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REPORT TO PLAN SPONSORS

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Message From The Firm

Last summer, we were hired as special fiduciary counsel for the San Diego City Employees' Retirement System (SDCERS). You have probably read about the SDCERS travails in the newspaper and in benefits publications. It could be the most publicized defined benefit plan in the country.

We were hired for the purpose of assisting the Board of Administration of SDCERS in complying with their fiduciary duties and for reviewing the conduct of their predecessors (with an eye to identifying and correcting any fiduciaries breaches).

For those of you not familiar with public retirement plans, the Board of Administration is similar to a Taft-Hartley Board for a multi-employer plan; for a traditional private sector plan, it might best be described as a combination of the committee and the trustee.

At the end of January, our report was completed and filed with the Board and is now posted on the SDCERS website at http://www.sdcers.org/images/pdf/sdcers_investigative_report_full.pdf. The factual investigation was done by Navigant Consulting, Inc. and we did the legal analysis and conclusions section.

As you can see from the report, we concluded that prior Boards of Administration, as fiduciaries, breached their duties under California state law which, in many ways, is similar to ERISA. While there were a number of reasons for the breaches, it was

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To Roth or Not to Roth



By Fred Reish (FredReish@Reish.com)

On January 1, 401(k) and 403(b) plans could allow their participants to make deferrals on a Roth basis. That means that, if the plan permitted, participants could make their deferrals on an after-tax basis, rather than before-tax.

At first blush, you might ask why anyone would want to pay taxes on their deferrals to a 401(k) or 403(b) plan. However, the law provides substantial advantages--to the right people--if they make Roth deferrals. Those substantial advantages are primarily that, when the accounts are ultimately distributed, both the principal and the earnings will be tax free to the participants.

Interestingly, if a participant is in the same tax bracket at retirement as he is today, Roth and regular deferrals produce exactly the same result. On the other hand, if you believe that tax rates are going to increase in the future and/or that you will be in a higher income tax bracket at retirement, then Roth deferrals make a lot of sense.

Also, if a participant already has a large traditional 401(k) account, it could make sense to contribute on a Roth basis in the future, in order to "hedge" your bet on future tax rates and to have the flex-

ibility to make taxable and non-taxable distributions in retirement, based on tax considerations.

Finally, if the Roth 401(k) account is rolled over into a Roth IRA, the minimum required distribution rules would not apply, that is, participants would not have to start taking distributions at 70½. That provides flexibility for estate planning and financial planning.

With that in mind, which employers should seriously consider offering a Roth feature?

First and foremost, organizations with a large number of highly paid people should almost certainly allow for Roth deferrals. That would include investment management firms, medical groups, accounting firms, law firms, consulting groups, some technology businesses, and so on. And, that is doubly true for organizations that have high-paid younger employees.

It should also be considered for organizations with financially astute employees. That could include, for example, financial services companies, brokerage firms, banks, pension administration and actuarial firms, insurance organizations, and

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Mergers and Acquisitions



By Marty Heming (MartyHeming@Reish.com)

In our experience, small and midsized employers, when contemplating the sale of their business or the purchase of another, often either ignore the employee benefits issues or regard them as something to be dealt with after the fact. For both practical and legal reasons, the issues related to retirement plans need to be resolved before the terms of the agreement are finalized. This is because, in many cases, one or more of the plans have problems which, if not resolved, will carry over to the new entity after the closing of the merger or acquisition.

The following is an example of a case which, if it had not been handled timely, could have adversely affected the deal. In this case, Company A was selling its assets to Company B and most of A's employees were going to be hired by B after the sale. Unbeknownst to A, its 401(k) plan had for many years failed to

include part time employees in violation of the terms of the plan. This defect was discovered in the course of the due diligence process. Unfortunately, A had not been aware that the plan provided that all employees, regardless of the number of hours worked, were permitted to make deferrals to the 401(k) plan. This failure to operate the plan in accordance with its terms subjected it to potential disqualification by the IRS. Company B also had a 401(k) plan. However, its plan had no defects. Initially the deal was structured so as to merge the seller's plan into the buyer's plan after the sale of the assets was completed, leaving the buyer's plan as the survivor. If this had occurred, the defect would have tainted B's plan, subjecting it to potential disqualification.

In order to permit the merger of the plans of Company A and B, the defective plan was submitted to the IRS under the Voluntary Correction Program ("VCP"). VCP allows a plan to be re-qualified

retroactively by making corrective payments to the plan and paying the IRS a compliance fee. The correction was to have Company A contribute to the Plan on behalf of the employees who were initially not included an amount equal to ½ of the average deferred by those who had actually participated. In addition, the 401(k) plan non-discrimination test which regulates the ratio between what the highly compensated and the non-highly compensated are permitted to defer needed to be re-calculated by including the part-time employees. During the process of obtaining the VCP, A's former employees were able to direct the investments of their money in the frozen plan while deferring new money into B's plan.

Fortunately, the problem with Company A's plan was discovered before the deal was closed and, thus, before the plans were merged. The morale to this story is that, before any acquisition or merger is finalized it is important to do due diligence on the plans and, if any issues arise, ERISA counsel should be consulted so that action can be taken to resolve problems in a timely manner. ❖

Message from the Firm

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apparent to us that a significant contributor to the problems was a lack of understanding by the prior Board members of their fiduciary responsibilities. And, we see the same issue with private sector plans. I believe that the only correction for that problem is fiduciary training. It is difficult to make good decisions if you are operating in the wrong context.

My purpose in mentioning this work is not to belabor the past, but instead to give you the benefit of our observations of the work of the current Board of Administration. To their credit, they insisted on an investigation of past acts and they understood their respon-

sibility to clean up any remaining problems. If that does not impress you, you should know that the Board members are either appointed by the City or elected by the employees and serve without pay. They do the work because of their commitment to quality retirement plans and to delivering benefits to retired and disabled employees and their beneficiaries.

I attended Board meetings where cameras from all the local television stations were present. If that isn't daunting, imagine that your committee meetings were telecast on the 6:00 p.m. news.

With that, I have finally gotten to the point of this introduction. If I, as an experienced benefits attorney, can give you one word of advice, it is that you should imagine that your

committee meetings will be broadcast on television. If your work was that open and visible, and if you did work that, upon seeing it on television that night, you were proud of what you had accomplished, then you almost certainly would have fulfilled your fiduciary responsibilities. So, if I can encourage you to keep one image in mind, that would be to imagine yourself as a member of the SDCERS Board of Administration, with the cameras rolling in the background.

Of course, as I said earlier, you have to have the right context. It is difficult to make prudent decisions if you don't understand the rules and the objectives of the game.

-Fred Reish

Timely Deposit of 401(k) Deferrals—Still No Safe-Harbor



By Nick Waddles (NickWaddles@Reish.com)

The timely remittance of employee deferrals into 401(k) plans continues to be a top enforcement priority for the Department of Labor (“DOL”). In fact, at the recently concluded Los Angeles Benefits Conference, the DOL announced that it is currently considering adopting a “safe-harbor” for the timely remittance of employee deferrals to 401(k) plans. As we understand it, the safe-harbor would provide that as long as deferrals were remitted within the number of days identified in the safe-harbor, the employer would be deemed to have complied with the relevant regulations.

The announcement should come as welcome news to those in the benefits community who have been looking for a “bright-line” test for determining when employee deferrals must be remitted to a 401(k) plan. The current regulations require that such deferrals be remitted as of the earliest date they may reasonably be segregated from the plan sponsor’s general assets. For many years there was a misunderstanding in the benefits community that employers could wait until the 15th business day of the following month to remit deferrals. However, the regulations are clear that employers must remit the deferrals as soon as reasonably possible, which is almost always long before the outer limit of the 15th business day of the following month.

To Roth or Not

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so on. The analysis required to make an intelligent decision about Roth deferrals is somewhat complicated. Employees at those types of organizations will probably be better suited to make good decisions.

The moral to this story is that Roth can be very valuable to some people, but much less so to others. In fact, in some plans (for example, plans with low average account balances), it offers little value, but substantial complexity.

However, where it fits, it can fit exceptionally well. Plan sponsors should look at their workforce and their plan, and evaluate the Roth opportunity in that context. ❖

Obviously, the adoption of a safe-harbor will provide plan sponsors with great certainty about the minimum number of days in which deferrals must be remitted. However, the official who made the announcement stated that the fact the DOL is considering adopting a safe-harbor is proof that no such rule currently exists. Thus, until we hear further from the DOL on this issue, the “as soon as possible” rule still applies.

NOTE: This rule also applies to deposit of the repayments of participants loans and to deferrals to private sector 403(b) plans that are subject to ERISA (for example, where the plan includes employer contributions, as well as the employee deferrals). ❖

2006 Lifetime Achievement Award

Institutional Investor has just named Fred Reish as the recipient of its 2006 Lifetime Achievement Award for his contributions to the retirement plan industry. In describing his contributions, Institutional Investor, through its publication “Defined Contribution & Savings Plan Alert” said:

Reish, a partner at Los Angeles-based Reish Luftman Reicher & Cohen, has become an icon among private-sector pension specialists and government officials seeking to hammer out fiduciary guidelines for the defined contribution industry. Through his efforts as a prolific writer, public speaker and participant in industry focus groups, Reish has emerged as one of the top national experts on the Employee Retirement Income Security Act and has been tapped repeatedly by government sources for guidance in drafting new fiduciary guidelines.

We are proud of our firm’s contributions to the retirement industry, and particularly to developing voluntary correction programs with both the IRS and the DOL and to the promotion of best fiduciary practices for 401(k), 457(b) and 403(b) plans.

For more information, please visit their website at <http://www.definedsavings-alert.com/>

**Institutional
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Redemption Fees



By Fred Reish (FredReish@Reish.com)

The mutual fund scandals have imposed another burden on plan sponsors and fiduciaries--as well as the advisors who serve 401(k) plans.

Let me explain. Because of those scandals, mutual funds have begun imposing redemption fees on short-term trades by 401(k) participants. Or, if the mutual funds already had redemption fees in place, they have begun enforcing those fees through the 401(k) recordkeepers.

As a matter of background, I should explain that redemption fees are assessed against participant trades if those trades are within a limited time period. For example, a mutual fund might provide that, if a participant buys and sells his shares within 30 days, the participant would pay a 1% redemption fee on the amount of the sale. The redemption fee would be kept by the mutual fund, as opposed to being paid to the mutual fund manager. In effect, the purpose of the redemption fee is to compensate the remaining shareholders for costs attributable to the expenses of transactions or to the disruption of the investment strategy of the fund.

Redemption fees have become popular with mutual fund companies. As a result, many--perhaps most--401(k) plans now hold mutual funds that impose those fees--or will, in the near future.

In and of itself, the imposition of redemption fees is not a significant problem. On the one hand, they may result in charges to innocent participants who inadvertently make trades within the time limits. On the other, they may benefit participants who have a buy-and-hold approach.

However, this change does present communication problems. Under the prudent

man rule, it appears that fiduciaries must do a prudent job of communicating these changes to participants, so that the participants do not inadvertently incur the charges. And, in order to obtain 404(c) protections, fiduciaries are obligated to provide adequate information about redemptions fees to participants.

Unfortunately, 401(k) providers have not done a particularly good job of communicating directly with the participants about these issues. Instead, most of the communication seems to be with the plan sponsor--apparently thinking that the plan sponsor will communicate with the employees.

However, these rules are detailed and complicated and should be communicated to participants by the recordkeeper or by the mutual funds (e.g., if a plan has 15 mutual funds that impose redemption fees, the requirements-- the time period or the amount of the redemption fee-- could be different for each fund--creating a complicated jungle of rules).

Fiduciaries should determine whether any of the mutual funds in their plans are imposing redemption fees and, if so, the fiduciaries should consider:

1. Removing that fund from the plan--to avoid administrative complexity; or
2. Assigning the job of communicating the redemption fees to the participants. That job could be given to one of the service providers or an advisor, if they will accept the responsibility.

This is a developing story. We will have additional comments about it in the future. ❖

Fees and Expenses

By Fred Reish

The U.S. Department of Labor (DOL) is working on a regulation which would provide greater disclosure of fees and expenses to plan sponsors and fiduciaries. The reasons for the DOL interest are obvious. Plan costs can significantly reduce the benefits of participants and there is a concern that many plan sponsors and fiduciaries are not doing an adequate job of investigating the expenses--and particularly the so-called "hidden costs"--being charged by plan providers, investment managers, consultants and advisors.

Those fees and expenses can include both direct and indirect costs, as well as revenue sharing among the parties serving the plan. For example, it is common for mutual funds to pay 12b-1 and subtransfer agency fees to administrators, recordkeepers and brokers who service most small 401(k) plans and many mid-sized plans.

Notwithstanding the old saying that "ignorance is bliss," in these circumstances ignorance is usually a job poorly done and an invitation to a lawsuit or DOL investigation.

While the DOL has made only general comments about the regulatory project, it appears that the Department will bring transparency to the equation by requiring full disclosure of all compensation, direct or indirect, to brokers and investment consultants, as well as disclosures about expenses, revenue sharing, and other financial benefits for plan providers, such as recordkeepers and administrators. It is likely that the disclosure will need to be made at or before the point of sale, so that the information would be available to fiduciaries when they make the critical decisions.

From the perspective of the 401(k) industry, this will require a significant effort to upgrade their systems to provide the needed information. On the other hand, for plan sponsors, it will be a welcome improvement in the transparency of information that is necessary to make decisions for the benefit of the participants.

All in all, it could be a significant step for improving the quality of small- and mid-sized plans.

Advantages of Voluntary Compliance Programs in Merger and Acquisition



By Nick Waddles (NickWaddles@Reish.com)

Many companies we represent acquire other entities — and some do it on a regular basis. In these cases, there are always employee benefit and retirement plan issues to consider. The failure to identify an employee benefit issue early can make complicated transactions more complicated. The following is a story about how a minor retirement plan document provision complicated a series of acquisitions by one of our clients.

In the early 2000's our client acquired a number of entities within its industry. Prior to the acquisitions, each of the entities sponsored its own 401(k) plan. As it acquired each new entity, our client restated the acquired company's 401(k) plan onto the same prototype plan document of a well-known recordkeeper. The recordkeeper's document contained the typical boilerplate controlled group lan-

guage that required coverage and participation for all eligible employees of all controlled group members, unless those members were specifically excluded in the adoption agreement. Unfortunately, as each entity was acquired and its plan restated, the other controlled group members were not specifically excluded in the new adoption agreement. Thus, each plan required coverage for all the employees of all the other controlled group members. Obviously, this was not what the employer intended in amending those plans.

We advised our client to submit an application under the IRS's Voluntary Compliance Program ("VCP"). VCP is available to help plan sponsors correct certain failures to operate a qualified plan consistent with its written terms. Our hope was that we would be successful in demonstrating to the IRS that our client (and the acquired entities) never intended to adopt plans that would provide multiple retirement plan benefits for all of the employees of the controlled group. This argument was particularly persuasive in light of the fact that each acquired entity historically sponsored its own plan and continued to do so after the acquisition. We pointed to this factor as a part of the proof of our client's (and the acquired entities') intent to ensure that the retirement benefits for employees were generally unaffected by the acquisition. Our goal was to convince the IRS to agree to reform the documents of the various acquired entities to provide coverage only for the employees of that particular entity. Our position was strengthened by the fact that the acquired entities all operated as separate profit centers and separately satisfied the coverage and non-discrimination rules on a stand-alone basis.

The Best Lawyers in America

Fred Reish and Bruce Ashton have been recognized as two of "The Best Lawyers in America." The Best Lawyers in America referral guide has been published biennially since 1983 and is regarded as the preeminent referral guide for the legal profession. The lists are compiled through a confidential peer-review survey in which thousands of lawyers in the U.S. evaluate their professional peers. For more information, check out the website at BestLawyers.com.

Mark Your Calendar! On-line Registration Now

DOL Speaks: The 2006 Employee Benefits Conference Renaissance Washington DC Hotel, Washington DC Monday, April 24 and Tuesday, April 25, 2006

Fred Reish will be co-presenting a workshop on "Fee Disclosure and the Trend Towards Transparency" on April 24th and 25th.

The Conference is exclusively focused on ERISA Title I issues presented by both Department of Labor senior representatives and private sector ERISA experts.

The following issues will be addressed:

- The latest regulatory and legislative updates on ERISA
- DOL audit enforcement
- Fiduciary matters

To register, please visit www.asppa.org

After much negotiating with the IRS, we were able to achieve the intended result. That is, through our VCP submission, the IRS gave our client permission to reform the adoption agreements to reflect the actual intent in restating those plans. Thus, the documents provided coverage and participation for the employees of their respective sponsoring entities, and not more.

The purpose of this story is to highlight the importance of carefully scrutinizing plan documents in mergers and acquisitions, or even when changing service providers. Also, it is likely that our client would have been faced with a much different — and certainly more costly — resolution had the IRS discovered this issue on audit. ❖

Asset Allocation and Information Overload

By Fred Reish (FredReish@Reish.com)

We periodically post articles by leading academics in the field of behavioral finance. It is a part of our work to support research into the financial behavior of employees in participant-directed plans. In addition, we support research at UCLA by Dr. Shlomo Benartzi, who is one of the best-known academics in the country in the field of behavioral finance.

We have posted an article on our website entitled "Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience." The authors are Julie Agnew and Lisa R. Szykman, who are on the faculty of William and Mary.

In their article, the authors evaluated information overload about investments in participant-directed retirement plans. In two experiments, participants were given information on six investment options and information on 60 investment options. In both cases, the participants were tested on information overload. The more knowledgeable participants experienced information overload when the number choices increased from six to 60. However, the less knowledgeable participants experienced a high degree of information overload with both six and sixty alternatives. In other words, the half of the participants with lower investment knowledge were overwhelmed with six investment options.

This study can be found on our website at http://www.reish.com/publications/pdf/wp_2004-15.pdf.

As this article suggests, fiduciaries should consider offering a limited number of quality investment options to the participants--and then undertake to provide the supporting education and services that allows the participants to utilize those investments successfully. ERISA contemplates that participants will combine mutual funds of different types into well-balanced portfolios into their accounts. The number of investment options, the quality of the investment education, and the other supporting services can determine whether the participants are successful or not. ❖

Around the Firm

Speeches: In February, Fred Reish presented "Top Fiduciary Issues" in New York as part of the Plan Sponsor Institute training program. Nick Waddles spoke on "Fiduciary Responsibilities" for A.G. Edwards & Sons. Bruce Ashton presented "Putting the 401(k) Participant First" to the National Financial Partners Corporation Conference in Dallas. On February 27-28, Fred presented a workshop at the ASPPA 401(k) Summit on the topic "Are 401(k) Advisors Plan Fiduciaries? New Insights and Best Practices." Bruce co-presented a workshop at the Summit on "Your Worst Nightmare: Meet the Attorney Who Sues Financial Advisors." In March, Nick White will present "Fiduciary Issues in Retirement Plans: The Duty to Protect Participants" at the ASPPA Benefits Council of South Florida. Fred will co-present a workshop on "Fee Disclosure and the Trend Towards Transparency" at the DOL Speaks: The 2006 Employee Benefits Conference in Washington D.C. on April 24th and 25th.

Quotes: Fred was quoted in the January issue of *Managing 401(k) Plans* magazine in the article "Four Fiduciary Duties Require Attention in 2006."

Articles: Fred's column in the January issue of *Plan Sponsor* magazine addressed the topic of "Lesson Plans: Lessons from Enron (re-visited)." Marty wrote an article on "What is a Pick-up Plan and Who Cares?" that was published in the Fall 2005 issue of *Plan Horizons*. Fred and Bruce co-wrote a 401(k) investments column in the Autumn 2005 issue of the *Journal of Pension Benefits* on "ERISA Section 404(c) Protection: Myths, Mistakes, and Answers About ERISA's 'Insurance Policy' for Fiduciaries."

Any U.S. federal income tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

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