

A Little Help from My Friends--In the Government

by Fred Reish and Bruce Ashton

2006 promises to be an eventful year for 401(k) plans. Both Congress and the DOL are working on rules that will change the landscape for plan sponsors and participants. This bulletin highlights changes that are likely to occur in the next few months.

Investment Advice. Pension reform legislation has been passed by both houses of Congress. A Joint Conference Committee is working on resolving the differences in the competing bills. While both bills have provisions on investment advice for plan sponsors and participants, the approaches are dramatically different.

The House bill has a provision that would permit brokers, mutual fund companies and others to give fiduciary investment advice, even if there is a conflict of interest. A conflict would occur where, for example, a mutual fund company recommended that a plan or participants use mutual funds that it managed (and on which, therefore, it received a management fee as a result of the advice). Similarly, a broker could, under the proposal, recommend funds that paid the broker a higher commission. To protect plans and participants, the law would require up-front disclosure of fees and commissions. The objective of the House version is to get advice for as many plans and participants as possible, while recognizing that some harm may occur because of the conflicts. In effect, the belief is that the potential benefit is greater than the potential harm.

The Senate bill would not permit conflicts of interest, but instead would create a fiduciary safe harbor for plan sponsors who offer investment advice services to their participants, so long as the advisors had the proper licensing. Under the proposal, fiduciaries, like plan committees, could offer investment advice services to their participants with little, if any, fear of being sued for a failure to prudently select and

monitor the advisor. The rationale behind this provision is that many plans do not offer participant-level investment advice because of a fear that there could be liability for the plan fiduciaries if the advice results in losses. The Senate proposal assumes that the benefit of widespread non-conflicted advice will be greater than any losses resulting from possible inept advisors.

The outcome is unpredictable. These are among the most controversial provisions in the bills. And powerful legislators have entrenched positions on both sides of the issue. For example, Representative Boehner, the House majority leader, strongly supports the House bill, while Senators Grassley and Bingaman are backing the Senate version. In effect, the fight is between House Republicans and Senate Republicans, with the Democrats siding with the Senate bill. One potential compromise is that the final bill will combine the two approaches, permitting conflicted advice but requiring plans that elect to offer participant-level investment advice to make non-conflicted advice available as well.

Default Accounts. The bills in the Joint Conference Committee have provisions that would offer a fiduciary safe harbor to plans that use multi-asset class investment options for default accounts. (A "default account" is an investment specified in a plan or by the fiduciaries for situations where participants do not direct how their accounts should be invested.)

Anticipating the legislation, the DOL has already started work on drafting regulations defining which multi-asset class vehicles would satisfy the safe harbor requirements. Our best guess is that the list will include managed accounts, age- and risk-based lifestyle funds, age- and risk-based asset allocation models, and balanced funds.

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Interestingly, the legislation would not create a fiduciary safe harbor for the most common default investments. Those are money market accounts, stable value and company stock. In other words, employers would be taking a greater fiduciary risk if they use any of those alternatives as the default option, while they would be taking virtually no fiduciary risk if they used the multi-asset class investment vehicles.

The DOL has also indicated that, if Congress does not act this year, it will propose a regulatory safe harbor for defaults into multi-asset class investment vehicles.

As a word of advice, plans should now consider using multi-asset class investments as their defaults. In particular, for new plans or plans switching providers, the fiduciaries should seriously consider that option. Also, if a plan does not currently offer investment options that would qualify for the safe harbor, the fiduciaries should add one at this time.

Automatic Enrollment. The pension reform bills also include provisions authorizing automatic enrollment and preempting any conflicting state laws. As a result, state payroll withholding laws that require employee consent for the withholding of deferrals would be pre-empted by ERISA. That proposal is non-controversial and should be part of any pension legislation that is sent to the President to sign.

If it is enacted this year, as we expect it to be, the use of automatic enrollment should expand quickly. Based on studies of plans that have already adopted automatic enrollment, the average plan should see an increase in participation from about 70% of the eligible employees to about 90%.

At the current time, most employers who adopt automatic enrollment are using a 2% or 3% pay deferral rate for those employees.

Automatic Deferral Increases. The proposed legislation would also permit employers to automatically increase the rate of deferrals for the participants. For example, if the employees are enrolled at 3% of pay, the deferral rate might be increased 1% per year thereafter until a cap (e.g., 10% or 12%) is reached. Of course, the participants would have the right to elect out of the automatic increases at any time.

Based on research by Shlomo Benartzi of UCLA for T. Rowe Price, employees are equally receptive to 1% or 2% increases. As a result, some plan sponsors may elect the latter to help participants get to reasonable savings rates more quickly. Also, that research suggested that many participants would be amenable to a cap as high as 20%.

The rationale for automatic deferral increases includes:

- 1) Most employees don't realize how much they need to defer for retirement.
- 2) Many automatically enrolled employees may assume that their employer enrolled them at the rate appropriate for achieving adequate benefits.
- 3) Most employees do not change from the deferral rate established by the employer for automatic enrollment.

Disclosure of Compensation. The DOL is working on regulations that will require consultants and plan providers to disclose all fees, revenue and other payments charged or otherwise received. The disclosure would be required before completing a transaction. For example, a plan provider would need to disclose all direct compensation from the plan, as well as indirect payments like revenue sharing receipts. Likewise, broker-dealers, brokers and other sales agents would need to disclose all commissions and other payments received, directly or indirectly, from the investment of plan assets. This would include, for example, finder's fees, commissions, bonus payments, and other items of value.

These disclosures, and others likely to be required by the regulations, would give fiduciaries much greater transparency about the fees and expenses paid from their plan assets and about the true cost of each service and investment used by their plans.

In addition, the DOL is working on increasing the disclosure of fees and expenses on the Form 5500 and on increasing the cost provided to participants under 404(c).

2006 stacks up to be an interesting year . . . a year in which participation is increased and investing is improved . . . and a year in which the sun shines brighter--and more openly--on fees and expenses. ❖

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