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Retirement Plans: Legislative, Regulatory, Judicial Developments
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Internal Revenue Service

- **Updated Prototype Retirement Plans: Adoption and Submission Deadline**
 - April 30, 2010 is the deadline for employers to:
 - adopt prototype retirement plans recently updated¹ by banks, insurers, mutual funds, broker-dealers, or similar financial institutions; and
 - submit the plan to the IRS for a favorable determination letter using IRS Form 5307.
 - IRS began accepting applications for determination letters on May 1, 2008.²
 - IRS has extended the deadline once and does not anticipate extending the deadline again.

- **Prototype Retirement Plans: Interim Amendment and Operational Compliance**
 - Although IRS requires financial institutions to submit their prototype plans once every six years, those plans must be amended in the interim to comply with changes in the tax qualification requirements.
 - IRS is very aware that many prototype plans are not complying with this interim amendment requirement because the financial institution or the employer is not timely adopting the required interim amendments.
 - IRS is disqualifying prototype retirement plans in record numbers either because of the interim amendment requirement or because employers are not operating their plans in accordance the prototype plan document, adoption agreement ,or interim amendments. The IRS is becoming much more aggressive, especially with respect to small employers.
 - Financial advisors discovering plan document or operational defects should advise employers to bring these disqualifying defects to the attention of their legal adviser and not attempt to bury them.

- **401(k) Fee Audits**
 - During audits of retirement plans to determine whether they are complying in operation with the terms of the plans, IRS is investigating fees paid to vendors servicing the plans.
 - Although the IRS' jurisdiction over 401(k) fees is unclear, it is an area in which they intend to investigate.

¹ In accordance with Revenue Procedure 2007-44, these prototype plans should have been updated for EGTRRA and other changes in plan qualification requirements listed in the 2004 Cumulative List in IRS Notice 2004-84.

² Announcement 2008-23 (April 7, 2008).

Department of Labor

- **408b-2 Service Provider Regulations**

- The DOL has proposed³ changes to its current regulations to require service providers to disclose in writing their fees and conflicts of interest.
- Many financial advisors have been misled by the proposed conflict of interest disclosure requirement.
 - The conflicts disclosure requirement suggests that financial advisors serving as investment advice fiduciaries could cure their conflicts of interest through disclosure.
 - However, the 408b-2 regulations provide relief only from ERISA's party in interest rules, not its conflict of interest rules.
 - The key point is that financial advisors serving as investment advice fiduciaries should be eliminating, not disclosing, conflicts of interest.
- The Obama administration's final 408b-2 regulations will likely require more detailed disclosure than the Bush Administration's proposal.
- The final 408b-2 regulations are expected in the first quarter of 2010 with a delayed effective date until January 1, 2011.

- **Schedule C for the 2009 Form 5500**

- The DOL has already issued a final revised Schedule C for the 2009 Form 5500.⁴
- Schedule C requires plan sponsors to disclose both direct fees (i.e., those paid by the plan or plan sponsor) and indirect fees (i.e., those paid by one service provider to another).
- Plan sponsors will expect financial advisors to assist them in complying with the revised Schedule C fee disclosures, particularly for record-keepers or other vendors receiving indirect fees from investment vendors.
- Financial advisors should expect some plan sponsors to start asking for assistance in early 2010, although the demand for assistance is likely to peak in June and July of 2010.

- **Investment-Related Disclosures by Plan Sponsor to Plan Participants**

- The DOL has proposed regulations⁵ that would significantly expand the investment-related information that plan sponsors must furnish for participant-directed 401(k) plans and other defined contribution plans.
- The DOL's proposal would require plan sponsors to present the information in a table format that would enable participants to more easily compare the investment alternatives under the plan. The points of comparison would include:
 - Performance data for 1-year, 5-year and 10-year periods along with the appropriate benchmarks for comparison.
 - Fees and expenses, including:

³ 72 Fed. Reg. 70988 (Dec. 13, 2007).

⁴ 72 Fed. Reg. 64731, 64788-64794, 64824-64828 (Nov. 16, 2007).

⁵ 73 Fed. Reg. 43013 (Jul. 23, 2008).

Amount and description of each shareholder-type fee charged directly against a participant's account (e.g., load charges, sales charges, redemption and surrender fees);

Annual operating expenses; and

Expense ratio reflecting the total annual operating expenses.

- The disclosure regulations for plan sponsors are not likely to be finalized until after the DOL issues the final 408b-2 regulations requiring service providers to disclose direct and indirect fees to the plan sponsors.

- **Investment Advice Regulations**

- After delaying the effective date of the Bush administration's investment advice regulations several times, the DOL formally withdrew them on November 20th.⁶

- In its withdrawal notice, the DOL acknowledged harsh criticism that the old regulations:

- Required only the fiduciary adviser to comply with the fee-leveling requirement and allowed affiliates of the fiduciary adviser to receive varying fees; and

- Did not adequately protect plan participants against investment advice that is influenced by the financial interests of the fiduciary adviser's affiliates.

- The DOL will re-propose the investment advice regulations and "anticipates that they will be published in the Federal Register shortly."

- **Plan Sponsor Demand for Plan Participant Financial Literacy**

- Plan sponsors will be demanding more assistance from financial advisors regarding the financial literacy of their plan participants.

- The demand is based on plan sponsor's concern that their plan participants are not taking advantage of their defined contribution plans.

- It is also based on a growing concern among policymakers about the ability of defined contribution plans to provide adequate retirement income.⁷

- The ERISA Advisory Council has made several recommendations for DOL to assist plan sponsors to improve the financial literacy of plan participants.⁸

The key recommendations are noteworthy:

- Update and expand Interpretive Bulletin 96-1 on investment education.

- Make available to plan sponsors best practices in investment education with a focus on increasing financial literacy.

- Allow the use of income replacement ratios and final pay multiples in employee benefit statements on an individualized basis.

- At a minimum, participants should have access to an estimated plan account balance necessary for retirement.

⁶ 74 Fed. Reg. 60156 (Nov. 20, 2009).

⁷ "Why It's Time to Retire the 401(k)," Time, Oct. 19, 2009. Earlier online version of the article is posted at <http://www.time.com/time/business/article/0,8599,1929119,00.html>.

⁸ "Report of the Working Group on Financial Literacy of Plan Participants and the Role of the Employer" posted at <http://www.dol.gov/ebsa/publications/AC-1107a.htm>.

- The following testimony from the American Benefits Council before the ERISA Advisory Council is also noteworthy:
 - Employees generally do not have the confidence to implement advice provided to them via on-line tools.
 - People want one-on-one help from a person who they can trust.

Judicial Developments

- **Caterpillar Settlement**
 - Last year, Caterpillar failed in persuading a federal district court⁹ to dismiss a class action alleging that Caterpillar:
 - Allowed its four 401(k) plans to charge plan participants with excessive investment management and other fees,
 - Maintained excessive cash in the employer stock investment fund; and
 - Offered investment funds whose investment adviser was a wholly-owned subsidiary of Caterpillar.
 - On November 5th, Caterpillar announced¹⁰ a tentative \$16.5 million settlement of the class action with the law firm representing the plan participants.
 - There are conflicting views on the significance of the settlement:
 - The settlement is unusual because Caterpillar had significant exposure for serving as the investment manager for some of the funds in its 401(k) plans' lineup.
 - The non-monetary settlement terms will evolve into best practices, such as:
 - not including retail mutual funds as core investment options;
 - undertaking competitive bidding in deciding to retain or replace recordkeepers and other service providers;
 - hiring an independent third party to monitor the plan; and
 - increasing and enhancing communications about 401(k) investment options and associated fees.
- **Other 401(k) Fee Litigation**
 - The 401(k) fee litigation that does not settle will go to trial and will result in liability for plan sponsors and their investment vendors.
 - As a result, benchmarking fees will become increasingly important to defend against allegations of imprudently allowing excessive fees.

Legislative

⁹ Martin v. Caterpillar, No. 07-cv-1009 (C.D. Ill. 2008).

¹⁰ The press release is posted at <http://www.cat.com/cda/files/1968861/7/110509%20Tentative%20Settlement%20of%20Lawsuit.pdf>.

- **401(k) Fair Disclosure and Pension Security Act of 2009 (H.R. 2989)**
 - In addition to 401(k) fee disclosure, this bill also addresses investment advice. The bill combines two earlier bills:
 - 401(k) Fair Disclosure for Retirement Security Act (H.R. 1984)
 - The Conflicted Investment Advice Prohibition Act of 2009 (H.R. 1988)
 - On June 24th, the House Education and Labor Committee approved H.R. 2989.
 - On October 1, 2009, the House Ways & Means Committee held a hearing on the bill.
 - Currently, the House Ways & Means Committee may drop the investment advice provisions of the bill in response to the mutual fund industry's lobbying.¹¹

- **Target Date Funds**
 - In 2007, DOL endorsed target-retirement-date funds, balanced funds, and managed accounts as qualified default investment arrangements ("QDIAs").¹²
 - Like other QDIAs, target-date funds must provide a glide path to reduce plan participants' equity exposure as they grow older. However, participants in target-date funds suffered significant losses in 2008 and 2009 because of the equity exposure, including participants with a 2010 target retirement date.
 - The magnitude of the target-date fund losses triggered a hearing in May 2009 by the U.S. Senate Special Committee on Aging.¹³
 - On June 18, 2009, DOL and SEC held a joint hearing on target-date funds addressing the following issues:¹⁴
 - How target date fund managers determine asset allocations and changes to asset allocations (including glide paths) over the course of a target date fund's operation;
 - How they select and monitor underlying investments;
 - How the foregoing, and related risks, are disclosed to investors; and
 - The approaches or factors for comparing and evaluating target date funds.
 - Many target-date funds are structured as a fund of funds. This structure raises significant conflicts of interest issues for plan sponsors to consider. For example,
 - A plan sponsor could be liable for allowing plan participants to invest in a target-date fund whose asset allocation is decided by a conflicted investment adviser.
 - The plan sponsor could be liable for not disclosing the investment adviser's conflict of interest to the plan participants if the target-date mutual fund or its investment adviser does not disclose the conflict of interest.

¹¹ "401(k) advice faces critical test in House: Ways and Means weighs provision restricting it to investment advisers," Investment News, Nov. 29, 2009, posted at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20091129/REG/311299979/1031/RETIREMENT>.

¹² 29 CFR 2550.404(c)-5, published at 72 Fed. Reg. 60451 (Oct. 24, 2007).

¹³ February 25, 2009, press release posted at <http://aging.senate.gov/record.cfm?id=308665>.

¹⁴ Hearing announcement published at 74 Fed. Reg. 24052 (May 22, 2009).

