

## Washington, D.C. Update: The Feds Have A Full Agenda

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In recent months, we have spent a considerable amount of time talking with government officials at the Departments of Treasury and Labor, as well as congressional staff members, concerning regulatory and legislative developments in Washington, D.C. The purpose of this bulletin is to bring you up to date on those subjects.

- **Department of Labor: Plan-level disclosure.** The Obama-appointed leadership of the DOL's Employee Benefits Security Administration (EBSA) has "re-started" the project to develop a regulation under ERISA section 408(b)(2), which requires that all arrangements with ERISA-governed retirement plans be reasonable. As you may recall, the prior administration had drafted a regulation which would require most service providers to disclose their fees, describe their services, and explain material conflicts of interest. The most important of the "covered" service providers were: broker-dealers; RIA firms; recordkeepers and bundled providers; and third party administrators. However, the Bush Office of Management and Budget (OMB) refused to approve that regulation...apparently because they felt it imposed too great a burden on businesses.

The DOL has almost completed the re-write of the regulation. Once that is done, it will be submitted to OMB for approval. In the typical case, it takes two to three months for OMB to approve a new regulation. At that point, EBSA can publish the regulation in the Federal Register. EBSA has said it expects to release the new regulation in May. While EBSA has not said so definitively, there are strong indications that the regulation will be issued in final, rather than proposed form.

Assuming the regulation is final, the question is when will service providers need to comply? EBSA has not given any specific indication of the effective date of the regulation, but DOL personnel have generally stated that it will allow adequate time for the private sector to prepare for the implementation. Some of us believe that means the regulation will not be effective until January 1, 2011.

Having said that, though, it means that every broker-dealer, RIA firm, recordkeeper and bundled provider, and TPA firm will need to have their agreements and compliance procedures in place before that date, so that they begin using them with new clients on the effective date (or before). In addition, for larger organizations, like many broker-dealers

and bundled providers, it means that they will need to train their personnel on how to use the new agreements, as well as adopting policies and procedures within the firm on issues such as disclosures of conflicts of interest. Also, it will take some time and effort for certain types of organizations to decide on how to describe their services. That would apply, for example, to broker-dealers and their registered representatives.

EBSA has not commented extensively on the changes from the prior version of the regulation. EBSA officials have stated, however, that the new regulation will not allow bundled providers to aggregate their costs, as they could in the proposed regulation. In other words, bundled providers will have to break out their revenues into several categories, such as investment management, administration and recordkeeping, transactional charges, and other types of revenues.

**R&R COMMENT:** *During 2008, we worked on drafting a large number of 408(b)(2) agreements for broker-dealers, RIA firms, recordkeepers and bundled providers, and third party administrators. We expect that those agreements will, for the most part, be compliant as drafted, because there will not be many changes in the final regulation. However, even those documents will need to be reviewed once the final regulation is published.*

*More importantly, once the final regulation is published, every service provider to ERISA-governed plans (including, for example, qualified retirement plans, ERISA-governed 403(b) arrangements, SIMPLE and SEP IRAs, as well as health and welfare plans that are governed by ERISA) should have their agreements reviewed and revised. While, at first blush, this may seem like a simple task of adding some language, in our experience it is not. This is because many service providers, and particularly some broker-dealers, don't have ERISA service agreements. In other words, they will be starting from scratch. In addition, they will need to review their marketing materials, websites and the like to ensure that what they say in those materials is consistent with their service agreement. This is especially the case for RIAs, which will need to*

*coordinate their Form ADV or equivalent brochure with the service agreement.*

*Service providers will also need to develop policies and procedures about the delivery of the agreements, the execution of the agreements, the provision of the supporting information, and so on. As a result, broker-dealers will need the full six or seven months remaining in 2010 after the regulation is published, in order to develop the needed compliance documents and procedures. Also, in our experience, almost all covered service providers will have some issues with the new regulation. For example, third party administrators need to, in particular, focus on the indirect payments they may receive from recordkeepers and investment providers. Bundled providers will need to focus on the “unbundling” of their information, as well as the large volume of information that needs to be provided. In their case, the simple gathering of the information may be difficult. For RIA firms, and all of the others, there needs to be a focus on identifying and describing indirect payments and on accurately describing conflicts of interest.*

*As a result, we recommend that providers and advisers start working on their agreements as early as possible.*

- **Department of Labor: Participant Investment Advice.** As you have probably already heard, the Department of Labor has withdrawn the regulation issued by the Bush Administration concerning participant-level investment advice. The regulation was withdrawn because EBSA is making major revisions to that regulation. In fact, the revisions have already been made. The new regulation was forwarded to the OMB some time ago and should be approved by the OMB within 45 days. At that point, the new proposed regulation will be published in the Federal Register and there will be a short (*e.g.*, 30 to 60 day) comment period. EBSA believes this issue has been so thoroughly vetted that it doesn't make any sense to have a long comment period. However, EBSA wants to make sure that interested parties have the opportunity to review and comment on the changes they make before issuing a final regulation.

Based on comments by EBSA officials, the new proposal will significantly change the existing regulation.

As background, the withdrawn final regulation had four exemptions to the prohibited transaction rules for fiduciary investment advice to participants. Those were:

- Detailed regulatory provisions explaining and amplifying the PPA for “level fee” advice to participants. (We have placed the quotes around level fee because it is unclear which entities or individuals must have levelized compensation, *e.g.*, are all affiliates considered under the soon-to-be issued proposed regulation?)
- Detailed regulatory provisions explaining and amplifying the PPA statutory exemption for computer model advice.

- A regulatory class exemption substantially loosening the protections that were required by the statute for level free fiduciary advice to participants.
- A regulatory class exemption substantially removing the conflict of interest protections for computer model advice that were required by the PPA provisions.

We have heard from DOL officials, as well as others, that the two regulatory class exemptions have been completely removed from the regulation. In other words, they will no longer exist.

Furthermore, we suspect that the new proposal will have additional provisions to protect participants against conflicts of interest. For example, under the DOL's interpretation of the PPA level fee exemption, the compensation of the adviser only needs to be levelized for the individual adviser and its supervisory entity (for example, for the RIA firm and the investment adviser representative, or for the broker-dealer and the registered rep). However, there has been a push to extend the levelizing of compensation to include all affiliates. For example, if the RIA firm is affiliated with a mutual fund management company, the compensation of the mutual fund management company would have to be levelized together with the RIA fee, if this approach is adopted. Similarly, if a broker-dealer is affiliated with an insurance company, the revenues of the insurance company and the broker dealer would have to be levelized under that approach. However, it remains to be seen if EBSA will adopt that approach in its final regulation.

Also, for computer model advice, there is an open question about so-called “off model” advice. That is, once an adviser has given computer model advice to a participant, may the participant ask for additional advice and, if so, may the adviser give personal advice, or must the adviser continue to use the computer model? The outcome of that issue remains to be seen.

Finally, keep in mind that the exemption adopted in the PPA applies to IRAs as well as 401(k) plans. An open question, that will presumably be clarified in the regulation, is how the exemption for computer model advice will apply to IRAs.

**R&R COMMENT:** *The DOL and the House Ways and Means Committee leadership, which appear to be working together on these issues, share a concern about the conflicts of interest on Wall Street and their potential impact on participants. As a result, we expect to see a substantial narrowing of the opportunities to provide participant-level fiduciary advice. If that is the case, advisers will need to seek alternatives to comply with more stringent requirements.*

*For example, broker-dealers may contract with third party investment advisers and managers so that their representatives can bring those unaffiliated advisory services to plans as a fiduciary solution. Alternatively, if the adviser is willing to be a fiduciary, recordkeepers may offer a service of collecting 12b-1 fees and other revenue*

*sharing, placing those amounts in an ERISA budget account, and then providing level compensation to the broker-dealer. Those are just two examples. We believe there will be a host of “solutions.”*

*In that vein, there appears to be one piece of good news. Based on conversations with DOL officials and others, we have learned that existing guidance, such as the SunAmerica Advisory Opinion, will continue to be valid. That will preserve the arrangements used by many plans and providers.*

*Also, Interpretive Bulletin 96-1 continues to provide advisers with opportunities to help participants through a fairly broad interpretation of investment education.*

- **Update on the Miller bill.** Congressman George Miller, Chair of the House Education and Labor Committee, previously introduced the 401(k) Fair Disclosure and Pension Security Act of 2009 (H.R. 2989), which proposes new ERISA rules concerning disclosures to plan sponsors by service providers, disclosures to participants by plan sponsors and service providers, and fiduciary advice to participants.

The latter subject, which imposes substantial restrictions on advice providers with conflicts of interest, was not in the bill as originally proposed by Congressman Miller. Instead, it is in a separate bill sponsored by a ranking member of the Committee, Congressman Rob Andrews from New Jersey.

Shortly before the House Education and Labor Committee approved the 401(k) Fair Disclosure bill, the conflicted investment advice provisions were added from Andrews' bill. That addition was made with little advanced notice and, because of its provisions, it heightened the controversy around the Miller bill.

The Miller bill was subsequently assigned to the House Ways and Means Committee because its provisions would impact tax qualified retirement plans and because of the intention that those rules would be extended to other non-ERISA retirement arrangements, such as 457 plans, non-ERISA 403(b) arrangements, and IRAs.

It now appears that the conflicted advice provisions failed to gain support in the House Ways and Means Committee. As a result, we understand that an agreement has been reached between the Ways and Means Committee and the Education and Labor Committee to remove the conflicted advice provision from H.R. 2989. However, the remainder of the bill, including the provisions on plan-level and participant-level disclosures, continues to be studied by the Ways and Means Committee, and it appears that an agreement is being reached between two committees about those provisions. As a result, it is possible that the Ways and Means Committee could approve the bill in the relatively near future. However, it is unlikely that the legislation will work its way through Congress in the near term, because the Senate has not begun its deliberations on similar legislative issues.

Accordingly, it is unlikely that we will have legislation in the near future. Therefore, the action over the next several months is focused primarily on the regulatory activities at the Department of Labor.

**R&R COMMENT:** *The investment advice provisions of H.R. 2989 – the Andrews' additions to the Miller bill – were much more restrictive than the regulation being developed by the Department of Labor. In addition, those restrictions would have applied to plan-level advice, as well as participant-level advice. With the agreement to remove those provisions from the Miller bill, the advisory community, and particularly the broker-dealer committee, can breathe a sigh of relief.*

*However, the removal of those provisions does not mean that they are dead. It is not uncommon for new and material changes to be developed over a period of time. It is possible that some version of those proposals could re-appear in legislation in the future.*

- **Target Date Funds.** Earlier this year, the Senate Special Committee on Aging, which is shared by Senator Kohl from Wisconsin, held hearings on target date funds. The hearings resulted from concerns by the Senator and others, about the substantial and dramatic losses incurred by target date funds in 2008. For example, the average 2010 fund—advertised as appropriate for someone within a year or two of retirement—lost approximately 25%. Senator Kohl felt that a loss of that magnitude shortly before retirement was shocking and unacceptable.

After the Committee hearings, the Senator wrote to the Secretary of Labor and the Chair of the Securities and Exchange Commission and asked that they investigate the matter. On June 18th, the SEC and the DOL held joint hearings. The fact of a joint hearing with the SEC and the DOL is remarkable in and of itself. The remarkable part is that the Department of Labor would be involved in hearings on the regulation of a type of mutual fund. However, the DOL is now in the position of being able to formally approve certain kinds of mutual funds through its power to write regulations about qualified default investment alternatives, or QDIAs, and the fiduciary safe harbor they provide for plans with defaulting participants. Because of the QDIA status, there is now more 401(k) money in target date funds than from any other source. In effect, they are an investment that is largely funded by 401(k) participants.

The DOL and SEC held joint hearings with numerous witnesses from all corners of the retirement and investment industries. The testimony can be found on both agency's websites.

At this point, the agencies seem to be expressing the greatest interest in:

- Whether the use of a year or date in the title of a target date fund is misleading, at least in some cases.
- Whether investors, such as 401(k) fiduciaries and participants, are being adequately warned about the risks involved in investing in target date funds.

- Whether providers and fiduciaries are giving adequate information to participants to understand the investments.
- Whether target date funds are being prudently selected and monitored by 401(k) fiduciaries.

The SEC is considering guidance for target date funds on labeling, marketing materials and communication about risks. The DOL is considering guidance that expands the communication requirements in the QDIA regulation, provides a checklist to plan sponsors for the selection of target date funds and also provides a checklist to participants for the use of such funds.

In addition, we have learned that Senator Kohl is considering legislation that would make the managers of target date funds and other qualified default investment alternatives fiduciaries under ERISA. This would be a major change in the law, since ERISA currently exempts mutual fund managers from fiduciary regulation under ERISA.

**R&R COMMENT:** *Regardless of whether the changes come in the form of regulatory action or legislation, it is likely that there will be a heightened level of governmental regulation of target date funds, especially as used in retirement plans and as QDIAs. If the Kohl approach is adopted, this will subject the fund managers to the fiduciary requirements of ERISA, which could have an impact on the investment options used in these types of funds, as well as the glidepaths in target date funds. Perhaps more importantly, this will subject the managers to the ERISA prohibited transaction rules, which could seriously impact how they structure their compensation arrangements. Finally, in conjunction with the new 408(b)(2) regulation, it will also impact the disclosures that the managers must make to plan fiduciaries.*

• **Department of Labor: Participant Disclosure Regulation.**

EBSA developed a regulation on enhanced participant disclosure for participant-directed plans in late 2008 and forwarded it to the OMB for approval. However, the OMB under the Bush Administration refused to approve the regulation. As with the participant investment advice regulation and the 408(b)(2) regulation, EBSA has decided to re-write the regulation from the perspective of the current administration. The Department is working on that project, but it is being given less priority than the investment advice regulation and the 408(b)(2) regulation. Nonetheless, we should see a new 404(a)(5) regulation on participant disclosures at some point later this year.

**R&R COMMENT:** *While many large plans and some providers for small plans are already giving participants the information they need, the new regulation will undoubtedly add requirements to what is currently being done. However, we suspect that, for those cases, the burden of compliance with the changes will primarily fall on providers (i.e., bundled providers and recordkeepers) to capture and report additional information to participants on their quarterly annual statements. One especially*

*difficult challenge will be to capture investment related information for products that do not have a prospectus (like mutual funds do). That would include, for example, collective trusts, separate accounts and the insurance company fixed income products. It remains to be seen how the regulation will address this issue.*

*However, for providers and/or plan sponsors who have provided only minimal information, the extra effort and expense could be substantial.*

*As this comment suggests, the burden of compliance will, for small- and mid-sized plans, fall primarily on the providers. For very large or mega plans, the plan sponsors often bear that responsibility.*

*Generally speaking, a better-educated and better-informed workforce will probably, over the long haul, produce the greatest sophisticated decisions by employees.*

*However, in the short run, these changes could be deceptive because employees will be provided with a greater volume of information, some of which they have not previously seen. For example, how will employees react to learning that they are paying for the investments and the operation of the plan? For a small plan, that could be 2% per year of their account. For a larger plan, that could be 1% per year of the account. Will some of the employees object to that?*

- **Department of Labor: Making 401(k) Money Last for a Lifetime.** In a recent speech, Secretary of Labor Hilda L. Solis stated:

“In the near future, we will be issuing a Request for Information, asking the stakeholders in the retirement plan community on how best to encourage employers to offer plan participants a lifetime income stream rather than just a lump sum distribution. Through this dialogue we also hope to educate participants on the value of selecting a lifetime income stream or annuity product when they retire, so that they will not outlive their retirement benefits. Our goal in issuing this RFI is to determine what steps the Department might take, by regulation or otherwise, to enhance participant’s retirement security by encouraging access to and use of lifetime income products. Please take this opportunity to weigh in once this RFI is issued — the people in this room have much expertise and creativity and this is your opportunity to help shape our future policies.”

On Monday, February 1, 2010, the DOL and Treasury Department jointly issued the request for information (RFI). The RFI notes that a principal objective of both the DOL and Treasury is providing retirement security for American workers. Although defined benefit pension plans provide such security, the number of workers covered by defined benefit plans has fallen significantly in the last three decades while the number of workers covered by defined contribution plans – in which the employee bears the investment risk – has risen dramatically. In response to this, the RFI states that “the

Agencies are considering whether it would be appropriate for them to take future steps to facilitate access to, and use of, lifetime income or other arrangements designed to provide a stream of income after retirement.”

Among the questions being asked are: the types of products available under both plans and IRAs; what impediments exist to plan sponsors offering these products in 401(k) plans; what education should be provided to participants regarding these arrangements; what disclosure obligations should be imposed on plans that offer these arrangements; and how should the qualified joint and survivor annuity rules apply to these arrangements? Comments must be submitted within 90 days after the RFI is published in the federal register.

***R&R COMMENT:** The 401(k) focus for the last decade has been on how to encourage and assist participants in accumulating retirement funds during their working years; and this remains an important issue. As the baby boom generation nears retirement, however, it has become apparent that they also need help in figuring out how to use their savings during their retirement years. In some cases, an individual (or his spouse) may spend almost as many years in retirement as the individual spent during his working years.*

*While annuity products have been around for a very long time, studies have shown that there is a marked reluctance on the part of most participants to select an annuity form of distribution. As a result, some providers are developing products that provide the guarantee of a life annuity but allow participants to continue to own their accounts in retirement (and, at death, in most cases, to leave the balance of their accounts to their families).*

*At the same time, there are a number of regulatory and practical issues that need to be addressed in providing this type of security to retirees. We welcome the attention the DOL and Treasury are bringing to this issue, and with the information they gather through the RFI, they will be able to provide practical and less burdensome regulations to plan sponsors, providers and participants.*

*We are working with several providers and organizations to respond to the RFI.*

This is just a partial list of the current regulatory and legislative initiatives in Washington, D.C., and it does not include information about the current state of legislation. 2010 promises to be an eventful year.

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