers who do not currently hold themselves out as plan fiduciaries. Providers may need to adopt fee-leveling, change the nature of their services so that they are not viewed as providing fiduciary advice, or otherwise eliminate any perceived conflicts of interest.

C. New Fiduciary Standard for Brokers Under The Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, is expected to impact the standard of conduct of those financial advisors who provide their services as registered representatives of broker-dealers. Although these rules under the Dodd-Frank Act do not directly impact the DOL's regulatory initiative to broaden the "fiduciary" definition under ERISA, they will undoubtedly be considered by the DOL as it moves forward with its proposed rulemaking.

The Dodd-Frank Act requires the U.S. Securities and Exchange Commission (the "SEC") to conduct a study of the different standards of conduct which apply to broker-dealers and investment advisers by January 2011. 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"). Under the Advisers Act, investment advisers have a fiduciary duty to act solely in the best interests of the client and to make full and fair disclosures of all material facts, including conflicts-related disclosures.

However, under current law, brokers are generally only subject to a duty of "suitability," which requires the broker to recommend investments that are suitable for the specific investor. The recommended investment does not have to be in the best interests of the client. Many brokers who advise plan clients do so in a non-fiduciary capacity, so they are not subject to

ERISA's fiduciary standards under current DOL regulations. Thus, non-fiduciary advisors can make recommendations which are conflicted, skewed to investments that generate higher fees, without any restriction under ERISA or the Advisers Act.

Depending on how the SEC decides to exercise its rulemaking authority under the Dodd-Frank Act, brokers who advise plan clients may be significantly impacted and may be subject to new conflicts-related disclosure requirements. These changes would be in addition to any future regulatory changes imposed by the DOL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.

II. 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.

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.[4]

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."[5] Specifically, the

[4] 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.
[5] *Budget of the U.S. Government, Fiscal Year 2011,* Office of Management and Budget.

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."[6]

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.[7] 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 the QDIA regulations to ensure meaningful disclosure is provided to participants and that 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. DOL's New Guidance on Target Date Funds.

On April 26, 2010, the DOL announced in its Spring 2010 Semiannual Regulatory Agenda that it will be amending its QDIA regulations to ensure participants receive proper disclosure whenever target date funds are used as the plan's default investment. On May 6, 2010, the DOL and the SEC issued joint guidance on target date funds entitled, "Investor Bulletin: Target Date Retirement Funds," proving 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

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[6] *Annual Report of the White House Task Force on the Middle Class*, February 2010.

[7] 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.

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

In response to the SEC's request for comments on its proposed regulations, the SEC received less than 50 response letters. However, three U.S. Senators submitted a well-publicized letter on August 23, 2010 (the last day of the comment period) recommending that the SEC require additional disclosures, including the relevance of the date used in the fund name and the use of any affiliated underlying funds. The 3 Senators included Sen. Tom Harkin (D-Iowa), Chairman of the Health, Education, Labor and Pensions (HELP) Committee; Sen. Michael Enzi (R-Wyoming), Ranking Member of the HELP Committee; and Sen. Herb Kohl (D-Wisconsin), Chairman of the Aging Committee. The letter also expressed the Senators' deep concern "about the limited scope of the proposed rule" which currently applies to mutual funds only, and encouraged the SEC to work closely with the DOL to the extent the SEC lacks jurisdiction to broaden the scope of its rule to non-mutual fund target date products

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.[8] 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. <u>DOL Advisory Opinion 2009-04A (Requested On Behalf of Avatar Associates)</u>.

1. <u>Fiduciary Status of Asset Managers</u>. 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. Accordingly, the mutual fund's investment adviser is generally not deemed to be a fiduciary of the plan investing in such mutual fund.

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[8] *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).

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. <u>Are Mutual Fund Managers Ever Subject to ERISA</u>? *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 <u>by itself</u> 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. <u>Plan Sponsors Are Alone in Fiduciary Responsibility</u>. 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.

III. Automatic IRA Act of 2010

Substantially similar pieces of legislation, both entitled the "Automatic IRA Act of 2010," were introduced in both chambers of Congress in August 2010. 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 had been 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 ongoing push for automatic IRAs.

A. Senate Version (S. 3760) Introduced by Senator Bingaman

Senator Jeff Bingaman (D-NM) introduced the Automatic IRA Act legislation to the Senate on August 6, 2010. 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, 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.[9]

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[9] 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.

B. House Version (H.R. 6099) Introduced by Senator Bingaman

On August 10, 2010, Richard Neal (D-MA), chairman of the Subcommittee on Select Revenue Measures of the Ways and Means Committee, introduced the Automatic IRA Act of 2010 during the House of Representatives' rare mid-recess session held on that day. The House version of the bill is similar to the Senate bill, with the following exceptions:

- An employer with 10 or more employees would be subject to the automatic IRA requirement in the first year after enactment and in all future years. Unlike the Senate version, there is no "phase-in" for employers of varying sizes during the first 4 years after enactment.

- Employees have the choice of contributing to either a traditional IRA or a Roth IRA. If no choice is made, traditional IRA accounts are the default vehicle.

- All automatic IRAs must be invested in: (1) a principal preservation fund or R Bonds; (2) a life-cycle investment option that is a QDIA within the meaning of the DOL regulations; or (3) a balanced investment option that is a QDIA.

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