The Changing Face of 401(k) Plans: Expectations, Perceptions, Products & Laws

presented by
FRED REISH, ESQ.
REISH LUFTMAN REICHER & COHEN
❖
May 7, 2010

Where Are We Going?

The big change . . . 401(k)'s are retirement plans. That means the focus will be on:

- benefit adequacy (income)
- participation
- deferral rates
- investments
- participant investing
- disclosures and conflicts of interest
- fees and expenses
- distributions

Participant Investing

- Qualified default investment alternatives
- Fiduciary advice to participants

Investing: PPA Fiduciary Adviser

Under ERISA, a person who gives individualized investment advice to a participant based on the particular needs of the participant is a fiduciary. That implicates the:

- fiduciary responsibility rules; and
- 406(b) prohibited transaction rules.

Note regarding IRC 4975 prohibited transaction rules.

4

Investing: PPA Fiduciary Adviser

Prior to the PPA 2006, fiduciary investment advice could be given to participants only if it was "pure" level fee. A withdrawn DOL regulation under the PPA would have allowed:

- statutory level fee advice
- statutory computer model advice
- class level fee advice
- class off-model advice

5

Investing: PPA Fiduciary Adviser

In March, the DOL issued a new proposed regulation, which explained the PPA prohibited transaction exemption for:

- computer model advice
- level fee advice

6

Investing: PPA Fiduciary Adviser

- Application to IRAs
- Implications for RIAs

7

Fiduciary Safe Harbor for QDIAs

The 404(c)(5) legislation and the DOL's regulation (the "QDIA" regulation) reflect a strong policy in favor of investing participants in "portfolio" investments, rather than in individual mutual funds.

Further, portfolio investing is consistent with ERISA's investment principles, which are based on generally accepted investment theories, such as modern portfolio theory.

8

Seeking the Safe Harbor

The fiduciary safe harbor for defaults into QDIAs may be obtained in a number of ways:

- Automatic enrollment
- Regular enrollment
- Change of investments
- Change of providers
- Any other default
  - Consider re-enrolling plan
  - Mergers

Note: Reversal in thinking.

9

Participant Investing: Target Date Funds

Target date funds suffered unexpectedly large losses in 2008 . . . on average, 2010 funds lost approximately 23% and one 2010 fund lost over 40%.

In addition to exposing the volatility of "appropriate" investments, the losses revealed significant design differences between similarly labeled investments.

11

Target Date Funds

The losses caught the attention of Senator Herb Kohl of Wisconsin, who chairs the Special Committee on Aging. His Committee held two sets of target date hearings in 2009.

The Senator also asked the DOL and SEC to hold hearings on target date funds.

12

Target Date Funds

In response, the DOL and SEC held a joint hearing on June 18th on the subject of target date funds.

It is contemplated that the agencies will soon issue guidance as a result of these hearings.

13

"THE GOOD NEWS IS YOU CAN RETIRE AT 65. THE BAD NEWS IS THAT IT'S 2065."

Target Date Funds

<u>Outcome and Issues</u>:

- DOL: Better disclosure to plan sponsors and participants.
- DOL: Amendment of QDIA regulation.
- SEC: Concerns regarding labeling and marketing.
- Fiduciary proposal by Senator Kohl.
- Selection and monitoring: like any other investment:
  - "to" and "through."
  - last 10 years.

15

The Fiduciary Process

The fiduciary process for selecting target date investments involves:

- The qualitative and quantitative analysis generally used for investments, including reasonableness of expenses.
- An analysis of asset allocation.
- An analysis of the glide path ("to" and "through").
- An analysis of its manager and its abilities and limitations.
- An analysis of the needs of the plan and the needs and abilities of the participants.

Note: Benchmarking issues
Open architecture.

16

Focus on Older Participants

Asset Allocation and Glide Path:

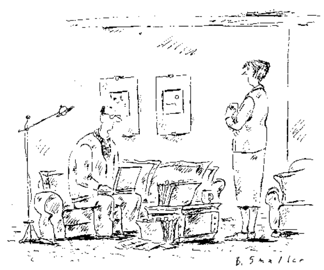
"It is in the glide path where we see the most fundamental differences between fund families. For instance, do the managers believe their job is to boost retirement account balances through aggressive growth strategies, or do they believe their job is more accurately stated by the Hippocratic paraphrase, 'First, lose no money?' "

--Popping the Hood II, An Analysis of Target Date Fund Families, by Turnstone Advisory Group LLC.

Note: Focus on final 10 years.

17

Benefit Adequacy



"If we take a late retirement and an early death, we'll just squeak by."

Benefit Adequacy and Deferrals

- Benefit adequacy defined
- Impact of deferral rates

19

Needed Levels of Deferrals

Percentage of Income a Participant Must Save Over 35 Years

	DC-Only Benefits Design		
	Plan A No Match	**Plan B** (3% Match)	**Plan C** (3% Match and 2% Profit Sharing)
Current Income			
$25,000	14%	11%	9%
$50,000	17%	14%	12%
$75,000	18%	15%	13%
$100,000	20%	17%	15%

Note: Based on 90% probability of achieving a 75% replacement ratio at retirement at age 65; full Social Security benefits at 67; a balanced investment strategy; and for the DB plan scenarios, a pension benefit at 65 equivalent to 22% of pre-retirement pay. High-income participants may be limited in their ability to achieve these savings rates through a qualified retirement plan. Source: The Vanguard Group, 2004.

20

Benefit Adequacy and Deferrals

- Gap analysis
- Automatic enrollment
- Automatic deferral increases
- Retirement age

21

Lifetime Income Disclosure

"Under the proposal, defined contribution plans subject to ERISA would be required to include "annuity equivalents" on benefit statements provided to employees.

"An annuity equivalent would be the monthly annuity payment that would be made if the employee's total account balance were used to buy a life annuity that commenced payments at the plan's normal retirement age (generally 65)."

Description of S. 2832 from Office of Senator Bingaman.

22

The Distribution Dilemma

Research has shown that, if retired participants withdraw more than 4% or 5% of their account balance per year, there is a significant possibility that they will run out of money during their retirement.

Consider:
- 4%
- 5%
- 6%
- 7%

23

Lifetime Income

SUMMARY: The Department of Labor and the Department of the Treasury (the "Agencies") are currently reviewing the rules under the Employee Retirement Income Security Act (ERISA) and the plan qualification rules under the Internal Revenue Code (Code) to determine whether, and, . . .

continued . . .

DOL/Treasury Request for Information on Lifetime Income Options.

24

Lifetime Income *(continued . . .)*

. . . if so, how, the Agencies could or should enhance, by regulation or otherwise, the retirement security of participants in employer-sponsored retirement plans and in individual retirement arrangements (IRAs) by facilitating access to, and use of, lifetime income or other arrangements designed to provide a lifetime stream of income after retirement.

25

Lifetime Income Alternatives

- Guaranteed:
  - annuities
  - guaranteed minimum withdrawal benefits (GMWBs)
- Not guaranteed:
  - Targeted payout funds

26

Guaranteed Distributions

The concept of GMWB (guaranteed minimum withdrawal benefits) <u>while participating</u>:

- benefit base
- account value

27

Guaranteed Income for Life

GMWB during retirement:

- guarantee income
- benefit base
- account value

28

The Relevant Facts

The following are key facts and circumstances to be evaluated:

- The needs of the participants: *Is a guaranteed feature appropriate for the workforce?*
- The value of the features offered: *Is the cost reasonable in relation to the features offered?*
- The quality of the underlying investments.

continued . . .

29

The Relevant Facts *(continued . . .)*

- Employee understanding: *Are the employees provided with the information needed to*
  - *appropriately evaluate the guarantee?*
- Portability of guaranteed feature:
  - *Is the guarantee transferable if the plan switches providers?*
  - *Is the guarantee transferable to an IRA?*
- Financial viability of the provider:
  - *Is it prudent to select the insurance company?*
  - *Note regarding fiduciary safe harbor.*

30

Key Action: Proposed Regulation

The Department's EBSA plans to publish a proposed regulation in June 2010 to amend the current regulatory definition of "fiduciary" to include more persons, such as pension consultants, as fiduciaries.

DOL Work Plan for 2009-2010.

31

Disclosures to Participants

DOL Work Plan for 2009-2010:

"Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans"

"The rulemaking will ensure that the participants and beneficiaries in participant-directed individual account plans are provided the information they need, including information about fees and expenses, to make informed investment decisions."

32

Disclosures to Participants

Issues and Outcomes:

- Provider burden for compliance.
- Possible "push-back" by participants.
- Impact on participant education.

33

REISH & REICHER

A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW

FRED REISH, ESQ.
11755 Wilshire Boulevard, 10th Floor ❖ Los Angeles, CA 90025-1539
(310) 478-5656 ❖ (310) 478-5831 [fax] ❖ (310) 776-7822 [direct fax]
FredReish@Reish.com ❖ www.linkedin.com/in/fredreish
www.reish.com