

**WHAT IS NEW IN DC:
THE MOST CRITICAL ITEMS TO
THE OBAMA ADMINISTRATION**

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TABLE OF CONTENTS

	Page
I. WHAT’S UP IN WASHINGTON?	1
II. BROADER “FIDUCIARY” DEFINITION	2
III. FEE DISCLOSURES TO PARTICIPANTS	5
IV. PARTICIPANT INVESTMENT ADVICE	9
V. 408(b)(2) DISCLOSURES FROM SERVICE PROVIDERS	13
VI. DEFAULT INVESTMENTS: TARGET DATE FUNDS	23
VII. LIFETIME INCOME OPTIONS	28
VIII. AUTOMATIC IRA ACT OF 2010 INTRODUCED IN BOTH SENATE AND HOUSE	32
IX. EFFECTS ON CLIENTS	34

WHAT IS NEW IN DC: THE MOST CRITICAL ITEMS TO THE OBAMA ADMINISTRATION

I. What's Up in Washington?

A. General Outlook on America's Private Retirement System.

Retirement security continues to be a major priority for the White House. The Obama Administration's position is that "the current system does not provide sufficient retirement security for millions of Americans" and it is pushing for significant legislative reform through Congress and for regulatory changes through the U.S. Department of Labor (the "DOL").¹ The Administration is coordinating these various reforms through the White House Task Force on the Middle Class (the "Middle Class Task Force"), which was newly created by President Obama in 2009. The Middle Class Task Force is chaired by Vice President Joe Biden and includes various members of the Cabinet, including the Secretaries of Labor and Treasury. The Administration's initiatives are extensive, and they are expected to impact plan sponsors, plan participants, and providers of all types.

B. Improving the Defined Contribution Savings System.

With respect to the 401(k) plan market, the Obama Administration has announced a series of changes that specifically target defined contribution plans and their investment and service providers.² These proposals are in the form of new regulations under the auspices of the DOL. Although the DOL, like many federal agencies, is organized under the Executive Branch of the federal government, its operation and pronouncements are usually distinct from those of the White House. However, in recent months, there has been a real blurring of lines between the Executive Branch and this separate agency. In fact, one of the recent fiduciary regulations under the Employee Retirement Income Security Act of 1974 ("ERISA") was actually unveiled by Vice President Biden, and not by the DOL's Employee Benefits Security Administration ("EBSA"), the regulator responsible for issuing them.³

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. Broader "fiduciary" definition
2. Fee disclosures to participants
3. Participant investment advice

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

² *Budget of the U.S. Government, Fiscal Year 2011*, Office of Management and Budget.

³ On February 26, 2010, Vice President Biden announced the DOL's proposed regulations on investment advice, 75 FR 9360 (March 2, 2010), as part of the Middle Class Task Force's year-end annual report.

4. 408(b)(2) disclosures from service providers
5. Default investments
6. Lifetime income options
7. Automatic IRA legislation

II. Broader “Fiduciary” Definition

The fiduciary standards under ERISA are “the highest known to the law.”⁴ 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. Consistent with the Obama Administration’s campaign to reduce conflicts of interest in the 401(k) plan industry, on October 21, 2010, the DOL released its proposed regulations to modify the existing regulatory definition of an “investment advice fiduciary.” These rules, if adopted, would broaden the existing regulatory definition of “investment advice” under ERISA considerably.

A. Overview of Existing Regulatory Definition

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 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

The proposed regulations, if adopted, would make two specific changes to the existing definition of “investment advice.” Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

⁴ Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

- 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 is 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. Under both the existing and the proposed rules, advice will constitute "investment advice" only if it is individualized advice for the particular plan client.

C. Safe Harbor for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the proposal effectively introduces a safe harbor that advisors would need to follow to avoid fiduciary status.

Generally, to avoid being characterized as an investment advice fiduciary under the proposed regulations, an advisor must be able 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, and (b) the advisor is not undertaking to provide "impartial investment advice." The proposal generally does not specifically require a written disclosure to be provided to the plan client, but the proposal clearly contemplates and encourages written disclaimers.

D. Two Specific Activities Exempted Under Safe Harbor

The proposed rules further state that investment education within the meaning of the DOL's longstanding guidance on non-fiduciary education, as provided under Interpretive Bulletin 96-1, shall not constitute investment advice.

Furthermore, investment advice shall not include a platform provider's marketing or making investment alternatives available to a plan (without regard to individual needs of a plan) or providing general financial information to assist a plan fiduciary's selection or monitoring of such investment alternatives, so long as the platform provider discloses in writing that it is not providing impartial investment advice.

E. Potential Impact on Financial Advisors

If the proposed regulations were finalized in their current form, brokers currently advising 401(k) plan sponsors and participants in a non-fiduciary capacity 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.

If they failed to provide any disclaimer, a broker could be viewed as an "investment advice fiduciary" and any variable compensation, such as 12b-1 fees, received by the broker would trigger a non-exempt prohibited transaction under ERISA. The penalties for a prohibited transaction generally include a right of rescission by the plan client, a "first tier" 15%-per-year excise tax and a "second tier" 100% excise tax, and a 20% civil penalty on any amounts recovered through DOL action.

Alternatively, a broker serving as a plan fiduciary could avoid these penalties by becoming a dual-registered investment adviser. This action would enable it to charge an asset-based fee (such as a wrap-fee), eliminating the problems associated with variable compensation.

F. Potential Impact on Other Providers

The proposed regulations, by their terms, would impact platform providers directly. To comply with the proposed safe harbor, they would need to disclose in writing that they are not providing impartial investment advice. This may have a substantial impact on platform providers that deliver advisory services regarding the selection of plan investment alternatives, especially those delivering such services in exchange for any type of direct or indirect compensation. Like brokers, platform providers offering advisory services could provide non-conflicted advice by adopting an asset-based fee, although this change would similarly require the provider to become registered as an investment adviser.

Similarly, TPAs that also provide advisory services in exchange for variable compensation would need to either provide the required disclaimers, or register as investment advisers in order to provide their advisory services for a level fee in a non-conflicted manner.

G. Outlook for DOL Proposed Regulations

This regulatory proposal is consistent with the Administration's aim to reduce conflicts in the 401(k) plan industry, and it aims to impose ERISA's fiduciary standards on a large segment of financial professionals who do not currently hold themselves out as fiduciaries. If adopted, the proposed regulations would force them 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. Given the significance of the DOL's rulemaking, the proposed regulations are expected to draw heavy comments. Written comments on the proposed regulations may be submitted to the DOL on or before January 20, 2011.

H. 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 are unrelated to the DOL’s regulatory initiative to broaden the “fiduciary” definition under ERISA, they are expected to impact the standard of care that brokers must adhere to when advising their clients, including retirement plan clients.

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.

III. 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. The final regulations are generally consistent with the DOL’s 2008 proposed rules, reflecting modest changes based on comments received by the agency.

In its press release announcing the issuance of these final rules, the DOL explained that existing law did not require plans to provide workers with “the information they need to make informed investment decisions regarding the investment of their retirement savings,” 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.

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 fiduciary obligation to provide the mandatory disclosures is generally imposed on the plan sponsor.

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). As discussed above, 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.

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 existing 404(c) regulations, participants generally must 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.

IV. Participant Investment Advice

Many fiduciary and non-fiduciary providers of investment services to DC plans are also offering participant-level advisory services. However, in the absence of an exemption or exclusion from the prohibited transaction rules under ERISA, investment providers can not also offer participant-level investment advice.

Investment providers to plans typically have a conflict when it comes to giving participant-level advice because of their variable compensation. The conflict is, of course, between (i) the interests of participants, and (ii) the financial incentive of the investment provider to steer participants to the funds which pay the highest fees to the provider.

Under ERISA's prohibited transaction rules, it is unlawful for a fiduciary to give conflicted advice to participants. Because of the strict nature of these rules, it does not matter if the advice is given in good faith or if it's "excellent" advice. So long as a conflict exists, the advice is tainted for ERISA purposes. And so, even if a provider's advice to participants does not actually cause an overconcentration in funds with the highest fees, the advice is unlawful and will result in prohibited transactions.

A. DOL Proposes New Regulations for Investment Advice

Fortunately, there is a specific exemption from the prohibited transaction rules that allow investment providers to offer advice to plan participants. This exemption was included as part of the Pension Protection Act of 2006, and the industry has been waiting for interpretive guidance from the DOL for some time now. Unfortunately, the DOL's rulemaking has gotten bogged down in politics.

Here's a brief summary of the regulatory "rollercoaster ride":

- DOL issues a formal Request for Information, soliciting comments on its regulations in December 2006.
- The DOL publishes regulations interpreting and expanding the PPA exemption for investment advice in August 2008.
- They are "finalized" on January 21, 2009 during the last days of the Bush Administration.
- As one of its earliest administrative actions, the incoming Obama Administration delays the effective date of these regulations.
- The DOL subsequently withdraws them on November 20, 2009, before ever having taken effect.
- Now, DOL has issued newly proposed regulations (March 2, 2010) providing interpretive guidance on the PPA exemption for investment advice.

B. Background: The Pension Protection Act of 2006

Under the Pension Protection Act of 2006, Congress had intended to encourage the availability of participant-level investment advice by enacting a new prohibited transaction exemption to provide relief from fiduciary liability for providing such advice under certain conditions. To qualify for fiduciary relief under the terms of the statutory exemption (the "PPA Statutory Exemption"), a fiduciary adviser (e.g., investment adviser, broker-dealer) is required to ensure that either (i) the fiduciary adviser's fees for its investment advice will not vary based on any investment options that are selected by participants (the "Fee-Leveling Safe Harbor"), or (ii) the investment advice will 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 "Computer Model Safe Harbor").

With respect to the Fee-Leveling Safe Harbor under the PPA Statutory Exemption, the DOL announced in its Field Assistance Bulletin (“FAB”) 2007-1 that the applicable fee-leveling requirement applies to both the individual representative of the fiduciary adviser and the fiduciary adviser itself. However, the compensation payable to the fiduciary adviser’s affiliates (e.g., affiliated investment advisers managing mutual fund options for a plan) may vary based on the investment options selected by plan participants. Thus, in the DOL’s view, the PPA Statutory Exemption gives fiduciary advisers a new type of self-dealing relief that was not previously available under ERISA. Prior to the enactment of the PPA Statutory Exemption, with certain narrow exceptions, ERISA would have imposed fee-leveling on the individual representative of the fiduciary adviser, the fiduciary adviser itself, and the fiduciary adviser’s affiliates.

C. Inclusion of Class Exemption in Final Regulations Triggers Withdrawal

The DOL had finalized its first iteration of the investment advice regulations during the last days of the Bush Administration, issuing them on January 21, 2009. This early 2009 release was highly unusual in that it included both (i) interpretive guidance with respect to the PPA Statutory Exemption, and (ii) a separate but related administrative exemption (the “Withdrawn Class Exemption”) concerning investment advice.

The Withdrawn Class Exemption mirrored the PPA Statutory Exemption’s Fee-Leveling and Computer Model Safe Harbors in many respects. However, the Withdrawn Class Exemption provided for significantly more expansive fiduciary relief as follows:

- New Fee-Leveling Safe Harbor. The Withdrawn Class Exemption would have created a similar but new safe harbor, mandating fee-leveling for the individual representative of the fiduciary adviser only (and not for the individual representative and the fiduciary adviser as required under the PPA Statutory Exemption). Thus, the compensation payable to the fiduciary adviser and its affiliates would be able to vary with the investment options selected by plan participants. For example, the Withdrawn Class Exemption would have allowed the individual representative of a broker-dealer to provide investment advice to participants, so long as the individual representative received a level fee. Conversely, the broker-dealer itself and its affiliates would have been able to receive variable compensation, including 12b-1 fees and revenue sharing payments.
- New Computer Model Safe Harbor. Once investment advice based on an objective computer model had been provided to a participant, the Withdrawn Class Exemption would have allowed the fiduciary adviser to follow up with subjective, individualized advice to the participant. Any such individualized advice would not have been subject to any fee-leveling requirement.

As discussed, the DOL under the incoming Obama Administration postponed on multiple occasions the effective date for both its interpretive guidance with respect to the PPA Statutory Exemption and the Withdrawn Class Exemption. Due to concerns over the Withdrawn Class Exemption and the perceived inadequacy of certain conditions, the DOL withdrew its final regulations in their entirety on November 20, 2009.

D. DOL Proposes Second Iteration of Its Investment Advice Regulations

The second iteration of the DOL's investment advice regulations, which were officially proposed on March 2, 2010 (the "Newly Proposed Regulations"), were actually unveiled a week ahead of its official publication in the Federal Register on February 26, 2010 by Vice President Biden. They are substantially similar to the interpretive portion of the DOL's withdrawn regulations relating to the PPA Statutory Exemption. However, the Newly Proposed Regulations do not re-introduce any kind of new administrative exemption akin to the Withdrawn Class Exemption that had previously been incorporated into the DOL's withdrawn regulations.

Thus, the Fee-Leveling and Computer Model Safe Harbors under the Newly Proposed Regulations are consistent with the existing safe harbors under the PPA Statutory Exemption. Under the Newly Proposed Regulations:

- with respect to the Fee-Leveling Safe Harbor, participant investment advice may only be provided if the fees earned by both the individual representative of the fiduciary adviser and the fiduciary adviser itself (and not including the fiduciary adviser's affiliates) do not vary with the investment options selected by participants, and
- with respect to the Computer Model Safe Harbor, a fiduciary adviser may only provide investment advice to participants based on an objective computer model, and may not supplement such advice with subjective, individualized advice.

However, in the preamble to the Newly Proposed Regulations, the DOL highlighted one new interpretive requirement that it was proposing for the Computer Model Safe Harbor. Although it is not expressly required under the PPA Statutory Exemption, the Newly Proposed Regulations state that the computer model advice must not "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future." In the preamble, the DOL clarified that differences in investment options' fees and management styles are likely to persist in the future. However, unlike the historical performance of asset classes, the historical performance of investment options in the same asset class are less likely to persist and therefore are less likely to constitute appropriate criteria for advice. Since many advisory computer models consider the historical performance of investment fund (rather than asset classes), many practitioners have questioned whether this approach will favor index funds. During the comment period for the Newly

Proposed Regulations, which ended on May 5, 2010, the DOL received over 70 letters from various organizations and individuals. A significant number of these comment letters objected to the perceived bias toward index funds, respectfully requesting that the DOL avoid infringing on the intellectual freedom of investment experts who should have the flexibility to rely on any and all generally accepted investment theories for their computer models.

V. 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 sponsor 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.”⁵ Consistent with this policy objective, the Administration published interim final regulations on July 16, 2010 requiring service providers to provide specific disclosures with respect to fees.

It should be noted that the Administration's policy objective to improve fee transparency in the 401(k) plan industry is based on political momentum which has been growing for several years. The U. S. Government Accountability Office (GAO), which is also known as the “investigative arm of Congress,” laid much of the groundwork in its reports.

- The November 2006 report by the GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, reported that the “problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered.”
- The GAO had concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the “hidden” compensation flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant).
- In its March 2009 report, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, the GAO concluded that there is a “statistical association between inadequate disclosure of potential conflicts of

⁵ *Annual Report of the White House Task Force on the Middle Class*, February 2010.

interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of nondisclosure” of indirect compensation arrangements.

In addition, the DOL’s fee disclosure rules for service providers are actually the second part of a three-pronged “reg project” designed to increase fee transparency.

- The first part involved improving a plan’s fee disclosures on Form 5500, Schedule C. The DOL has already issued final regulations on the revised Schedule C and they apply starting with the 2009 plan year⁶.
- The second part involves requiring service providers to give mandatory disclosures to plan sponsors under ERISA Section 408(b)(2). The interim final regulations were published on July 16, 2010.
- The third part involves mandatory disclosures from the plan sponsor to the plan’s participants. As discussed earlier, the final regulations were released on October 14, 2010.

The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that 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 size of such fees.⁷ In 1998, the DOL published a 19-page booklet, “A Look At 401(k) Plan Fees,” for plan participants and a 72-page report, “Study of 401(k) Fees and Expenses,” for plan sponsors.⁸ Unfortunately, the DOL’s efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has 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.

⁶ 72 Fed. Reg. 64710 (Nov. 16, 2007).

⁷ “Protect Yourself against the Great Retirement Rip-off,” *Money Magazine* (April 1997). “Your 401(k)'s Dirty Little Secret,” *Bloomberg Personal* (September 1997).

⁸ A Look at 401(k) Plan Fees” is posted at 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>.

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.

In addition to the above requirements under the statute itself, the current DOL regulations interpreting the statute impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.⁹ Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

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

1. Statute and Prior Regulations

ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service between a plan and a party in interest (e.g., a plan service provider) 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. The prior regulations said little as to when a service provider contract or arrangement was reasonable.

⁹ 29 CFR 2550.408b-2(c).

2. Proposed Regulations

In December 2007, the U.S. Department of Labor (“DOL”) proposed amending its regulations to provide that certain service provider contracts would be reasonable only if the covered service provider discloses to a responsible plan fiduciary specified information about the services to be performed, the compensation to be received and potential conflicts of interest of the service provider. The intent of the proposal was to enable plan fiduciaries to assess the reasonableness of compensation paid for plan services.

3. Interim Final Regulations

On July 16, 2010, the DOL released a revised version of the fee disclosure regulations with an effective date of July 16, 2011. Thus, the final regulations will apply to existing services arrangements as of July 16, 2011 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.

4. 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. Welfare plans - because of significant differences between service and compensation arrangements of welfare plans and pension plans, the DOL intends to develop separate and more specifically tailored disclosure requirements for welfare plans,
- b. IRAs,
- c. Simplified employee pensions, and
- d. Simple retirement accounts.

5. 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.
 - 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 in items VI.D and E, 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.

6. 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.

7. 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.

- i. 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.
- ii. 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.
- iii. 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.

8. 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.

9. Immediate Impact and Issues

Currently, service providers need not disclose specific types of information to plan sponsors or similar fiduciaries. The 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 final regulation clarifies that the new rules will apply to contracts in place when the regulation becomes effective on July 16, 2011. 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.

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.

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.¹⁰

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.”¹¹ 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.”¹²

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, 2009.¹³ 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

¹⁰ 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.

¹¹ *Budget of the U.S. Government, Fiscal Year 2011*, Office of Management and Budget.

¹² *Annual Report of the White House Task Force on the Middle Class*, February 2010.

¹³ 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.

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," 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

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.¹⁴ 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

¹⁴ *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).

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.

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.”¹⁵

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 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.¹⁶ 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.

¹⁵ *Annual Report of the White House Task Force on the Middle Class*, February 2010.

¹⁶ U.S. Senators Jeff Bingaman (D-NM), Johnny Isakson (R-GA), and Herb Kohl (D-WI) introduced this bill in December 2009.

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.

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 14th 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.¹⁷

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:

- 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.

¹⁷ 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.

- 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.¹⁸ 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.

VIII. Automatic IRA Act of 2010 Introduced in Both Senate and House

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.

¹⁸ 29 CFR 2550.404a-4.

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.¹⁹

¹⁹ 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.

IX. Effects on Clients

Service providers to plans, including financial advisors, always need to be careful to distinguish between actual law and proposed rulemaking. As a general rule, firms make product changes and alter fee arrangements in response to actual changes in the law. However, when it comes to providing value-added services to individual plan clients, knowledge of proposed changes and current events in Washington are invaluable and this information can be successfully integrated into an advisor's service model.

A. Employer's Duty of Prudence. All fiduciary decisions, investment choices and service selections made by a plan sponsor should be made under a prudent review process in accordance with ERISA. Prudence requires plan sponsors to consider all relevant facts and circumstances, including practices in the 401(k) plan industry that are causing concerns for Washington. Even though Washington may not have finalized a proposed requirement, plan sponsors should take such considerations into account for purposes of their fiduciary reviews and evaluations.

Many plan sponsors realize that, at the end of the day, they are genuinely responsible for the retirement savings of their employees. Many of them also recognize that ERISA requires them to do something as a fiduciary, but they are not exactly sure of what it is they are supposed to be doing. Keeping clients apprised of their fiduciary duties under current law is important, but keeping them up to date on current event is also a value-added service. If Washington has

concerns over certain problems or issues in the 401(k) plan world, plan sponsors should have a basic understanding of these concerns and be mindful of them for purposes of running their own plans.

B. Demonstrating Your Expertise. Knowledge of current events in Washington is also another way for advisors to distinguish themselves and demonstrate expertise in the 401(k) plan market. When discussing such current events with plan sponsors, remember that the Administration is focusing on these 4 core areas: fiduciary status, fees and conflicts of interest, default investments (target date funds), and lifetime income options.

C. Prepare Your Clients. In light of the Obama Administration's success in getting its proposed health care reform made into law, many practitioners realize that there is a very good chance that the Administration's retirement initiatives will also pass, especially since these retirement initiatives are primarily in the form of agency regulations (and will not be subject to a vote or the threat of filibuster in Congress). Unfortunately, nobody likes transitioning to new rules, new agreements, new forms and new fiduciary procedures. It is important to keep plan clients aware that change is coming down the road and prepare them for what's coming down the road, so that they won't be surprised or disappointed that they weren't better informed when the changes are actually mandated.

D. Best Practices. Of course, the best type of client messaging when it comes to regulatory change, is that you are "ahead of the curve" and that your services have already taken Washington's concerns and policy objectives into account. You may wish to consider adopting the following "best practices" to address the same concerns that the regulators are trying to tackle.

1. Facilitate Client's Prudent Review of Target Date Funds. Although the Administration has not yet proposed any specific regulations concerning the required disclosures for target date funds, it is clear that they are concerned that plan sponsors are not evaluating them properly. Advisors can help plan sponsors (i) understand their "fund of funds" structure and related fees, (ii) evaluate the glide path and the quality of the underlying funds, and (iii) assess the target date fund's overall investment risks. Plan sponsors need to 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., 2010). Advisors should also encourage the plan sponsor to provide appropriate education about the target date funds to participants, including basic information about the glide path and potential volatility.

2. Help Plan Sponsors Evaluate "Hidden" Fees. Plan sponsors have a duty to ensure fees paid from the plan are reasonable, but they need assistance, especially when it comes to evaluating indirect compensation and revenue sharing. An advisor might feel

uncomfortable helping a plan client identify and evaluate so-called hidden compensation, out of fear that the plan sponsor might conclude that the total fee is excessive. However, it is important for the plan client to bear in mind that all fees must be considered in light of the quality of services provided, and the DOL has made it clear that no fiduciary decision should ever be made based on fees alone.

Given the explosion in 401(k) plan fee litigation and regulatory scrutiny of fees, it is important that the plan sponsor monitor the plan's fees on an ongoing basis and conclude that they are reasonable. Advisors who are able to incorporate fee monitoring into their value-added service model, will have a tremendous advantage over advisors who are afraid to talk about fees at all. Just as plan sponsors should conduct fiduciary reviews of the plan's investment options on an ongoing basis, they should also conduct reviews of the plan's fees on a routine basis. In any event, disclosure of indirect compensation is required for Form 5500 reporting purposes beginning with the 2009 plan year. Plan sponsors will be forced to identify indirect compensation because of these new 5500 reporting rules, and they will most certainly need help understanding and getting comfortable with this financial information.

3. Clarify Fiduciary vs. Non-Fiduciary Services. As demonstrated by the Obama Administration's handling of the "investment advice" regulations, it will not tolerate conflicts of interest and it will not dilute the strict requirements under prohibited transaction exemptions. And as evidenced by the DOL's proposal to broaden the "fiduciary" definition, there is a desire to impose ERISA's stringent fiduciary standards on providers when there is an expectation of impartial advice. Advisors can help plan sponsors understand the difference between fiduciary and non-fiduciary guidance, and advisors can also minimize personal liability for themselves under ERISA by ensuring the plan sponsor understands which of their services are intended to include fiduciary "investment advice". In particular, if an advisor does not intend to provide fiduciary advice to participants, the advisor should make it absolutely clear that such information is intended to be for general educational purposes only, and that it does not include customized recommendations for an individual participant.