

Message From The Firm

The Pension Protection Act (PPA) is making its mark on the 401(k) community.

The use of automatic enrollment is expanding rapidly. Many of our plan sponsor clients, who are typically mid-sized corporations, either already automatically enroll or are planning on switching to automatic enrollment on January 1, 2008. We are also seeing more use of automatic enrollment by small plans, particularly between \$5 to \$10 million in assets. Frankly, I am surprised with how quickly automatic enrollment is being accepted. I now believe it is possible that, within the next five years, automatic enrollment will become the "regular" way to set up a 401(k) plan.

There also has been rapid acceptance of age-based lifecycle funds, risk-based lifestyle funds and managed accounts. While these vehicles were already gaining acceptance—because of concerns about participant investing abilities, the PPA safe harbor for default accounts seems to have accelerated their popularity.

So, we are witnessing a rapid improvement in 401(k) plans—at least in terms of participation and participant investing. The next step is to improve the information given to participants about the deferrals rates that are needed for benefit adequacy.

Of course, it is impossible to talk about 401(k) plans and fiduciary responsibility without also mentioning expenses and revenue sharing. In my opinion, indirect payments between plan providers—typically sourced in the investments—is the issue of 2007. The drip torture goes on and on . . . class action lawsuits, popular media attention, proposed DOL guidance, . . . In the end, though, participants will be the big winners if fiduciaries pay more attention to fees and expenses—and to the revenue sharing which they support. However, it is not an automatic answer to say that low

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Status of Default Investment Regulations

By Fred Reish (FredReish@Reish.com)



The Pension Protection Act (PPA) added a new section 404(c)(5) to ERISA. That section provides a fiduciary defense for default investments for participants in 401(k) plans and ERISA 403(b) plans. However, not every type of investment qualifies for the new fiduciary protection.

Before getting into the substance of this article, I need to clarify two things:

- 404(c)(5) fiduciary protection is, technically speaking, a defense; however, it is being referred to as a fiduciary safe harbor because of the protection it gives fiduciaries.
- A "default" investment is one where a participant is given the opportunity, but does not direct the investment of his account. Therefore, the fiduciaries, *i.e.*, the plan sponsor or the committee, must invest the money for the participant—either as they decide or as directed by the plan.

The PPA directed the U.S. Department of Labor (DOL) to issue a regulation defining the types of default investments that qualify for the fiduciary safe harbor by February 17th—a few months ago. The DOL issued a proposed regulation last year, but that proposal turned out to be highly controversial and the final

regulation has been delayed . . . perhaps until July or August.

Notwithstanding that delay, we have a high degree of confidence that certain investments will qualify for the fiduciary safe harbor. (By the way, those investments will be called qualified default investment alternatives, or QDIAs.) Because of our confidence that the three categories of investments specified in the proposed regulation will be included in the final regulation, we recommend that plan sponsors add at least one of those three types of investments to their plans at this time and that they consider one of them for the plan's default investment. Those three categories are:

- Age-based funds, which are commonly named after the anticipated year of retirement, like 2020 funds, 2025 funds, and so on.
- Risk-based lifestyle funds, including balanced funds.
- Managed accounts, where an investment manager agrees to act as a fiduciary to manage participant accounts.

There are two other categories of investments which are in "contention" to be included in the final regulation.

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Maintaining Confidentiality: Publicly-Traded Company Stock in 401(k) Plans



By *Stephanie Bennett* (StephanieBennett@Reish.com)

Most plan sponsors understand the benefit of complying with section 404(c) of ERISA—relief from liability for participant investment decisions. However, few plan sponsors comply with the requirements to obtain that relief.

For plans that offer publicly-traded company stock as an investment option, the regulations under 404(c) impose an additional requirement. That requirement is a confidentiality procedure for the information related to the purchase, sale and holding of company stock and the exercise of voting rights. Not only must the plan maintain a confidentiality procedure, but: (1) the procedure must be

communicated to participants; (2) the plan must designate a fiduciary responsible for ensuring that the procedures are followed; and (3) the fiduciary must ensure that the procedure is sufficient to safeguard the confidentiality of the information.

Over the years we have performed numerous 404(c) compliance reviews and provided expert testimony on 404(c) compliance in litigation matters, but have yet to encounter a plan that meets the confidentiality procedure requirements in the regulation. Oftentimes plans fail to even have a written confidentiality procedure. In the few cases we reviewed where the company had a confidentiality procedure, those companies failed to ensure that the information related

to the purchase, sale and holding of company stock and the exercise of voting rights is kept confidential. That is, those companies failed to follow their procedures. Failures ranged from providing company officers access to obtain reports that reveal participant company stock purchases and sales through the recordkeeping software, to failing to provide participants with information regarding the confidentiality procedures.

The protection offered by 404(c) is a great benefit to plan fiduciaries. However, satisfying the requirements for obtaining that protection requires documentary as well as operational compliance. That being said, if a plan offers company stock as an investment option it is not enough to have a confidentiality procedure—the company must implement the procedure to ensure that the information regarding participant company stock purchases and sales remains confidential. ❖

Fiduciary Responsibility for 401(k) Fees and Expenses

The costs charged to 401(k) plans and the indirect revenues received from plan providers have been the subject of a great deal of media attention, fiduciary litigation, and anticipated DOL guidance.

Because of that, fiduciaries are becoming increasingly more concerned about their responsibilities for understanding and evaluating costs and revenue sharing. This newsletter has several short articles on different aspects of that topic.

This article discusses the DOL's view of the responsibility of plan fiduciaries. In a 1979 advisory opinion, the DOL explained that its interpretation of ERISA was that plan sponsors, and their officers and committee members who serve as fiduciaries, must understand and evaluate the compensation paid to all providers to the plan, including compensation that was paid indirectly. (Indirect compensation will be discussed in another of the short articles in this newsletter.) Specifically, the DOL stated:

" . . . the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan

to [the provider] is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by [the provider] . . . The responsible Plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that [the provider] receives with respect to the Plan's investments . . . to make an informed decision whether [the provider's] compensation for services is no more than reasonable."

More recently, as a part of its proposed changes to the Form 5500, the DOL explained that, in its view, fiduciaries were required to monitor expenses at least annually:

"The Department believes that an annual review of such expenses is part of a plan fiduciary's on-going obligation to monitor service provider arrangements with the plan. . . ."

However, there is no explicit requirement in ERISA that fiduciaries review costs and revenue sharing on any specific time frame. Instead, the general requirement is that the plan operations be reviewed as frequently as is needed for the specific issue. In our view, expenses typically do

not change so quickly that they would all require an annual review. On the other hand, fiduciaries should make sure that the annual charges of any service provider do not exceed the amount in the contract with the provider.

Regardless of the frequency, a prudent review of costs and revenue sharing requires that information be gathered about all of the expenses charged to the plan and about all the compensation paid, directly or indirectly, to any service providers. Without gathering that information, the fiduciaries cannot properly review it and reach an informed and reasoned decision, as is required by ERISA.

Once gathered, the information should be reviewed by the fiduciaries should and compared to (i) the costs for similar services in the competitive marketplace and (ii) the value to the plan (that is, are the investments and services actually benefiting the participants and is that benefit worth the cost?).

The information reviewed by the committee, as well as any documentation related to the analysis, should be placed in a due diligence file and retained for at least six years.

Revenue Sharing and Indirect Payments



By Fred Reish (FredReish@Reish.com)

As discussed in other articles in this newsletter, revenue sharing and indirect payments are the subject of a great deal of controversy, litigation, and new DOL guidance on prohibited transactions and reporting and disclosure.

Unfortunately, these payments—typically from mutual funds and their investment managers to other providers, such as the recordkeeper and the adviser—are not well understood and, in fact, the terminology is, in and of itself, somewhat confusing. For example, the securities industry uses language such as 12b-1 fees, subtransfer agency fees, and shareholder servicing fees. The 401(k) community has come to refer to these payments as revenue sharing. The DOL calls them indirect payments. Plaintiffs' attorneys label them as "hidden fees." Fortunately, the issue is much more simple than the terminology. In the DOL's instructions for the Schedule C for the proposed 2009 changes to the 5500, it states that the following must be reported:

[M]oney or any other thing of value (for example, gifts, awards, trips) paid by the plan or received from an entity other than the plan or the plan sponsor by a person who is a service provider in connection with that person's position with the plan or services rendered to the plan.

If the proposal is finalized in its current form, plan sponsors will need to report all money and other things of value paid by one provider to another provider. Of course, it is contemplated that the providers will give the information to the employer so that the Schedule C can be properly completed. In fact, the proposed Schedule C asks that the plan sponsor report to the DOL all providers who did not supply the needed

information. (In explaining the proposed filing requirements, I have left out some of the details, such as minimum amounts. But those details are not necessary for the purposes of this column.)

Why does the DOL require that information be reported? There are two reasons. First, fiduciaries have a responsibility to know and evaluate the amounts they are paying for plan services, regardless of whether those payments are direct or indirect. Secondly, fiduciaries are required to be aware of, and take into consideration, any potential conflicts of interest, such as where a provider or adviser may be financially incentivized to make a recommendation that is not in the best interest of the plan or its participants.

While the DOL's general description of payments is broad—"money or any other thing of value," the 5500 proposal goes on to provide additional detail about the types of payments. The following examples are given:

[F]inder's fees, placement fees, commissions on investment products, transaction-based commissions, subtransfer agency fees, shareholder servicing fees, 12b-1 fees, soft-dollar payments, and float income.

However, those detailed examples are not limiting. The rule is that fiduciaries have to know about money or any other thing of value that is being paid indirectly to any plan provider or service provider—if a payment relates to the plan or to any plan transactions. ❖

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fees are good. In fact, the search for the 401(k) "Holy Grail" of expenses is to find the right balance between fees and value. If a plan can spend a little more money and significantly increase the quality of participant investing, the levels of deferrals, the participation rates, and the adequacy of the plan benefits, the money will have been well spent. That is value. However, value cannot be determined until there is transparency of costs and revenues, so that the fiduciaries can properly evaluate the amounts of money being paid, directly or indirectly, for each service.

Several of the articles in this newsletter focus on these topics. If you want to know more, make sure to read those articles.

-Fred Reish

Financial Advisors and ERISA Litigation

Two of the firm's benefits partners, Joe Faucher and Bruce Ashton, will be speaking at the CFDD's 2007 Advisor Conference on Monday, October 1st at 1:15 to 2:15 p.m. in Scottsdale. The title of their program is ERISA Litigation: What is the Nature of Recent Lawsuits, Who are the Named Defendants and What Safe Guards Minimize Your Exposure?

The description is:

Win or lose, litigation is expensive, time-consuming and emotionally draining. Class action lawyers are increasingly filing lawsuits against plan sponsors, fiduciaries and service providers. Financial consultants are also being targeted. This session will examine recent ERISA cases, including the class actions involving plan fees, expenses and claims that consultants are fiduciaries. Attendees will also learn if they are a potential target and what they can do to minimize risk.

The session will use real-life examples and will give practical pointers for avoiding problems. It will be a valuable program for advisers who are focusing on the 401(k) marketplace.

For more information, visit the CFDD's website at <http://www.401kduediligence.com/CFDDconference2007.asp>.

Domestic Partner Benefits



By Heather Bader-Abrigo (HeatherAbrigo@Reish.com)

We are seeing an increasing number of employers paying health insurance premiums for the domestic partners of employees. Before implementing this type of program, employers need to be aware of the tax consequences for the employees.

This issue was brought to us by one of our clients. The client pays health insurance premiums for its employees, their spouses, their dependents, and domestic partners. Our client wanted to know if the payment of premiums for a domestic partner would be taxed to the employee for federal income tax purposes.

First and foremost, the value of employer provided health insurance for employees, employee's spouses, and dependents is excluded from the employee's gross income under §106 of the Internal Revenue Code. A domestic partner is not considered a "spouse" as a result of The Defense of Marriage Act. The Defense of Marriage Act defines spouse as "only to a person of the opposite sex who is a husband or wife."

In order for the premiums for domestic partners to be excluded from the employee's gross income, the domestic partners must satisfy the definition of a "dependent" under Code §152. Section 152 defines a dependent as a "qualifying child" or a "qualifying relative."

A "qualifying child" is (1) a child, descendant of the child, brother, sister, stepbrother or stepsister or descendant; (2) who has the same principal place of residence for more than one-half of the taxable year; (3) who is not over 19 (or 24 for students) by the end of the calendar year; and (4) the qualifying child has not provided over one-half of his or her

support for the calendar year. A domestic partner would not satisfy the definition of a "qualifying child."

Therefore, a domestic partner must fall within the definition of a "qualifying relative." A "qualifying relative" is an individual who (1) has a relationship with the taxpayer that is not void by local law; (2) whose income must be less than the exemption amount as defined in Code §151(d) (which is currently \$2,000); (3) who is a family member or has the same residence as the employee; and (4) who receives at least one-half of his or her support from the employee. The problem with satisfying the definition of "qualifying relative" is not the income restrictions placed upon the domestic partner, but the first requirement: whether the relationship of the taxpayer is illegal under local law. However, in 2003, the U.S. Supreme Court struck down state criminal laws regarding private consensual sexual activity. This calls into question whether the first requirement is enforceable.

We advised our client that, if they decide to pay the premiums for domestic partners, they have two options. The first option is to pay the premiums for the domestic partner and to include the fair market value of the coverage in the employee's taxable income. The second is to pay the premiums for the domestic partner, but not include the fair market value of coverage in the employee's income. In that case, the employer should obtain affidavits or certifications from the employee regarding the dependency status of the domestic partners.

Note: Employers should also consider the impact of state income tax laws. We have researched the tax laws of various states and found that they vary significantly. ❖

DOL Penalties and Blackout Notices

Several years ago, as a part of the Sarbanes-Oxley legislation Congress amended ERISA to require notices for blackout periods. The notice must be given at least 30 days before the last day on which a participant can make changes (which is the practical equivalent of saying at least 31 days before the blackout begins). For this purpose, a "blackout" is a period of more than three consecutive business days in which a participant cannot exercise certain rights relative to a plan, for example, the right to change the investments in his account. (As a cautionary note, the rules are more detailed than described.)

Most often, a blackout occurs when a plan sponsor switches providers, which is called a "conversion." A blackout can also occur when the fiduciaries remove and replace an investment.

If the notice is not properly given, the Department of Labor can impose substantial penalties. But, the DOL has discretion to reduce those penalties.

For the first few years, we did not hear of any cases where the DOL imposed penalties on failed or late blackout notices. However, more recently the DOL has been imposing penalties. Those penalties are at a significantly discounted rate, but the amounts are still punitive. For example, if a plan covers 100 employees and the notice is five days late, the DOL could impose a reduced penalty of \$10 per day, times the number of employees. That would amount to a \$5,000 penalty.

However, the DOL will often start with a higher proposed penalty and a reduction would need to be negotiated based on the facts and circumstances of the case. In that regard, we are beginning to see some patterns in the amounts assessed after serious and thoughtful negotiations. As a result, it is important that plan sponsors be represented by experienced ERISA counsel in the discussions with the DOL.

Litigation About 401(k) Fees



By Fred Reish (FredReish@Reish.com)

By now, most plan sponsors and advisers are aware of the class action litigation against major American corporations and their providers concerning 401(k) costs and revenue sharing. However, less is known about the specific allegations in those lawsuits. This article quotes selected provisions from one of the complaints. The reference to “defendants” is to the plan sponsor, the committee members and, in some cases, the provider.

“Defendants breached their fiduciary obligations to the Plan . . . by, among other conduct to be proven at trial, one or more of the following acts:

- *Allowing or causing the Plan to pay—directly or indirectly—fees and expenses that were . . . unreasonable . . .;*
- *Failing to inform themselves of, and understand, the various methods by which vendors in the 401(k) industry collect payments and other revenues from 401(k) plans;*
- *Failing to establish, implement, and follow procedures to properly and prudently determine whether the fees and expenses paid by the Plan were reasonable and incurred solely for the benefit of Plan participants; . . .”*

What can plan sponsors and committee members do to avoid being caught up in this type of litigation? They can engage in a prudent process in the selection of their providers and in monitoring those providers and their costs and revenue sharing. Plan sponsors and fiduciaries can make that process much easier if they work with providers and advisers who willingly give them the information

needed to perform their fiduciary tasks. Those points are driven home by a report from the ERISA Advisory Council.

“The Advisory Council makes the following recommendations in an effort to further educate plan sponsors and fiduciaries:

- *Plan sponsors should avoid entering into transactions with vendors who refuse to disclose the amount and sources of all fees and compensation received in connection with plan.*
- *Plan sponsors should obtain all information on fees and expenses as well as revenue sharing arrangements with each investment option.*
- *Plan sponsors should also determine the availability of other mutual funds or share classes within a mutual fund with lower revenue sharing arrangements prior to selecting an investment option.*
- *Plan sponsors would require vendors to provide annual written statements with respect to all compensation, both direct and indirect, received by the provider in connection with its services to the plan.*
- *Plan sponsors need to be aware that with asset-based fees, fees can grow just as the size of the asset pool grows, regardless of whether any additional service are provided by the vendor, and as a result, asset-based fees should be monitored periodically.*
- *Plan sponsors should calculate the total plan costs annually.”*

In a nutshell, the key steps are to:

- Work with advisers and providers to get full information about plan costs and revenue sharing.

- Regularly review and evaluate that information and compare it to competitive costs and the value received by the plan and its participants.
- Reach a reasoned and informed decision and place the appropriate documentation in the plan’s due diligence file. ❖

Senate Finance Committee

Bruce Ashton, Nick White and Fred Reish, as a part of a small group, met Senator Max Baucus, the Chairman of the Senate Finance Committee. In that role, Senator Baucus is one of the most important political figures in America, because all tax law changes and, therefore, tax policy, are within the jurisdiction of the Finance Committee.

The meeting gave to Fred, Nick and Bruce the opportunity to give input to the Senator concerning retirement plan and health care issues.

Senator Baucus listed a number of important priorities from his perspective, including American competitiveness, education, energy dependence, and health care.

All in all, it appears that there will be little legislative activity in 2007 on retirement issues, with the possible exceptions of a technical corrections bill for the Pension Protection Act and the development of a universal IRA deferral program for employers who do not sponsor qualified plans. The latter would apply to all but the smallest employers. However, it appears that there would not be a mandated employer contribution. Instead, it would simply facilitate employee savings through payroll withholding.

On the other hand, 2007 could be the beginning of a significant investigation of universal health care. But, 2007 is likely to be just the beginning, with the outcome not being determined until after the 2008 Presidential elections.

Summary of Testimony of Fred Reish in the Report of the Working Group on Prudent Investment Process of the DOL Advisory Council

The DOL Advisory Council recently released its Report on Prudent Investment Process. That report included a summary of testimony given by Fred Reish. That summary follows:

Mr. Reish is a practicing lawyer specializing in employee benefits and tax matters. He has over thirty years of experience counseling clients in his area of expertise. He possesses extensive experience in all areas of Sec. 404(c) and his comments were limited to this portion of the Working Group's charge.

Mr. Reish provided an overview at the beginning of his testimony. He stated that Sec. 404(c) has at its core, the paramount objective of informing participants to properly balance their tolerance for risk and their need for investment returns. He stated that before there was a 404(c) this very concept was actually based on ERISA's adoption of Modern Portfolio Theory ("MPT") and other generally accepted investment theories. However, Mr. Reish testified, it is now obvious to the most casual observer that most participants lack the knowledge to develop appropriate portfolios.

Mr. Reish testified that the benefits of Sec. 404(c) are significant and he supplied footnoted data that shows that many employers do not fully comprehend the statute. He testified that in his experience the most common failures to comply with Sec. 404(c) can be grouped under five different categories. First, the prospectus delivery requirement is either misunderstood or executed improperly. Second, failure to notify the participant of the identity of the 404(c) fiduciary. Third, participant information notification is either misunderstood or executed improperly. Fourth, plans often fail to notify the participants that the plan even intends to comply with 404(c). Finally, Mr. Reish testified that the confidentiality procedures for pass-through voting of company stock are often not developed and communicated. These five areas notwithstanding, Mr.

Reish stated that the good news is that for the most part, plan sponsors and providers are furnishing participants with the balance of the information required in the statute.

Mr. Reish recommended that the 404(c) regulation be improved by the following:

- *Addition of a participant education element;*
- *Clarification on what information must be furnished to participants;*
- *Elimination of the prospectus delivery requirement;*
- *Disclosure of all expenses, revenue and conflicts of interest;*
- *Addition of disclosures regarding company stock;*
- *Notifications that the summary plan description transfers liability;*
- *Representation in the SPD concerning fiduciary liability and participant responsibilities;*
- *Facilitation of use of default investments;*
- *Clarifications of responsibilities concerning brokerage accounts;*
- *Modification of definition of "broad range;"*
- *Facilitation of electronic delivery*

With regard to investment education, Mr. Reish stated that for the vast majority of the plans in existence, basic investment education is already offered to participants. To the extent that additional investment education is codified, the burden and expense of providing that education would most likely be absorbed by vendors rather than plan sponsors.

Mr. Reish also feels that clarification on what information must be furnished to participants is required. The main focus of his argument is that 404(c) notice requirements are best understood

when they are realized in light of mutual funds and similar investment vehicles. He claims that a weakness in the regulation is revealed when one applies the regulation to illiquid or non-diversified or non-publicly traded investments. According to Mr. Reish, 404(c) appears to place the greatest disclosure requirements on diversified mutual funds which may be the easiest of the different types of investments to evaluate. In his opinion, the disclosure requirements should be just the opposite, that is to say, the greatest disclosure burden should attach to the investments that are most risky and that are the most difficult to evaluate.

He testified that the SPD is the most effective instrument for informing the participants that the plan intends to satisfy the 404(c) conditions and to obtain the relief provided by the statute. In essence the SPD is the perfect disclosure to inform participants that the fiduciaries are relieved of any losses which are a direct and necessary result of investment instructions and directions by participants and beneficiaries. Mr. Reish believes that it is the one document that is almost certainly provided to all participants and that there is little risk that the information will be mislaid or not delivered. Likewise Mr. Reish testified that the SPD should be the document to disclose the representation concerning fiduciary responsibility and participant responsibilities. In his opinion, the participants should be aware of the ongoing duties of fiduciaries of 404(c) plans as well as their own duties with respect to the plan. Mr. Reish testified that the SPD would heighten the awareness of the duties of fiduciaries to prudently select and monitor the investment choices offered by the plan and for participants to combine prudently selected funds in a manner which develop portfolios in their accounts that properly balance risk and reward.

In addition to his verbal testimony, Fred submitted a set of written recommendations which he and Stephanie Bennett prepared. Those written comments can be found at www.reish.com/publications/pdf/testimony.pdf. ❖

Default Investment

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Those are:

- Asset allocation models (without the requirement that they be managed by a fiduciary); and
- Stable value vehicles.

My educated guess is that the former—the asset allocation models—will be included, but that the latter—stable value—will only be allowed in a limited way, if at all. The stable value option will likely be limited or excluded because the legislative and regulatory history of ERISA says that the law's

investment principles are based on generally accepted investment theories, such as modern portfolio theory, which requires a mixture of asset classes to balance risk and return. In addition, there is a concern among investment advisers that, without some exposure to equities, participants will have little, if any, chance of achieving their retirement goals.

Of course, those are just my best guesses. In truth, the matter is uncertain.

The outcome of the fight to be included on the list is one of great importance. Most likely, the types of investments described in the final regulation will become popularly viewed as pre-approved investments—something equivalent to

a governmental seal of approval. If that perception prevails, those investments are destined to capture a disproportionate share of 401(k) money. That is the case because, among other things, automatic enrolment is rapidly becoming popular and, in automatic plans, 50% to 80% of the participants may default into QDIAs.

Even though there is a delay in the issuance of the final regulation, there is no need for plan sponsors to wait. We are confident that the three non-controversial categories—age-based funds, risk-based funds, and managed accounts—are virtually certain to be included in the “pre-approved” category. ❖

Around the Firm

Speeches: Nick White presented “The New EPCRS Under Rev. Proc. 2006-27” at the ASPPA Benefits Council of North Florida seminar on May 14. Bruce Ashton presented “Pension Protection Act: DOL Interpretations of Participant Investment Advice Rules” at a teleweb seminar for the International Foundation of Employee Benefit Plan on May 10. He also presented the “Latest Developments in Participant Education” at the Los Angeles Chapter of WP&BC Spring Seminar. Fred Reish was a panelist at the National Retirement Partners Conference on the topic “Retirement Investment Experts” on May 4. He also spoke about “Participant-Directed Plans: Where Are we Going? How Are we to Get There” at the 36th Annual Pension Trust & Employee Benefits Seminar, sponsored by the University of South Carolina on April 26, and about “Fees, Expenses & Revenue Sharing Under the Microscope” at the Elite Advisor Summit on April 13. Nick presented “The Pension Protection Act: Emphasis On 401(k) Provisions” at the International Society of Certified Employee Benefits Specialists (ISCEBS) seminar on April 26.

Quotes: Debra Davis was quoted in the article “Rules Likely to Give Roth 401(k) Plans a Boost” published in the May 5 issue of the Wall Street Journal Online. She was also quoted in the article “Getting Personal: New Rules Are Boon for Roth 401(k) Plans” published in the May 2 issue of the Dow Jones Newswires.

Articles: Fred's column in the May issue of Plan Sponsor magazine addressed the topic “Fees Ability: How to Look at Fees and Expenses.” Bruce wrote an article on “Terms for Resolving 412(i) Audits;” Fred, Bruce and Stephanie Bennett co-wrote the article “The Duty to Remove Investments” that was published in the Spring issue of Journal of Pension Benefits. Debra's column in the Journal addressed “Automatic Enrollment of Undocumented Workers in Retirement Plans.”

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Just out of Reish



Statistics of Success

WHAT ARE THE statistics of success for your 401(k) plan? More specifically, what is the statistic of success for your 401(k) plan? I ask that question because there is only one true measure of the success of a 401(k) plan: whether your plan is providing adequate retirement benefits for your participants. While there is no uniform definition for the adequacy of benefits, a good one, which was used by the Vanguard group in a published study, is a replacement ratio (including Social Security) of 75% of a participant's final pay. While "broad-based" is not defined in the law, I suggest that, in order for a plan to be viewed as successful, at least two-thirds of the eligible employees should be on target for an income replacement ratio of at least 75%. If we use 66.67% as the benchmark for broad-based success, then, as a practical matter, a plan might need to have an 85% participation rate.

Since it may be hard to get the most important statistic of success—the income replacement ratio—I suggest that you start by asking for data about the three "pillars" of a successful plan. Those pillars of success are: (i) participation levels, (ii) deferral rates, and (iii) the quality of participant investing.

Of course, participation levels are critical. Unless an employee is making deferrals, there is virtually no chance of accumulating adequate benefits. Once an employee is participating in the plan, the critical question is whether the employee deferrals, plus the employer contributions, will be enough to fund an adequate retirement benefit. A rough rule-of-thumb used by some in the industry is that the employee deferrals and company contributions should be at least 15% of pay per year. The least important of the three, but still very important, is the quality of the participant investing—that is, how the employees use the investments. Based on a study by Putnam, the amounts of

deferrals are more important for producing benefits than is the quality of investing, but the quality of investing is more important than the quality of the investments provided by the employer. As an aside, it is interesting that most of the fear of fiduciary liability centers on the selection and monitoring of investments, when those activities are less important than participation, deferrals, and investing.

What kind of provider and adviser should you align your plan with?

Once the plan sponsors and fiduciaries have determined the statistics for their plan, they should ask their advisers or consultants for information on national averages in each of those categories or, better yet, averages based on comparable companies with similar plans.

Then, the plan sponsors and fiduciaries should ask their advisers and providers

for their personal statistics. Based on my experience and on data that I have reviewed, the average rates of participation for providers may vary by as much as 33.3%; that is, some providers may have average participation rates for all the plans they recordkeep in the low 60% range, while others may be in the low to mid-80% range. Even more pronounced differences can be found in terms of the quality of participant investing, with those providers that are committed to improving participant investing producing numbers as high as 70% or more of the monthly cash flow going into the investment solutions I mentioned above. Other providers have 20% or less of their inflows going into those solutions. Finally, I suspect that, when the data become available, we may find that the average deferral rates for providers, calculated systemwide, may vary from as low as 4% to as high as 8% or 9%.

What kind of provider and adviser should you align your plan with? One that has average statistics of 60% participation, 4% deferral rates, and 20% quality investing, or one that has an average participation rate of 80%, deferral rates of 8%, and quality investing at 70%?

It is a general premise of business management that, if something is important, a business will measure it. Stated inversely, if an activity is not measured, then the business probably doesn't think it's important. Elevate the importance of the success of your plan by measuring benefits, participation, deferrals, and investing.

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