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401(k) Provisions of Pension Protection Act of 2006

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This Bulletin gives you our overview of the 401(k) provisions of the Pension Protection Act of 2006 (PPA). We will be following up with detailed Bulletins on the provisions of the Act relating to:

- » Investment advice to participants
- » Automatic enrollment
- » 404(c) changes and safe harbor investments
- » Plans with company stock

While much of the publicity surrounding the new law deals with defined benefit pension plans, we believe that the most far-reaching provisions are for defined contribution plans and particularly for participant-directed defined contribution plans, such as 401(k)s, 403(b)s and 457(b)s. And, we believe that, by and large, the long-term effect of those changes will be highly favorable--when measured by the law's impact on participants' benefits. Unfortunately, though, some of the provisions of the new law were--at least at a detailed level--poorly conceived and badly drafted. Hopefully, those defects can be cleared up by technical corrections legislation or by Department of Labor (DOL) regulations.

This Bulletin gives you our thoughts on the most important provisions affecting 401(k) and other participant-directed plans. Then, we give examples of unresolved issues that arise as a result of some conceptual and drafting errors.

In terms of importance, we believe that, over the long term, the following changes are the most favorable:

Permanency of the EGTRRA provisions. The PPA made permanent the improvements enacted as a part of EGTRRA in 2001, but which were due to sunset after 2010. Those improvements include the increased limits on deferrals, the increase in the 415 limits, the removal of deferrals from the calculation of the maximum deductible amount, and the addition of a Roth feature for deferrals. While, all things considered, this is probably the most important change in the PPA, it almost seems like yesterday's news--since, for several years now, we have anticipated that the improvements would be made permanent.

Automatic enrollment. The PPA introduces two related concepts. The first is the preemption of state payroll withholding laws that interfere with automatic enrollment. The second is the creation of a safe harbor design in the Internal Revenue Code for automatically enrolled plans that satisfy certain requirements, including minimum amounts of matching or profit sharing contributions. Some reports on the law have discussed those two provisions as if they are one in the same. They are not. That is, an employer can sponsor an automatically enrolled plan that does not require any employer contributions or, alternatively, an employer can sponsor a safe harbor automatically enrolled plan. The difference is that the former must satisfy the ADP, ACP and top heavy requirements, while the latter is deemed to have satisfied those requirements.

However, there are some conceptual problems with the legislation, as well as poor drafting. Incidentally, we assume that some of the drafting mistakes were

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the result of last-minute changes to the legislation--and we mean "last minute." For example, the effective date for the preemption of state laws is the date of enactment (that is, the date on which President Bush signed the legislation, which was August 17, 2006). That sounds simple enough. However, one of the requirements for the automatic enrollment preemption is that the money be invested in one of the new 404(c) default safe harbor investments. However, the section of the law dealing with the default investments provides that it is not effective until the DOL issues a regulation defining the requirements for those investments, which it is not required to do for six months. So, is the preemption effective now, or is it when the DOL issues the regulation? It's not clear.

Also, the PPA does not address its impact if a plan sponsor is located in a state that does not impose limitations on automatic enrollment--and, therefore, the plan sponsor does not need the benefit of the preemption. Is that plan sponsor still required to invest the money as required by the 404(c) default regulation and to satisfy the other requirements for the preemption? What if the plan already automatically enrolls and is investing the defaults in a different way? Must the fiduciaries now transfer that money to the safe harbor defaults? It's not clear.

We will discuss these issues in more detail in our upcoming Bulletin on the automatic enrollment changes, together with some of the unresolved issues and practical considerations related to the legislation.

404(c) changes, including safe harbor defaults. The PPA made three changes to 404(c). The first, and most important, is that it directed the DOL to amend its 404(c) regulation to provide fiduciary protection for certain types of default investments. (A default occurs where a participant does not direct the investment of his account and where the plan--either in the document or through action by the fiduciaries--directs the investment of the participant's money.) Fiduciaries will be provided with protection under 404(c) for default investments if the investment option considers different asset classes to take into account risk and reward. As a practical matter, it is likely that the DOL's regulation will be worded generally, but will be consistent with age-based lifecycle funds, risk-based lifestyle funds, age- and risk-based asset allocation models, managed accounts, and most balanced funds.

Another 404(c) change is that, when a plan goes through a blackout to change providers or specific investments, the fiduciaries will not have 404(c) protection unless they satisfy ERISA's requirements for blackouts, including the Sarbanes-Oxley blackout notice requirements. Conversely, if the fiduciaries satisfy those notice requirements, and if the plan already satisfies 404(c), the fiduciaries will continue to be entitled to the 404(c) protections during the blackout period. The DOL is directed to provide guidance on fiduciary duties during blackouts.

The third change is that, if a plan maps the proceeds from a removed investment to a new investment with similar risk-and-return characteristics, and satisfies other specified requirements, then the plan will continue to be entitled to 404(c) protection for the new investments--even though the plan sponsor/fiduciaries made the decision to map into that new investment. Two caveats: the devil is in the details, that is, there are specific requirements that must be followed, including the fact that the participants must be given the opportunity to direct their investments before the mapping. And the plan must have been 404(c) compliant before the mapping occurred. We will be sending a detailed Bulletin on this subject, discussing the requirements, as well as our practical thoughts on complying with them.

Investment advice. The law creates a prohibited transaction exemption for investment advice given to participants. In that regard, the law creates two exceptions from the prohibited transaction rules. The first is for investment advisors who provide advice for a level fee; the second is for anyone who provides advice through the use of a computer model (which would include advisors whose compensation can be affected by the advice given, that is, by the commissions from the recommended investments). That doesn't seem particularly surprising . . . until you consider that providing investment advice for a level fee has never been a prohibited transaction (or, stated slightly differently, it has always had an exemption from the prohibited transaction rules). That raises the obvious question, if it already has an exemption, why does it need another exemption? Neither the law nor the committee report adequately explains that.

Assuming that this new exemption controls and that, therefore, level-compensation advisors are subject to these rules, they must now satisfy a fairly complex

set of requirements that they did not need to satisfy in the past. At least in theory, that would have the effect of hurting participants because of increased fees (due to increased compliance burdens)--which surely cannot be the intended purpose of the law. As an example of one of those requirements, level-fee advisors must now hire an independent auditor to annually audit their compliance with the requirements of the new law and to provide an annual report to the fiduciaries of the plans using their participant-level investment advice. (Before you think we got it wrong, there are two independent auditor requirements in the new statute. The first is for those who use the computer model; the second (that is, the one described above) applies to both types of advisors. We agree that it doesn't make sense for a level-fee advisor to be required to incur that additional effort and cost, but that is what the statute says.) Perhaps this conundrum can be explained. Our upcoming Bulletin will attempt to do that.

Additionally, the new provisions on investment advice apply only to advice given to participants. Therefore, there is no relief for advice given to plan fiduciaries on the selection and monitoring of the plan investment options. That is not a problem, in and of itself. However, it limits the benefit of the new law.

Those are just a few of the highlights, unresolved issues and surprises in the legislation. There are more. We will discuss some of them in our upcoming Bulletins. ❖

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