WHAT'S UP IN WASHINGTON, EFFECTS ON YOU AND YOUR CLIENTS

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I. What's Up in Washington?

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

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

The Administration's diverse and broad initiatives would impact current plan sponsors as well as employers that do not currently maintain any type of plan. Under the most far-reaching mandate, employers that do not already sponsor a retirement plan would be forced to adopt "automatic IRAs" that would take payroll contributions from employees automatically, unless they affirmatively opted out. Only the smallest of employers (with 10 or fewer employees) would be exempt from this proposed mandate.

B. Improving the Defined Contribution Savings System.

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

Given the unprecedented involvement of the White House in the development of DOL regulations under ERISA, it is important to bear in mind that these rules are designed to make strategic improvements in the 401(k) plan arena, and that they not being issued haphazardly in isolation of one another. In sum, the DOL and the Administration are targeting these three areas:

1. Conflicts of interest

[1] *Annual Report of the White House Task Force on the Middle Class*, February 2010.
[2] *Budget of the U.S. Government, Fiscal Year 2011,* Office of Management and Budget.
[3] On February 26, 2010, Vice President Biden announced the DOL's proposed regulations on investment advice, 75 FR 9360 (March 2, 2010), as part of the Middle Class Task Force's year-end annual report.

- Participant investment advice
- Broader “fiduciary” definition
- Service providers

2. Default investments
3. Lifetime income options

II. Conflicts of Interest: Participant Investment Advice

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

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

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

A. DOL Proposes New Regulations for Investment Advice

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

Here’s a brief summary of the regulatory “rollercoaster ride”:

- DOL issues a formal Request for Information, soliciting comments on its regulations in December 2006.

- The DOL publishes regulations interpreting and expanding the PPA exemption for investment advice in August 2008.

- They are “finalized” on January 21, 2009 during the last days of the Bush Administration.

- As one of its earliest administrative actions, the incoming Obama Administration delays the effective date of these regulations.

- The DOL subsequently withdraws them on November 20, 2009, before ever having taken effect.

- Now, DOL has issued newly proposed regulations (March 2, 2010) providing interpretive guidance on the PPA exemption for investment advice.

B. Background: The Pension Protection Act of 2006

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

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

C. Inclusion of Class Exemption in Final Regulations Triggers Withdrawal

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

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

- New Fee-Leveling Safe Harbor. The Withdrawn Class Exemption would have created a similar but new safe harbor, mandating fee-leveling for the individual representative of the fiduciary adviser only (and not for the individual representative and the fiduciary adviser as required under the PPA Statutory Exemption). Thus, the compensation payable to the fiduciary adviser and its affiliates would be able to vary with the investment options selected by plan participants. For example, the Withdrawn Class Exemption would have allowed the individual representative of a broker-dealer to provide investment advice to participants, so long as the individual representative received a level fee. Conversely, the broker-dealer itself and its affiliates would have been able to receive variable compensation, including 12b-1 fees and revenue sharing payments.

- New Computer Model Safe Harbor. Once investment advice based on an objective computer model had been provided to a participant, the Withdrawn Class Exemption would have allowed the fiduciary adviser to follow up with subjective, individualized advice to the participant. Any such individualized advice would not have been subject to any fee-leveling requirement.

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

D. DOL Proposes Second Iteration of Its Investment Advice Regulations

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

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

- with respect to the Fee-Leveling Safe Harbor, participant investment advice may only be provided if the fees earned by both the individual representative of the fiduciary adviser and the fiduciary adviser itself (and not including the fiduciary adviser's affiliates) do not vary with the investment options selected by participants, and

- with respect to the Computer Model Safe Harbor, a fiduciary adviser may only provide investment advice to participants based on an objective computer model, and may not supplement such advice with subjective, individualized advice.

However, in the preamble to the Newly Proposed Regulations, the DOL highlighted one new interpretive requirement that it was proposing for the Computer Model Safe Harbor. Although it is not expressly required under the PPA Statutory Exemption, the Newly Proposed Regulations state that the computer model advice must not "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future." In the preamble, the DOL clarified that differences in investment options' fees and management styles are likely to persist in the future. However, unlike the historical performance of asset classes, the historical performance of investment options in the same asset class are less likely to persist and therefore are less likely to constitute appropriate criteria for advice. Since many advisory computer models consider the historical performance of investment fund (rather than asset classes), many practitioners have questioned whether this approach will favor index funds. The DOL is expected to receive significant commentary with respect to this proposed interpretive requirement, which had not been surfaced previously with the interpretive portion of the DOL's withdrawn regulations. The comment period for the Newly Proposed Regulations ends on May 5, 2010.

III. Conflicts of Interest: Broader "Fiduciary" Definition

The fiduciary standards under ERISA are "the highest known to the law."[4] And unlike securities laws which generally allow you to mitigate conflicts of interest through disclosure, ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption.

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

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

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

As announced in its Fact Sheet regarding this proposed regulation, the DOL believes there is a need to re-examine the types of advisory relationships that could give rise to fiduciary duties on the part of those providing advisory services. The Fact Sheet makes specific reference to pension consultants and financial asset appraisers. The DOL further stated that it had reached this conclusion based on its experience in implementing the current regulation, which has not been updated since its adoption in 1975. "The current regulation may inappropriately limit the types of investment advice relationships that should give rise to fiduciary duties on the part of the investment adviser."[5] The Assistant Secretary of Labor of EBSA, Phyllis Borzi, commented that the DOL is "concerned that it allows advisers from whom plans expect impartial advice to evade fiduciary responsibility."[6]

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

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

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

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

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

IV. <u>Conflicts of Interest: Service Providers</u>

A. "<u>Hidden" Fees and Conflicts of Interest</u>

[5] EBSA Unified Agenda, Fall 2009
[6] Live Q&A Session with EBSA, December 9, 2009, available at http://www.dol.gov/regulations/chat-ebsa.htm.

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

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

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

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

B. <u>Retirement Security Initiative – Improving Transparency</u> .

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."[7] Consistent with this policy

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

objective, the Administration is coordinating with the DOL to finalize its 2007 proposed regulations requiring service providers to provide specific discloses with respect to fees and conflict of interests.[8]

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

- The November 2006 report by the GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, reported that the "problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered."

- The GAO had concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the "hidden" compensation flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant).

- In its March 2009 report, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans,* the GAO concluded that there is a "statistical association between inadequate disclosure of potential conflicts of interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of nondisclosure" of indirect compensation arrangements.

In addition, the DOL's proposed fee and conflict of interest disclosure rules for service providers are actually the second part of a three-pronged "reg project" designed to increase fee transparency.

- The first part involved improving a plan's fee disclosures on Form 5500, Schedule C. The DOL has already issued final regulations on the revised Schedule C and they apply starting with the 2009 plan year [9].

- The second part involves requiring service providers to give mandatory disclosures to plan sponsors under ERISA Section 408(b)(2).

- The third part involves mandatory disclosures from the plan to its plan participants.[10]

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[8] 72 Fed. Reg. 70988 (Dec. 13, 2007).
[9] 72 Fed. Reg. 64710 (Nov. 16, 2007).
[10] Proposed 29 C.F.R. 2550.404a-5 published at 73 Fed. Reg. 43013 (Jul. 23, 2008).

The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than a decade ago. In 1997, the DOL held a hearing on 401(k) plan fees, which appeared to have been in response to several consumer magazines criticizing the size of such fees.[11] In 1998, the DOL published a 19-page booklet, "A Look At 401(k) Plan Fees," for plan participants and a 72-page report, "Study of 401(k) Fees and Expenses," for plan sponsors.[12] Unfortunately, the DOL's efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, the DOL is proposing to require service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

C. Background – Prohibited Transaction Rules Under ERISA.

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

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

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

In addition to the above requirements under the statute itself, the current DOL regulations interpreting the statute impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.[13] Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

D. Proposed Regulations under ERISA Section 408(b)(2).

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[11] "Protect Yourself against the Great Retirement Rip-off," *Money Magazine* (April 1997). "Your 401(k)'s Dirty Little Secret," *Bloomberg Personal* (September 1997).
[12] A Look at 401(k) Plan Fees" is posted at http://www.dol.gov/ebsa/publications/401k_employee.html. The Study of 401(k) Fees and Expenses is posted at: http://www.dol.gov/ebsa/pdf/401kRept.pdf.
[13] 29 CFR 2550.408b-2(c).

The DOL has proposed amending its regulations to require service providers to disclose in writing their fees and conflict of interests.[14] If adopted as proposed, the new regulations will impose significant administrative burdens on service providers and expose them to significant risk of legal liability for failure to disclose their fees and conflicts of interest.

1. Service Providers Affected. The proposed rules are limited to service providers that:

- are fiduciaries under ERISA or under the Investment Advisors Act of 1940;
- provide securities brokerage, investment advice (to the plan or plan participants), investment management, custodial, recordkeeping, consulting, or third party administration services, regardless of whether they receive the compensation directly from the plan or plan sponsor, or indirectly from third parties, or
- provide accounting, actuarial, appraisal, auditing, legal or valuation services but only if they receive any compensation indirectly from third parties.

Thus, service providers who are plan fiduciaries (e.g., investment advice fiduciaries) and service providers involved with plan administration or investments are subject to the new disclosure rules, even if they do not receive any indirect compensation. However, accounting, actuarial, legal, and similar professional service providers are subject to the new disclosure rules only if they receive indirect compensation. According to the DOL, the distinction is based on its belief that the service providers subject to the enhanced disclosure requirements are most likely to have conflicts of interest.

Although the focus of the proposed 408(b)(2) regulations is 401(k) fees, the proposal applies to services provided to health or other welfare plans as well as 401(k) and other retirement plans.

2. Fee Disclosures. An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, all services to be provided to the plan and, with respect to each such service:

- the fees to be received by the service provider (expressed as a specific monetary amount or formula, percentage of the plan's assets, or per capita charge);

[14] 72 Fed. Reg. 70988 (Dec. 13, 2007). If DOL adopts the 408(b)(2) regulations as proposed, the final regulations would take effect 90 days after publication in the Federal Register.

- whether the service provider will bill the plan, deduct fees directly from plan accounts, or reduce the plan's investment earnings to pay the fees, and

- how any prepaid fees will be calculated and refunded when a contract terminates.

i. Types of Fees. For purposes of the proposed rule, fees include money or any other thing of monetary value (e.g., gifts, awards, and trips) to be received by the service provider (or its affiliate) directly from the plan or plan sponsor, or indirectly from third parties (i.e., from any party other than the plan or the plan sponsor), in connection with the services to be provided pursuant to a contract or arrangement with the plan or because of the service provider's position with the plan.

Fees may include direct or indirect compensation to the service provider.

- Direct compensation: This is compensation received by a service provider directly from the plan sponsor or plan.

- Indirect compensation: This is compensation received by a service provide from a third party (i.e., not the plan sponsor or the plan). Revenue sharing would be example of indirect compensation. Indirect compensation is typically paid from the plan's investments (or the plan's investment providers) to the plan's service providers. Thus, indirect compensation in the context of DC plans is actually a cost that is ultimately borne by participants.

ii. Special Fee Disclosure Rule for Bundled Services. If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundled services must provide the required disclosures. In addition, the bundled service provider is not required to disclose the fee allocation among the services except for fees separately charged:

- against a plan's investment (e.g., management fees paid to a mutual fund's investment adviser) or

- on a transaction basis (e.g., brokerage commissions).

3. Conflicts of Interest Disclosures. An affected service provider must also disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. The service providers must 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;

- expect to participate in, or otherwise acquire an interest in, any transaction to be entered into by the plan in connection with the services and, if so, a description of the transaction and the service provider's participation or interest therein;

- have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;

- will be able to affect its own compensation or fees, from whatever source, without the prior approval of the plan sponsor or similar plan fiduciary; and

- have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

4. *Timing and Format of Disclosures*. There is no specified timeframe to disclose the information other than prior to entering into the contract. All of the required disclosures need not be contained in the service contract and may be provided in electronic format. The service contract must include a representation by the service provider that, before the contract was entered into, all the required conflicts of interest information was provided to the responsible plan fiduciary. During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of the service provider's knowledge of the change.

5. *Curing Disclosure Failures Under Proposed Regulations*. A service provider's failure to comply with the disclosure obligations under the proposed 408(b)(2) regulations would result in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL has also proposed a class exemption[15] that would provide relieve for them. Conspicuous by its absence is any relief to the service provider that fails to comply with the proposed 408(b)(2) regulations.

[15] 72 Fed. Reg. 70893 (December 13, 2007). The class exemption would be effective 90 days after its publication in the Federal Register.

6. *No Conflict of Interest Relief for Fiduciaries*. To some extent the proposed regulations are misleading because they require service providers, including fiduciary service providers, to disclose their fees and conflicts of interest. As a result, some fiduciaries—particular investment advisers—have inferred that they can cure conflicts of interest by disclosing them as they do under the Investment Advisers Act of 1940. However, the inference is erroneous.

The regulations provide a narrow exemption that allows the use of plan assets to pay for reasonable fees, but they do not provide any additional exemption for fiduciary conflicts of interest. Thus, a fiduciary disclosing its conflicts of interest under the proposed 408(b) regulations will not get any relief from ERISA's prohibitions against self-dealing. Essentially, the proposed 408(b) regulations are designed to force non-fiduciary service providers to disclose their conflict of interests, even though they are not subject to the conflicts of interest rules that apply to fiduciaries.

7. *Outlook for Finalization of 408(b)(2) Regulations*. The DOL had announced that the regulations may be finalized as early as May 2010.[16] If she is correct, it appears that the final regulations will preempt the fee disclosure legislation pending in Congress, which include:

- The 401(k) Fair Disclosure for Retirement Security Act of 2009, introduced by Rep. George Miller (D-CA), the chairman of the House Education and Labor Committee;
- The Defined Contribution Fee Disclosure Act of 2009, introduced by Senators Harkin (D-IA) and Kohl (D-WI); and
- The Defined Contribution Plan Fee Transparency Act of 2009, introduced by Rep. Richard Neal (D-MA), Chairman of the House Ways and Means Subcommittee on Select Revenue Measures.

Although there are differences, the 3 legislative proposals and the DOL regulations focus on similar types of disclosure requirements with respect to indirect compensation and conflicts of interest. It should be noted that unlike the other proposals, Rep. Miller's bill would imposes a substantive condition, requiring 401(k) plans to include at least one index fund in the investment menu in order to rely on ERISA Section 404(c) - the provision which relieves the plan sponsor of any responsibility for the investment allocation decisions made by participants.

V. 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

[16] See *Live Q&A Session with EBSA* available at http://www.dol.gov/regulations/chat-ebsa-static.htm.

fund, with investments in a mix of asset classes. They are designed to provide a convenient investment solution for individual investors who do not want to be burdened with the responsibility of finding the right mix of assets for their retirement investments. The defining characteristic of a target date fund is its "glide path," which determines the overall asset mix of the fund over time. The fund's asset allocation automatically becomes more conservative (i.e., higher allocation to fixed income investments and lower allocation to equity investments) as the fund gets closer to its target date.

Despite the immense popularity of these financial products, Congress and regulators have voiced deep concerns regarding the design of target date funds, especially funds with near-term target dates. The average investment loss for funds with a target date of 2010 was roughly -25% due to the market turmoil in 2008, with individual fund losses running as high as -41%, according to an analysis by the U.S. Securities and Exchange Commission ("SEC").[17]

B. Administration's Proposals for Target Date Funds.

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."[18] 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."[19]

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[17] 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.
[18] *Budget of the U.S. Government, Fiscal Year 2011,* Office of Management and Budget.
[19] *Annual Report of the White House Task Force on the Middle Class*, February 2010.

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.[20] At this hearing, the Director of the SEC's Division of Investment Management reported that it was focusing on the regulation of target date funds, with a view towards making recommendations in 2 areas: (1) fund names (e.g., use of a target year in the name of the fund), and (2) fund sales materials. The Assistant Secretary of Labor of EBSA reported that the DOL was re-examining the QDIA regulations to ensure meaningful disclosure is provided to participants and that it was also considering more specific guidelines for selecting and monitoring target date funds as a default investment and as an investment option. Both agency representatives acknowledged that additional rules were necessary to protect plan participants, and both agencies appear to favor enhanced disclosure with respect to target date funds.

On April 26, 2010, the DOL announced in its Spring 2010 Semiannual Regulatory Agenda that it will be amending its QDIA regulations to ensure participants receive proper disclosure whenever target date funds are used as the plan's default investment. The DOL also announced in its Regulatory Agenda that it will be developing a fiduciary checklist designed to assist plan sponsors evaluate and select target date funds

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.[21] 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

[20] 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.

[21] *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).

volatility. This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments. Thus, even in funds with a target date of 2010, underlying equity funds constituted up to 68% of assets, which in turn contributed to recent volatility and investment losses.

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

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

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

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

- Under ERISA Section 3(21)(B), a plan's investment in a registered investment company "shall not by itself cause such investment company or such investment company's investment adviser" to be deemed to be a fiduciary. Accordingly, the mutual fund's investment adviser is generally not deemed to be a fiduciary of the plan investing in such mutual fund.

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

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

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

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

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

E. Congressional Scrutiny of Target Date Funds.

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

VI. 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."[22]

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 participant 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.

Unlike the Administration's other initiatives to promote retirement security, the push towards lifetime income options is still in its infancy (as reflected by the RFI from the Labor and Treasury Departments).

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 were co-authored by Mark Iwry, who was recently appointed by the Treasury Secretary to serve as the Deputy Assistant Secretary for Retirement and Health

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

Policy. The white papers include proposals to encourage DC plan annuitization by using deferred annuities as the default investment for participants for certain purposes.

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

In contrast to these tax-related measures, the Lifetime Income Disclosure Act puts a different spin on the subject of lifetime income and 401(k) plans.[23] Under this proposed legislation, 401(k) plan sponsors would be required to inform participants annually of how their account balances would translate into guaranteed monthly payments – a "retirement paycheck for life." The goal of this legislation is to give participants an understanding of how much projected retirement income they can expect from their savings. The legislation directs the DOL to issue tables that employers may use in calculating an annuity equivalent and model disclosures. Employers and service providers who use the model disclosure and guideline assumptions would be insulated from liability under ERISA.

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

VII. Effects on Clients

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

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

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

evaluations. For example, if Washington is in the planning stages of forcing plan providers to disclose fees and conflicts of interest to plan sponsors, wouldn't it be prudent for plan sponsors to request and review that type of information right now?

Many plan sponsors realize that, at the end of the day, they are genuinely responsible for the retirement savings of their employees. Many of them also recognize that ERISA requires them to do something as a fiduciary, but they are not exactly sure of what it is they are supposed to be doing. Keeping clients apprised of their fiduciary duties under current law is important, but keeping them up to date on current event is also a value-added service. If Washington has concerns over certain problems or issues in the 401(k) plan world, plan sponsors should have a basic understanding of these concerns and be mindful of them for purposes of running their own plans.

B. Demonstrating Your Expertise. Knowledge of current events in Washington is also another way for advisors to distinguish themselves and demonstrate expertise in the 401(k) plan market. When discussing such current events with plan sponsors, remember that the Administration is focusing on 3 core areas: conflicts of interest, default investments (target date funds), and lifetime income options (whose rulemaking is still in its infancy)

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

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

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

2. *Help Plan Sponsors Evaluate "Hidden" Fees*. Plan sponsors have a duty to ensure fees paid from the plan are reasonable, but they need assistance, especially when it comes to evaluating indirect compensation and revenue sharing. An advisor might feel uncomfortable helping a plan client identify and evaluate so-called hidden compensation, out of fear that the plan sponsor might conclude that the total fee is excessive. However, it is important for the plan client to bear in mind that all fees must be considered in light of the quality of services provided, and the DOL has made it clear that no fiduciary decision should ever be made based on fees alone.

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

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