

BEST PRACTICES: COMPLIANCE WITH RETIREMENT ISSUES

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BEST PRACTICES: COMPLIANCE WITH RETIREMENT ISSUES

I. Recent Updates to ERISA

Retirement security continues to be a major priority for the White House. The Obama Administration's position is that "the current system does not provide sufficient retirement security for millions of Americans".¹ The Administration is specifically targeting defined contribution plans and their investment and service providers, and it is pushing for reform through regulatory changes under the auspices of the U.S. Department of Labor (the "DOL")

Two pieces of rulemaking, in particular, have generated a great deal of interest among compliance professions. They include the proposed regulations on participant investment advice and the final regulations on fee disclosures under section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

A. Participant Investment Advice

Many fiduciary and non-fiduciary providers of investment services to DC plans are also offering participant-level advisory services. However, in the absence of an exemption or exclusion from the prohibited transaction rules under ERISA, investment providers can not also offer participant-level investment advice.

Investment providers to plans typically have a conflict when it comes to giving participant-level advice because of their variable compensation. The conflict is, of course, between (i) the interests of participants, and (ii) the financial incentive of the investment provider to steer participants to the funds which pay the highest fees to the provider.

Under ERISA's prohibited transaction rules, it is unlawful for a fiduciary to give conflicted advice to participants. Because of the strict nature of these rules, it does not matter if the advice is given in good faith or if it's "excellent" advice. So long as a conflict exists, the advice is tainted for ERISA purposes. And so, even if a provider's advice to participants does not actually cause an overconcentration in funds with the highest fees, the advice is unlawful and will result in prohibited transactions.

1. DOL Proposes New Regulations for Investment Advice

Fortunately, there is a specific exemption from the prohibited transaction rules that allow investment providers to offer advice to plan participants. This exemption was included as part of the Pension Protection Act of 2006, and the industry has been waiting for interpretive guidance from the DOL for some time now. Unfortunately, the DOL's rulemaking has gotten bogged down in politics.

Here's a brief summary of the regulatory "rollercoaster ride":

¹ *Annual Report of the White House Task Force on the Middle Class*, February 2010.

- DOL issues a formal Request for Information, soliciting comments on its regulations in December 2006.
- The DOL publishes regulations interpreting and expanding the PPA exemption for investment advice in August 2008.
- They are “finalized” on January 21, 2009 during the last days of the Bush Administration.
- As one of its earliest administrative actions, the incoming Obama Administration delays the effective date of these regulations.
- The DOL subsequently withdraws them on November 20, 2009, before ever having taken effect.
- Now, DOL has issued newly proposed regulations (March 2, 2010) providing interpretive guidance on the PPA exemption for investment advice.

2. Background: The Pension Protection Act of 2006

Under the Pension Protection Act of 2006, Congress had intended to encourage the availability of participant-level investment advice by enacting a new prohibited transaction exemption to provide relief from fiduciary liability for providing such advice under certain conditions. ERISA Section 408(b)(14) now provides a statutory exemption (the “PPA Statutory Exemption”) for a fiduciary adviser (*i.e.*, investment adviser, broker-dealer, bank or insurance company) that provides participant-level investment advice for participant-directed plans.

To qualify for this exemption, the advice must be provided under an “Eligible Investment Advice Arrangement” as defined under ERISA Section 408(g). According to the statute, there are two types of Eligible Investment Advice Arrangements. The arrangement will qualify as such if either: (i) the fiduciary adviser’s fees for its investment advice does not vary based on any investment options that are selected by participants (the “Fee-Leveling Safe Harbor”), or (ii) the investment advice will be provided through an objective computer model that is independently certified not to favor investment options that would result in greater fees for the fiduciary adviser (the “Computer Model Safe Harbor”).

In addition, the PPA Statutory Exemption requires express authorization from a separate plan fiduciary (other than the fiduciary adviser), such as the plan sponsor. The Eligible Investment Advice Arrangement must be audited by an independent auditor annually to assure compliance with the requirements of ERISA Section 408(g). The fiduciary adviser must also

provide disclosures to participants before providing investment advice, concerning the fiduciary adviser's fees and material affiliations with other parties involved in the arrangement.

With respect to the Fee-Leveling Safe Harbor under the PPA Statutory Exemption, the DOL announced in its Field Assistance Bulletin ("FAB") 2007-1 that the applicable fee-leveling requirement applies to both the individual representative of the fiduciary adviser and the fiduciary adviser itself. However, the compensation payable to the fiduciary adviser's affiliates (e.g., affiliated investment advisers managing mutual fund options for a plan) may vary based on the investment options selected by plan participants. Thus, in the DOL's view, the PPA Statutory Exemption gives fiduciary advisers a new type of self-dealing relief that was not previously available under ERISA. Prior to the enactment of the PPA Statutory Exemption, with certain narrow exceptions, ERISA would have imposed fee-leveling on the individual representative of the fiduciary adviser, the fiduciary adviser itself, and the fiduciary adviser's affiliates.

3. Inclusion of Class Exemption in Final Regulations Triggers Withdrawal

The DOL had finalized its first iteration of the investment advice regulations during the last days of the Bush Administration, issuing them on January 21, 2009. This early 2009 release was highly unusual in that it included both (i) interpretive guidance with respect to the PPA Statutory Exemption, and (ii) a separate but related administrative exemption (the "Withdrawn Class Exemption") concerning investment advice.

The Withdrawn Class Exemption broadened both the PPA Statutory Exemption's Fee-Leveling and Computer Model Safe Harbors significantly. With respect to Fee-Leveling, the Withdrawn Exemption would have only required fee-leveling for the individual representative of the fiduciary adviser (e.g., broker-dealer receives variable 12b-1 compensation, but registered representative receives level fee).

With respect to the Computer Model Safe Harbor, the Withdrawn Class Exemption would have allowed the fiduciary adviser to provide advice based on an objective computer model, and then follow up with subjective, individualized advice to the participant. Any such "off model" advice would not have been subject to any fee-leveling requirement.

As discussed, the DOL under the incoming Obama Administration postponed on multiple occasions the effective date for both its interpretive guidance with respect to the PPA Statutory Exemption and the Withdrawn Class Exemption. Due to concerns over the Withdrawn Class Exemption and the perceived inadequacy of certain conditions, the DOL withdrew its final regulations in their entirety on November 20, 2009.

4. DOL Proposes Second Iteration of Its Investment Advice Regulations

The second iteration of the DOL's investment advice regulations, which were officially proposed on March 2, 2010 (the "Newly Proposed Regulations"), were actually unveiled a week ahead of its official publication in the Federal Register on February 26, 2010 by Vice President Biden. They are substantially similar to the interpretive portion of the DOL's withdrawn regulations relating to the PPA Statutory Exemption. However, the Newly Proposed Regulations do not re-introduce any kind of new administrative exemption akin to the Withdrawn Class Exemption that had previously been incorporated into the DOL's withdrawn regulations.

Thus, the Fee-Leveling and Computer Model Safe Harbors under the Newly Proposed Regulations are consistent with the existing safe harbors under the PPA Statutory Exemption.

Under the Newly Proposed Regulations, with respect to the Fee-Leveling Safe Harbor, participant investment advice may only be provided if the fees earned by both the individual representative of the fiduciary adviser and the fiduciary adviser itself (and not including the fiduciary adviser's affiliates) do not vary with the investment options selected by participants. For example, a dual registrant advisory firm could charge an asset-based fee offset by 12b-1 fees from the plan's mutual funds (*i.e.*, firm gets level fee). To comply with the proposed rules, the individual advisor would also have to receive level compensation from the advisory firm for services to the plan client. However, the rules would permit an affiliate of the advisory firm to receive variable compensation. By way of illustration, if the advisory firm's affiliate was the plan's bond fund manager, the proposed rules would permit the individual advisor to recommend that participants invest in the affiliated bond fund, even though the recommendation would generate additional fees for the affiliated fund manager.

With respect to the Computer Model Safe Harbor, a fiduciary adviser may only provide investment advice to participants based on an objective computer model, and may not supplement such advice with subjective, individualized advice. However, in the preamble to the Newly Proposed Regulations, the DOL highlighted one new interpretive requirement that it was proposing for the Computer Model Safe Harbor. Although it is not expressly required under the PPA Statutory Exemption, the Newly Proposed Regulations state that the computer model advice must not "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future." In the preamble, the DOL clarified that differences in investment options' fees and management styles are likely to persist in the future. However, unlike the historical performance of asset classes, the historical performance of investment options in the same asset class are less likely to persist and therefore are less likely to constitute appropriate criteria for advice. Since many advisory computer models consider the historical performance of investment fund (rather than asset classes), many practitioners have questioned whether this approach will favor index funds. During the comment period for the Newly Proposed Regulations, which ended on May 5, 2010,

the DOL received over 70 letters from various organizations and individuals. A significant number of these comment letters objected to the perceived bias toward index funds, respectfully requesting that the DOL avoid infringing on the intellectual freedom of investment experts who should have the flexibility to rely on any and all generally accepted investment theories for their computer models.

During a recent web chat on January 4, 2011 that included a live Q&A session, the DOL informally announced its intent to finalize its investment advice regulations by May 2011.

B. Fee Disclosures from Service Providers Under ERISA Section 408(b)(2)

1. Background: “Hidden” Fees and Conflicts of Interest

There has been a great deal of discussion surrounding the so-called “hidden” payments flowing from the plan’s investments to its service providers (e.g., recordkeeper, pension consultant). Plan sponsor are undoubtedly aware of the “hard dollar” fees invoiced directly to the plan or the employer, but they may not necessarily understand that the service provider can also receive indirect compensation from the plan’s investment funds and the managers of such funds. The hidden payments made to a plan’s service provider might include shareholder servicing fees (as well as 12b-1 fees and sub-transfer agency fees) paid from the plan’s investment funds or revenue sharing payments made directly from the fund managers. Thus, a plan sponsor could conceivably select what appears to be a “free” administrative service for the plan, without understanding that the provider’s compensation was being passed on to plan participants in the form of higher embedded costs in the plan’s investment funds.

A plan sponsor’s ignorance of the fact that administrative service providers can receive such indirect compensation creates a potential conflict of interest for the administrative service provider. By steering plan clients to the arrangement with the highest level of indirect compensation, the provider is presumably able to receive fees in excess of what plan clients would otherwise agree to if they knew the true cost of services. Ironically, the arrangement with the highest level of indirect compensation may be the most attractive to an uninformed plan client, because it would have lower “hard dollar” fees, creating the false impression that this service arrangement was the cheapest for the plan.

For example, let’s assume that an employer is looking for a provider of administrative services to its 401(k) plan. The provider offers the plan sponsor two options: (1) the employer can order services *a la carte* with no restriction on the combination of services and investment funds available for an annual fee of \$10,000, and (2) the employer may choose pre-packaged services with a limited investment menu for an annual fee of \$4,000. If the plan sponsor does not realize that the provider is receiving “hidden” compensation from the plan’s investment funds and fund managers, the plan sponsor may prematurely conclude that the second option is

the best choice for the plan and its participants. Unfortunately, the total compensation payable to the provider under the pre-packaged option may greatly exceed \$10,000 (*i.e.*, the cost of the first option), and the hidden cost would be directly or indirectly borne by the plan's participants.

Revenue sharing among a plan's investment and service providers is not prohibited under ERISA. But without full disclosure of the indirect compensation paid to the plan's service providers, the plan and its participants might end up paying fees that are unreasonable, resulting in a breach of its fiduciary duties under ERISA.

2. Retirement Security Initiative – Improving Transparency.

To address these concerns, the Obama Administration wants to improve “the transparency of 401(k) fees to help workers and plan sponsors make sure they are getting investment, record-keeping, and other services at a fair price.”² Consistent with this policy objective, the Administration published interim final regulations on July 16, 2010 requiring service providers to provide specific disclosures with respect to fees.

It should be noted that the Administration's policy objective to improve fee transparency in the 401(k) plan industry is based on political momentum which has been growing for several years. The U. S. Government Accountability Office (GAO), which is also known as the “investigative arm of Congress,” laid much of the groundwork in its reports.

- The November 2006 report by the GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, reported that the “problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered.”
- The GAO had concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the “hidden” compensation flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant).
- In its March 2009 report, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, the GAO concluded that there is a “statistical association between inadequate disclosure of potential conflicts of

² *Annual Report of the White House Task Force on the Middle Class*, February 2010.

interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of nondisclosure” of indirect compensation arrangements.

In addition, the DOL’s fee disclosure rules for service providers are actually the second part of a three-pronged “reg project” designed to increase fee transparency.

- The first part involved improving a plan’s fee disclosures on Form 5500, Schedule C. The DOL has already issued final regulations on the revised Schedule C and they apply starting with the 2009 plan year³.
- The second part involves requiring service providers to give mandatory disclosures to plan sponsors under ERISA Section 408(b)(2). The interim final regulations were published on July 16, 2010.
- The third part involves mandatory disclosures from the plan sponsor to the plan’s participants. As discussed earlier, the final regulations were released on October 14, 2010.

The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than a decade ago. In 1997, the DOL held a hearing on 401(k) plan fees, which appeared to have been in response to several consumer magazines criticizing the size of such fees.⁴ In 1998, the DOL published a 19-page booklet, “A Look At 401(k) Plan Fees,” for plan participants and a 72-page report, “Study of 401(k) Fees and Expenses,” for plan sponsors.⁵ Unfortunately, the DOL’s efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, the DOL is now requiring service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

3. Background – Prohibited Transaction Rules Under ERISA.

The prohibited transaction rules under ERISA cover a broad spectrum of activities. In addition to banning transactions that involve fiduciary conflicts of interest, the prohibited transaction rules also prohibit the use of plan assets with respect to many other activities (other than the payment of benefits). Fortunately, there is a specific exemption that allows the use of plan assets to pay fees for reasonable services.

³ 72 Fed. Reg. 64710 (Nov. 16, 2007).

⁴ “Protect Yourself against the Great Retirement Rip-off,” *Money Magazine* (April 1997). “Your 401(k)'s Dirty Little Secret,” *Bloomberg Personal* (September 1997).

⁵ A Look at 401(k) Plan Fees” is posted at http://www.dol.gov/ebsa/publications/401k_employee.html. The Study of 401(k) Fees and Expenses is posted at: <http://www.dol.gov/ebsa/pdf/401kRept.pdf>.

ERISA Section 408(b)(2) provides relief from ERISA’s prohibited transaction rules for the use of plan assets to pay for services between a plan and a party in interest (e.g., recordkeeper). The conditions of this statutory exemption are satisfied if:

- the contract or arrangement is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

In addition to the above requirements under the statute itself, the current DOL regulations interpreting the statute impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.⁶ Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

4. Background on Interim Final 408(b)(2) Regulations

a. Statute and Prior Regulations

ERISA §408(b)(2) provides relief from ERISA’s prohibited transaction rules for service between a plan and a party in interest (e.g., a plan service provider) if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services. The prior regulations said little as to when a service provider contract or arrangement was reasonable.

b. Proposed Regulations

In December 2007, the U.S. Department of Labor (“DOL”) proposed amending its regulations to provide that certain service provider contracts would be reasonable only if the covered service provider discloses to a responsible plan fiduciary specified information about the services to be performed, the compensation to be received and potential conflicts of interest of the service provider. The intent of the proposal was to enable plan fiduciaries to assess the reasonableness of compensation paid for plan services.

c. Issuance of Interim Final Regulations

⁶ 29 CFR 2550.408b-2(c).

On July 16, 2010, the DOL released a revised version of the fee disclosure regulations. The effective date for these interim final regulations was recently pushed back from July 16, 2011 to January 1, 2012.⁷ Thus, the final regulations will apply to existing services arrangements as of January 1, 2012 as well as to new arrangements entered into on or after that date. The one-year lead time is intended to accommodate the costs and burden of transition to the new disclosure regime. However, because the regulations are interim as well as final, new requirements may be added before the effective date. It is not clear whether any additional changes will have an extended effective date for compliance.

5. Covered Plans Under Interim 408(b)(2) Regulations

Under the proposed regulations, all employee benefit plans subject to Title I of ERISA were subject to the regulation's disclosure requirements. The final regulations retrench by defining a covered plan to mean an employee pension plan. Excluded from this definition and, therefore, not affected by the disclosure requirements of the final regulation are:

- a. IRAs,
- b. Simplified employee pensions, and
- c. Simple retirement accounts.

6. Covered Service Providers

The final rule is limited to service providers that reasonably expect to receive \$1,000 or more in compensation (direct or indirect) from providing plan services that fall under one of the following categories:

a. Services as a fiduciary under ERISA or as a registered investment adviser. Such services include:

(1) Provider of Fiduciary Services. Services provided directly to a covered plan in the capacity of an ERISA fiduciary.

(2) Investment Product Fiduciary. Services provided as a fiduciary to an investment contract, product or entity that holds plan assets. To be included in this new category, the plan must have a direct equity investment in the contract, product or entity. Fiduciary services provided to underlying investments (i.e., to second tier investment vehicles) are not taken into account.

⁷ EBSA News Release, February 11, 2012 (announcing DOL's intent to delay effective date to January 1, 2012).

(A) Mutual funds are not considered to hold plan assets and, therefore, fund investment advisers are excluded from the definition of a covered service provider. Accordingly, mutual funds are not subject to the general disclosure obligation.

(B) Insurance products providing a fixed rate of return are generally considered not to hold plan assets. Thus, products, such as GICs, general account investments and deferred fixed annuities will not result in the insurer becoming a covered service provider. However, a variable annuity based on a separate account that may be treated as a plan asset could give rise to compensation subject to disclosure.

(C) Fiduciaries to plan asset vehicles, such as collective trusts, hedge funds and private equity funds are potentially subject to the fee disclosure rules.

(3) Registered Investment Adviser. Services provided directly to the covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or state law.

b. Recordkeeping or brokerage services provided to individual account plans that permit participants to direct the investment of their accounts. This category assumes that one or more designated investment alternatives have been made available through an investment platform. As discussed in items VI.D and E, the final regulations expand the disclosure obligation of such recordkeepers and brokers to compensation information regarding each designated investment alternative.

c. Services within a broad list of categories that are reasonably expected to be paid for by indirect compensation or compensation paid among related parties. Service categories include investment consulting, accounting, auditing, actuarial, appraisal, development of investment policies, third party administration, legal, recordkeeping and valuation services.

7. Required Disclosure

a. General. A covered service provider must disclose in writing to the plan sponsor or similar plan fiduciary all services to be provided to the plan, not including nonfiduciary services. Service providers must also disclose whether they will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940.

(1) Formal Contract No Longer Required. Unlike the proposed regulations, the final regulation does not require a formal written contract delineating the disclosure obligations.

(2) Disclosure of Conflicts No Longer Required. In addition, the final rule eliminates required disclosure of conflicts of interest on the part of service providers. The reasoning for this change is that the expanded disclosure of compensation arrangements with parties other than the plan will be a better tool to assess a service arrangement's reasonableness, as well as potential conflicts of interest.

b. Distinction Based on Direct or Indirect Compensation. Different rules apply to the receipt of direct and indirect compensation, with the latter thought more likely to implicate conflicts of interest.

(1) Direct compensation is defined as compensation received from the plan.

(2) Indirect compensation is defined as compensation received from a source other than the plan, the plan sponsor, the covered service provider or an affiliate or subcontractor in connection with the services arrangement. For example, indirect compensation generally includes fees received from an investment fund, such as 12b-1 fees, or from another service provider, such as a finder's fee.

(3) Non-monetary compensation valued at \$250 or less, in the aggregate, during the term of the contract, is disregarded.

c. Disclosure of Compensation. Covered service providers are required to disclose all direct and indirect compensation that the service provider, an affiliate or a subcontractor expects to receive from the plan. In the case of indirect compensation, the service provider must identify the services for which the indirect compensation will be received as well as the payer of the indirect compensation.

(1) Format. Compensation may be expressed as a dollar amount, formula, percentage of covered plan assets, a per capita charge, or by any other reasonable method that allows a plan fiduciary to evaluate the reasonableness of the compensation.

(2) Manner of Receipt. Disclosure must include a description of the manner in which the compensation will be received, such as whether it will be billed or deducted directly from participants' accounts.

(3) Transaction-Based Fees Received by Affiliates or Subcontractors. Compensation set on a transaction basis (e.g., commissions or soft dollars) or charged directly against the plan's investment (e.g., 12b-1 fees) and paid among the covered service provider, an affiliate or a subcontractor must be separately disclosed. The services for which the compensation is to be paid, the recipient and the payer must be identified. Other types of compensation do not require separate disclosure.

(4) Bundled Services. Except for the special rules discussed below, there is no requirement to unbundle service pricing.

d. Special Rules for Recordkeepers. A person who provides recordkeeping services must provide a description of the direct and indirect compensation that the service provider (and its affiliates and subcontractors) expects to receive for recordkeeping services.

(1) If there is no explicit fee for recordkeeping services, a reasonable, good faith estimate of the cost to the plan of such services must be provided. The estimate may take into account the rate that the service provider would charge to a third party or prevailing market rates for similar services.

(2) Disclosing a de minimis amount of compensation for recordkeeping when the amount has no relationship to cost will not be regarded as reasonable.

e. Special Rule for Platform Providers. Recordkeepers and brokers that make designated investment alternatives available must provide basic fee information for each such alternative for which recordkeeping or brokerage services are provided. This information is in addition to information regarding the recordkeeper's or broker's own compensation. The information to be provided includes the expense ratio, ongoing expenses (e.g., wrap fees), as well as transaction fees (e.g. sales charges, redemption fees and surrender charges) that may be charged directly against the amount invested.

(1) Pass-Through of Information on Investment Products. A recordkeeper or broker may satisfy its disclosure obligations for unaffiliated mutual funds by passing through the fund prospectus without having the duty to review its accuracy, provided that the disclosure material is regulated by a state or federal agency.

(2) Responsibility of Other Service Providers. If there is no recordkeeper or broker to provide the required information as to the fees associated with a designated investment alternative that holds plan assets, such responsibility passes to the fiduciary of the investment contract, product or entity.

(3) Exclusion for Brokerage Windows. Open brokerage windows are not subject to the disclosure requirements for platform providers.

8. Timing of Disclosures

Disclosure of information regarding compensation or fees must be made reasonably in advance of entering into, renewing or extending the contract for services. All of

the required disclosures need not be contained in the same document and may be provided in electronic format.

a. During the term of the contract, any change to the previously furnished information must be disclosed within 60 days (expanded from 30 days under the proposed regulations) of the service provider's becoming informed of the change.

b. In contrast to the proposed regulation, the final rule provides that a service contract will not fail to be reasonable (*i.e.*, there will not be a prohibited transaction) solely because the service provider makes an error, provided that the service provider has acted in good faith and with reasonable diligence. Errors or omissions must be disclosed within 30 days of the service provider's acquiring knowledge of the error or omission.

c. When an investment contract, product or entity is initially determined not to hold plan assets but this fact changes, if the covered plan's investment continues, disclosures are required as soon as practicable, but not later than 30 days from the date on which the service provider acquires knowledge that the investment vehicle holds plan assets.

9. Curing Disclosure Failures: Prohibited Transaction Exemption

a. Relief for Plan Sponsor. As under the proposed 408(b)(2) regulations, the final rule provides that a service provider's failure to comply with the disclosure obligations results in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL had proposed a separate class exemption that would have provided relief for the plan fiduciary. This exemption is now incorporated into the final regulation. There is no relief for a service provider that fails to comply with the disclosure requirements.

b. Corrective Action. Relief would be provided if the plan sponsor or similar plan fiduciary enters into a service contract under the reasonable belief that the service provider has complied with its disclosure obligations under the final regulations. To qualify for relief, the plan sponsor or similar fiduciary must take corrective steps with the service provider after discovering the disclosure problem by requesting in writing the correct disclosure information. If the service provider fails to comply within 90 days of such request, the plan fiduciary must notify the DOL not later than 30 days following the earlier of the service provider's refusal to furnish the requested information; or the date which is 90 days after the date the written request is made.

c. Termination of Service Contract. As under the proposed regulations, the plan sponsor or similar fiduciary must also determine whether to terminate or continue the service contract by evaluating the nature of the particular disclosure failure and determining the extent of

the actions necessary under the facts and circumstances. Factors to consider, among others, include the responsiveness of the service provider in furnishing the missing information, and the availability, qualifications, and costs of potential replacement service providers.

10. Immediate Impact and Issues

Currently, service providers need not disclose specific types of information to plan sponsors or similar fiduciaries. The interim final disclosure regulations require service providers to disclose extensive amounts of information, including the identity of third parties from whom a service provider receives fees as a result of providing services to the plan.

While conflict of interest disclosures have been eliminated, required fee disclosure will present significant internal tracking and communication challenges for large/complex companies. The ongoing 60-day disclosure deadline for information changes will result in similar challenges.

The final regulation clarifies that the new rules will apply to contracts in place when the regulation becomes effective on January 1, 2012. Service providers should begin preparing now to meet the new disclosure requirements, but should be prepared for possible changes to the rules due to the interim status of the regulation.

Through a live web chat hosted by the DOL on January 4, 2011, it was announced that the DOL was planning to “finalize” its interim 408(b)(2) regulations by April 2011. With respect to finalizing these rules, the DOL is expected to proceed in one of two ways: (1) it may simply indicate that its interim rule will become the final rule “as is” without any modifications, or (2) the final rule may reflect changes based on the feedback provided by the public on the interim rule. On February 11, 2011, the DOL announced that it would be pushing back the effective date of these rules from July 16, 2011 to January 1, 2012 to ensure that it has sufficient time to “finalize” them and to ensure that providers have sufficient time to comply with the finalized rules.

11. Practice Tips

If they have not done so already, financial services firms should develop a compliance strategy for providing the required 408(b)(2) fee disclosures to existing clients on or prior to January 1, 2012.

- Identify all ERISA account subject to 408(b)(2) disclosure rules.
- Identify sources and amounts of indirect compensation received from plan investments, and transaction-based compensation payable to affiliates and subcontractors.
- Consider special disclosure requirements for recordkeepers and platforms.

- Consider developing a “template” or model disclosure for clients for each of the firm’s various service programs.
- For RIAs, review adequacy of investment management agreement for disclosure purposes.
- For dual registrants, disclose all indirect compensation (even if offset against client’s asset-based fee).
- Develop procedures to comply with requirement that changes to previously provided information generally must be disclosed within 60 days after provider becomes aware of change.

II. Applicability of Code Section 4975 to IRA Beneficiaries

A. Overview of Prohibited Transaction Rules

From a policy perspective, the “prohibited transaction” rules are one of the key protections embedded in the statutory framework to ensure that all fiduciary decisions are made for the exclusive benefit of plan participants. There are similar sets of rules in federal securities laws (*e.g.*, Section 206 of the Investment Advisers Act), but ERISA’s prohibited transaction rules are unique in that they are absolute. You can never enter into a non-exempt prohibited transaction under ERISA, even if conflicts have been fully disclosed and the client provides its written consent.

There are actually 2 sets of prohibited transaction rules: (i) Section 406 under Title I of ERISA, and (ii) Section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”), which was added to the Code as part of Title II of ERISA.

The prohibited transactions rules cover both individual retirement accounts (“IRAs”) and tax-qualified retirement plans. However, the rules apply to the 2 types of retirement vehicles in different ways.

Any “employee pension benefit plan,” which includes all tax-qualified plans covering employees (*e.g.*, 401(k) plan), is subject to section 406 under Title I of ERISA. Under Title I, if a fiduciary causes an employee pension benefit plan to engage in a non-exempt prohibited transaction, the relevant party can and will be subject to civil penalties and liability for losses or improper profits. SIMPLE and SEP IRAs are also viewed as “employee pension benefit plans,” since they feature employer contributions and/or payroll deductions by employees. Accordingly, SIMPLE and SEP IRAs are subject to the prohibited transaction rules under ERISA section 406.

Tax-qualified vehicles that do not cover any employees are not employee pension benefit plans. Thus, “Keogh” plans, such as tax-qualified plans sponsored by sole proprietors, are not subject to Title I of ERISA. Similarly, Traditional, Roth and Rollover IRAs, which are

maintained for the benefit of the IRA owner (and not any employees), are also exempt from the prohibited transaction rules under ERISA section 406.

In addition to being subject to Title I, employee pension benefit plans are also subject to Title II's prohibited transaction rules under Section 4975 of the Code. The disqualified persons involved in non-exempt prohibited transaction are subject to a "first tier" 15% excise tax on the amount of the prohibited transaction. If the failure is not corrected, the 15% excise tax is imposed again in each subsequent tax year. A "second tier" 100% excise tax is also imposed, if the prohibited transaction is not corrected by the time of the IRS's assessment of the excise tax. For example, if the IRS assesses an excise tax on an outstanding prohibited transaction in "year 3," the cumulative excise tax would be 145% of the amount involved in the prohibited transaction (15% + 15% + 15% + 100%), plus any applicable interest and penalties.

IRAs are subject to the Title II prohibited transaction rules under Code Section 4975, and they are not subject to the Section 406 of ERISA. However, with regard to the application of Code Section 4975, special rules apply.

B. Application of Code Section 4975 to IRAs

Prohibited transactions generally include any direct or indirect transactions between an IRA and a disqualified person in accordance with the provisions of Code Section 4975. A "disqualified person" includes:

- The IRA owner (although not expressly identified in the statutory definition);
- Any fiduciary with respect to the IRA;
- Any service provider to the IRA, including but not limited to the IRA custodian;
- Certain family members (*i.e.*, spouse, ancestor, lineal descendants, and spouses of lineal descendants) of the IRA owner, fiduciary or service provider;
- Any corporation, partnership or trust which is at least 50% owned by the IRA owner, fiduciary or service provider; and
- Any officer, director or a 10% shareholder of any such corporation, partnership or trust.

If an IRA is involved in a prohibited transaction, four different types of penalties may apply:

- IRA is disqualified;
- IRA is disqualified and excise taxes apply;
- Excise taxes apply (and no IRA disqualification); or
- Prohibited investment taxed as distribution from IRA.

C. Prohibited Transactions Involving IRA Owner

Special rules apply when an IRA owner is the person involved in a prohibited transaction. Curiously, the statutory definition of a “disqualified person” fails to include IRA owners (although it does include employers sponsoring plans). In spite of this apparent oversight in the literal wording of this definition in Code Section 4975, the IRS takes the position that an IRA owner is always a disqualified person based on the statute’s legislative history (*e.g.*, PLR 8849001).

If the IRA owner engages in a prohibited transaction, the IRA ceases to be tax-qualified as of the first day of the taxable year in which the prohibited transaction occurred in accordance with the provisions of Code section 408(e)(2). In addition, the IRA owner is subject to taxation as though he or she had received a distribution from the IRA as of the date of disqualification. In other words, the pre-tax value of the IRA’s assets on the first day of the taxable year in which the prohibited transaction occurred, becomes fully and immediately taxable as income to the IRA owner. If the IRA owner is under age 59 1/2, the 10% penalty tax for early distribution also applies under Code section 72(t) (unless an exemption, such as for disability, is available).

In theory, a prohibited transaction involving the IRA owner will only result in disqualification of the IRA, and it will not trigger the customary excise taxes as provided in the special rules under Code Section 4975(c)(3). But as a practical matter, although the “plain” language in Code Section 4975(c)(3) states that excise taxes are not imposed when an IRA is disqualified in accordance with Code Section 408(e)(2), the IRS takes the position that both penalties (*i.e.*, IRA disqualification and excise taxes) will apply if the IRA owner has investment control over the IRA.

NOTE: Because of the literal wording of Code Section 4975(c)(3), many people have heard about the “special rules” providing that a prohibited transaction involving the IRA’s owner will not trigger the excise taxes that normally apply under Code Section 4975. However, this view is erroneous, because it does not consider the exception that “overshadows” these rules.

The IRS takes the rigid position that the excise tax relief provided under Section 4975(c)(3) only applies to an IRA owner if he or she is a disqualified person solely by reason of his or her beneficial ownership of the IRA. For example, if the IRA owner has investment control over the IRA’s assets, then the IRA owner is a disqualified person because of his or her dual status as both the IRA owner and the IRA fiduciary. In PLR 200324018, the IRS states that when the IRA owner is also a fiduciary with investment control, the statutory relief from the excise taxes is not available.

Since IRA owners typically have the right to direct the IRA's investments (or the right to appoint a designee to direct such investments on behalf of the IRA owner), typically, a prohibited transaction involving the IRA owner will trigger both disqualification of the IRA and the "first tier" 15% excise tax and, if uncorrected, the "second tier" 100% excise tax. Thus, the penalty for such prohibited transactions is significantly more severe than mere disqualification.

D. Examples of Prohibited Transactions Involving IRA Owner

The prohibited transaction rules broadly cover all direct and indirect transactions between the IRA and the IRA owner. Examples include the following:

- Loan to IRA Owner. An IRA is permitted to invest in notes or lend money to a third party. However, the IRA owner cannot borrow funds from the IRA (even if the loan is made to the IRA owner at a favorable interest rate).

NOTE: However, it is interesting to note that an IRA owner is permitted to take a distribution from the IRA, and then roll the money back to the same or a different IRA within 60 days. This rollover transaction effectively allows the IRA owner take a 60-day interest-free loan.

- Transactions with IRA Owner. The IRA owner is generally prohibited from engaging in principal transactions with the IRA. For example, the IRA owner cannot sell any personal assets to the IRA, and similarly the IRA owner cannot personally buy any securities or investments currently held by the IRA, even if a third party performs an appraisal to determine pricing.

NOTE: There are a few prohibited transaction exemptions that permit certain types of transactions with the IRA owner. However, they are few in number and apply in extremely narrow situations (*e.g.*, Code Section 4975(d)(16) permitting sale by IRA to IRA owner of certain bank stock held by IRA in connection with S corporation election made by bank.)

- Fiduciary "Self-Dealing" by IRA Owner. The prohibited transaction rules under Code Section 4975 include a general prohibition against any act by an IRA fiduciary who deals with the assets of the IRA "in his own interest" or "for his own account." This prohibition has been interpreted as imposing a duty of undivided loyalty on the IRA account owner towards his or her own IRA. As provided in Section 54.4975-6(a)(5) of the Treasury Regulations, an IRA fiduciary may not use his or her authority to cause the IRA to enter into a transaction with "a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary." This term is not precisely defined, but the regulation states, by way of example, that it includes

entities in which the IRA owner has at least a 50% interest and certain family members, which are also separately viewed as disqualified individuals. As a result, the general prohibition against “self-dealing” by the IRA owner is somewhat duplicative, in that it prohibits transactions with parties that are already viewed as disqualified persons. For example, if the IRA owner causes the IRA to provide a loan to the IRA owner’s son, the transaction would be prohibited for two separate reasons: (i) the IRA owner engaged in prohibited self-dealing by helping a person in whom he has an “interest”, and (ii) the IRA loaned money to a disqualified person.

- Earning Fees from Personal IRA. The self-dealing prohibitions under Code Section 4975 would also prohibit a financial advisor from investing his or her personal IRA assets in investments that generated fees (*e.g.*, 12b-1 fees, commissions) for himself or herself.
- Special Rules: Break Points. In general, it would be a prohibited transaction for an IRA owner to transfer the IRA to a financial institution in order to secure a lower “breakpoint” fee from the same financial institution for both the IRA and non-IRA assets. For example, if a RIA ordinarily charges 85 basis points to manage a client’s portfolio but is willing to reduce its fee to 60 basis points if the portfolio has at least a \$1 million, a prohibited transaction would arise if the client is only able to reach the \$1 million breakpoint by including his \$300,000 IRA along with \$700,000 of non-IRA assets. Although there is no exception for breakpoints in investment management fee schedules, Prohibited Transaction Exemption 97-11 allows fee breakpoints in brokerage services (including “letter of intent” programs which reduce sales loads when IRA and non-IRA assets are used for mutual fund purchases). In addition, Prohibited Transaction 93-33 allows commercial banks to give free or discounted banking services to IRA customers.
- Special Rules: “Checkbook LLC” IRA. Various IRA-related products are promoted under the brand of a “checkbook LLC” or “checkbook IRA.” Although the names of the products are often similar, there is a great deal of diversity with respect to their product design. Having said that, the basic “pitch” is that the checkbook IRA gives the IRA owner the flexibility to invest in real estate and other asset classes that are typically restricted by IRA providers. Typically, this involves the following steps: (i) the IRA owner creates a limited liability company (“LLC”), (ii) all of the IRA’s assets are transferred to the LLC in exchange for 100% of the membership interest, and (iii) the IRA owner serves as the LLC’s manager under its operating agreement and can freely invest the LLC’s assets (like a “checkbook”) without the involvement or interference of the IRA custodian. At the end of the day, the IRA owns 100% of the LLC, and the LLC has what appears to be freely transferable cash to invest in real estate or any other type of investment that is ordinarily restricted by the IRA provider.

The IRA's ownership of the new LLC is not prohibited under Code Section 4975. This fact is supported by Swanson v. Commissioner, 106 T.C. 76 (1996), an old tax court decision that is sometimes cited by the promoters of the "checkbook LLC" and other similar products. The transfer of the LLC membership interests to the IRA is not prohibited because, when the LLC is newly formed, it is an empty "shell" with no owners or assets and therefore is not a disqualified person.

However, even though the IRA's ownership of the newly formed LLC is permitted under Code Section 4975, the "checkbook" label may be somewhat misleading. While the use of a checkbook LLC may free the IRA owner from the IRA provider's administrative restrictions on investing in real estate or other asset categories, the LLC is subject to the same legal restrictions that apply to the IRA under the prohibited transaction rules. When an IRA owns 100% of an entity, the IRA is also deemed to have direct ownership of the underlying assets of such 100%-owned entity, as provided under Section 2510.3-101(h)(3) of the DOL's ERISA regulations (which are sometimes called the "look through" rule). Thus, the underlying assets of the checkbook LLC are deemed to be the IRA's assets and are subject to the same prohibited transaction rules that would apply if the LLC had never been formed. For example, the LLC is prohibited from purchasing property from the IRA owner, lending money to the IRA owner, or engaging in any other type of prohibited transaction with disqualified individuals.

NOTE: This analysis should not be construed as being critical of all "checkbook LLC" or "checkbook IRA" products. However, compliance professionals should exercise caution in reviewing any "aggressive" product features or promotional statements to ensure they are consistent with ERISA.

E. Prohibited Transactions Not Involving IRA Owner

If the disqualified person engaging in the prohibited transaction is not the IRA owner, the customary excise taxes under Code Section 4975 apply and the IRA is not subject to disqualification. For example, if the IRA owner hires an investment advisor to manage the assets of the IRA, the customary excise taxes would apply in the event the advisor caused the IRA to engage in a prohibited transaction (*e.g.*, advisor sells securities from its personal account to the IRA in a principal transaction).

F. Prohibited Investments

Although it is not technically a prohibited transaction, an IRA is subject to disqualification if any part of the IRA's assets is invested in life insurance contracts.

An IRA's investment in a collectible is treated as a taxable distribution by the IRA to the IRA owner under Code Section 408(m). Collectibles include works of art, antiques, gems, stamps, coins and other related items (subject to certain exceptions).

Pledging the assets in an IRA as security or collateral for a loan is also treated as a taxable distribution to the IRA owner under Code Section 408(e)(4), but a pledge of IRA assets will not disqualify the IRA. (In theory, the excise tax relief provided under Section 4975(c)(3) would exclude the IRA owner's pledging of IRA assets from the excise taxes, but it is unclear if the IRS would assert that this relief does not apply if the IRA owner retains investment control over the assets.)

NOTE: Ironically, a pledge of an IRA owner's non-IRA assets may lead to a prohibited transaction in certain instances. Specifically, DOL Advisory Opinion 2009-03A held that it would be a prohibited transaction for an IRA owner to grant to a brokerage firm a security interest in the assets of his non-IRA account as collateral for potential debt owed to such firm by the IRA. The DOL indicated that this transaction was prohibited because it was akin to a guarantee or extension of credit from the IRA owner to the IRA.

G. Practice Tips

In order to avoid potential issues under the prohibited transaction rules, IRA providers, trustees and custodians should consider adopting appropriate compliance policies and procedures, including:

- Restricting or limiting loans from the IRA to any party, including but not limited to the IRA owner.
- Prohibiting principal transactions between the IRA owner and the IRA.
- Prohibiting transactions involving the IRA owner's family members or controlled businesses or entities.
- For advisory firms, prohibiting financial advisors from earnings fees on personal IRA investments.
- Reviewing "break points" and other types of fee discounting practices to ensure compliance with the prohibited transaction rules.
- Reviewing any "checkbook LLC" or similar IRA programs.
- Prohibiting IRA from investing in life insurance and collectibles, and restrictions against pledging IRA assets.
- Adopting procedures for reporting and escalating any potential prohibited transaction concerns involving IRAs.

III. Issues With Annuities, Target Date Funds and Stable Value Funds

A. DC Plan Annuitization.

One of the key retirement security goals of the Obama Administration is to “reduce barriers to annuitization of 401(k) plan assets” and promote “guaranteed lifetime income products, which transform at least a portion of retirees’ savings into guaranteed future income, reducing the risks that retirees will outlive their savings or that their living standards will be eroded by investment losses or inflation.”⁸

1. DOL and IRS Request for Information (RFI).

In connection with the Administration’s goals to promote DC plan annuitization, the DOL, Internal Revenue Service and the Treasury Department issued a joint release on February 2, 2010, requesting information regarding lifetime income options for participants in retirement plans. In this release, these agencies announced that they were currently reviewing the rules under ERISA and the related rules under the Internal Revenue Code, to determine whether and how they could enhance the retirement security of participants by facilitating access to lifetime income arrangements. The requests for information addressed a range of topics, including participant education, required disclosures, 401(k) plan and other tax-qualification rules, selection of annuity providers, ERISA Section 404(c) and QDIAs.

2. DOL and IRS Hearing in September 2010.

On September 14th and September 15, 2010, the DOL, IRS and the Treasury Department held a 2-day joint hearing to consider the specific issues raised in the various comments submitted by the public in response to the RFI regarding lifetime income options. The hearing focused on the following 3 areas of specific interest:

- Fostering Education to Help Participants Make Informed Retirement Income Decisions. The agencies were interested in hearing about the type of information that would help participants make better informed decisions regarding their retirement income. DOL Interpretive Bulletin 96-1 provides guidance on how plan sponsors can provide “investment education” to participants without fiduciary liability, and the DOL appears to be interested in expanding it to cover “retirement income education.”
- Disclosure of Account Balances as Monthly Income Streams. The agencies were interested in hearing how participants may be more likely to choose lifetime income

⁸ *Annual Report of the White House Task Force on the Middle Class*, February 2010.

options if their benefit statements were to include disclosures noting what their individual accounts are worth when converted to a hypothetical monthly benefit. The discussed approach was along the lines of recent legislative proposals, such as the *Lifetime Income Disclosure Act*, which was recently reintroduced to the new session of Congress by U.S. Senators Jeff Bingaman (D-NM), Johnny Isakson (R-GA), and Herb Kohl (D-WI) in February 2011

- Modifying Fiduciary Safe Harbor for Selection of Issuer or Product. The current DOL regulatory “safe harbor” on how a plan fiduciary can prudently select an annuity provider for its DC plan is largely procedural, requiring an objective, analytical search for an annuity provider, in consultation with an expert as necessary. The agencies heard testimony on whether these safe harbor standards should be modified, and whether they should apply more broadly to other types of lifetime income products.

Given the specificity of these 3 areas, it appears that the DOL and Treasury Department (and IRS) have narrowed their areas of focus, which could signal that these agencies are preparing to move ahead with rulemaking in these areas. Compliance professionals should pay close attention to the current and proposed regulatory standards under ERISA, and ensure that the firm’s annuity distribution practices are consistent with them.

3. Current Law and Approaches to DC Plan Annuitization.

The Administration’s goals to promote DC plan annuitization should not mislead people into believing that the current rules prohibit the use of annuities. Although there are numerous types of annuity arrangements for DC plans, they can be categorized into three basic approaches as described in sections a, b and c below.

a. Annuitization Outside of Plan: IRA Annuity Portal.

Just as retired participants can roll over their DC plan accounts to individual retirement accounts, they can also roll them over to individual retirement annuities (“IRA annuities”). Of course, participants can shop for annuities by contacting annuity providers individually. However, rollover processing platforms have developed internet portals (“IRA annuity portals”) which are designed to give participants access to wholesale or institutionally priced immediate annuities. With the use of these portals, participants seeking to roll over their plan accounts to IRA annuities may request annuity quotes from multiple insurance carriers. These portals are not available to individuals and must be implemented by the plan sponsor.

These IRA annuity portals are typically provided as a convenience by the employer to its employees, and not as an employer-provided benefit. Under DOL Reg. Section 2510.3-21, an IRA annuity will not be treated as an ERISA plan sponsored by the employer so long as:

- (a) the employer does not make any contributions to the IRA annuity,
- (b) participation is completely voluntary for employees,
- (c) the sole involvement of the employer is to permit the annuity provider to publicize the program to employees without any endorsement, and
- (d) the employer receives no compensation from the annuity provider.

So long as the IRA annuity is not an ERISA plan sponsored by the employer, the employer has no fiduciary duty to evaluate the quality or cost of the IRA annuities offered to participants through the IRA annuity portal.

PRACTICE TIP: Review sales practices to ensure FAs do not inadvertently encourage any employer to assume a role causing the employer to become IRA fiduciaries, and consider adopting appropriate policies or procedures.

b. Immediate Annuities as Distribution Option Inside of Plan.

A 401(k) plan can provide annuity distribution options to participants in the same manner that money purchase plans customarily provide them. Money purchase plans are a type of DC plan, but employers must make mandatory contributions on behalf of plan participants and they are also required to offer annuity payment options in accordance with federal tax law. Typically, if a participant elects to receive a distribution in the form of an annuity under a money purchase plan, the sponsor will purchase an individual annuity contract on behalf of the participant and then distribute the contract to the electing participant.

Although it is not mandated by law, a 401(k) plan or any other type of DC plan could be amended (a) to offer annuity payment options to participants, and (b) to provide for the purchase and distribution of individual annuity contracts to those participants electing an annuity payment option. The individual contracts would provide fixed annuities, making fixed dollar payments over the life of the individual (or joint lives of the individual and his or her spouse).

A major concern shared by plan sponsors is the potential fiduciary liability in the event the insurance company becomes insolvent and fails to make the required payments under the annuity to participants. To address this concern, the DOL issued Reg. Section 2550.404a-4 in 2008, providing a non-exclusive safe harbor for the selection of annuity providers for DC plans. This safe harbor is satisfied if the plan fiduciary:

- (a) engages in an objective and thorough search of annuity providers;
- (b) considers the ability of the annuity provider to make future payments;
- (c) considers the cost (including fees and commissions) of the annuity contract relative to its benefits and services;

- (d) concludes that the annuity provider is financially able to make all future payments and that the cost of the annuity contract is reasonable; and
- (e) if necessary, consults with experts to comply with these standards.

c. Deferred Annuities As Investment and Distribution Option Inside of Plan.

A DC plan could use a variable group deferred annuity contract to make an annuity option available to participants for both investment and distribution purposes. Unlike an individual annuity contract issued in the name of the participant, a group contract is issued in the name of the plan trust or the plan sponsor. And instead of being purchased with a one-time premium payment, the individual plan participant invests in the variable annuity investment gradually over time (the “accumulation phase”). During this accumulation phase, the participant directs the investment of his or her premium contributions into the variable annuity’s underlying mutual funds and/or a fixed account providing a stated rate of return. After the participant retires, the value of the participant’s underlying investments (based on the performance of the underlying mutual funds and fixed account) is converted into an annuity and the “payout phase” begins. Under the terms of many contracts, before the payout phase begins, the participant can determine whether the payments will be fixed amounts, or variable amounts fluctuating with the value of the underlying mutual fund investments.

As discussed above, the selection of an annuity provider in connection with providing a variable annuity option to participants for investment and distribution purposes is a fiduciary act governed by the standards of ERISA Section 404(a)(1). Thus, it would be prudent for plan sponsors to adhere to the recent guidance provided under Section 2550.404a-4 of DOL regulations with respect to the non-exclusive safe harbor and, if necessary, consult with experts to comply with these standards.

PRACTICE TIP: Review sales practices to ensure FAs do not inadvertently assume any fiduciary responsibilities with regard to selection of annuities.

B. Target Date Funds.

In light of the surprising level of volatility across a number of target date funds intended for the oldest of retirees, both the SEC and the DOL have decided to move ahead with rulemaking in their respective areas to improve the transparency of target date investments.

1. SEC / DOL Co-Publish Investor Bulletin on Target Date Funds.

On May 6, 2010, the DOL and the SEC issued joint guidance on target date funds entitled, “Investor Bulletin: Target Date Retirement Funds,” providing basic guidance concerning the features of target date funds, and the ways to evaluate a target date retirement fund that will

help increase awareness of both the value and risks associated with these types of investments. As announced in its Regulatory Agenda and as recently confirmed by Assistant Secretary Borzi, the DOL will also be issuing a “best practices” fiduciary checklist later this year, which is designed to assist small and medium-sized plan sponsors evaluate and select target date funds

2. SEC Proposal to Change Advertising Rules for Target Date Funds.

The SEC voted unanimously on June 16, 2010, to propose rule amendments requiring target date funds to clarify the meaning of the date in a target date fund’s name and to enhance the information provided in advertisements to investors. Under the proposed rules, if adopted, marketing materials for target date funds that include a date in their name would also have to include the fund’s expected asset allocation at the target date as a “tag line” immediately adjacent to the fund’s name. The newly proposed rule would also require the marketing materials to include a visual depiction, such as a chart or graph, showing a fund’s glide path over time. Marketing materials would also have to include a statement of the target date fund’s asset allocation at the “landing point” (i.e., when the fund becomes most conservative) and when the fund will reach the landing point. In addition, the marketing materials would need to state that a target date should not be selected solely based on age or anticipated retirement date; that the fund is not a guaranteed investment and that asset allocations may be subject to change without a vote of shareholders

3. DOL Issues Proposed Rules on Target Date Disclosures.

On November 30, 2010, the DOL published its proposed regulations on target date disclosures. The proposed rule would amend its existing QDIA regulations (29 CFR 2550.404c-5) as well as its recently finalized participant-level fee disclosure regulations (29 CFR 2550.404a-5), requiring specificity as to the information that must be disclosed to participants concerning investments in target date funds.

a. Proposed Changes to QDIA Regulations.

The QDIA regulations, which were issued pursuant to the Pension Protection Act of 2006, provide fiduciary relief to sponsors of 401(k)-style plans that feature a default investment choice for participants. If the applicable conditions are satisfied, the plan’s automatic investment of a participant’s account in a default investment choice (in the absence of actual investment directions from the participant) is deemed to be a participant-directed action. Thus, defaulted participants alone (and not the plan sponsor) are held responsible for the plan’s automatic investments. Among other regulatory requirements necessary for the plan sponsor to obtain this relief, the default investment choice must meet the requirements of a QDIA, and the plan sponsor must furnish a QDIA notice to participants explaining the default arrangement.

Under the DOL's proposal, with respect to any target date fund series selected as the plan's QDIA, the QDIA notice would need to explain how its asset allocation changes over time and when its most conservative asset allocation is reached (*i.e.*, landing point), as well as include an illustration of the fund's glide path. If the name of the target date fund includes a reference to a particular date (*e.g.*, "Retirement 2050 Fund"), the QDIA notice would also need to explain the relevance of the date and the intended age group. If applicable, the QDIA notice would also need to include a disclaimer that the target date fund may lose money near and following retirement.

b. Proposed Changes to Participant-Level Fee Disclosure Regulations.

The DOL recently finalized its participant-level fee disclosure regulations on October 14, 2010. The regulations will require annual and quarterly disclosures of plan-related fee information and annual disclosures of investment-related information to participants, effective with plan years beginning on or after November 1, 2001. The annual investment-related disclosures are required to be provided in the form of a comparative chart.

Under the DOL's proposed change to its participant-level fee disclosure regulations, the annual comparative chart with investment-related disclosures would need to be supplemented with an appendix that includes additional information about any target date fund series included in the plan's menu of investment options. This appendix would be required, even if the target date fund series is not utilized as the plan's default investment option. The information required in the appendix is substantially similar to the applicable information required under the proposed change to the QDIA notice, as described above (*i.e.*, explanation of glide path and any reference to a particular date in the fund's name, disclaimer regarding investment losses near and following retirement).

c. Informal Follow-Up Guidance.

The DOL informally stated during its web chat on January 4, 2011 that a target date fund's prospectus is unlikely to satisfy the proposed requirement for target date disclosures. Thus, once the target date disclosure rules are finalized, plan fiduciaries (or their administrative service providers) will need to develop customized disclosures for target date funds, which are expected to be roughly 2 pages in length. The DOL also informally stated that it does not intend to develop a "model" target date disclosure for a plan's QDIA notice or the appendix to the annual comparative chart. The comment period for the public to provide feedback on its proposed regulation ended on January 14, 2011, and the DOL has not yet indicated when it is likely to finalize its proposed rule. We anticipate that the DOL will prioritize finalization of the interim final regulations under ERISA Section 408(b)(2) and the participant investment advice regulations, and then pursue finalization of its target date disclosure regulations.

PRACTICE TIP: Consider development of materials that will be “fiduciary friendly” that plan investors can pass through to plan participants in satisfaction of DOL rules for TDF disclosures.

4. Congressional Scrutiny of Target Date Funds.

On December 16, 2009, U.S. Senator Herb Kohl (D-WI), chairman of the Senate Special Committee on Aging, announced his intent to introduce legislation that would require target date fund managers to take on ERISA fiduciary responsibility in order for such funds to be eligible for designation as the plan’s QDIA. Senator Kohl was quoted as taking issue with the fact that “[m]any target date funds are composed of hidden underlying funds that can have high fees, low performance, or excessive risk” and concluding that “there is no question that we need greater regulation and transparency of these products.” Unlike the Obama Administration’s regulatory proposal to improve disclosure with respect to target date funds, Senator Kohl’s legislative proposal involves imposing ERISA’s fiduciary standards on target date fund managers.

Due to the nature of ERISA’s prohibited transaction rules, Senator Kohl’s proposal would require substantial changes to the current “fund of funds” structure and fee arrangements in many target date fund products.

Target date funds typically have a “fund of funds” tiered investment structure. Instead of investing in portfolio securities directly, the target date fund actually invests in other mutual funds, which in turn invest in portfolio securities. A conflict of interest arises in this fund-of-funds structure because many target date funds invest in affiliated mutual funds. From a product development perspective, when a fund family creates a target date fund, it naturally has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers. Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. A related conflict arises with respect to the mix of funds that underlie the target date fund. Because equity funds typically pay higher fees than other funds, the fund family has an incentive to design the target date fund so that it has a higher exposure to equity, increasing its aggregate fees at the expense of plan participants and also increasing the product’s expected volatility. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments.

Although an investment manager for a target date fund is permitted to invest in affiliated underlying funds under the Investment Company Act of 1940, it would not be permitted to manage the target date fund’s investment in this conflicted manner if it were

actually subject to the fiduciary standards under ERISA as contemplated in Senator Kohl's proposal.

C. Stable Value Funds.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, includes an expansive definition of a "swap" to include just about any instrument whose value is linked to a financial measure or the occurrence of an event. Title VII of this law imposes numerous requirements on any financial instrument deemed to be a "swap" and on counterparties to swap transactions. These requirements have significant implications with regard to the manner in which swaps are settled, cleared, traded and sold.

Because of this expansive definition, stable value contracts could easily be viewed as swaps. The Dodd-Frank Act directs the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") to conduct a joint study to determine whether the stable value contracts utilized by defined contribution plans with participant-directed investments fall within the statute's swap definition. The SEC and CFTC are further directed to consult with the DOL, the Treasury Department and state insurance regulators for purposes of this study, which is due on October 21, 2011.

However, even if the SEC and CFTC determine that stable value contracts are swaps, they must make a further determination of whether a regulatory exemption for stable value contracts is appropriate and in the public interest. In any event, the SEC and CFTC must issue regulations implementing their determinations. Under a "grandfathering" rule, stable value contracts that are in place when these regulations first become effective will not be deemed swaps, and such regulations will only impact stable value contracts that are entered into after the regulations go into effect.

As provided under the statute, it is unclear if stable value contracts utilized by defined benefit plans (as well as defined contribution plans with employer-directed investments) will automatically be subject to regulation as swaps.

Stable value contracts are a popular investment option for defined contribution plans, but many defined benefit plans also investment in them. If the CFTC or the SEC ultimately decide to impose substantive requirements on stable value contracts, it will have a large-scale impact on plans and plan participants.

IV. Sales Practice Issues – Senior Suitability and Retirement Income Products

A. SEC, FINRA and NASAA Initiatives

During Christopher Cox’s tenure as SEC Chairman, the SEC held a series of annual “Seniors Summits” from 2006 through 2008. These events were designed to educate senior citizen investors and their families, as well as the financial services professionals who advise them. Both Financial Industry Regulatory Authority (“FINRA”), and the North American Securities Administrators Association (“NASAA”), the umbrella organization for state securities regulators, participated in these Seniors Summits. These events were the start of an ongoing coordinated initiative to increase awareness as well as enforcement of the securities laws and rules designed to protect senior investors.

In September 2007, the SEC Staff, NASAA and FINRA published a report entitled, Protecting Seniors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminars. While this report did not create or modify existing regulator obligations to senior investors, it identified practices that many financial service firms had adopted with regard to advertising and marketing to seniors. The report was publicized with the hope that additional firms would adopt and improve on the practices identified. Sample practices included banning the use of marketing materials to target senior investors (such as referring to an event as a “senior seminar”), using web-based training modules to use as a reference when creating materials for senior-oriented events, and performing unannounced compliance visits to senior-oriented meetings.

In 2008, a broader initiative was launched to identify compliance and supervisory practices that have been developed by financial service firms with regard to senior investors. The findings of the SEC Staff, NASAA and FINRA were published in a report, entitled Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Servicing Senior Investors (September 22, 2008). Sample practices included training firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse or coercion), maintaining a list of approved and prohibited professional designations which may be used by advisors on their business cards, and limiting sales of certain products based on investor’s life stage and risk profile. An Addendum to the Protecting Senior Investors report was issued on August 12, 2010. The Addendum identified additional practices in the same areas covered in the original report, including: (i) communicating effectively with senior investors, (ii) training firm employees on senior-specific issues, (iii) establishing an internal process for escalating issues, (iv) obtaining information at account opening, (v) ensuring the appropriateness of investments, and (vi) conducting senior-focused supervision, surveillance and compliance reviews.

PRACTICE TIP: Review September 2008 *Protection Senior Investors Report* and August 2010 Addendum as reference for evaluating and enhancing current compliance policies and procedures with regard to senior investors.

B. Senior-Specific Certifications and Professional Designations

On March 20, 2008, NASAA adopted the NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations, which makes it unlawful for an advisor to sell securities or provide advice with the use of credentials (*e.g.*, “chartered retirement advisor,” “certified retirement specialist”) in a misleading manner. The rule is designed to stop an advisor from using meaningless certifications or designations in order to create the misleading impression that they have credentialed expertise. Advisors cannot use a self-conferred designation. The designation generally must (i) be from an educational organization (and not primarily a marketing organization), (ii) with meaningful standards for assuring competency, (iii) with meaningful procedures for disciplining unethical conduct, and (iv) with meaningful continuing education requirements.

On September 24, 2008, the National Association of Insurance Commissioners (“NAIC”) adopted a model rule imposing similar restrictions on insurance producers, entitled the NAIC Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which was enacted on July 21, 2010, included provisions encouraging states to adopt laws enhancing senior investor protections. Section 989A of the Dodd-Frank Act offers monetary grants to state securities commissions that adopt the NASAA Model Rule. State insurance commissions are also eligible for such grants if they adopt (i) the NAIC Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities, as well as (ii) the Suitability in Annuity Transactions Model Regulation of the NAIC.

Bolstered by the financial incentives offered under the Dodd-Frank Act, NASAA’s Model Rule has been endorsed by various state securities regulators and has already been adopted in over 20 states. Additionally, many states have adopted, or are in the process of adopting, both sets of Model Rules from the NAIC governing the sale of annuities.

NOTE: FINRA Regulatory Notice 07-43 provides that member firms must have adequate supervisory procedures to ensure that registered representative are not using designations in a misleading manner.

PRACTICE TIP: Review any current or pending state law requirements regarding senior-specific certifications to ensure adequacy of supervisory procedures. If no state law requirements comply, consider adopting procedures consistent with the NASAA Model Rules as a “best practice.”

C. Suitability in Fixed Annuity Transactions

In March 2010, the NAIC adopted the 2010 Suitability in Annuity Transactions Model Regulation. This model rule enhanced the protections afforded under prior version of the model rules with regard to the sale of fixed annuities. The original model rules, which were adopted in 2003, were entitled the Senior Protection in Annuity Transactions Model Regulation, in recognition of the fact that they provided targeted protection for “senior consumers” only. In 2006, the model rules were modified to protect all consumers, not just those over age 65.

The *2010 Suitability in Annuity Transactions Model Regulation* introduced the following key changes:

- Enhanced suitability standards to be more consistent with the suitability standards for the sale of variable annuities (which are regulated as “securities” by FINRA);
- Ensuring that the insurer remains responsible for suitability compliance and that it monitors all recommendations made prior to the issuance of annuity contracts; and
- Mandatory training for insurance producers on annuities in general and on specific products they are selling.

Under the prior version of the model suitability rules, the insurance producer had to make reasonable efforts to obtain suitability information about the consumer’s financial status, tax status, investment objectives and other information that could be reasonably considered in making an annuity recommendation. The 2010 model rule clarifies and expands the categories of *suitability information* to include 12 different factors, which are similar to those found under the corresponding FINRA rules for variable annuities (*i.e.*, age, annual income, financial situation, financial objectives, intended use of annuity, financial time horizon, existing assets, liquidity needs, liquid net worth, risk tolerance, and tax status).

The 2010 model suitability rules carried over the prior version’s requirement that producers have reasonable grounds for believing that the recommendation is suitable based on the information disclosed by the consumer. But in addition, to be more consistent with the FINRA suitability standards for variable annuity sales, the 2010 model regulation now requires producers to also have a reasonable basis to believe the following:

- The consumer has been reasonably informed of the annuity’s features, including surrender charges, tax penalties, limitations on interest returns and market risk.
- The consumer would benefit from certain features of the annuity (*e.g.*, annuitization, death benefits).
- The particular annuity as a whole, the underlying subaccounts to which funds are allocated, and any riders are suitable.
- In the case of an annuity exchange, the exchange is suitable taking into consideration any surrender charges, new surrender or “lock-in” period, whether the consumer had another annuity exchange in the preceding 36 months, and other factors.

The suitability obligation does not apply if: (i) no recommendation is made, (ii) the consumer provides materially inaccurate information, (iii) a consumer fails to provide suitability information and the transaction is not recommended, or (iv) the consumer buys or exchanges an annuity that is not based on the recommendation.

As provided under the 2010 Model Regulation, the insurer must establish a supervision system that is reasonably designed to achieve the insurance producer’s compliance. This system must include reasonable procedures to inform producers of the applicable requirements and also incorporate them into training manuals. The insurer must also establish standards for product training for insurance producers, and also provide product-specific training. The insurer must maintain procedures for reviewing each recommendation prior to issuance of the annuity to ensure the recommendation is suitable (*e.g.*, electronic screening system which flags recommendations for further review), and for detecting recommendations that are not suitable. An annual report on the effectiveness of the supervision system must be provided to the insurer’s senior management.

The mandatory training requirement for insurance producers under the 2010 Model Regulation includes a one-time 4 credit training course approved by the state’s insurance department. Fortunately, the satisfaction of substantially similar training requirements in another state is deemed to be sufficient. Thus, insurance producers licensed to sell in multiple states (*e.g.*, licensed as resident producer in home state and as non-resident producer in neighboring states) will not need to take multiple training courses.

D. Coordination Between NAIC Model Regulation and FINRA Rule

To prevent states (which adopt the NAIC Model Regulation) from implementing conflicting and duplicative suitability standards, the NAIC’s *Suitability in Annuity Transactions Model Regulation* provides that annuity sales made in compliance with FINRA suitability and supervision rules (*i.e.*, FINRA Rule 2330) will automatically satisfy the NAIC Model Regulation. Thus, the sales of variable annuities which are regulated as “securities” by FINRA

are automatically subject to the requirements of FINRA Rule 2330. In addition, if a broker-dealer voluntarily subjects its fixed annuity sales to FINRA's suitability and supervision rules, it will also be exempt from the NAIC Model Regulation. However, non-compliance with FINRA requirements will trigger the requirements under (and enforcement provisions of) the NAIC Model Regulation.

PRACTICE TIP: The NAIC Model Regulation impacts both insurance companies and broker-dealers. Upon adoption, certain states may be imposing substantive suitability standards on fixed annuities for the first time. All firms should review current and pending state law requirements (including whether the firm has flexibility of applying FINRA standards on sale of fixed annuities) and confirm adequacy of existing compliance policies.

E. Oversight of Indexed Annuities Will Not Be Transferred to FINRA

The sales of "equity-indexed" or "fixed indexed" annuities have increased in recent years. Unfortunately, according to the SEC, this growth in sales has been accompanied by complaints of abusive sales practices. Many indexed annuities have large commissions and long surrender periods, which can make them unsuitable for seniors and others who may need ready access to their assets. (See, *e.g.*, FINRA Investor Alert: Equity-Indexed Annuities – A Complex Choice.)

Indexed annuities provide earnings at rates that are linked to a securities index. However, the gains attributable to increases in the securities index are typically capped, reduced by an asset fee or limited to a portion of the actual gain (*e.g.*, annuitant participates in 80% of gains in S&P500 index). Thus, indexed annuities often have less potential "upside" in comparison to corresponding variable annuities. On the other hand, indexed annuities have minimum guaranteed interest rates, making them less risky than variable annuities.

As a historical matter, the status of indexed annuities under federal securities law has been unclear, and insurers generally have asserted that they are not registerable securities for purposes of the Securities Act of 1933, as amended (the "1933 Act"), on the grounds that the guaranteed interest feature makes them annuities, and therefore exempted securities as defined under Section 3(a)(8) of the 1933 Act (like fixed annuities). However, the SEC adopted Rule 151A under the 1933 Act in December 2008, which would have clarified the status of indexed annuities as "securities," bringing these investment products under the SEC's jurisdiction and subjecting them to the registration requirements for securities (like variable annuities). Rule 151A was scheduled to become effective in January 2011, but the D.C. Circuit Court of Appeals vacated the SEC's final rules on July 12, 2010. The court ruled that the SEC had failed to properly determine that its rulemaking was "necessary or appropriate in the public interest", and therefore that the SEC's determination was arbitrary and capricious.

A few short weeks after the D.C. Circuit Court of Appeals' decision to vacate Rule 151A, the Dodd-Frank Act was enacted on July 21, 2010, which further assured that indexed annuities would be exempt from securities regulations. Section 989J of the Dodd-Frank Act provides that indexed annuities are "exempted securities" as defined under Section 3(a)(8) of the 1933 Act if three conditions are met. First, the value of the annuity contract must not vary with the value of a separate account. Second, the indexed annuity must comply with the state's nonforfeiture law (*i.e.*, laws governing minimum value of annuity contract upon surrender) or the NAIC's *Model Standard Nonforfeiture Law* if state law does not impose a nonforfeiture requirement. Third, the indexed annuity must be issued by an insurer that has adopted policies which meet the requirements of NAIC's *Suitability in Annuity Transactions Model Regulation*.

Since it appears that indexed annuities and the insurers who issue them are generally able to satisfy these conditions, as a general rule, indexed annuities will remain under the exclusive jurisdiction of state insurance commissioners.

PRACTICE TIP: Given the high level of the public policy debate concerning indexed annuities, insurers and broker-dealers should consider reviewing and enhancing the suitability of such investments for senior investors.