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

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

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

#### **A. General Outlook for DOL Rulemaking in 2013.**

The landscape for tax-qualified retirement plans is changing. Change can be accomplished by legislation, like the Pension Protection Act of 2006, which left a sizable footprint in the retirement market. But change can also be achieved through agency action, and that is what is happening right now. 2012 was a big year for the U.S. Department of Labor (“DOL”), as several of its new rules went into effect. Covered providers were required to deliver 408(b)(2) fee disclosures to their plan clients for the first time by July 1, 2012. Plan sponsors and recordkeepers began furnishing new participant-level fee disclosures by August 30, 2012 in the case of calendar year plans. The prohibited transaction exemption for providing investment advice to participants became effective just over a year ago at the end of 2011 (December 27, 2011).

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

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

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

On October 14, 2010, the DOL finalized its regulations concerning the fee and investment-related disclosures that must be provided to participants in 401(k) plans and other defined contribution plans with participant-directed investments. In its press release announcing the issuance of these final rules, the DOL explained that the previous regulations did not require

plans to provide workers with “the information they need to make informed investment decisions,” such as fee and expense information. However, the new rules would enable the estimated 72 million affected participants “to meaningfully compare the investment options under their plans.”

A. Types of Plans Covered

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

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

B. Coverage of Participants

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

C. Annual and Quarterly Disclosure of Plan-Related Information

Under the DOL’s final regulations, participants must be furnished general information about the plan annually, including an explanation of how participants may give investment allocation instructions and information concerning the plan’s investment menu. Plan participants must also receive an annual explanation of the *general administrative service fees* (*e.g.*, record-keeping fees) which may be charged against their accounts as well as any *individual expenses* charged for individualized services (*e.g.*, plan loan processing fees). 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, with respect to 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 of the particular plan making the disclosure.

#### G. Impact on Plan Sponsor's Other Fiduciary Duties

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

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

#### H. Effective Date

When the DOL's participant disclosure regulations were finalized, they included a delayed application date. The new disclosure requirements are imposed on plan sponsors and fiduciaries for plan years beginning on or after November 1, 2011. In the case of calendar year plans, they went into effect on January 1, 2012. Under the final regulation, plan administrators were not required to provide the first disclosure until 60 days after: (1) the effective date of the 408(b)(2) service provider fee disclosure rule (*i.e.*, July 1, 2012), or (2) the date the regulations apply (*i.e.*, plan years beginning on or after November 1, 2011). Thus, plan administrators of calendar year plans had until August 30, 2012, to provide the initial disclosure.

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

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

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

## J. Potential Impact on Financial Advisors

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

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

There is a good chance that a significant number of plan participants will be "caught off guard" by the new fee disclosures delivered to them, as the new rules are implemented. Additionally, as a result of the anticipated feedback from participants and their ongoing scrutiny of the plan's fees, plan sponsors may become more sensitive to the level of the plan's fees. Plan sponsors had substantial time to prepare for the new disclosure which finally went into effect (for calendar year plans) on August 30, 2012. During the initial phase of implementation, advisors should help plan sponsors in making the change and in dealing with participant reactions. Thus, advisors can discuss the new disclosure rules with the plan's recordkeeper, to determine the extent to which the newly mandated fee disclosures are (or are not) being provided to participants. The advisor can also meet with participants to discuss the new fee disclosures, and integrate a review of this information into investment education sessions with participants. If the

plan sponsor is concerned with the potential reaction and scrutiny from participants, advisors can remind the sponsor that a prudent review of the plan's investments and services is the best defense against fiduciary liability, and that the sponsor can always strengthen its fiduciary review process if it has any concerns.

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

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

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

Fortunately, there is a specific exemption from the prohibited transaction rules that allows these investment providers to offer advice to plan participants. This exemption was included as part of the Pension Protection Act of 2006. The DOL had finalized its first iteration of the investment advice regulations on January 21, 2009, during the last days of the Bush Administration. However, under the new Obama Administration, the DOL withdrew these regulations, publishing new final regulations on October 25, 2011. Although various aspects of the DOL's rules changed during the rulemaking process, the basic features remain consistent with the statutory framework of the Pension Protection Act.

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

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



the Fiduciary Adviser's advice to participants must be limited to the advice generated by a computer model certified by an expert.

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

#### B. Fee-Leveling Arrangement

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

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

#### C. Computer Model Arrangement

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

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

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

D. Effective Date

The DOL's participant investment advice rules apply to transactions occurring on or after December 27, 2011.

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

A. "Hidden" Fees and Conflicts of Interest

There has been a great deal of discussion surrounding the so-called "hidden" payments flowing from the plan's investments to its service providers (*e.g.*, recordkeeper, pension consultant). Plan sponsors are undoubtedly aware of the "hard dollar" fees invoiced directly to the plan or the employer, but they may not necessarily understand that the service provider can also receive indirect compensation from the plan's investment funds and the managers of such funds. The hidden payments made to a plan's service provider might include shareholder servicing fees (as well as 12b-1 fees and sub-transfer agency fees) paid from the plan's investment funds or revenue sharing payments made directly from the fund managers. Thus, a plan sponsor could conceivably select what appears to be a "free" administrative service for the plan, without understanding that the provider's compensation was being passed on to plan participants in the form of higher embedded costs in the plan's investment funds.

A plan sponsor's ignorance of the fact that administrative service providers can receive such indirect compensation can result in 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 the ERISA fiduciary duties of the sponsor and provider.

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

To address these concerns, the Obama Administration wants to improve "the transparency of 401(k) fees to help workers and plan sponsors make sure they are getting investment, record-keeping, and other services at a fair price."<sup>1</sup> Consistent with this policy objective, interim final regulations were published on July 16, 2010 requiring service providers to provide specific disclosures with respect to fees. After several postponements of the effective date, final regulations were issued on February 2, 2012, establishing July 1, 2012 as the date by which initial disclosure was to be made.

The DOL initiative to educate plan sponsors about 401(k) fees and to improve fee transparency actually began more than a decade ago. In 1997, the DOL held a hearing on 401(k) plan fees in response to several consumer magazines criticizing the size of such fees.<sup>2</sup> In 1998, the DOL published a booklet for plan participants called "A Look At 401(k) Plan Fees," as well as a much more sizable 72-page report for plan sponsors ("Study of 401(k) Fees and Expenses").<sup>3</sup> Unfortunately, the DOL's informal efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees apparently failed. In light of that failure, the DOL is now requiring service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

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

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

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

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 prohibit the use of plan assets with respect to many other activities (other than the payment of benefits). Fortunately, there is a specific exemption that allows the use of plan assets to pay fees for reasonable services.

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

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

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

D. Final 408(b)(2) Regulations

1. Interim Final Regulations and 2012 Final Regulations

On July 16, 2010, the DOL released interim final regulations under ERISA Section 408(b)(2) that were ultimately followed by final, final regulations issued on February 2, 2012. If a service provider is paid directly or indirectly with plan assets, such arrangement will trigger a prohibited transaction under ERISA, unless the plan sponsor receives certain fee disclosures required under the DOL's rules. The purpose of these rules is to ensure plan fiduciaries have sufficient information, to be able to assess the reasonableness of the compensation paid for plan services.

The effective date for the interim rules was pushed back from July 16, 2011 to January 1, 2012, and then to April 1, 2012.<sup>5</sup> The final regulations then provided for a

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

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

further postponement to July 1, 2012; this last set of final rules apply to existing services arrangements as of that date, as well as to new arrangements entered into thereafter. It was hoped that the rapidly dwindling lead time originally provided would mitigate the costs and burden of transition to the new disclosure regime.

## 2. Covered Plans

Under the proposed regulations, all employee benefit plans subject to Title I of ERISA were subject to the regulation's disclosure requirements. The final regulations retrenched by defining a covered plan to mean an employee pension plan. IRAs, Simplified Employee Pensions, SIMPLE retirement accounts and certain legacy 403(b) arrangements (for which no employer contributions have been made after 2008) are excluded from this definition and, therefore, not affected by the disclosure requirements of the final regulation.

## 3. Covered Service Providers.

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

- a. Services provided (i) in the capacity of an ERISA plan fiduciary, (ii) as an investment adviser registered under either the Investment Advisers Act of 1940 or state law or (iii) as a fiduciary to certain look-through investment products that holds plan assets, such as collective trusts, hedge funds and private equity funds but not including mutual funds or insurance products providing a fixed rate of return. To be included in the third category, the plan must have a direct equity investment in the contract, product or entity and fiduciary services provided to underlying investments (*i.e.*, to second tier investment vehicles) are not taken into account.
- b. Recordkeeping or brokerage services provided to individual account plans that permit participants to direct the investment of their accounts. This category assumes that one or more designated investment alternatives have been made available through an investment platform. As discussed, the final regulations expand the disclosure obligation of such recordkeepers and brokers to compensation information regarding each designated investment alternative.
- c. Services within a broad list of categories that are reasonably expected to be paid for by indirect compensation or compensation paid among related parties. Service categories include investment consulting, accounting, auditing, actuarial,

appraisal, development of investment policies, third party administration, legal, recordkeeping and valuation services.

#### 4. Required Disclosure

- a. General. A covered service provider must disclose in writing to the plan sponsor or similar plan fiduciary all services to be provided to the plan, not including nonfiduciary services. Service providers must also disclose whether they will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940.
  - i. Formal Contract No Longer Required. Unlike the proposed regulations which would have required that the terms of the service contract or arrangement be in writing, the final regulation does not require a formal written contract delineating the obligations of the service provider.
  - ii. Disclosure of Conflicts No Longer Required. The interim final rule had eliminated the required disclosure of conflicts of interest on the part of service providers. The reasoning for this change was that the expanded disclosure of compensation arrangements with parties other than the plan would be a better tool for purposes of enabling fiduciaries to assess a service arrangement's reasonableness, as well as potential conflicts of interest. To improve a plan fiduciary's ability to make such an assessment, the final 2012 regulations added a requirement that the service provider also describe the arrangement between the payer of any indirect compensation and the service provider (or an affiliate or subcontractor of the service provider) pursuant to which the indirect compensation will be paid.
- 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 or plan sponsor.
  - 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 and describe the payer's arrangement with the service provider resulting in the payment 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 be performed in the same way that compensation is estimated and may take into account the rate that the service provider would charge to a third party or prevailing market rates for similar services. The final 2012 regulations add the requirement that an explanation be provided of the methodology and assumptions used to prepare the estimate.

- 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 issuer of the disclosure material is regulated by a state or federal agency. It is possible to meet the disclosure obligations by furnishing information replicated from such an issuer's disclosure materials.
  - 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 investment entity.
  - iii. Exclusion for Brokerage Windows. Open brokerage windows are not subject to the disclosure requirements for platform providers. As a result of a 2012 DOL field assistance bulletin, it was feared that disclosure with respect to particular investments available through a brokerage window would be triggered by significant participant utilization of those investments. However, the DOL subsequently clarified that this was not the case, although it continues to maintain that plan fiduciaries must



consider the nature and quality of service provided through a brokerage window to satisfy their duty of prudence.

5. Form of Disclosures

All of the required disclosures need not be contained in the same document and may be provided in electronic format. However, the DOL has indicated that it is likely to introduce a potentially significant change that will be required in the future to make information provided in multiple formats more accessible. This new requirement will obligate service providers to furnish a guide or disclosure summary to assist plan fiduciaries in reviewing disclosures. The DOL attached a sample guide to the final regulations as an appendix and has reserved a place in the final regulations to contain such a requirement. However, at the present time, the sample guide is only offered as a suggestion and is not required.

The sample guide included with the regulations consists of two columns. Information to be listed in the first column would include the services to be provided, various categories of service provider compensation (*i.e.*, direct, indirect and shared compensation) and fees and expenses relating to investment options. The second column would show where the services listed in the first column are to be found in the service agreement or where information relating to investment fees and expenses can be accessed on the internet. Thus, such a guide would enable plan fiduciaries to locate compensation information disclosed through multiple and/or complex documents.

6. Timing of Disclosures.

- a. General. Disclosure of information regarding compensation or fees must be made reasonably in advance of entering into, renewing or extending the contract for services.
- b. Changes in Information. 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. The final 2012 regulations relax the 60-day rule for recordkeeping platforms and fiduciaries of look-through investments by providing that disclosure of any changes to investment information must be made at least annually. This eliminates the need to make frequent or even non-stop notifications with regard to minor modifications of investment information.
- c. 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. Under the final 2012 rule, this treatment also applies to errors or omissions that occur with respect to disclosure updates.

- d. 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.

#### 7. 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. Factors to consider in making this determination include the responsiveness of the service provider in furnishing the missing information, and the availability, qualifications, and costs of potential replacement service providers. Under the

2012 final rule, this decision is to be governed by the fiduciary standard of prudence. In the DOL's view, this means that if the requested information relates to services to be performed after the 90-day period and such information is not disclosed promptly after the end of the 90-day period, the plan fiduciary must terminate the contract or arrangement "as expeditiously as possible" consistent with its duty of prudence.

#### 8. Immediate Impact and Issues

Up to now, service providers have not been required to disclose specific types of information to plan sponsors or similar fiduciaries. The final disclosure regulations, however, 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 final rules apply to new contracts as well as contracts in place when the final regulation became effective on July 1, 2012. Service providers should be prepared for additional changes to the disclosure rules resulting from a potential future requirement that a disclosure summary be provided. Investment vendors, including platform providers, have responded to the changes in different ways. For example,

- Some providers are simply disclosing the fee for their bundled services without itemizing the fee for each component service. Providing an "all in" fee is generally permitted. However, if the bundled services include recordkeeping, the fee for recordkeeping must be broken out and separately disclosed. And if there is no explicit recordkeeping fee, a reasonable, good faith estimate of its cost must be provided, along with an explanation of the methodology used to determine that cost.
- Multiple providers often service the same plan, and some are planning to disclose their own fees only, without reference to other providers. This is fine, if each provider is a "covered provider" that has separately agreed to service the plan. For example, if a recordkeeper and a TPA are separately engaged by the same plan, separate disclosures from each provider would make sense. But if the recordkeeper promises to do everything, and then turns around and hires the TPA to serve as its "subcontractor," then the recordkeeper must disclose its fee as well as the TPA's revenue share.

- Some providers are subcontracting their disclosure responsibility. While a covered provider is ultimately responsible for providing the disclosure, the covered provider can hire a third party to prepare and deliver the required fee disclosures.

Financial advisors can assist plan sponsors by serving as the “quarterback” who helps coordinate the entire disclosure process. Advisors should be pro-active and confirm that the plan’s providers will be making the appropriate fee disclosures, and then clarifying for the plan sponsor what the plan sponsor will be receiving and from whom.

Financial advisors can also play a key role, helping plan sponsors “interpret” the disclosures received from their providers. A qualified advisor can help a plan sponsor determine if its fees are unreasonably high in light of the quality of the services provided, and the advisor can assist the plan sponsor investigate alternative plan service and investment arrangements, as necessary or appropriate.

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

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

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

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

ERISA has a functional definition of a fiduciary that focuses on a person’s actions. If you provide “investment advice” within the meaning of ERISA, you are automatically deemed to

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

be a fiduciary. Under the current regulation, a person is deemed to provide fiduciary investment advice if:

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

It should be noted that this 5-factor definition of “investment advice” is narrower 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.

The regular basis and primary basis prongs of this test are particularly important. This was illustrated in the 2007 case of *Ellis v. Rycenga Homes* which applied these factors to a set of facts where periodic meetings between a broker and a plan trustee over the course of a 20-year relationship, resulted in the plan’s consistently following the broker’s suggestions. This led to the court’s holding that the broker was a fiduciary, because of the regularity of the advice and the plan’s heavy reliance on the adviser.

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

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

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

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

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

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

D. Potential Impact on Providers.

If the proposed regulations had been finalized as first issued, non-fiduciary advisors would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would have effectively been forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance. Alternatively, a provider could accept its status as a plan fiduciary. However, as a fiduciary, it would no longer be able to provide investment advice for any variable compensation (*e.g.*, 12b-1 fees) and it would be subject to ERISA and the prohibited transaction rules.

E. Outlook for DOL Proposed Regulations.

Since the DOL announcement that it would be re-proposing its "fiduciary" definition, it has clarified that its re-proposed rule would only impose fiduciary status on those advisors who provide "individualized" advice to plan clients. The DOL has informally indicated that the re-proposed rule will be substantially similar in approach to its initial proposal. Its rulemaking the next time around will be coordinated with the U.S. Securities and Exchange Commission (the "SEC"), which is working on its own proposal to impose fiduciary status on broker-dealers as authorized under the Dodd-Frank Act.<sup>7</sup> The DOL's re-proposed rule is expected in the second part of 2013.

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

F. Practical Implications of Broader “Fiduciary” Definition.

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

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

**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

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the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

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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.<sup>8</sup>

B. Administration's Proposals for Target Date Funds.

1. Retirement Policy Objectives.

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

2. SEC and DOL Comments at Senate Hearing.

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

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

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

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

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



that the DOL was re-examining its regulations for “qualified default investment alternatives” (QDIAs) 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. SEC / DOL Co-Publish Investor Bulletin on Target Date Funds.

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

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

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

5. DOL Issues Proposed Rules on Target Date Disclosures.

On November 30, 2010, the DOL published its proposed regulations on target date disclosures. The proposed rule would amend its existing QDIA regulations (29 CFR 2550.404c-5) as well as its recently finalized participant-level fee disclosure regulations

(29 CFR 2550.404a-5), requiring specificity as to the information that must be disclosed to participants concerning investments in target date funds.

a. Proposed Changes to QDIA Regulations.

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

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

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

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

*Background.* As discussed above in section III, the DOL finalized its participant-level fee disclosure regulations on October 14, 2010 and required plan fiduciaries to implement them commencing August 30, 2012. The regulations require annual

and quarterly disclosures of plan-related fee information and annual disclosures of investment-related information to participants. The annual investment-related disclosures are required to be provided in the form of a comparative chart.

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

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

The comment period for the public to provide feedback on its proposed regulation ended on January 14, 2011 and was subsequently extended until July 9, 2012 to allow consideration of additional SEC research on individual investors' understanding of target date funds. However, the DOL has not yet indicated when it is likely to finalize its proposed rule. Given the recent finalization of the regulations under ERISA Section 408(b)(2) and the participant investment advice regulations, the target date disclosure regulations may be next on the agenda.

### C. Conflicts of Interest in Fund-of-Funds Structure.

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

From a product development perspective, when a fund family creates a target date fund, it naturally has a financial incentive to include as many affiliated underlying funds as possible in

the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers. Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. In the report prepared by the Senate Special Committee on Aging, it was reported that target date funds have higher expense ratios than the rest of the core portfolio in 401(k) plans.<sup>12</sup> Furthermore, although many target date funds invest in affiliated underlying funds exclusively, the reality is that many fund families do not have “best in class” funds for each and every applicable asset class.

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

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

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

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

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

- 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, former U.S. Senator Herb Kohl (D-WI), then 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.

F. Best Practices Regarding Target Date Disclosures.

Although the DOL has not yet finalized its proposal concerning the required disclosures for target date funds, it is clear that there is a concern that participants are not getting the appropriate information and education. As a “best practice,” advisors can help provide meaningful information about the plan’s target date funds to participants right now. Participants need to focus on the key features of a target date investment, such as its glide path, landing point and its potential volatility. While educating participants about target date funds, advisors should also work with plan sponsors to ensure that they are prudently evaluating the target date fund series in the plan’s menu, especially if it is being utilized as a QDIA. In light of the level of investment losses sustained by all types of target date funds in recent years, plan sponsors should

pay particular attention to the expected volatility and equity/fixed income mix of target date funds intended for participants who are already in or nearing retirement (*e.g.*, 2015 Retirement Fund).

## **VII. Lifetime Income Options**

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

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

Some observers, however, have reservations about the appropriateness of using annuities as a default investment, given the fact that the needs of individuals tend to vary considerably during the decumulation phase of retirement. Some experts have been critical of default annuities, noting their inflexible nature and that default annuitization may not be easily reversed by participants (without significant economic cost). The Government Accountability Office, the watchdog or investigative arm of Congress, has also noted that, for some participants, default annuities may not be appropriate, given their health or other conditions. Proponents of default annuities have developed a proposal to offer default annuities over a two-year trial period, during

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

which the retiree would receive monthly income unless the retiree opted and made an affirmative decision by the end of the trial period to take a lump sum.

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

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

D. 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 former Senator Kohl, then 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.

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



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.

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

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

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

- 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

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

“investment education” to participants without fiduciary liability, and the DOL appears to be interested in expanding it to cover “retirement income education.”

- Disclosure of Account Balances as Monthly Income Streams. Along the lines of various legislative proposals such as the *Lifetime Income Disclosure Act*, the agencies were interested in hearing how participants may be more likely to choose lifetime income options if their benefit statements were to include disclosures noting what their individual accounts are worth when converted to a hypothetical monthly benefit.
- Modifying Fiduciary Safe Harbor for Selection of Issuer or Product. Under current law, a DOL regulatory “safe harbor” provides guidelines on how a plan fiduciary can prudently select an annuity provider for its DC plan.<sup>16</sup> This safe harbor is largely procedural, requiring an objective, analytical search for an annuity provider, in consultation with an expert as necessary. The agencies heard testimony on whether these safe harbor standards should be modified, and whether they should apply more broadly to other types of lifetime income products.

Given the specificity of these 3 areas, it appears that the DOL and Treasury Department (and IRS) have narrowed their areas of focus, signaling that these agencies are preparing to move ahead with rulemaking in these areas. In fact, the IRS has already begun to take action.

#### F. IRS Tax Relief.

1. Required Minimum Distributions. 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 70½ 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.

The IRS recently followed this up with a proposed regulation that would relax the minimum required distribution rule, as it applies to defined contribution plans, in order to promote longevity annuities, an annuity product with an income stream that begins at an age later than normal retirement, such as age 80 or 85. Proposed regulations issued on February 2, 2012 represent the first of what will be a series of actions to allow such annuities in tax-qualified retirement plans. The market for longevity annuities is currently very small, but the Administration would like to see an expansion of their use because they allow retirees to self-manage a significant portion of their retirement assets until a relatively advanced age. Such a deferred annuity would commence level monthly payments at the elected age (*e.g.*, age 80) and

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

provide protection against outliving retirement assets, but the minimum distribution rules presented an obstacle to their use, because they generally require plan distributions to commence at age 70 ½ (rather than a later date consistent with the annuity starting date under a longevity annuity). Under the proposed regulation, a defined contribution plan or IRA investment in a qualifying longevity annuity would be exempted from the minimum distribution rules. To qualify, the annuity premium would have to be limited to the lesser of \$100,000 or 25% of a participant's account balance, and the starting date of the annuity could be no later than age 85. Nevertheless, because of the minimum distribution requirement, the annuity cannot be a variable annuity (where payout is affected by underlying investments) or have a cost of living adjustment once payments begin.

2. Split Annuities. Another proposed regulation issued on February 2, 2012 would encourage DB Plan sponsors to offer split distribution options, where participants may elect to receive a portion of their accrued benefits as an annuity and the other portion as a lump sum. The goal of the proposed rule would be to give participants greater flexibility in their lifetime income choices, eliminating the "all or nothing" choice that many DB Plan participants currently face when deciding between a lump sum or an annuity.

Under current law, if a plan were to offer split options to participants, statutory actuarial assumptions (*i.e.*, applicable mortality table and applicable interest rate under Section 417(e)(3) of the Internal Revenue Code) would generally need to be used to calculate each bifurcated benefit (*i.e.*, partial lump sum and partial annuity). Under the proposal, however, plans would only be required to use the statutory assumptions to calculate the partial lump sum, meaning that the plan's regular conversion factors would be used to calculate the partial annuity.

For example, let us assume that a newly retired participant (age 62) has accrued a normal retirement benefit of \$1,350 per month (payable at age 65). Let us further assume that this benefit either has an **immediate** monthly annuity value of \$1,200 (determined using the plan's regular conversion assumptions), or an immediate lump sum value of \$100,000 (determined using statutory assumptions). If the participant were to elect 25% of his benefit as an annuity (and the remaining 75% as a lump sum), under the proposed regulations, the participant would be entitled to a \$300 immediate monthly annuity and a \$75,000 current lump sum. As illustrated, the proposed regulations would allow the plan to use simple arithmetic (25% x \$1,200) to arrive at the value of the partial annuity. Conversely, a much more complex calculation would be required under the current rules, if the statutory assumptions (rather than the plan's regular conversion assumptions) were used to calculate the immediate partial annuity.

3. New Tax Rules Favoring Annuities. The IRS has also released a pair of revenue rulings to further encourage the annuitization of plan benefits. Unlike the proposed regulations on longevity annuities, these rulings are effective immediately.

- Revenue Ruling 2012-4 encourages employers to use their defined benefit plans as a way to offer lifetime income options for their employees' 401(k) account balances. Specifically, if an employer sponsors both defined benefit and a defined contribution plans, participants may be permitted to roll over their 401(k) balance to the defined benefit plan, and convert it into a plan annuity. The advantage of this

arrangement for participants is that they can easily annuitize their 401(k) benefit at favorable rates (rather than the rates otherwise available in the retail marketplace). This ruling is effective for rollovers on or after January 1, 2013, although plan sponsors were entitled on its holdings for pre-2013 rollovers.

- Revenue Ruling 2012-3 confirmed that offering deferred annuities in a 401(k) plan will not accidentally trigger IRS death benefit rules. Under these rules, defined benefit plans must pay death benefits to a participant's surviving spouse in the form of special type of annuity, unless the spouse opts out. 401(k) plans are typically exempt from these rules, as long as they provide for payment of the participant's account balance to the surviving spouse. Before the Revenue Ruling was released, there was a concern that the spousal death benefit rules might apply to a 401(k) participant who invests in deferred annuities. The good news is that, provided annuitization is not automatic or irrevocable, the IRS has clarified that the spousal death benefit requirements will not apply. This removes another obstacle for plan sponsors that want to use deferred annuities. The IRS has indicated its intent to issue future guidance on other annuity arrangements.

#### G. DOL Lifetime Annuity Guidance.

The DOL has yet to issue guidance facilitating lifetime income features in retirement plans. However, it is anticipated that 2013 will see the issuance of rules requiring plan sponsors to disclose the lifetime income value of participants' defined contribution account balances, achieving by regulation what some have sought to do by legislation. Questions to be addressed would be how the value of account balances should be projected to a future retirement age and what factors and assumptions should then be used to convert the resulting account balances to periodic lifetime payments.

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