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A PROFESSIONAL CORPORATION

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Questions And Answers

Target Date Funds

Q1. *What factors should be taken into account in selecting a TDF series as a plan investment? Are there any special considerations if the TDF will be used as a qualified default investment alternative*?

A1. On February 28, 2013, the DOL fulfilled its commitment to assist plan fiduciaries in obtaining and evaluating relevant information when selecting and monitoring target date funds ("TDF"s) by publishing a series of tips on "What to Remember When Choosing Target Date Funds." These tips suggest that the starting point for comparing and selecting a TDF should be consideration of the fund's prospectus which would include its historical performance as well as fee and expense information. Other characteristics of a particular TDF revealed in its prospectus, most obviously its target date, glidepath and the point at which it reaches its most conservative asset allocation (the "landing point"), would enable the plan fiduciary to determine how well the investment aligns with the plan's objectives, thereby enabling the fiduciary to meet its duties under ERISA.

Since plan sponsors typically lack expertise with TDFs and have exposure to liability for investment losses if they make an imprudent choice, advisors can provide valuable service by helping plan sponsors in identifying these objectives. These may range from preservation of savings to maximizing the investment potential of every dollar contributed to the plan, with stable retirement spending representing an intermediate goal. An advisor should ensure that the TDF's glidepath and allocation of assets across the selected asset classes are consistent with these objectives and that they are effectively implemented through appropriate investment styles and forms of investment to achieve the best outcome.

Understanding the Glidepath. A key consideration for plan sponsors and their advisors in reviewing the suitability of a TDF is whether the glidepath and landing point used by the TDF align with the plan objectives and the needs of the plan's participants. An advisor should know the percentage the TDF will hold in equities (with their greater potential for growth as well as risk and volatility) at the fund's starting point and its target date, as well as when the fund will reach its most conservative investment allocation with its highest percentage of investments in fixed income. Moreover, there should be an understanding of the rate of conversion from equities to fixed income embodied by the glidepath so that the relative growth potential, risk and inflation fighting capacity of the fund at any stage in a participant's career can be gaged.

To or Through Investment Philosophy. Many TDFs continue to maintain a significant investment in equities from the landing point and/or target date "through" a participant's death based on the perception that this will be needed to support inflation adjusted spending after retirement. This would meet the needs of a plan where participants gradually draw down account balances over a period of years. On the other hand, if a plan's participants have shown a pattern of cashing out when they retire, a TDF whose most conservative investment allocation will be attained at or near retirement age (thereby reducing the volatility of account balances at that time) may be a more appropriate choice.

Investment Strategy and Other Fund Characteristics. The DOL also wants plan sponsors to understand the TDF's investment strategy reflected by, among other things, the asset classes established to achieve diversification. For example, a sponsor should know if asset classes other than equity and fixed income securities are represented, such as potentially inflation resistant real estate. Further, investment style, such as whether the TDF's underlying investments are actively or passively managed, as well as the form of the underlying investments, *e.g.*, mutual funds, ETFs, collective trusts or separately managed accounts, should be examined for their effect on such critical issues as fees and expenses.

TDF Modifications. The DOL also recommends that plan fiduciaries periodically review whether there have been any significant changes to a target date fund's characteristics or the plan's objectives since the fund's original selection. Fund modifications requiring attention include changes in the management team or a shifting of the fund's investment strategy, as well as whether or not the original investment strategy has been effectively implemented. A change to the target date fund or to the plan's objectives for the fund could require that the fund be replaced.

Proposed QDIA Regulation. In November 2010, the DOL proposed that for any TDF selected as a plan's QDIA, the QDIA notice would need to contain disclosures explaining how its asset allocation changes over time and when its landing point would be reached, as well as include an illustration of the fund's glide path. If the name of the TDF 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.

Although the DOL's proposal focuses on target date disclosures, it would also require general changes to the QDIA notice requirement that would apply to any type of QDIA (*e.g.*, balanced fund). As proposed, with respect to any default investment choice selected as the plan's QDIA, the QDIA notice would need to describe the investment's objectives and principal strategies, including the types of assets held by the investment

choice. The QDIA notice would also need to include historical investment performance and a disclaimer that past performance is not necessarily an indication of how the investment will perform in the future. The DOL has informally indicated 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.

Definition of Fiduciary

Q2. *The DOL has promised to redefine the term, "investment advice fiduciary." Who qualifies as a fiduciary? What does it means to be one? What kind of changes do you see making their way into the DOL's new proposed regulation?*

A2. The DOL's proposal to expand the regulatory definition of who is an "investment advice fiduciary" is part of its campaign to eliminate conflicts in the 401(k) industry. Under this definition, your actions control your status, and you are deemed a fiduciary if you provide any "investment advice." The existing definition of investment advice imposes a five-factor test under which a person receiving a fee or other compensation from a plan must: (i) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or property, (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement or understanding, with the plan or its fiduciary that (iv) the advice will serve as a primary basis for investment decisions with respect to plan assets, and (v) the advice will be individualized based on the particular needs of the plan.

The regular basis and primary basis prongs of this test are particularly important. This was illustrated in the 2007 case of *Ellis v. Rycenga Homes* which applied these factors to a set of facts where periodic meetings between a broker and a plan trustee over the course of a 20-year relationship resulted in the plan's consistently following the broker's suggestions. This led to the court's holding that the broker was a fiduciary, because of the regularity of the advice and the plan's heavy reliance on the adviser.

Under the DOL's proposed rulemaking, however, an adviser would have been deemed a fiduciary if there were any understanding that the advice could be considered in connection with the plan's investment decisions, even if not provided on a regular basis. Thus, even one-time casual advice could trigger fiduciary status. The DOL's September 19, 2011 announcement that the fiduciary advice regulations would be re-proposed signaled that certain problematic areas of the original proposal would be addressed, if not fixed. If the re-proposed regulations are similar to the original, many non-fiduciary advisers could, for the first time, find themselves subject to ERISA's fiduciary standards. Among other things, these new ERISA fiduciaries would not be able to receive variable compensation, including 12b-1 fees and other similar types of compensation.

Given the DOL's desire for fundamental change, the "primary basis" standard of the current rule is not likely to be retained, even though the DOL appears to recognize that investment advice under the revised rule should exclude advice not delivered on an individual basis. The American Bar Association Section of Taxation recently recommended a compromise solution, some form of which could well be adopted. Under this proposal, there would have to be an understanding on the part of a provider that the advice to be rendered will be a "substantial consideration" by a plan or a plan fiduciary in connection with an investment management decision. For this purpose, "substantial consideration" would not rise to the level of a "primary basis" but would be more than a "material consideration."

The DOL announcement that the fiduciary regulation would be re-proposed stated that the revised rules would, among other things, clarify that fiduciary advice is limited to individualized advice directed to specific parties. Assuming the mutuality requirement of the current regulation is also eliminated, the ABA Tax Section also recommended an express requirement that advice be individualized, thereby incorporating the concept of privity between plan and adviser. This would address the fear that liability claims could be asserted based on the proffer of general information that happens to be used by a plan in the context of a securities purchase, even though the information is available to all comers. Without such a privity requirement, plans are likely to find that sources of information to which they now have access will no longer be available and that investment professionals will be far less free in offering their views.

If an individualized advice requirement is adopted, the DOL may seek to protect plans from a misunderstanding as to whether an adviser is acting in a fiduciary capacity by conditioning exclusion from fiduciary status on delivery of a notice that the information or advice is not intended to be fiduciary advice. The ABA Tax Section thinks that this notice could be incorporated in the 408(b)(2) disclosure materials, but one can imagine the DOL requiring such notice closer to the time the advice is given.

Some legislators and policymakers fear that any DOL revision of the 1975 fiduciary regulation will discourage financial service providers from offering professional investment advice to retirement plans and retirees at a time when it is increasingly needed. On July 9, 2013, Sen. Orrin Hatch acted on these misgivings by proposing legislation that would, among other things, provide for joint jurisdiction of the Treasury Department and the DOL over prohibited transaction rules applicable to retirement plans. The bill would also give Treasury sole jurisdiction over IRA prohibited transaction rules. (This legislation, named the SAFE Retirement Act, covers a broad range of other issues to be discussed in Q&A No. 4.) If enacted, the SAFE Retirement Act would restore the allocation of regulatory authority that existed before 1978. The reasoning is that the grant of additional powers to the DOL in 1978 was premised on the reasonableness of the 1975 fiduciary regulation that the DOL is now seeking to change. In essence, Sen. Hatch and certain other legislators feel the DOL is overreaching in its proposal to revise the fiduciary regulation.

Tax Reform

Q3. *With the size of the deficit a contentious political issue, all suspect that the tax incentives for retirement plans will likely change in the near future. What are key pending legislative proposals that will affect the tax treatment of retirement plans?*

A3. **401(k) Tax Advantages.** The amount of tax revenue forgone on account of retirement plans is very large and this makes 401(k) plans an easy target for revenue raising initiatives. Retirement saving through a 401(k) plan is tax-advantaged because the government generally taxes neither the original plan contributions nor the investment returns on those contributions until they are paid as benefits. Since the budget process looks at revenues and expenditures within a ten-year window, and the payment of most retirement benefits occurs outside that window, the amount of taxes forgone because of 401(k) contributions tends to be viewed as a permanent expenditure. As pressure builds to control the federal deficit, legislative proposals will be considered to reduce the tax cost of the retirement plan expenditure.

Current Limitations. The tax code already contains various limitations on 401(k) plan contributions that could be adjusted for the purpose of reducing tax expenditures (which, by the way, is another name for a tax increase). For example, in the case of 401(k) plans, the maximum amount of annual contributions from all sources for any employee is currently $51,000, and the limit increases to $56,500 if the employee is at least 50 years old. The limit on annual contributions includes elective deferrals by participants which themselves are capped at $17,500. Another limitation subject to being reduced by legislation is the cap on the plan sponsor's deduction for contributions to a 401(k) plan equal to 25% of the compensation otherwise paid during the taxable year to the plan's participants. Further, compensation in excess of $255,000 cannot be considered in calculating contributions to a participant's plan account. Over the years, Congress has raised or lowered these amounts depending on the needs of the time. However, the most threatening tax reform proposals would not simply adjust the current limits. Rather, the new tax reform proposals would fundamentally change the way the limits are calculated.

20/20 Cap. Consider, for example, the so-called 20/20 Cap proposed by the National Commission on Fiscal Responsibility and Reform. The 20/20 Cap would limit the maximum excludable contribution to a defined contribution plan to the lesser of $20,000 or 20% of income. This proposal applies to both employee elective deferrals as well as nontaxable employer contributions. The 20/20 Cap is hard on high earners; if you earn $100,000 per year, the most that can be put into your 401(k) account is $20,000.

Refundable Tax Credit. Brookings Institution has also designed a much-discussed refundable tax credit proposal that would shift the demographics of those receiving the tax benefits of the retirement plan tax expenditure from a perceived slant favoring highly compensated employees. Under this tax reform proposal, all employer and employee contributions would be included in gross income without any deductions and exclusions.

In their place, a flat-rate refundable tax credit would be deposited directly into a plan participant's retirement savings account. Although the current contribution limits would not change, the refundable tax credit would benefit low earners at the expense of the more highly compensated. Critics have noted that this would seriously diminish the incentive many employers have to maintain qualified plans.

28% Tax Benefit Cap. The Obama Administration's FY 2014 budget proposes to limit the tax value of any particular tax deductions and exclusions to 28% of the specified item's amount in order to increase taxable income that would otherwise be subject to a maximum 39.6% tax rate. This proposal, which originated in the 2013 budget, would apply to 401(k) contributions (as well as health care contributions), regardless of who makes them. Thus, a taxpayer subject to a top 39.6% tax rate would pay an 11.6% tax (39.6% - 28%) on the value of any 401(k) contributions. Under this proposal, those receiving the highest contributions to their 401(k) accounts could be subject to an additional $6,554 in tax liability. Critics of the Administration's proposal were quick to point out that it contains an element of double taxation in that the same plan contributions would be taxed again when withdrawn from the plan.

Conclusion. The 20/20 Cap, refundable tax credit, Administration's 28% tax value cap, and other tax reform proposals represent a fundamental reduction of the incentives for maintaining a qualified plan. Such cutbacks in the tax incentives for retirement plans seem to be the order of the day and have the potential to reduce the role of employers and to shrink the system.

Q4. *What initiatives are being made at the state level that affect retirement benefits? Are there any Federal proposals that complement or mirror local initiatives?*

A4. **NCPERS Proposal**. The National Conference on Public Employee Retirement Systems (NCPERS) has proposed amendments to ERISA and state laws allowing the establishment of state-sponsored multiple employer cash balance plans covering private-sector workers. The NCPERS proposal, or ones like it, are being considered by several state legislatures. The target group that this proposal seeks to benefit consists of employees of small employers that do not have access to pension plans. The assumption is that they would benefit from a state's bargaining power, experience and expertise.

The NCPERS Secure Choice Pension ("SCP") initiative is a bolder variation of prior proposals for state-run plans (involving voluntary contributions to DC plans) in that it entails a cash balance plan design requiring employer contributions to fund an annual salary credit of 6% of compensation plus minimum interest credits of 3% per year with potentially higher interest credits up to the yield on 10 year Treasury Bills plus 2%. Amounts contributed plus earnings credited to the participant's account would be guaranteed, although the allocation and interest crediting rates can be adjusted prospectively to better reflect benefit and financial needs. Although employer participation would be voluntary, withdrawal liability would be assessed on terminating employers as under a multiemployer plan.

There is uncertainty as to how SCP plans would operate where assets are not sufficient to fund the promised lifetime benefit. One possibility that is mentioned in this regard is cutting back benefits, but this may not be realistic if employees have been promised state-backed benefits. Extending amortization periods for funding purposes is another technique that is mentioned. Ultimately, however, the states will be subject to the unfunded liabilities of SCP plans. The possibility that responsibility for private-sector pensions would be shifted to taxpayers at a time when states are struggling to meet the demands of public employee systems is a major political weakness of the SCP proposal.

California Secure Choice. In September 2012, California enacted an auto-IRA program to be administered by the state in which employers with 5 or more employees and no other retirement plan will be required to participate. Employees are automatically enrolled and contribute 3% of pay unless they opt out. There is a state-guaranteed investment return. Contributions will be pooled and invested by investment managers selected by the state which may end up being CALPERS. Implementation of the program is conditioned on receiving an IRS ruling that contributions will be pre-tax and DOL approval that the program is not an ERISA plan.

Other States. In Massachusetts, 2012 legislation authorizes the state treasurer to create a multiple employer defined contribution plan that will receive contributions from non-profit employers employing fewer than 20 persons as well as from their employees. The plan will be managed by the treasurer separately from the state's public-employee pension fund and will allow employees to direct the investment of their accounts from an investment menu selected by the treasurer. The Massachusetts legislation requires the treasurer to obtain IRS approval of the plan and to ensure that it complies with ERISA.

According to the National Conference of State Legislatures, Connecticut, Illinois, Maryland, Michigan, New York, Pennsylvania, Rhode Island Washington State, Vermont, Virginia, and West Virginia have also considered pension legislation for private-sector employees, although in some cases such proposals only authorize study of the matter and in others the proposals were defeated or tabled.

Harkin Proposal. To help prepare workers for paying basic retirement expenses, Senator Tom Harkin has proposed a new universal retirement system built around the following principles:

(i) automatic and universal enrollment,
(ii) a regular stream of income starting at retirement age,
(iii) financing through the current payroll system by employee and employer contributions and government credits, and
(iv) management by privately-run, licensed and regulated entities established pursuant to the legislation.

Although expected shortly, there is, as yet, no specific legislative proposal implementing these principles. However, it is understood that the pensions to be paid would be based on a participant's total contributions supplemented by investment performance and government credits for low-wage earners. Participants would be allowed to increase or decrease contributions or to opt out of the system entirely. The proposal is intended to appeal to employers by relieving them of any fiduciary responsibility, although employer participation is mandatory if the employer does not already offer a plan with a minimum level of employer contributions and some level of employer matching contributions to the new plans will be required. The Harkin initiative bears a similarity to current proposals being considered by state legislatures under which state governments would sponsor hybrid defined benefit-type plans covering private-sector workers, except that the new managing entities, dubbed "USA Retirement Funds", take on the role of the state government in managing investments.

Hatch Proposal.

Private Plans. The Safe Retirement Act proposed by Senator Orrin Hatch on July 9, 2013 is likely to provide serious competition for the Harkin proposal. In contrast to Harkin's USA Retirement Funds that would pool funds and limit payout to a regular stream of income for life, the SAFE Retirement Act would authorize new 401(k)-style plans with individual accounts controlled by participants who would be able to contribute up to $8,000 annually without the burden of discrimination testing. There would be reduced administrative burdens, no required employer contributions and automatic deferrals (subject to a participant's opting out) of 3% to 15% of pay. These new plans would be called "Starter 401(k)s", indicating that their underlying purpose would be to broaden access to retirement plan programs by encouraging plan adoption by small and start-up businesses that might not be able to afford employer contributions. Sen. Hatch's proposal would also increase the tax credit for adopting a new qualified plan that can apply for up to 3 years from $500 to an amount up to $5,000 (assuming the plan covers at least 20 non-highly compensated employees, *i.e*., $250 for each such participant).

Public Plans. The SAFE Retirement Act contains a number of other proposals to increase the efficiency of private retirement plans, but the showstopper is a measure designed to shore-up public retirement systems. To address the public pension debt crisis, state and local governments would be able to adopt a so-called SAFE Retirement Plan under which the plan would annually purchase a deferred fixed income annuity contract (under which benefits would generally commence at age 67) from an insurer for each plan participant with the government employer's annual contribution on the participant's behalf. Premium payments to insurers would be due no later than 90 days after the close of the plan year, and the selection of insurers would be subject to a bidding process.

Sen. Hatch's proposal would have the advantage of eliminating underfunding, at least on an ongoing basis, and at the same time, enhance public pension security while transferring investment risk to the insurers. In effect, the SAFE Retirement Plan would convert the prevailing system of final average pay plans into career average plans. Whether this would

be a good thing depends on where you sit. Some might take the view that eliminating benefits based on final pay will prevent abuses seen under the current system that are caused by manipulating pay so that it spikes immediately before benefit commencement. However, career average plans tend to result in smaller benefits, and public employee interests see this as a takeaway to which they have voiced opposition. On the other hand, the proposal would not prevent a government employer from establishing another defined benefit or defined contribution plan.

Re-Enrollment Default Investments: Bidwell v. University Medical Center

Q5. *Many recordkeepers offer re-enrollment services that require participants to provide new or updated investment instructions for their accounts. Employees who fail to re-enroll are defaulted into a qualified default investment alternative ("QDIA"). Recordkeepers have relied on the preamble to the QDIA regulations as legal authority to support the re-enrollment default investments. Please explain how a recent court decision will support the practice of re-enrollment default investments.*

A5. **Preamble to QDIA Regs.** The preamble to the QDIA regulations explains that "it is the view of the Department that nothing in the final regulation limits the application of the fiduciary relief to investments made only on behalf of participants who are automatically enrolled in their plan." The preamble then explains that the QDIA regulations also apply to the failure of a participant to provide investment direction following the elimination of an investment alternative or change in service provider (*i.e.*, plan conversions) as well as any other failure of a participant to provide investment instruction. When a participant has "the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided" by the QDIA regulations so long as all of its conditions have been satisfied.[1]

5th Circuit *Bidwell* Case. In its June 29, 2012 decision in *Bidwell v. University Medical Center*, the U.S. Court of Appeals for the Sixth Circuit relied on the QDIA regulations and its preamble to provide relief for an employer that implemented default investments following a re-enrollment. The facts in *Bidwell* are as noteworthy as the court's legal analysis.

Facts. In 2008, the employer changed the default investment under its 403(b) plan from a stable value fund to a target date fund. The employer instructed the recordkeeper to send a notice of the change by first-class mail to all participants who were 100% invested in the

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[1] Preamble to final QDIA regulations at 72 Fed. Reg. 60452, 60453 (2007). The preamble also explains that QDIA regulations may also apply when a participant fails to provide investment instructions following a rollover or when the plan administrator has determined that a participant's investment directions are inadequate (*e.g.*, if the investment election form does not exist, is illegible or does not provide the information necessary for an effective election).

stable value fund. The notice also advised these participants that their investments would be moved to the target date fund unless the participants gave instructions otherwise by a specified deadline. Two participants who had affirmatively elected to invest in the stable value fund did not respond by the deadline and were defaulted into the target date fund. When these participants received their next quarterly statement, they directed their investments back into the stable value fund. In the interim, one participant suffered an $85,000 investment loss; the other participant incurred a $16,900 investment loss. They filed claims for reimbursement with the plan administrator. After the plan administrator and federal district court rejected the claims, the participants appealed to the 6th Circuit.

Arguments. On appeal, the participants argued that QDIA regulations should not shield the employer from claims of plan participants who had affirmatively elected to invest in the stable value fund. In other words, because they affirmatively elected into the stable value fund, they had a right to have their investment remain within the stable value fund until they explicitly directed otherwise. In relying upon the preamble to the QDIA regulations, the 6th Circuit said: "In essence, the DOL explained that, upon proper notice, participants who previously elected an investment vehicle can become non-electing plan participants by failing to respond. As a result, the plan administrator can direct those participants' investments in accordance with the plan's default investment policies and with the benefit of the [QDIA fiduciary liability] protections." The 6th Circuit also rejected the participants' argument that the QDIA regulations did not apply to a transfer of funds but only a failure to provide instructions with respect to contributions. Although the participants alleged that they did not receive a QDIA notice, they did not allege that the employer's delivery method was inadequate. In any event, the 6th Circuit noted that it is not the actual receipt of notice that is relevant, but the acts of the fiduciary in attempting to ensure that notice is delivered. In this case, it was reasonable for the employer to rely on the dependability of the first-class-mail system.

I*mpact*. Although the Sixth Circuit's decision is binding in only Kentucky, Michigan, Ohio and Tennessee, it is likely that courts in other jurisdictions will cite it favorably.

408b-2 and 404a-5 Disclosure Aftermath

Q6. *What should financial advisors be telling their plan sponsor clients now that the 408b-2 and 404a-5 disclosures have been made?*

A6. **Disclosure Failures**. If a service provider has failed to provide the required 408b-2 disclosures to the plan sponsor, the plan's fee payment to the service provided can be a prohibited transaction. *However*, a plan sponsor can obtain relief from the prohibited transaction penalties by taking steps to cure a known disclosure failure. First, the plan sponsor must make a written request for information, and the delinquent service provider is obliged to respond within 90 days. If the service provider refuses or is unable to respond to the request for information, the plan sponsor must notify DOL no later than 120 days after

requesting information, and decide whether to terminate the service arrangement. The DOL has announced that plan sponsors can provide the notice online.[2] In addition, if the requested information relates to future services and is not disclosed promptly after the end of the 90-day period, the plan sponsor is obliged to terminate the service arrangement—consistent with the duty of prudence—as expeditiously as possible.

Fee Reasonableness Now Becomes Key Issue. All plan sponsors have a specific duty to assure that the plan's fees for investment and administrative services are reasonable. Now that ERISA Section 408(b)(2) requires investment vendors and recordkeepers to provide comprehensive fee information, plan sponsors have a corresponding responsibility to review and understand this information. Thus, as a practical matter, the fiduciary bar is being raised for plan sponsors to evaluate the reasonableness of the service provider's compensation. One of the keys to making a proper evaluation is establishing a prudent fee review process, which will most likely require plan sponsors to ask for additional information beyond what is included in a service provider's 408(b)(2) fee disclosures.

Fee Policy Statement. It is now standard practice for plans to maintain an investment policy statement or IPS. Like an IPS, plan sponsors should seriously consider establishing and adopting a fee policy statement or FPS. The written procedures maintained in a formal FPS can give plan sponsors the procedural discipline necessary to conduct a proper view of a plan's fees and services. The plan's FPS should be customized to the plan's circumstances and objectives, and the FPS's procedures should complement the plan's IPS procedures. That is to say, the plan's review under the IPS should be coordinated with the plan's review under the FPS. And like an IPS, a solid FPS can help plan fiduciaries demonstrate that they are acting with the procedural prudence required under the law.

Value Proposition. Rather than seeking a service provider with low fees, plan sponsors should seek out the service provider with the best "value proposition." In order to evaluate the reasonableness of the service provider's fees, the plan fiduciary should make appropriate inquiries about the service offering. Is the service provider genuinely committed to helping both the plan sponsor and the plan participants on an ongoing basis? If so, is the service provider willing to make that commitment in writing? Consistent with DOL's guidance, a service provider's fees should always be evaluated in light of the services provided. Plan fiduciaries should make an effort to work with service providers that are open and forthcoming about the types of services they offer and the fees for such services.

Fee Disclosures to Participants. If a plan sponsor has fee-related concerns because of the reaction of participants to the fee disclosures, the plan sponsors may need assistance from advisors in meeting or communicating with participants in order to clarify the investment and fee information with educational materials. The plan sponsor may also need assistance in enhancing its fiduciary review process.

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[2] See July 18, 2002 EBSA News at http://www.dol.gov/ebsa/newsroom/2012/EBSA071812.html. The online notice website is at http://www.dol.gov/ebsa/regs/feedisclosurefailurenotice.html.

Brokerage Accounts

Q7. *In light of the DOL's original and revised guidance on offering brokerage accounts under 401(k) plans, what should plan sponsors be concerned about?*

A7. There is no bright line test for determining whether the proper fiduciary review of brokerage accounts has been undertaken, or whether "sufficient information" has been disclosed. It will be a facts and circumstances analysis, case by case. However, financial advisors should help their plan sponsor clients maintain good documentation of efforts to satisfy the unique rules applicable to brokerage windows.

Original FAB. On May 7, 2012 the DOL issued a Field Advice Bulletin ("FAB") that was intended to primarily clarify the participant disclosure requirements.[3] Nevertheless, the FAB included a question and answer ("Q&A") that imposed an "affirmative obligation" on a plan sponsor to examine the investments available within brokerage account and determine whether any should be treated as a designated investment alternative ("DIA"). The Q&A was controversial and the retirement industry persuaded the DOL to revise it.

Revised FAB. On June 30, 2012 the DOL revised the FAB to eliminate the "affirmative obligation" duty to examine the investments available within brokerage account.[4] However, the revised FAB explains that the general ERISA duties of prudence and loyalty would require consideration of the nature and quality of services provided in connection with the brokerage account. In addition, a plan's failure to offer any DIA (as a means to avoid the disclosure rules for DIAs) would "raise questions" under those ERISA fiduciary duties. The DOL intends to further examine the fiduciary obligations of plan sponsors with brokerage accounts.

Implications. In light of the revised FAB, here are some of the more important points for financial advisors to remember when assisting their plan sponsor clients:

- Where a plan sponsor has determined a brokerage account would be a prudent investment option for the participants, financial advisors should assist with the implementation.
- Even though brokerage windows are not subject to the specific DIA disclosure requirements (*e.g.*, benchmarking or performance data), financial advisors should be prepared to help with the following general disclosure requirements for brokerage accounts offered by a plan:

[3] FAB 2012-02 (May 7, 2012). DOL's participant disclosure regulations are published at 29 CFR 2550.404a-5 with conforming changes to the ERISA Section 404(c) regulations at 29 CFR 2550.404c-1.
[4] FAB 2012-02R (July 30, 2012).

- A general description of the brokerage account that includes how investment instructions are to be provided, special restrictions or limitations if any, how the brokerage window is different from the plan's DIA, and to whom questions may be directed.
- Detailed fee and expense information that is chargeable to the participant's account rather than on a plan-wide basis, including commissions and per-trade charges.
- Preparation of quarterly fee statements that include a description of the related services.

- Financial advisors should be careful to provide accurate brokerage account information requested by their plan sponsor clients. Although the plan sponsor is ultimately responsible for compliance with the participant disclosures, the plan sponsor is not liable where there has been reasonable and good faith reliance on information provided by service providers.

Capturing IRA Rollovers

Q8. *How can a financial advisor accept rollover assets from 401(k) participants when the financial advisor serves as an investment advice fiduciary for the plan sponsor*?

A8. A fiduciary advisor can accept rollover assets from participants where the financial advisor has been engaged as a non-fiduciary advisor when the rollover-related services are offered to the participant.

Rationale. With regard to the same retirement plan, a financial advisor may serve as a fiduciary in some instances (*e.g*., advising the plan sponsor) and as a non-fiduciary in other instances (*e.g*., educating a plan participant). A financial advisor who offers rollover-related services to participants in a non-fiduciary capacity is not subject to the ERISA restrictions that otherwise apply to those services delivered to the plan in a fiduciary capacity. In determining whether a financial advisor is acting in a fiduciary capacity when communicating with participants, three factors come into play.

(i) whether financial advisor's communications take place in a plan setting;
(ii) whether the financial advisor is using plan-related authority in making the communication; and
(iii) whether the communication is primarily related to the plan.

With these three factors in mind, the following steps should be taken to demonstrate the financial advisor is acting in a non-fiduciary capacity in offering rollover services to participants.

Communication Setting. A financial advisor's communications regarding the rollover services should be made in a non-plan related setting. Therefore, the financial advisor

should not discuss, promote, or offer rollover services at any plan meetings conducted by the plan sponsor. At these plan meetings, the financial advisor cannot discuss the advisability of taking a plan distribution or rolling over funds to an IRA. However, the financial advisor can discuss the availability of rollover distribution features in a plan as an element of plan education. The advisor can follow up at one-on-one meetings with plan participants on certain rollover topics.

Plan Sponsor's Role. The plan sponsor should confirm in writing (*e.g.*, by means of an investment advisor agreement or confirmation letter) that the financial advisor's rollover services are unrelated to any services it provides to the plan sponsor or plan. Consistent with this understanding, the plan sponsor should not endorse or encourage the use of the financial advisor's rollover services.

Participant's Role. The financial advisor must not suggest in any way that the participant is obligated to work with the financial advisor. Rather, the participant must understand that the rollover services are not associated with the plan and the financial advisor is not offering the rollover services in a fiduciary capacity. To confirm this understanding, the participant should sign an acknowledgment form.

Non-Plan Assets. ERISA would not apply to a participant's assets held outside the plan sponsor's plan. Thus, a financial advisor serving as an investment advice fiduciary for the plan sponsor could accept and manage the non-plan assets. For this purpose, the participant's outside assets would include assets held in an IRA or another employer's retirement plan.

Pending Changes. Notwithstanding the controversy that its initial proposal generated, the DOL is anticipated to expand the definition of investment advice fiduciary. In connection with that proposal, the DOL has requested comments on whether "investment advice" should include recommendations related to taking plan distributions. Thus, it is possible that the final regulation relating to fiduciary advice may change the conditions under which a financial advisor may accept rollover assets from 401(k) participants when the financial advisor serves as an investment advice fiduciary for the plan sponsor.

New Areas of Potential Litigation

Q9. *We know that we live in a litigious society. We further know that Americans are woefully underprepared for retirement. Can you put yourself in the shoes of our advisors and TPAs and tell us where you believe liability exists in our industry and where litigation will be focused in the next few years?*

A9. *Effect of 408(b)(2) Regulations*. Before considering new areas of liability, we should think about the impact recent developments will have on existing liability theories. The predominant threats of litigation in the last decade have been stock drop cases and excess fee cases. The new disclosures required by ERISA Section 408(b)(2) are likely to

highlight conflicts of interest and compensation payments that were previously hidden, which may be used to support such claims.

The new 408(b)(2) rules became effective July 1, 2012, and all plan sponsors must now receive comprehensive disclosures from their service providers concerning the hard-dollars and soft-dollars (such as 12b-1 fees) that they receive as compensation. These disclosures are designed to support the plan sponsor's fiduciary duty to manage plan fees, and to ensure that they understand the indirect or "hidden" compensation of providers. If these tools are not utilized to negotiate competitive fees, the 2012 case of *Tussey v. ABB, Inc.* shows that a plan sponsor may be held liable. Further, the DOL has issued pronouncements to the accounting industry that plan auditors should be looking for 408(b)(2) compliance, or lack thereof, as part of the annual audit process.

Going forward, the new 408(b)(2) fee disclosures will force plan sponsors to monitor and benchmark all plan service provider compensation, both direct and indirect. If there are plan sponsor failures in this regard, there are likely to be claims of fiduciary breach and assertions of prohibited transactions. However, I think it will take the plaintiffs' bar a year or two to evaluate whether the new disclosures help their cause.

In order to protect themselves against these kinds of claims, a plan sponsor selecting a new provider should consider obtaining relevant information about the provider's services and fees by soliciting bids from multiple providers. If the provider utilizes one or more subcontractors, their information should also be requested and reviewed. Reviews of providers should be conducted at reasonable intervals (*e.g*., annually). To demonstrate that these reviews are part of an ongoing process, findings should be documented including a brief summary of the information gathered and the areas of fiduciary review. A well-documented review of the reasonableness of fees and expenses helps demonstrate that the plan sponsor has prudently fulfilled its fiduciary duties under ERISA.

TDFs – A New Litigation Frontier? If I had to predict a potentially new area for litigation, I would identify the selection of target date funds for a plan's investment menu. In November 2010, the DOL showed its concern about these investments by issuing proposed regulations that would require participant notification as to how the asset allocation of any fund selected as a default investment changes over time (*i.e*., the fund's glidepath) and when its most conservative asset allocation is reached (*i.e.*, the fund's landing point). This notice would need to include an illustration of the fund's glide path, and if the name of the target date fund includes a reference to a particular date (*e.g.*, "Retirement 2050 Fund"), it would also need to explain the relevance of the date and the intended age group. The SEC is proposing similar TDF changes.

Target date funds typically have a "fund of funds" tiered investment structure. This fund of funds structure creates conflicts of interest, because many target date funds invest in affiliated mutual funds. There is a natural incentive to include as many related funds as possible in the underlying fund mix and to have an excessive concentration in funds with the highest fees, such as equity funds. As a result, target date funds tend to have higher

expense ratios than other 401(k) plan investments. In addition, many of them are excessively volatile, even as they approach their target dates.

The DOL, however, has advised that ERISA's statutory structure insulates mutual fund investment managers from fiduciary liability. Since the managers of target date funds do not have any fiduciary duty under ERISA with respect to the plans investing in them, plan sponsors alone are responsible for the evaluation, selection and monitoring of these funds. Thus, another recession, or even a stock market correction, could trigger a waive of law suits against plan sponsors that have not adequately evaluated the target date funds in their plan's investment menu.