

QUALIFIED PLANS 2005-3

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1. IRS Proposes Rules for Roth 401(k) Contributions

The IRS recently published proposed regulations that provide guidance on Roth contributions to 401(k) plans. 70 Fed. Reg. 10062 (Mar. 2, 2005). The proposed regulations would supplement the recently issued comprehensive final regulations under Code sections 401(k) and 401(m). (Qualified Plans 2005-1). Although the proposed regulations do not specifically address Roth contributions to 403(b) plans, this guidance also should be generally applicable to such plans.

The proposed regulations would apply to plan years beginning on or after January 1, 2006. Comments are requested by May 31 and IRS officials have expressed an intent to finalize them soon after. The IRS and Treasury also asked for comments on the need for guidance on the taxation of Roth account distributions.

A. Background

Provisions for Roth contributions to 401(k) and 403(b) plans were added to the Code by EGTRRA. Roth contributions are permitted for taxable years beginning after December 31, 2005. (Like other EGTRRA changes, they are scheduled to "sunset" after 2010 unless Congress acts to make them permanent.) The key elements of Roth contributions are as follows:

- **After-Tax Contributions** Roth contributions are made on an after-tax basis. Plan sponsors will need to withhold applicable federal, state, and local taxes on Roth contributions.
- **Tax-Free Distributions** Roth contributions and earnings on Roth contributions that satisfy a five-year "aging" requirement, and are distributed after certain events (e.g., attainment of age 59½, death, or disability), are not taxed when they are distributed.

- **No Income Limits.** Roth contributions may be made available to all participants in a 401(k) or 403(b) plan. Unlike Roth IRAs, Roth plan contributions are not limited to individuals with incomes below statutory thresholds (e.g., generally \$150,000 for joint filers, \$95,000 for single filers).

B. Summary of Roth 401(k) Guidance

Code section 402A provides that Roth contributions are generally treated like elective deferral contributions to a 401(k) or 403(b) plan, subject to special rules governing the tax treatment of Roth accounts. The proposed regulations provide the following guidance on Roth 401(k) contributions:

- **Contribution Election.** A Roth contribution is an elective contribution that (1) is designated at the time of the contribution election as a Roth contribution, (2) is treated by an employer as income to the employee at the time of contribution, and (3) is maintained by a plan in a separate account.
- **Separate Accounting.** Roth contributions, earnings, and distributions must be tracked in a separate account. Gains, losses, and other credits or charges must be allocated to a Roth account and other plan accounts on a reasonable and consistent basis. Forfeitures may not be allocated to a Roth account.
- **Compliance With Elective Deferral Requirements.** Roth contributions must be nonforfeitable, must follow the distribution-timing rules applicable to pre-tax elective deferral contributions, and are treated as elective deferral contributions for most purposes. Notably, Roth accounts, unlike Roth IRAs, are subject to the minimum required distribution rules during a participant's lifetime (e.g., at 70½).
- **401(k) and (m) Nondiscrimination Testing.** Roth contributions are treated like elective deferrals for testing purposes. A plan may permit an employee to designate whether excess

contributions (as determined after ADP and ACP testing) are attributable to his or her pre-tax or Roth contributions. If a Roth contribution is distributed as an excess contribution, only income on the distributed Roth contribution is subject to tax.

- **Catch-Up Contributions.** Although the proposed regulations do not specifically provide that catch-up contributions may be made as Roth contributions, Treasury staff have informally indicated that catch-up Roth contributions will be permitted as well.

C. Plan Amendments

Plan amendments will be necessary to implement a Roth contribution feature. For example, it will be necessary to provide the extent, if any, to which an employee can choose whether his or her distribution from a plan is attributable to his or her pre-tax and Roth contributions. It also will be necessary to update a plan's rollover distribution language to incorporate the eligible rollover distribution rules applicable to Roth accounts.

The IRS has not stated whether it intends to publish a model or sample amendment or when plans must be amended if this feature is added (e.g., in advance of the end of their EGTRRA remedial amendment period).

D. Unresolved Issues

There are many unresolved issues, including

- **Election Procedures.** No guidance is provided on when or how elections may be made, changed or revoked.
- **"BRF" Testing.** Presumably, the right to make Roth 401(k) contributions will be subject to the "current availability" and "effective availability" nondiscrimination rules under section 401(a)(4). This would be consistent with the current rules for after-tax contribution features, but generally should pose no difficulty if the feature is available to all plan participants.
- **Interaction of Code Section 401(k) and 402A Distribution Rules.** The proposed regulations provide that Roth

contributions are subject to the 401(k) distribution-timing rules (*e.g.*, no in-service distributions before age 59½ other than hardship). However, for a distribution from a Roth account to be tax-free, it must also be a "qualified distribution." A qualified distribution is a distribution that (1) is not made within five years of the participant's first Roth contribution to the plan or a predecessor plan and (2) is made after a participant attains age 59½, dies, or becomes disabled. Thus, for example, pre-59½ hardship distributions may result in the taxation of distributions from a Roth plan account.

- **Rollover Distributions into Roth IRAs.** A participant who has a Roth account must be able to roll a distribution of his or her Roth account into a 401(k) or 403(b) plan that accepts Roth rollover contributions or to a Roth IRA. As noted above, the proposed regulations provide that the minimum required distribution rules apply to distributions from a Roth 401(k) – both before and after a participant's death. If, however, a participant rolls his or her Roth account balance into a Roth IRA, the Roth IRA is not subject to the minimum required distribution rules during the participant's lifetime, thus apparently permitting a plan participant to sidestep the lifetime minimum required distribution rules.
- **Payroll Withholding Issues** Plans that currently permit participants to elect to defer a large percentage of their compensation (*e.g.*, up to 70% of compensation) may need to revisit these contribution limits to ensure that enough of a participant's paycheck is available to satisfy the federal and state tax withholding requirements that will apply to Roth contributions (*e.g.*, federal withholding rates between 10% and 35% of gross income, FICA).
- **W-2 Reporting.** We expect future IRS guidance to address how Roth contributions and distributions should be reported on a participant's Form W-2 and Form 1099-R.

E. Pros and Cons of Roth 401(k) Contributions

There are significant benefits and drawbacks for plan sponsors to consider in deciding whether to add Roth contributions to their 401(k) or 403(b) plans. The possible benefits of adding Roth contributions include –

- more after-tax savings opportunities for highly compensated employees who are ineligible to make Roth IRA contributions,
- reduced administrative costs for lower-income participants who might otherwise bear higher Roth IRA maintenance fees, and
- the ability to test after-tax contributions (currently tested under the ACP test) as elective deferrals under the ADP test.

The possible drawbacks of Roth contributions include –

- extra oversight, communications, and administrative costs,
- increased demand for investment and other financial information to help employees decide between making Roth and traditional contributions, and
- considerable potential for participant confusion and misunderstandings.

Our experience with deemed IRAs suggests that, except for the governmental sector, relatively few plan sponsors want to add complex new options to their plans. We suspect, however, that Roth contributions may have some broader appeal – primarily because of the favorable tax treatment of Roth distributions and the exemption from the Roth IRA contribution limitations on higher-income individuals.

2. DOL Proposes Abandoned Plans Program

The Department of Labor ("DOL") recently published for comment three proposed regulations and a proposed class exemption that address the problem of abandoned plan assets held by financial institutions. 70 Fed. Reg. 12046, 12074 (Mar. 10, 2005). The proposed regulations and exemption are designed to encourage service providers to

voluntarily terminate abandoned plans and distribute their assets to participants by limiting their liability and allowing them to receive fees in connection with termination activities. We believe that the program generally provides significant protections for institutions that wish to terminate abandoned plans. Unfortunately, the program's usefulness is handicapped by the fact that a substantial number of entities holding plan assets will be ineligible to participate; and, because of fee restrictions, financial institutions may be unwilling to open IRA accounts in connection with abandoned plans. These issues are likely to be raised during the comment period which ends May 9.

DOL explained that it developed the program in response to requests for assistance from participants in so-called "abandoned plans." Plan abandonment often occurs because a plan sponsor has been dissolved in bankruptcy, incarcerated, or has disappeared, leaving no plan sponsor, named fiduciary or administrator in existence to administer the plan. Although a financial institution, such as a trustee, may hold the plan's assets, these institutions have no authority or incentive to perform the necessary steps to terminate the plan and distribute benefits to participants. As a result, participants are denied access to their benefits and plan assets are often unnecessarily diminished by recurring administrative costs. DOL has estimated that nearly \$900 million in assets may belong to abandoned plans.

A. Overview of Program

In response to this problem, the DOL has developed a comprehensive program that permits, but does not require, certain financial institutions to terminate abandoned individual account plans. Under the proposed regulations, all activities related to the termination of abandoned plans must be performed by a "qualified termination administrator," or a "QTA." A termination administrator will be qualified only if it is eligible to be a trustee or issuer of an individual retirement account or annuity and it holds the assets of an abandoned plan. Under this definition, many service providers, such as recordkeepers, who hold abandoned plan assets will not qualify as QTAs and will not be eligible for the relief provided by DOL's program in its current form.

Under the regulations, a "QTA" may determine that a plan is abandoned when either no contributions to or distributions from the plan have been made in the last 12 months or other circumstances suggest that the plan is or may become abandoned. In addition, the QTA must

determine that the plan sponsor no longer exists, cannot be located, or is unable to maintain the plan after making reasonable efforts to locate the plan sponsor. For purposes of abandonment determinations, a QTA will be deemed to have made reasonable efforts to locate the plan sponsor if it provides a notice informing the sponsor of its determination to the last known address of the sponsor, or a corporate sponsor's agent for service of legal process, by a method of delivery that acknowledges receipt. The proposal provides a model notice for use in notifying a plan sponsor of the QTA's intent to terminate the plan.

Following a QTA's determination of abandonment, the QTA must provide notice to the DOL of its finding of abandonment and its intent to serve as a QTA. Again, the regulations provide a model notice for this purpose. The plan will be deemed terminated 90 days after the administrator furnishes this notice to the DOL, unless the DOL objects to the termination or waives the 90-day period.

After a deemed termination occurs, a QTA must take certain specific steps to wind up the affairs of the plan and distribute benefits. The regulations specify the standards that will apply to several of the QTA's required activities. These steps include:

1. Making reasonable efforts to locate and update plan records necessary to determine benefits payable to participants.
2. Calculating the benefits payable to participants based on plan records.
3. Engaging necessary service providers to wind up the affairs of the plan and distribute benefits.
4. Paying reasonable expenses associated with the QTA's authority and responsibilities.
5. Notifying plan participants of the termination and their ability to elect a distribution.
6. Distributing benefits in accordance with the elections received from participants.
7. Filing a terminal report for the plan. (Proposed reporting regulations are described more fully below.)

8. Filing a final notice of termination with the DOL.

Importantly, the regulations specifically limit the liability of QTAs. The regulations provide that if a QTA carries out its termination responsibilities in accordance with the regulation, the QTA is deemed to satisfy its responsibilities under section 404(a) of ERISA, except with respect to the selection and monitoring of service providers. In the latter situation, if the QTA selects and monitors service providers consistent with ERISA's general prudence rules, the QTA will not be held liable for the acts and omissions of service providers with respect to which the QTA has no knowledge.

What about IRS compliance issues? (Some time ago, IRS was reportedly considering a position that abandoned plans were not qualified, because they were no longer "maintained by an employer," but this was never finalized in any way.) The Preamble (70 Fed. Reg. at 12050) indicates that IRS has given its blessing to the program subject to the following 3 conditions (which apparently do not include amending the plan for all currently applicable requirements).

1. The QTA makes a reasonable determination of whether the survivor annuity rules apply (and, presumably, administers compliance with them if they do apply).
2. Each participant and beneficiary is fully vested in their accounts.
3. Each participant and beneficiary receives a Code section 402(f) rollover notice.

IRS nevertheless reserves the right to pursue appropriate remedies against parties responsible for the plan such as the business owner, plan sponsor or plan administrator.

B. Safe Harbor Regulation for Participants Who Fail to Make an Election

The regulations acknowledge that not all participants will provide distribution elections in response to notices from the QTA. DOL states that if notices are returned to the QTA as undeliverable, the QTA must take steps consistent with its general fiduciary obligations to locate and notify missing participants of their entitlement before distributing benefits. To ensure compliance with ERISA, DOL

states that the QTA should follow DOL's Field Assistance Bulletin 2004-2 on missing participants (Qualified Plans 2004-10).

In addition, for those participants who fail to provide distribution elections in a timely manner, the proposed regulations establish that the individual's benefit generally must be rolled into an individual retirement account or annuity. Proposed Safe Harbor Rollover Regulations, 29 C.F.R. § 2550.404a-3. Because the selection of an IRA provider, and the investment options in which IRA assets are invested, are fiduciary functions, the DOL was concerned that financial institutions would not perform these tasks because of potential liability in connection with these determinations. Accordingly, DOL has proposed a safe harbor regulation through which a QTA would be deemed to satisfy its fiduciary obligations in connection with the selection of an IRA provider, and the investment of distributed funds, for participants who fail to make distribution elections. This safe harbor mirrors the recently finalized safe harbor regulation for automatic rollovers of mandatory distributions under section 401(a)(31)(B) of the Code by requiring these distributions to be invested in a product designed primarily to preserve principal. 29 C.F.R. § 2550.404a-2 (Qualified Plans 2004-10).

In developing the safe harbor regulation, DOL determined that relief should not be limited to QTAs terminating abandoned plans. Accordingly, the proposed safe harbor relief is available to fiduciaries in connection with rollover distributions from any terminating defined contribution plan whenever a participant fails to elect a distribution option.

C. Proposed Reporting Requirements

Under the regulations, QTAs are required to file a terminal report for an abandoned plan within two months following the distribution of the plan's assets. A separate proposed regulation addresses the content, timing, and method of filing for the terminal report. Proposed Reporting Regulation, 29 C.F.R. § 2520.103-13. The terminal report provides information such as the total assets of the plan as of the termination date and the amount of termination expense paid by the plan. Importantly, the regulation provides that the QTA is not subject to the generally applicable reporting requirements of ERISA, other than the requirement to file the terminal report. Therefore, the QTA will have no liability to satisfy any of the plan administrator's reporting obligations, such as the Form 5500.

D. Proposed Class Exemption

DOL also published a proposed exemption that provides relief for the following transactions: (1) the QTA's selection of itself or an affiliate to provide services in connection with the termination of a plan, (2) for participants who fail to elect a distribution option, the QTA's selection of itself or an affiliate as an individual retirement plan provider, (3) the investment of distributed assets on behalf of non-responsive participants in proprietary investment products of the QTA or an affiliate, and (4) the receipt of fees by the QTA in connection with these transactions. 70 Fed. Reg. 12074 (Mar. 10, 2005).

Relief for the QTA's selection of itself to provide termination services is subject to two conditions: fees paid to the QTA must be consistent with industry rates for similar services, and may not exceed fees charged by the QTA for similar services provided to customers that are not plans terminated pursuant to the abandoned plan regulations. Exemptive relief for the QTA's selection of itself to receive rollover distributions is subject to a number of conditions that closely track the requirements of the proposed safe harbor regulation. Notably, unlike the safe harbor regulation, the exemption limits the ongoing fees that may be charged to the IRA to the income earned by the account. We note that a similar condition was included in the proposed DOL regulations for automatic rollovers, but was dropped in response to significant negative comment from the industry. We expect that the reappearance of this restriction in the abandoned plans exemption will again engender substantial negative comment from IRA providers unwilling to open accounts subject to such a limitation.

3. Bankruptcy Bill Resurfaces and Takes Off

Over the past 8 years, Congress has repeatedly attempted to pass major bankruptcy reform, but failed for various unrelated reasons (most recently, in 2001 and 2003, over abortion clinic protest activity provisions). The proponents, however, now appear likely to succeed – and quickly.

On March 10, the Senate passed the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" (S. 256) by a vote of 74 to 25. The 500-page bill was approved by the House Judiciary Committee on March 16 and the full House is expected to consider it in early April. The

Administration has already indicated the President would sign the legislation.

Many of the bill's provisions would make it tougher for debtors to shed their debts in bankruptcy. However, several provisions would have a favorable impact on debtor's interests in tax-favored retirement plans by –

- expanding the protection from bankruptcy creditors – generally limited now to ERISA-covered plans – to more uniformly cover participant interests in non-ERISA 403(b) plans, governmental, church and 457 plans. The bill also would shelter up to \$1 million in an IRA, plus most rollover contributions (but not from governmental 457(b) plans), and with no dollar limit for SIMPLEs and SEPs,
- preventing most plan loans from being automatically discharged in bankruptcy and allowing loan payments to continue during the bankruptcy process, and
- specifically providing that amounts withheld from wages or received from employees for contribution to an employee benefit plan subject to Title I of ERISA, a governmental plan, 457 plan, or 403(b) plan are excluded from the bankruptcy estate of the employer.

The bill also includes several provisions relating to employers in bankruptcy and their executives. In particular –

- the priority claim under section 507(a)(4) of the Bankruptcy Code for contributions owed to employee benefit plans during the 180 days prior to the bankruptcy petition would be increased from \$4,000 to \$10,000 per employee,
- the "look-back" period for determining fraudulent transfers under section 548 of the Bankruptcy Code would be extended from one year to two years, and would include certain transfers to "insiders" outside the ordinary course of business,
- retention bonuses to induce "insiders" to continue working for the debtor would be disallowed absent certain judicial findings, including that such

services are "essential to the survival of the business," and

- allowable administrative expenses would not extend to special severance payments to insiders, including payments that are not made under a program generally applicable to all full-time employees, and that exceed 10 times the amount of the mean severance pay amount for non-management employees made in the same calendar year.

In general, the bankruptcy changes would become effective 180 days after enactment, and would not apply to cases commenced before that date.

4. DOL Guidance on Insurance Broker Fee Form 5500 Reporting

In response to a request made by Fortis Benefits Insurance Company ("Fortis"), the Department of Labor ("DOL") recently provided guidance regarding an insurer's obligation to report broker compensation arrangements to plan administrators for inclusion in the plans' Form 5500 Schedule A (Insurance Information). DOL Adv. Op. 2005-02A (Feb. 24, 2005). Fortis represented to DOL that some insurers had incorrectly interpreted existing guidance to underreport various types of compensation paid to brokers and agents. In its response to Fortis, DOL took a very expansive view of insurers' Schedule A reporting obligations.

The Schedule A is attached to the Forms 5500 filed by plan administrators of pension and welfare plans. The Schedule A includes various information concerning the insurance policies, annuity contracts, and guaranteed investment contracts used to provide plan benefits. Insurers have a statutory duty to provide to plan administrators (and certify as "complete and accurate") the information the administrators need to complete the Schedule A. ERISA § 103(e). In the past, DOL has issued only limited guidance concerning the fees and commissions required to be reported on Schedule A, and the variety and complexity of the compensation arrangements appeared to have outpaced that guidance. The Schedule A instructions generally provide, and have provided for years, that "all sales commissions" paid by insurers to brokers, agents, and other persons are reportable, along with other fees paid to such persons including "service fees, consulting fees, and

finders fees." The instructions were amended to clarify that commissions based on the aggregate value of contracts placed by an individual were required to be allocated and reported to the plans whose purchases led to the payment on a proportionate basis. The instructions have included an exception to the reporting requirement for "override" commissions paid to a general agent or manager for managing an agency or performing other administrative functions.

A. Broad Scope of Reportable Payments

Advisory Opinion 2005-02A seems to articulate a general rule requiring an insurer to report all amounts paid by the insurer to a broker, agent, or other person directly or indirectly attributable to a contract or policy providing plan benefits. According to DOL, "this includes commissions and fees paid by an insurance company where the broker's, agent's, or other person's eligibility for the payment or the amount of the payment is based, in whole or in part, on the value (e.g., policy amounts, premiums) of contracts or policies (or classes thereof) placed with or retained by an ERISA plan." DOL specifically identified the following examples of reportable compensation:

- sales commissions based on individual contracts;
- persistency and profitability bonuses based on aggregate sales;
- non-monetary compensation (prizes, trips, stock awards, etc.) where eligibility for or the amount of the compensation is paid on policy value;

If a payment is "attributable" to a contract, DOL indicates that it would not fail to be reportable simply because –

- it is characterized as profit-sharing payments, delayed compensation, or reimbursements for marketing or other expenses where eligibility or amount is based on policy value;
- the payments is made from bonus pools rather than directly from an insurer's general assets;
- policy premiums were paid solely from employer assets (rather than plan assets) or the policy was issued to the

employer sponsoring the plan rather than directly to the plan; or

- the agent or broker signed the contract on behalf of the insurer.

In addition, DOL stated that insurers must report finder's fee payments made by a third party to brokers, agents, and other persons in connection with a policy if the insurer in some fashion reimburses the third party for the payment.

B. Allocating Complex Payments Across Customers

Reiterating the principles articulated in Advisory Opinion 86-17A, DOL stated that compensation based on aggregate sales must be reported by allocating it among plans to whom the payments were attributable on a proportionate basis. Insurers are permitted to use "any reasonable method" of allocating commissions and fees, provided the method is disclosed to the plan administrator. DOL did not identify particular acceptable allocation methodologies, but did indicate that it would be unreasonable to allocate a disproportionate portion of a producer's commissions to non-ERISA plans in order to avoid ERISA disclosure obligations. Recognizing that insurers may record the commissions and fees paid to brokers, agents, and other persons on a calendar-year basis, DOL stated that insurers reasonably could allocate such payments on that basis (rather than on a policy or plan year basis).

An insurer must disclose its "reasonable" allocation method to plan administrators. However, DOL did not elaborate on the nature or extent of the required disclosure.

C. The General Agent Exception

DOL also addressed the "single, narrow exception" to the insurer's reporting obligation – the "general agent override" exception.

- DOL reiterated that the recipient of a non-reportable override must be a "general agent" or "manager," and that a "broker representing the insured" will not qualify as a general agent or manager for these purposes. DOL did not define either "general agent" or "manager" though both terms are subject to interpretation throughout the insurance industry, and may have different meaning and/or relevance in

different lines of business or parts of the country.

- DOL confirmed that the reporting exception applies only to payments made for "managing an agency" or "performing administrative functions for the insurer," yet it still did not clarify the many existing issues relating to what constitutes agency management or "administrative" (versus other) functions.
- Perhaps most significantly, in an interpretation that surprised many, DOL indicated that a payment that otherwise qualifies as an override (i.e., paid to a general agent for management) would be nonetheless reportable if calculated under a formula based, in whole or in part, on the value of contracts or policies placed with or retained by plans. Since overrides are an exception to the general rule, which requires reporting of all fees and commissions directly or indirectly attributable to plan policies, the only effect of the exception as now interpreted would be to exclude general agent payments that are somehow deemed "attributable" to a policy or policies though neither the eligibility for, or the amount of, the override is based on policy value. It is not clear that such compensation arrangements exist.

D. Open Issues

Despite the fact that the Advisory Opinion was issued to clarify ambiguities in the Schedule A reporting obligation and promote a "level playing field" for insurers who may be pressured by producers to pay non-reportable compensation, it appears that ambiguities remain. For example, some insurers believe that it is still not clear whether the following are reportable: (1) sales-based compensation paid to the insurer's employees, (2) services fees paid to brokers for services provided to a single plan (i.e., compensation clearly attributable to a single plan), and (3) amounts paid to the insurer's non-sales sub-contractors, such as printers, where the payment is per policy or per member. It is possible that the DOL would provide additional guidance on these or other issues, if asked, but we are unaware of such requests.

5. **SEC Modifies Point of Sale and Confirmation Disclosure Proposals**

Early last year, the Securities and Exchange Commission (SEC) proposed rules to enhance disclosure of commissions and other compensation by brokers selling mutual funds, 529 college savings plans and variable insurance products. SEC Rel. No 34-49148, 69 Fed. Reg. 6438 (Feb. 10, 2004). The proposal (Qualified Plans 2004-2) would have required brokers to disclose, at "point of sale" and in confirmations, detailed information on sales loads, 12b-1 fees and other compensation received by brokers and their affiliates, including the value in dollars of sales commissions. Standardized disclosure forms were included in the proposal. These proposals were significant to ERISA-covered plans because plan fiduciaries could expect to receive automatically (and plan service providers could be required to provide automatically) considerably more information about compensation received by the brokers and other service providers in connection with plan investments in mutual funds.

Thousands of comments were submitted on the proposed rule and standardized forms, including suggestions about how the proposed disclosure requirements should be revised to communicate more effectively to investors, while better balancing the benefit of disclosure against the costs of compliance. Accordingly, the SEC has revised the proposed standardized disclosure forms and reopened the comment period (until April 4) for these proposals. SEC Rel. No. 33-8544, 70 Fed. Reg. 10521 (March 4, 2005). While some of the procedures for disclosure are changed, the proposed rule still has the underlying objective of ensuring that mutual fund investors receive adequate information about how their brokers are compensated and the conflicts of interest that their brokers' compensation arrangements may create. Key aspects of the new proposal are summarized below.

Revised Forms – The revised forms now include different model formats tailored to different types of securities, including models for different share classes of mutual funds. In revising the forms, the SEC has tried to omit "industry jargon" (such as the term "revenue-sharing") in favor of plain English. The forms also include more comprehensive information about all of the costs of investing in mutual funds, by describing investment management and other fund costs as well as commissions and other distribution costs. The forms

permit more standardized information, in an attempt to balance investor desire for individualized commission and cost information with the efficiencies of using standardized cost disclosure. Disclosure in terms of "dollars" (as compared to the percentage of assets or "basis points" information typically provided currently) will still be required.

Supplemental Disclosure – To avoid "information overload" on standardized forms while ensuring that investors receive important information about their brokers' compensation arrangements, the SEC is proposing Internet-based supplemental disclosure that would shift some information from the standardized forms to an Internet website that investors can access if they so desire. For example, the standardized form requires brokers to disclose that they receive payments for promoting certain mutual funds. Detailed information about the payments, the source and amount paid, would be available on an Internet website or on request by toll-free number.

6. **SEC Adopts Final Redemption Fee Rule for Mutual Funds**

One year after proposing a rule that would have required mutual funds to impose a mandatory 2% fee upon the redemption of shares held by an investor for five business days or less (Qualified Plans 2004-03), the Securities and Exchange Commission ("SEC") has adopted a significantly different final rule. Release No. IC-26782 (Mar. 11, 2005); 70 Fed. Reg. 13328 (Mar. 18, 2005). Specifically, the final rule requires mutual fund boards to consider whether redemption fees are necessary, but does not require mutual funds to impose redemption fees. Also, mutual funds that distribute shares through "financial intermediaries" will be required to provide shareholder information upon request, but the final rule does not impose the burdensome automatic reporting requirements of the proposed rule.

Last year, the SEC proposed mandatory redemption fees as a means to deter "market-timing," *i.e.*, too frequent trading of shares of mutual funds, a practice believed to reduce the investment return of long-term shareholders. The proposed rule was criticized on the basis that it would not deter serious market-timers, but would impose unnecessary fees and new costs on inexperienced investors and on investors of small amounts. The retirement services community was generally opposed to a mandatory redemption fee rule, and also urged the SEC to adopt uniform standards for

any redemption fees that funds voluntarily impose to facilitate administration and collection of the redemption fees.

The first requirement under the final rule is that mutual fund boards must affirmatively consider by the rule's compliance date (18 months from now, *i.e.*, October 16, 2006) whether their funds should adopt redemption fees to protect against market-timers. The boards are free to design their own redemption fee rules, except for two limitations: (1) the redemption fee cannot exceed 2 percent of the amount redeemed, and (2) the holding period for which the fee applies cannot be less than 7 calendar days (a departure from the 5-business day concept in the proposed rule). At this point, boards may adopt their own methods of imposing the redemption fees (*e.g.*, FIFO, *i.e.*, "first in, first out," or LIFO, *i.e.*, "last in, last out") and determine the circumstances in which the redemption fees do not apply, so long as the exceptions are disclosed.

The other key requirement of the final rule is that there be a written agreement between a mutual fund and each financial intermediary that holds shares of the fund for the benefit of shareholders. Under the final rule, financial intermediaries include brokers and banks that hold shares in "nominee" name, and, with respect to "participant-directed" employee benefit plans, a plan administrator (as defined by ERISA section 3(16)(A)), or an entity that maintains plan participant records, such as a plan recordkeeper.

Written agreements between a mutual fund and its intermediaries are required even if the fund does not impose redemption fees. The agreement must provide that intermediaries, upon request only (different from the proposed rule's automatic weekly reporting requirement), will provide the fund with information that identifies individual shareholders and their transactions in the fund's shares. For this purpose, the rule defines "shareholder" to include (among others) participants in participant-directed plans. According to the SEC, its privacy rules would prevent a mutual fund from using information received from an intermediary for its own marketing purposes, unless permitted under the intermediary's privacy policies. *See* 17 C.F.R. 248.11(a) and 248.15(a)(7)(i). The agreement must provide that the intermediary will execute the fund's instructions to restrict or prohibit further purchases or exchanges by a specific shareholder who has engaged in trading that violates the fund's market timing policies (as identified by the fund).

While this rule is final, the SEC is still considering the idea of uniform requirements for redemption fees (even if funds are not required to impose the fee). The SEC's final rule release explains that, although it received comments on uniform standards, the comments were offered in the context of a mandatory redemption fee, and there was no consensus about what uniform features would be effective. Accordingly, the SEC has requested comment on the need for uniform rules and the specifics of how the rule should work. In particular, comments are requested on whether –

- a LIFO or FIFO method is more effective,
- waivers of redemption fees of de minimis amounts (*e.g.*, less than \$50) are appropriate,
- there should be limits on holding periods,
- redemption fees should not apply to transactions that are not shareholder-"initiated," such as shares purchased by dividend reinvestment and "non-discretionary" plan transactions (including contributions, loan repayments and employer-directed transactions),
- there should be exceptions for financial emergencies.

The rule's effective date is May 23, 2005, and the compliance date is October 16, 2006. Comments are due to the SEC by May 9.

7. IRA Owner's Direct Payment of "Wrap Fees" Not Treated as IRA Contribution

The IRS recently released a favorable private letter ruling (PLR 200507021, Nov. 23, 2004) on a broker-dealer's "wrap fee" programs. Most of the subject programs allowed unlimited trades, but focused primarily on asset allocation, advisory, custody, and other research services in return for the single "wrap fee" based on a "%-of-assets." In these programs, the broker-dealer stated that brokerage/trading costs would amount to roughly 15% of total costs. However, one program was a non-advisory program where the client could pay directly for trades or instead pay a flat "%-of-assets" fee like the other programs for unlimited trades.

In all cases, the IRS ruled that the IRA owner's payment of the wrap fee from non-IRA assets would not be treated as an additional IRA contribution. Importantly, the IRS did not require any allocation of a portion of the wrap fee allocable to brokerage transactions. In Revenue Ruling 86-142, the IRS addressed the treatment of brokerage commissions paid under IRAs and qualified plans. It concluded that such expenses were not "recurring administrative or overhead expenses," such as trustee or actuary fees, but rather are intrinsic to the value of the trust's assets; as a result any direct payment by the IRA owner/employer of such fees resulted in a deemed contribution to the IRA/plan, subject to the section 404 plan deduction limits or the section 219 IRA contribution limits. This contrasts with the treatment of trustee and other annual fees, which are deductible under section 212 when paid directly by the IRA owner and not subject to the IRA contribution limits. Rev. Rul. 84-146; Rev. Rul. 68-533 (trustee fees are not treated as additional contributions to a qualified plan).

The apparent IRS thinking here is that it is too complex to require an allocation of a portion of a wrap fee to the trading function. This thinking apparently extended to the non-advisory program because the fee also covered trustee and recordkeeping fees.

Unfortunately, the ruling - which was pending almost 4 years at IRS - does not cover whether payment of the fee from the IRA would be taxed as a distribution (presumably not), or whether the owner can reimburse the IRA for the wrap fee and get the same favorable outcome (presumably not). As with all private rulings, it only applies to the requestor and the facts presented to IRS. However, it is a helpful development on common current practices.

8. PBGC Regulation Roundup

PBGC recently published final amendments to its financial reporting regulation under section 4010 of ERISA and proposed amendments to its premium, benefit valuation, and employer liability regulations. We summarize them below.

A. Final Section 4010 Regulation

Section 4010 of ERISA requires annual reporting of certain financial and pension plan information if the aggregate unfunded vested benefits of plans maintained by members of the controlled group is greater than \$50 million, the conditions for imposing a lien under section 412(n) of the Internal Revenue Code ("IRC") for missed

contributions exceeding \$1 million have been met, or any portion of a funding waiver granted for an amount in excess of \$1 million is outstanding. In December 2004, PBGC proposed amendments to the section 4010 regulation to assist the agency in focusing on risks to the single-employer insurance program (Qualified Plans 2004-12). The proposed amendment required electronic filing of section 4010 information in a standard format, specified additional information that must be reported, including financial information about "exempt entities," permitted PBGC to require the submission of "any other information relating to the information" specified in the regulation merely by putting the new requirements on the agency's website, and changed the method for calculating unfunded vested benefits for purposes of applying the \$50 million threshold test for application of the regulation.

Based on comments PBGC received, for the first year the regulation is in effect, PBGC will permit electronic filing under alternate formats and will permit the use of optional assumptions for calculating the \$50 million threshold for applying the regulation. Also, PBGC eliminated the requirement to provide financial information on exempt entities - in response to comments emphasizing that this would be burdensome and unlikely to yield useful information. An exempt entity is an entity that is not a contributing sponsor of a plan and that has annual revenue, annual operating income, and net assets of five percent (or \$5 million in some circumstances) or less of the controlled group's annual revenue, annual operating income and net assets.

The regulation is effective April 8, 2005 and applies to reporting for information years ending on or after December 31, 2004.

B. Proposed Amendment to PBGC Premium Regulation

PBGC's proposed amendment to its premium regulation would require electronic filing of premium information beginning with plan years after 2005 for plans with 500 or more participants, and beginning the following year for all plans. 70 Fed. Reg. 11592 (Mar. 9, 2005). Electronic filing of premium information currently is an option under PBGC's "My PAA" program (Qualified Plans 2004-2). PBGC has invited comments in particular on the following issues:

- Whether contributions may or must be included in assets in determining unfunded vested benefits for purposes

of calculating the variable rate premium.

- Whether "significant events" must be taken into account when using the alternative calculation method for the variable rate premium. Significant events are a five percent or greater increase in a plan's actuarial cost attributable to a plan amendment; extension of coverage to a new group resulting in a five percent or greater increase in the plan's liability for accrued benefits; a merger, consolidation or spin off under IRC section 414(l) that is not de minimis; a shutdown that triggers immediate eligibility for benefits; the offer of a subsidized retirement window; a cost-of-living increase for retirees that increases the plan's liability for accrued benefits by five percent or more, and any other event or trend resulting in a material increase in the value of unfunded vested benefits.
- Whether certain fully funded plans qualify for the variable rate premium exemption.
- Whether a plan may base its variable rate premium on accrued rather than vested benefits.

Comments must be received by May 9.

C. Proposed Amendment to Regulation for Valuing Benefits under Terminated Plans

PBGC's regulation under section 4044 of ERISA specifies the assumptions that PBGC uses to value a plan's benefit liabilities for determining whether the plan is underfunded and the amount of the underfunding. 29 C.F.R. § 4044.51-57. PBGC's stated goal is to conform to the assumptions used by private sector insurers in pricing group annuities. To help meet that goal, PBGC has proposed to amend its regulation on valuation of benefits to replace outdated mortality tables with more current mortality tables. 70 Fed. Reg. 12429 (Mar. 14, 2005).

Since 1993, PBGC has used the 1983 Group Annuity Mortality ("GAM") tables, in combination with an interest factor derived from a survey of annuity

pricing information obtained from private insurers, to develop the value of benefits of healthy participants. PBGC derives the interest factor by solving for the interest rate that, in combination with PBGC's mortality assumption, produces the average market price determined in the survey.

PBGC's use of the GAM-83 tables resulted in lower than market interest rates for valuing annuities. This is because the GAM-83 table assumed shorter lives than many insurers currently use in pricing annuities. PBGC proposes switching to the 1994 GAM tables for healthy lives, which now are commonly used by private insurers. Using the newer GAM-94 tables assuming longer lives should produce a higher interest rate, more closely in line with market annuity rates (which are still relatively low). The regulation also would be amended to include updated mortality tables for valuing disabled lives.

Comments on the proposed amendment must be received by May 13.

D. Proposed Regulation on Liability for Facility Shutdown Under Section 4062(e)

PBGC has proposed a regulation that provides a formula for determining liability that may arise when an employer ceases operations at a facility, resulting in a greater than 20 percent decrease in the number of employees who are participants in the plan. 70 Fed. Reg. 9258 (Feb. 25, 2005). When this occurs, section 4062(e) provides that the employer is treated as if it were an employer that has withdrawn from a multiple employer plan and sections 4063, 4064 and 4065 of ERISA apply.

Under section 4063 of ERISA, a substantial employer that withdraws from a multiple employer plan is liable for a percentage of the plan's unfunded benefit liabilities, determined under section 4062 of ERISA as if the plan had terminated, based on the employer's share of the total contributions made to the plan during the preceding five years. This statutory formula does not work in a situation where section 4062(e) applies because there is only one employer. Section 4063(b) provides, however, that liability may be based on any other equitable basis prescribed by PBGC in regulations.

The proposed regulation codifies the formula that PBGC has used or attempted to use on a case-by-case basis in the past. An employer's liability under section 4063 would be determined by

multiplying the plan's unfunded benefit liabilities, calculated under section 4062 of ERISA as if the plan had terminated on the date the facility ceased operations, by a fraction. The numerator of the fraction is the number of employees who are participants in the plan and were separated from service as a result of the facility's cessation of operations. The denominator of the fraction is the total number of employees who were participants in the plan before the facility's cessation of operations.

Comments on the regulation must be received by April 26.

9. DOL Addresses "Pay or Play" Issues

For the first time, the Labor Department has taken a look at a "pay for play" factual situation most common to public sector plans that are not covered by ERISA. It has done so in a February 23, 2005 information letter addressed to William Lindsay, a trustee of a Taft-Hartley Fund, IBEW Local 25 Health and Benefit Fund, who received vendor campaign contributions from TPAs in connection with his election to the New York legislature. The affected trustee did not serve on the subcommittee involved in hiring the TPA or in the final selection, and later returned the contributions to the TPAs who made them.

Without concluding that Mr. Lindsay or the campaign contributors violated ERISA, the Department describes the range of prohibited transactions provisions that may well be violated where an ERISA plan fiduciary accepts such contributions and proceeds to use his/her influence to participate in discussion of, and vote on, the vendor's contracts. The Department proceeds to explain how the trustee/politician's recusal from campaign contributor decisions generally should protect him/her from committing prohibited transaction violations.

While the Department's analysis on this score raises no new legal issues, there is a significant mention of a related legal issue in the letter. The Department builds upon its position in its Enron amicus brief where it argued that there may be circumstances where the general requirements of prudence and loyalty require fiduciaries to share information in their possession with other fiduciaries. In this letter, the Department writes that there may be circumstances in which recusal will not protect a fiduciary against violations of prudence and loyalty standards. It appears that what DOL officials have in mind is that, if a fiduciary is offered a bribe or has

improper connections to a vendor, this information must be disclosed to the voting fiduciaries because they are required to know it before the vote in order to fulfill their fiduciary responsibilities.

10. IRS Narrows Scope of Memo Targeting Abusive Qualified Plan Schemes

Last year, Carol Gold, the IRS's Employee Plan's Director, issued a directive authorizing IRS agents to take adverse action against certain qualified plans on nondiscrimination grounds, even though the plans' appear to satisfy numerical nondiscrimination tests (Qualified Plans 2004-11). On February 4, 2005, in response to a comment letter that expressed concern that IRS agents might apply the directive broadly to prohibit plan designs that the IRS and plan sponsors have long considered permissible under the nondiscrimination regulations, Ms. Gold clarified and narrowed the scope of the earlier directive.

Most importantly, the response letter, clarified that "the intent of the October 22, 2004 memorandum is to focus upon plans that attempt to satisfy the nondiscrimination tests by using nominal contributions or benefits for the lowest paid non-highly compensated employees where the nominal contributions or benefits result from very short periods of service." (Emphasis added.) The original directive included language targeting plan designs in which benefits were limited to a select group of highly compensated employees and to the lowest paid of the nonhighly compensated employees and "additional situations" with "similar facts," without any explicit "short service" requirement. The follow-up letter also noted that the directive "is not intended to suggest that plan designs that have been consistently and repeatedly approved by the Service are now in question."

The follow-up letter, although helpful, continues to endorse portions of the original directive that might be troubling for some plan sponsors. For example, the directive is not limited to situations in which coverage of short-service nonhighly compensated employees results from "questionable hiring practices." Instead, the directive might be read to target situations where a plan satisfies nondiscrimination testing requirements by covering short-service employees, even where individuals have short periods of service due to normal turnover. It is also not clear whether the IRS intends to target only those plans where all covered nonhighly compensated employees are short-

service employees, or intends to target plans covering a combination of long-service and short-service nonhighly compensated employees.

The follow-up letter also does not address a fundamental problem with the original directive. The original directive undercuts plan sponsors' reliance on Treasury regulation language promising that Treasury's numerical, "bright line" nondiscrimination regulations are the "exclusive rules for determining whether a plan satisfies section 401(a)(4)." See Treas. Reg. §1.401(a)(4)-1(a). This kind of move away from a numerical testing approach should, we think, be implemented through Treasury regulations, with the opportunity for public comment.

11. USERRA Notice Released

The Veterans Benefits Improvements Act of 2004 (Qualified Plans 2004-10) provides a number of new benefits to those individuals serving in the uniformed services, and requires employers to provide notices of USERRA rights, benefits and obligations to each person entitled to such rights or benefits, effective March 10, 2005.

The Veterans' Employment and Training Service Office of the DOL issued a model notice and interim final rule on March 10. 70 Fed. Reg. 12106. (The Preamble notes that over 460,000 members of the National Guard and Reserves have been mobilized since the 9/11 attacks.) The Model notice highlights reemployment rights, health benefit issues and enforcement matters, but does not address retirement benefits. Comments are solicited by May 9.

The USERRA notice may be provided by posting where employee notices are customarily provided, but DOL indicated that other methods – including electronic mail or regular mail – are permitted.