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ERISA Update . . . and the Impact on Advisers

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DOL Concerns About 408(b)(2) Disclosures:

- Lengthy and complex disclosures
- Plan-specific disclosures
- Broad ranges of services and compensation
- Coming soon: Change disclosures

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The DOL's Regulatory Agenda

Guide or Similar Requirement for Section 408(b)(2) Disclosures:

*This rulemaking would amend [the 408(b)(2) regulation] so that covered service providers may **be required to furnish a guide or similar tool** along with such disclosures.*

*A guide . . . may assist fiduciaries, especially **fiduciaries to small and medium-sized plans**, in identifying and understanding the **potentially complex disclosure documents** that are provided to them or if disclosures are located in **multiple documents**.*

Sample Guide to Initial Disclosures

Required Information	Location(s)
Description of the services that ABC will provide to your Plan.	Master Service Agreement § 2.4, p. 1
A statement concerning the services that ABC will provide as [an ERISA fiduciary] [a registered investment adviser].	Master Service Agreement § 2.6, p 2
Compensation ABC will receive from your Plan ("direct" compensation).	Master Service Agreement § 3.2, p 4
Compensation ABC will receive from other parties that are not related to ABC ("indirect" compensation").	Master Service Agreement § 3.3, p 4 Stable Value Offering Agmt § 3.1, p. 4
Compensation that will be paid among ABC and related parties.	Master Service Agreement § 3.5, p 6

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Pension Benefit Statements:

As part of this initiative, the Department will explore whether, and how, an individual benefit statement should and could present a participant's accrued benefits in a defined contribution plan (i.e., the individual's account balance) as a lifetime income stream of payments in addition to presenting the benefits as an account balance.

The DOL and Projections of Retirement Income

	1. Account Value	2. Monthly Income after Retirement	3. Survivor Monthly Income
A. Estimated for Current Account Value	$124,023.02	$459.92	$229.96
B. Projected at Retirement	$665,715.09	$2,468.67	$1,234.34

- **All future projections are shown in today's dollars, which account for inflation.** Inflation changes the purchasing power of money. Presenting your projections in today's dollars will give you an idea of how much you could buy with your retirement account when you retire.
- **Caution: projected values at retirement are only estimates.**

Deferrals

- Gap analysis:
  - Projects the results of the participants current behavior—in terms of retirement income.
  - Provides reasonable benchmarks for comparing those results to typical needs.
  - Provides guidance about how to close the "gap."
  - Products and services for retirement income.

The DOL's Regulatory Agenda

Definition of Fiduciary:

> *This rulemaking would amend the regulatory definition of the term "fiduciary" . . . to more broadly define as employee benefit plan fiduciaries persons who render investment advice to plans for a fee.*

- The DOL will also be issuing proposed prohibited transaction exemptions.

Fiduciary Status for Investment Advice

The Department of Labor is working on a proposed regulation that, if finalized, will:

- Expand the definition of fiduciary investment advice; and
- Cause the current practices of many financial advisers to be considered fiduciary investment advice.

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Fiduciary Prohibited Transaction

The fiduciary prohibited transaction rules are found in ERISA section 406(b), for example:

406(b)(1) prohibits a fiduciary from dealing with the assets of the plan in his own interest.

Note: Compensation versus commissions.

Internal Revenue Code

The Internal Revenue Code also includes the concept of fiduciary advice in §4975(e)(3)(B).

The definition applies to the prohibited transaction rules for qualified plan and IRAs.

But, *see* PTCE 86-128.

- Need for expansion of 86-128.

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DOL Tips and Custom TDFs?

The DOL Tips say that fiduciaries should ***"inquire about whether a custom or non-proprietary target date fund would be a better fit"*** and that ***"a Custom TDF may offer advantages"*** to plan participants.

Source: Tips for ERISA Plan Fiduciaries, U.S. DOL Employee Benefits Security Administration, February 2013.

continued . . .

Tips from DOL

"Some TDF vendors may offer a pre-packaged product which uses only the vendor's proprietary funds as the TDF component investments.

Alternatively, a "custom" TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF."

continued . . .

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Prudent Selection of TDFs

The DOL guidance also says:

> *"You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates . . . the possible significance of other characteristics of the participant population, such as participation in a . . . defined benefit pension plan . . . salary rates, turnover rates, contribution rates and withdrawal patterns."*

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Prudent Selection of TDFs

Because these differences [investment strategies, glide paths, and investment-related fees] can significantly affect the way a TDF performs, it is important that fiduciaries understand these differences when selecting a TDF as an investment option for their plan."

Note: Anticipated final TDF regulations for QDIA and participant disclosures.

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DOL Investigations of Advisers

The DOL is increasing its investigations of recordkeepers, RIAs and broker-dealers:

- Purpose is to focus on "the receipt of improper or undisclosed compensation by employee benefit plan consultants and investment advisers."

- Also to ensure that plan fiduciaries and participants receive comprehensive disclosure about service provider compensation and conflicts of interest. (408(b)(2))

Allocation of Revenue Sharing

There are three basic ways to allocate revenue sharing:

- Pro-rata
- Per capita
- Equalization

The first two ways are also commonly used to allocate expenses.

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Revenue Sharing

There are three models for revenue sharing:

- No revenue sharing

  -- allocate expenses

- Pay plan expenses, *e.g.*, recordkeeper

  -- expense recapture accounts

- Separately allocate revenue sharing and plan expenses ("equalization" or "levelizing")

Note: Consequences on quarterly statements.

The Law on Allocations

There is not clear guidance on how revenue sharing should be allocated among participant accounts.

However, it is settled is that fiduciaries must engage in a prudent process and must apply the general principles of ERISA to make decisions about these questions.

A Prudent Fiduciary Process

The general requirement is that fiduciaries must engage in a prudent process and make “informed and reasoned” decisions.

This means that fiduciaries must analyze the facts that are relevant to the decision and make an informed decision.

The potential breach is a failure to engage in that process.

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Field Assistance Bulletin (FAB) 2012-02R

In 2012, the DOL issued a FAB that provided detailed answers to questions about the application of the 404a-5 regulation.

Some of those answers were surprising to the benefits community and present disclosure issues for advisers.

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Asset Allocation Models (AAMs)

In Question and Answer (Q&A) 28 of the FAB, the DOL asked:

> *A plan offers ten designated investment alternatives. The plan also offers three model portfolios (labeled 'conservative,' 'moderate,' and 'growth') made up of different combinations of the plan's designated investment alternatives. Is each model portfolio a designated investment alternative under the regulation?*

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Asset Allocation Models

If a model portfolio is treated as a designated investment alternative (or DIA), certain disclosure requirements apply.

For example, participants need to be given information about the expense ratio of the model portfolio, its historical performance, expenses per thousand, and so on.

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Asset Allocation Models (AAMs)

In the Answer, the DOL concluded that, if certain requirements are met, an AAM will not be considered a DIA.

Instead, it would be viewed as a service to assist participants in deciding which investments to use and how much to invest in each.

- Query regarding drafting and distribution of disclosures.

Asset Allocation Models

First Requirement: The AAMs must be *"clearly presented to the participants and beneficiaries as merely a means of allocating account assets among specific designated investment alternatives."*

Second Requirement: The investment cannot be in an "entity," but instead must be an investment directly in the underlying mutual funds.

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Asset Allocation Models

<u>Third Requirement</u>: The participants must be given a description of the model portfolio and how it works.

<u>Fourth Requirement</u>: The participant disclosure materials *"also must explain how it [that is, the model] differs from the plan's designated investment alternatives."*

<u>Fifth Requirement</u>: The AAMs cannot include investments that are not designated investment alternatives.

Asset Allocation Models

Other Considerations:

Careful thought needs to be given to related issues.

That would include, for example, the description of the removal of an investment from the plan's line-up—and, therefore, from the AAM; the re-balancing of the portfolio and how it occurs; and any changes to the allocations in the portfolio.

Designated Investment Managers

In Q&A 4 of the FAB, the DOL introduces the concept of a “designated investment manager” or DIM. A DIM is an ERISA 3(38) investment manager that is selected by the plan fiduciaries and made available to participants to manage their accounts.

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