

QUALIFIED PLANS 2006-9

Friday, September 29, 2006

Page 1

HIGHLIGHTS

1. *Proposed DOL Rules Clarify Fiduciary Relief for Default Investments*
2. *Class Action Lawsuits Target Plan Fees*
3. *SEC Finalizes Rule 22c-2 and Extends Compliance for Redemption Fee Rule*
4. *PBGC Guidance on Use of PPA Interest Rate and 2006 Participant Notice Requirement*
5. *SEC Guidance on "Backdating" and Other Option Grant Issues*
6. *Court Rules Cash Balance Plan's Definition of Retirement Age – Earlier of 65 or 5 Years of Service – Violates ERISA*
7. *DOL Explores Changes in "Independent" Accountant Rule*
8. *IRS Allays Concerns About Effective Date of Final 403(b) Rules*
9. *Final IRS Rules on Stock Redemptions and the ESOP Dividend Deduction*

1. Proposed DOL Rules Clarify Fiduciary Relief for Default Investments

The Department of Labor ("DOL") has already issued proposed regulations implementing the default investment provisions of the Pension Protection Act of 2006, Public Law 109-280 ("PPA"). 71 Fed. Reg. 56806 (Sept. 27, 2006). The regulations, when finalized, would provide fiduciary relief to plan sponsors and other fiduciaries who invest participant account balances in certain "qualified default investment alternatives" – including most lifecycle and balanced funds – and meet other conditions described in the regulations. Importantly, the fiduciary relief available under the regulation applies to individual account plans whether or not they meet the requirements of ERISA section 404(c) regulations. The regulations should encourage plans to offer so-called "automatic enrollment features" that automatically implement 401(k) payroll deductions for employees, unless they affirmatively opt out of participation. The regulations would also pave the way for fiduciaries to use default investment options and obtain relief in plan transitions, such as a change in the plan's

administrative services provider. Comments are due by November 13. The regulations will be effective 60 days following the publication of the final regulation.

A. Background

Prior to the PPA, some plan sponsors were reluctant to adopt automatic enrollment features because of concerns that they would be liable for investing participant account balances without affirmative investment instructions. Specifically, DOL had taken the position that protection under ERISA section 404(c)(1) is not available in the absence of affirmative participant investment elections. The PPA made significant changes to ERISA to encourage employers to adopt automatic enrollment programs, including adding provisions that make it easier for such plans to satisfy various tax qualification tests and clarifying the application of ERISA's preemption rules to state laws that restrict employers from wage withholding without an employee's consent. In addition, section 624 of the PPA added new ERISA section 404(c)(5) which generally extends the protection available under ERISA section 404(c) to fiduciaries who invest

account balances of auto-enrolled participants or of participants who, for other reasons, have not provided investment directions.

ERISA section 404(c)(5) provides that a participant in an individual account plan that meets certain notice requirements will be treated as exercising control over the assets of his account which are invested by the plan fiduciary in accordance with regulations issued by the DOL. The statute requires a participant to receive prior notice of how contributions will be invested in the absence of instructions as well as his right to reallocate his investments. The statute requires the DOL to issue final regulations by February of 2007. ERISA section 404(c)(5) is effective beginning with 2007 plan years.

B. Scope of Relief

According to DOL, the proposed regulation is potentially available where participant directions are lacking due to auto-enrollment as well as "any other failure of a participant or beneficiary to provide investment instructions." 71 Fed. Reg. at 56806 n.5. This would include the participant's failure to provide instructions following the elimination of an investment alternative or a change in service provider (a "conversion") or following a rollover from another plan. (To the extent that a fiduciary wishes instead to "map" to "reasonably similar" investment alternatives in the case of a conversion, new section 404(c)(4) of ERISA should provide relief.)

Fiduciaries that meet the requirements of the regulation would not be liable for losses that result from the investment of the participant's account balance in a qualified default investment alternative or for investment decisions made by the manager of the investment alternative. Nonetheless, like any other investment option, fiduciaries would remain responsible for prudently selecting and monitoring the default option (and any investment manager for that option), and would be liable for any losses that result from a failure to do so. Investment managers that manage qualified default investment options would remain subject to applicable fiduciary standards. DOL did note that, in choosing a default option, a plan fiduciary would be required to "carefully consider investment fees and expenses" and that relative fees and expenses of possible options should be "an important consideration" in selecting among them. 71 Fed. Reg. at 56808.

Importantly, the DOL interprets ERISA section 404(c)(5) as providing relief regardless of whether the plan meets all of the detailed requirements of

section 404(c) regulations. As a result, fiduciaries of non-404(c) plans may qualify for 404(c)-like fiduciary relief in connection with default investments, but not with respect to investment decisions affirmatively made by plan participants (although a recent 7th Circuit case, discussed in Qualified Plans 2006-4, suggests that 404(c)-like relief in connection with affirmative participant instructions may be available without meeting the strict requirements of the 404(c) regulations). Jenkins v. Yager, 2006 WL 956944 (7th Cir. Apr. 14, 2006).

C. Qualified Investment Products and Services

Plan fiduciaries must meet a number of conditions in order to qualify for relief. Chief among them, plan assets must be invested in a "qualified default investment alternative." A qualified default investment alternative:

- may not hold employer securities, except if the investment alternative is a registered investment company, similar regulated pooled vehicle, or, in the case of an investment management service, the securities were acquired as a result of a matching contribution or prior to management by the service and the manager has authority to dispose of the securities;
- may not impose penalties or restrict the ability of a participant to transfer out of the investment alternative;
- must be (1) a registered investment company under the Investment Company Act of 1940, or (2) managed by an investment manager meeting the requirements of ERISA section 3(38);
- must be diversified so as to minimize the risk of large losses; and
- must qualify as a one of the three type of investment products or services as described in the regulation, summarized below.

The relief provided by the regulation is conditioned on the use of one of three types of investment products or services.

The first type of "qualified" default option is a fund or portfolio designed to provide varying degrees of long-term capital appreciation and capital

preservation based on a participant's age, retirement date or life expectancy. This could be a stand-alone product or a "fund of funds" comprised of various investment options available under the plan. Examples include "life cycle" or "retirement date" funds. A participant's account would be invested in the appropriate fund or portfolio based solely on the participant's age, life expectancy or retirement date.

The second type of "qualified" default option is a single default option for all plan participants. This option is described as an investment fund or model portfolio designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for the plan as a whole. According to DOL, an example of such an option may be a balanced fund. Like the first option, it could be a stand-alone investment product or a fund of funds utilizing other options otherwise available under the plan.

Third, a plan could select an investment management service through which a professional investment manager allocates the assets of a participant's account among equity and fixed income investments based solely on the participant's age, life expectancy or target retirement date.

Significantly, DOL specifically rejected the use of capital preservation investment products such as stable value and money market funds as qualified default investment options, stating that those investments would be unlikely to generate a sufficient rate of return to provide adequate retirement savings for participants. Interestingly, the Department has specifically blessed the use of these investment products in other contexts, such as for automatic rollovers and for investing certain missing participant account balances. See 29 C.F.R. § 2550.404a-2; Field Assistance Bulletin 2004-02 (Sept. 30, 2004). The omission of stable value products is surprising since many plans currently use them as default options.

The DOL acknowledged that the only relevant information that plan fiduciaries may have regarding a participant who fails to provide investment instructions is the participant's age. 71 Fed. Reg. at 56810. Accordingly, none of the permissible default investments require the plan or manager to take into account other factors that could affect retirement asset allocations such as risk tolerance, other assets, level of income, or lifestyle preferences.

D. Proposed Additional Conditions for Relief

- A fiduciary may invest a participant's assets in a default option only after the participant has been given the opportunity to direct the investment of the assets in his or her account and fails to do so.
- Plan terms must provide that any material provided to the plan relating to a participant's investment in a qualified default investment alternative (e.g., prospectuses, proxies, account statements) will be provided to the participant or beneficiary. (It is unclear why the plan document itself should have to address such matters.)
- A participant must be able to transfer out of the default investment option without financial penalty on the same terms as any other investment option, and at least as frequently as once within any three-month period.
- The plan must offer a broad range of investment options consistent with the requirements of ERISA section 404(c) regulations.
- The plan must provide a notice to participants at least 30 days before the first plan investment under the regulation and before the beginning of each subsequent plan year. The notice must describe the default option, the circumstances under which plan accounts will be invested in the default option, and the participant's rights with respect to directing assets to other options under the plan. (These notice requirements and the requirements of Code section 401(k)(13)(E), relating to auto-enrollment, could likely be met in a single notice.)

E. Observations

The DOL proposal goes a long way to filling a major gap in ERISA's fiduciary framework for defined contribution plans. An accompanying DOL fact sheet estimates that resulting aggregate 401(k) plan account balances will increase between \$45 billion and \$90 billion (over what period is not

stated). Nevertheless, steps the DOL – or plan sponsors – can take to remedy participant inertia in managing their plan accounts are still needed.

2. Class Action Lawsuits Target Plan Fees

Several class-action lawsuits were filed in recent weeks against plan sponsors, and their officers, directors and employees, attacking investment-related fees paid to plan service providers. Specifically, the complaints target revenue-sharing arrangements between plans, mutual funds (and other investment providers), and plan service providers such as recordkeepers, trustees and third-party administrators ("TPAs"). Some of the cases also allege that plans suffered losses due to improper fee arrangements and the holding of excess cash in company stock funds. At least 20 suits are expected to be filed against plan sponsors by one class action plaintiff's law firm. We understand that another firm may bring similar actions against financial institutions and other plan service providers.

A. Background

The structure and fee arrangements of 401(k) plans have been subject to increasing debate and scrutiny in the recent past. Examples include:

- An SEC Staff Report Concerning Examinations of Select Pension Consultants identified disclosure of fees by pension consultants as an issue important to the SEC. The DOL followed the report with a Fact Sheet offering guidance for plan sponsors selecting pension consultants, including monitoring of fees and identifying conflicts of interest. (These are covered in Qualified Plans 2005-6.)
- Investigations by Elliot Spitzer, the New York Attorney General, of expense reimbursements and commissions paid to insurance brokers and producers in connection with sales of variable annuities to plans.
- Recent DOL initiatives (Qualified Plans 2006-7) relating to fee disclosures, including proposed changes to the Form 5500 which would require plan administrators to disclose indirect fees,

including revenue sharing, on the plan's Form 5500.

- Forthcoming changes to the ERISA statutory exemption that allows parties in interest to provide services to plans. DOL has said that its focus in the proposed changes will be to clarify a plan fiduciary's duties in assessing whether the service provider arrangement and the compensation earned by the service provider are reasonable.
- Although *Haddock v. Nationwide* (Qualified Plans 2006-02) involved an action by plan sponsors against a plan service provider, the plaintiffs' argument in *Haddock* that revenue sharing payments are plan assets that must be used for the benefit of plans and participants is echoed in the new cases.

B. The Claims

The plaintiffs' basic claim in most of the complaints is that "revenue sharing" payments represent a compensation source for plan service providers that was not properly accounted for by plan fiduciaries in negotiating the service providers' fees, and was not disclosed to plan participants. Plaintiffs' define revenue sharing in extremely broad terms, essentially including all asset-based compensation paid to administrative service providers in connection with plans. This broad definition is necessary to plaintiff's argument that the total amount of these third-party payments – plus the "direct" compensation paid to plan service providers – is *per se* unreasonable. The complaints also imply that revenue sharing payments are "plan assets" and broadly allege that plan recordkeepers, consultants and TPAs are fiduciaries.

Some of the complaints also contain claims relating to the plan's company stock investment alternative. There, the claims assert that unitizing the plan's company stock fund improperly dilutes participants' gains when the stock rises because the cash held within the company stock fund depresses the fund's overall returns. Some complaints also allege that plan fiduciaries caused the plan to pay excessive fees to the manager of a unitized company stock fund.

Typically, the lawsuits allege (among other things) that defendants have breached their fiduciary

duties of loyalty and care to the 401(k) plan, and have failed to discharge their duties "in accordance with the documents and instruments governing the plan." ERISA § 404(a)(1)(A), (B) & (D). Based on these alleged fiduciary breaches, plaintiffs have pleaded two claims for relief. First, plaintiffs allege a cause of action under section 502(a)(2) of ERISA, which permits a participant or a fiduciary in an ERISA-covered plan to bring a civil action for relief under ERISA section 409(a), "to make good to such plan any losses to the plan resulting from [any] breach" of its fiduciary duties. From this, plaintiffs claim that defendants are liable to restore to the 401(k) plan the "losses" that arose from defendants' alleged fiduciary breaches.

Plaintiffs also attempt to plead a cause of action under section 502(a)(3) of ERISA for "appropriate equitable relief" to redress the alleged ERISA violations. Plaintiffs assert that they are entitled to an equitable accounting of "excess fees and expenses" that allegedly have been paid out to the 401(k) plan's service providers. Plaintiffs further assert that a surcharge should be imposed on defendants for all amounts that can not be properly accounted for by them.

C. Analysis and Observations

These claims represent the next development in the evolution of the law regarding fees and relationships between plans and their service providers. The potential impact of the cases on the structure and operation of plans is significant. Each of the complaints alleges that plan recordkeepers, consultants and third-party administrators are fiduciaries and, perhaps most importantly, rely on the assertion that revenue sharing payments are plan assets. The retirement services industry as a whole would be greatly affected if a court were to agree with these assertions. Equally troubling are the allegations that plan sponsors had a fiduciary duty to affirmatively disclose revenue sharing payments to participants.

The complaints do not allege prohibited transactions or name the service providers as defendants. However, particularly in light of Haddock, we believe that suits against plan service providers are just around the corner. Certainly, this round of litigation could be used by plaintiffs' lawyers to elicit discovery for purposes of preparing another round of lawsuits that will more directly affect plan service providers by alleging, for instance, direct or co-fiduciary liability, or "knowing participation" in a prohibited transaction.

As with the rash of litigation involving plan investments in employer securities that followed the Enron bankruptcy, these cases should serve as a reminder to plan sponsors and their advisors of the importance of good fiduciary processes. Plan sponsors can take a number of actions to guard against being named as a defendant in these types of suits, including:

- Documenting the plan fiduciary's review and negotiation of all plan services arrangements, including investment, recordkeeping, trustee, and administration.
- Reviewing and revisiting fee arrangements and investment alternatives on a regular basis. As noted in a study of 401(k) fees and expenses commissioned by the DOL in 1998, the fee arrangement that is best for a new plan, with low average asset values, may not be the best for the same plan a few years later when the plan's asset values have grown, either through increased participation, merger with other plans, or market upturn.
- Reviewing the plan's fiduciary governance structure to make sure that plan fiduciaries are clearly identified and that fiduciary authority is allocated to the most appropriate people. Not only can this step help the plan to operate more efficiently and result in better decisions and documentation, but it can also drastically limit the number of named defendants and therefore reduce costs in the event of a lawsuit.
- Implementing/reviewing the plan's investment policy statement ("IPS") to make sure decisions are being made in accordance with the IPS and that the IPS accurately reflects the fiduciary's intentions and plan operations.
- Ensuring that the plan does not obligate the sponsor, rather than the plan, to pay plan expenses (while all plans should have appropriate plan expense language, some sponsors may also consider paying plan expenses themselves).

- Regularly reviewing and documenting decisions regarding the liquidity targets for the plan's unitized stock fund, the manager's compliance with the targets, and the fees associated with the managing the company stock fund.

3. SEC Finalizes Rule 22c-2 and Extends Compliance for Redemption Fee Rule

The Securities and Exchange Commission ("SEC") recently adopted final amendments to Rule 22c-2, the redemption fee rule. Investment Company Act Rel. No. 27504 (available at www.sec.gov). Originally adopted in 2005 (Qualified Plans 2005-3), rule 22c-2 is intended to address abuses associated with short-term trading in mutual fund shares by requiring mutual fund boards of directors to consider whether a redemption fee policy or other policies and procedures designed to detect and deter abusive short-term trading are appropriate for their funds. The rule also requires most mutual funds to enter into shareholder information agreements with "intermediaries" that hold shares on behalf of other investors. These "intermediaries" include banks, brokers and other financial institutions that process mutual fund transactions for 401(k) and other participant-directed retirement plans, and also any "plan administrator" of a participant-directed plan.

The final rule amendments address requirements for the shareholder information agreements required by rule 22c-2 and extend the date by which funds must comply with certain requirements. Under the final rules –

- Mutual funds are only required to enter into agreements with "first-tier" intermediaries submitting purchases and redemptions directly to the fund (or its principal underwriter or transfer agent). These "first-tier" intermediaries must agree to provide, upon a fund's request, identification and transaction information for shareholder accounts held directly with the first-tier intermediary. A first-tier intermediary must use "best efforts" to obtain and forward (or have forwarded) underlying shareholder identity and transaction information from "indirect" intermediaries that submit orders to the fund through the first-tier intermediary. If an indirect intermediary does not

comply with a fund's information requests, the first-tier intermediary must prohibit the indirect intermediary from purchasing additional fund shares at the fund's request.

- Mutual funds may treat some intermediaries as individual investors for purposes of their policies against frequent trading. For example, a fund may apply its redemption fees or exchange limits to plan-level transactions, rather than to directions of individual plan participants, and in that event, the plan would not be considered an "intermediary" subject to the information-sharing requirements. This change is expected to reduce the burden on the funds and small retirement plans that hold mutual fund shares on behalf of only a few participants.
- If a fund does not have an agreement with a particular intermediary, the fund may not accept any new share purchase orders from that intermediary. However, the prohibition only applies to the intermediary with which the fund does not have an agreement; the fund may continue to accept purchase orders from other intermediaries.

The final rule release also provides guidance with respect to short-term trading policies and restrictions imposed by intermediaries, which may be different from a fund's policies. For example, a financial institution offering clients access to a range of funds distributed by different mutual fund complexes might impose for its clients a set of uniform restrictions on short-term trading. In the final rule release, the SEC agrees that a fund may defer to the intermediary's restrictions on short-term trading (even if different from the funds' policies), so long as the fund's prospectus discloses that shareholders may be subject to different restrictions imposed by intermediaries. The retirement plan industry has persistently urged the SEC to consider uniform requirements for redemption fees and other restrictions on short-term trading because non-uniform policies are complicated to administer and difficult to communicate within retirement plans, but the SEC has decided against standardization in favor of preserving funds' flexibility to adopt policies suited to their individual situations. Guidance allowing funds to defer to an intermediary's own policies should allow intermediaries to mitigate some

of the difficulties resulting from differences among policies of the different mutual funds that they may offer to their clients.

As originally adopted, the rule had a compliance date of October 16, 2006. Funds' boards still must consider and adopt policies by that date. However, the date for completing the required shareholder information agreements is extended to April 16, 2007, and funds must be able to obtain information from intermediaries under the agreements by October 16, 2007.

4. PBGC Guidance on Use of PPA Interest Rate and 2006 Participant Notice Requirement

Under the Pension Protection Act of 2006 ("PPA"), the interest rate described in the Pension Funding Equity Act of 2004 ("PFEA") will be used to determine unfunded vested benefits for purposes of the variable rate PBGC premium. This rate also will be used to determine whether certain notice and reporting requirements under sections 4010 and 4043 of ERISA apply. PBGC has issued guidance on the application of the interest rate under PPA in a Federal Register Notice and a Technical Update. Technical Update 06-4 (Aug. 30, 2006); 71 Fed. Reg. 50477 (Aug. 25, 2006).

The PPA also repealed the participant notice requirement under section 4011 of ERISA and replaced it with a new notice requirement for plan years beginning after 2006. For plan years beginning in 2006, PBGC has issued guidance and a model participant notice. Technical Update 06-3 (Aug. 25, 2006); Technical Update 06-4 (Aug. 30, 2006).

We summarize the key elements of this guidance below.

A. Interest Rate for Variable Rate Premiums

A variable rate premium is owed under section 4006(a)(3)(E) of ERISA if a plan has "unfunded vested benefits" determined using specified assumptions. Unfunded vested benefits for this purpose are measured using the interest rate published by PBGC for the month in which the premium payment year begins. The PFEA changed the interest rate for determining unfunded vested benefits for purposes of the variable rate premium from a rate based on 30-year Treasury Bill yields to a rate based on a percentage of the annual rate of

return of investment grade corporate bonds ("PFEA Rate"). The PFEA Rate expired at the end of December 2005, and the rate based on Treasury Bills again applied. PBGC therefore published monthly rates based on the Treasury Bill rates for January through August 2006.

The PPA extended the PFEA Rate to plan years beginning in 2006 and 2007. PBGC therefore has published revised rates for January through August 2006 based on a percentage of the PFEA Rate. 71 Fed. Reg. 50477 (Aug. 25, 2006). The revised rates for January through August range from 90 to 100 basis points higher than the corresponding Treasury Bill rates, which should result in lower vested benefit values.

B. Applying the PFEA Rate to Notice and Reporting Requirements

The interest rate for determining the variable rate premium is also used to determine whether the report to PBGC under section 4010 of ERISA (corporate and financial information) is required, and whether and when a notice to PBGC of a "reportable event" under section 4043 of ERISA is required. PBGC Technical Update 06-4 (Aug. 30, 2006) explains how the PFEA Rate applies for these purposes.

Section 4010 Notice – Under section 4010, a contributing sponsor and each member of its "controlled group" (generally, trades or businesses directly or indirectly linked by an 80% ownership interest based on vote or value) must report pension plan and financial information to PBGC if the aggregate value of the unfunded vested benefits of the defined benefit pension plans in the controlled group at the end of the preceding plan year exceeds \$50 million. The variable rate premium interest rate is used to determine unfunded vested benefits for this purpose. In January 2006, because of the expiration of the PFEA Rate at the end of 2005 and the uncertainty about whether it would be extended, PBGC announced that the section 4010 reporting requirement was waived for information years ending on or after December 31, 2005 and on or before June 30, 2006 if no filing would be required using the PFEA Rate. (Qualified Plans 2006-1.) (An "information year" is the fiscal year or, if controlled group members have different fiscal years, the calendar year.) Under PPA, the same rate used for the waiver, *i.e.*, the PFEA Rate, continues to apply for information years beginning in 2006. PBGC intends to issue guidance at a later date on the

applicable interest rate for information years beginning in 2007.

For years beginning after 2007, PPA amended section 4010 to eliminate the \$50 million aggregate unfunded vested benefit threshold for reporting. Instead, reporting will be required if the "funding target attainment percentage" of any plan maintained by a controlled group member is less than 80% as of the end of the preceding plan year. PPA § 505(b). The funding target attainment percentage is a term used in the PPA's new single-employer plan funding rules and generally means the ratio, expressed as a percentage, of the value of plan assets to the present value of benefits accrued as of a plan year, using specified assumptions. PPA §101. [We note that section 4010(d)(2)(B), added by section 505(b) of the PPA, should refer to section 303(d)(2), not section 302(d)(2).] PBGC intends to issue guidance on this change at a later date as well.

Reportable Event Notices – Section 4043(a) of ERISA and the related regulation (29 C.F.R. Part 4043) require notice to PBGC within 30 days after certain "reportable events." Notice of some reportable events is waived, or the notice date is extended, if the plan is not subject to a variable rate premium.

For any reportable event that occurs in a plan year beginning between January 1, 2006 and December 31, 2007, the PFEA Rate is used to determine whether a variable rate premium is required for purposes of a waiver of the reportable event. The PFEA Rate also is used to determine whether a variable rate premium is due for plan years beginning between January 1, 2006 and December 31, 2007 for purposes of the waiver under Technical Update 97-6 (waiving post-event reporting for certain small employers that do not make quarterly contributions if no variable rate premium is owed). An extension of certain reportable event filings is available if no variable rate premium was due for the plan year preceding the reportable event year. The PFEA Rate is used to determine whether a variable rate premium is owed if the year preceding the reportable event year begins between January 1, 2006 and December 31, 2007.

Section 4043(b) of ERISA and the related regulation (29 C.F.R. Part 4043) require 30 days advance notice to PBGC of certain reportable events if the contributing sponsor is not publicly traded, the aggregate value of unfunded vested benefits of plans maintained by members of the controlled

group exceeds \$50 million, and the aggregate funded vested percentage for the underfunded plans is less than 90 percent. 29 C.F.R. § 4043.61. For reportable events with an effective date in a plan year beginning between January 1, 2007 and December 31, 2007, the PFEA Rate is used to value vested benefits to determine whether advance reporting is required.

C. Participant Notice under Section 4011

Generally, section 4011 of ERISA requires the plan administrator of certain plans to provide a notice to plan participants stating the plan's funded status and the limits of PBGC's benefit guaranty if the plan were to terminate. The PPA repealed section 4011 of ERISA for plan years beginning after 2006. Technical Updates 06-3 and 06-4 provide a model notice and guidance in determining whether a notice is required for plan years beginning in 2006.

A participant notice is not required under section 4011 of ERISA for plans that are not required to pay a variable rate premium. For 2006, the PFEA Rate is used to determine whether a variable rate premium is due.

A participant notice also is not required if a plan meets specified funded levels ("DRC test"). For 2006, a plan is not required to issue a participant notice if the plan meets the DRC test for either the 2006 or 2005 plan year. As applied to the 2006 plan year, a plan satisfies the DRC test if the plan's funded current liability percentage (a) is at least 90% for the 2006 plan year or (b) is at least 80% for the 2006 plan year and at least 90% for either the 2005 and 2004 plan years or the 2004 and 2003 plan years. As applied to the 2005 plan year, a plan satisfies the DRC test if the plan's funded current liability percentage (a) is at least 90% for the 2005 plan year or (b) is at least 80% for the 2005 plan year and at least 90% for either the 2004 and 2003 plan years or the 2003 and 2002 plan years.

Technical Update 06-3 includes tables of interest rates needed for the calculations used to determine whether a plan meets the DRC test. The 2006 notice is due two months after the due date, including extensions, for the 2005 Form 5500. Due dates that fall on a weekend or federal holiday are extended until the next business day.

5. SEC Guidance on "Backdating" and Other Option Grant Issues

Many companies are reviewing their past practices on granting stock options to determine if they face any accounting, securities law or tax issues. Guidance on key accounting issues in this area was provided in a letter issued by the SEC's Office of the Chief Accountant on September 19th. Specifically, the SEC letter focuses on how to determine the "measurement date" of an option under the accounting rules which applied until very recently (Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25")).

As we noted in Qualified Plans 2006-5, tax issues arise in this area if the exercise price of an option is below the fair market value of the underlying shares on its grant date (i.e., the option is issued at a discount or "in-the-money"). To date there is little IRS guidance on how to determine the grant date for tax purposes (and the SEC guidance on how to determine the "measurement date" of an option for accounting purposes may provide analogous authority on the issue). This and other tax issues in this area – including the Code section 162(m) \$1 million deduction limit – received considerable attention at a September 6 hearing before the Senate Finance Committee. The IRS Commissioner, senior SEC officials and Justice Department attorneys testified at the hearing. Committee Chairman Grassley (R-IA) seems quite interested in pursuing changes to tighten the tax rules in the executive pay area, so developments definitely are worth watching.

We summarize below the guidance provided in the SEC letter.

Measurement Date Under APB 25 Generally – The determination of an option's "measurement date" is key to the accounting treatment for the option under APB 25. The measurement date is defined as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." A company will be required to record a compensation charge equal to the difference, if any, between the exercise price and the market price of the underlying stock (the "discount") at the measurement date. The SEC letter addresses a number of option grant scenarios that may result in accounting charges under these rules, as described below.

Backdating – The SEC letter confirms that dating a stock option document "as of" a date prior to the measurement date (i.e., the date on which the terms of the award become final) results in a compensation charge equal to the discount on the measurement date.

Administrative Delays – The SEC letter addresses two option grant methods that may result in a measurement date other than the date when the board of directors (or committee) approves the awards:

- awards are made by oral authorization from the board of directors (or committee) and completion of the documents evidencing such award occurs at a later date; or
- a member or committee of management is delegated authority to make awards within specific parameters set by the board of directors (or committee) and appropriate approval is obtained at a later date.

The determination of the appropriate measurement date in these situations is based on the company's facts, circumstances and pattern of conduct. Essentially, if the company considers the terms and recipients of the awards to be "fixed" and "unchangeable" on a date prior to the completion of all corporate actions (e.g., delivery of stock option agreement), such earlier date may be appropriate as the measurement date. However, any delay in the completion of all required corporate action suggests that the option terms may not have been final as of such earlier date.

Uncertainty as to Individual Award Recipients – Another common practice for many companies is to approve awards by authorizing an aggregate number of options to be granted without finalizing the number of options for each individual employee. The SEC letter generally states that if management has discretion to determine the number of options to be granted to each employee, the measurement date will not occur until final decisions are made by management.

Exercise Price Based on Future Market Price – Some companies set the exercise price for an option using a formula based on the market price of the underlying shares after the date the option is approved. For example, the exercise price may be determined as the lowest (or an average of) market

price of the company's stock during a 30-day period beginning on the award approval date. In this scenario, a measurement date would occur at the end of the period, and the compensation charge would equal the discount, if any, at such time.

Validity of Prior Grants – In some circumstances, the validity of a stock option grant may be questioned as a result of non-compliance with the terms of the stock option plan (e.g., no discount option grants or exceeding the pool of shares approved under the plan). In a majority of these cases, the company intends to honor the award and settle the award in stock. Generally, the SEC letter takes the position that a substantive arrangement mutually understood by both the company and its employees reflects the economic substance of past option grants and should serve as the basis for the company's accounting treatment.

Other Miscellaneous Option Practices – The SEC letter also addresses the appropriate accounting treatment for several other option practices, including: (1) grants of options to new employees prior to commencement of employment; (2) incomplete (or missing) documentation of past options; (3) timing of option grants in coordination with the disclosure of material non-public information; (4) adjustment to an option's exercise price following release of information to the public; and (5) documentation of option exercises as though such exercises occurred as of a date other than the actual date of exercise.

6. Court Rules Cash Balance Plan's Definition of Retirement Age – Earlier of 65 or 5 Years of Service – Violates ERISA

In Laurent v. PricewaterhouseCoopers LLP, 2006 WL 2546805 (S.D.N.Y., Sept. 5, 2006), a district court held that a cash balance plan's provision that defined "normal retirement age" as the earlier of age 65 or five years of service violates ERISA. While few plans have adopted such a definition, this decision, if followed by other courts, could expose those plans to potential significant liability for additional plan benefits. Moreover, the decision's reasoning is suspect because ERISA expressly permits sponsors to define normal retirement age as any age before age 65, and thus appears to authorize such a plan definition.

In Laurent, PricewaterhouseCoopers ("PWC") converted its defined benefit plan to a cash balance formula in July 1999. The cash balance accounts

grew with pay credits and hypothetical investment credits. The investment credits were based on the performance of investment funds selected by participants. The plan defined normal retirement age as "[t]he earlier of a date a Participant attains age 65 or completes five (5) years of service." Use of such an early normal retirement age allowed the plan to permit participants to self-direct the "investment" of their cash balance accounts and avoid the application of the "whip saw" effect which could require lump sum benefits far in excess of a participant's cash balance account.

Apparently, this retirement definition attracted the attention of some IRS examiners during the plan qualification process. The district court quoted a PWC letter dated September 1999 addressed to IRS where PWC explained that "a low retirement age in a qualified defined benefit plan" was PWC's response to "poor rule making by the Treasury Department." In the same letter, PWC complained that the whip saw rules reflected in Notice 96-8, which required that a lump sum be actuarially equivalent to the present value of an annuity payable at a participant's normal retirement age at a mandated interest rate, was "neither mandated nor suggested by the law or the legislative history." PWC explained in its letter that its plan retirement provision ensured that participants who requested a lump sum distribution received only the balance of their hypothetical account.

Four participants who received lump sum distributions filed an action contending that their distributions were not actuarially equivalent to an annuity and that the plan's retirement age definition was invalid under ERISA. On defendants' motion to dismiss the complaint for failure to state a claim upon which relief can be granted, the court held that the plan's retirement age provision was invalid under ERISA. The court acknowledged that ERISA permits a retirement age to be stated as any age before 65, but held that the plan must state a single fixed age as the retirement age. In the court's view, the PWC plan's definition of retirement age as five years of service was invalid because it authorized different retirement ages, depending upon the age when a particular participant entered service. To support its conclusion, the court relied upon two decisions, from the Second and Eleventh Circuits, and a Revenue Ruling interpreting ERISA's vesting provisions. The court held that "normal retirement age is a term of art under ERISA that was incorporated into the Act in 1976 to differentiate it from the vesting period limitations of a pension, which are based upon years of service as opposed to a set age... Thus, a normal retirement age below

age 65 cannot be defined in reference to length of service." Laurent, 2005 WL 2546805 at *6 (citation omitted).

The Laurent court's conclusion that ERISA requires a fixed retirement age that may not be stated in terms of service appears to conflict with the terms of the statute. ERISA defines normal retirement age as the "time a plan participant attains normal retirement age under the plan." ERISA § 3(24) (A) (emphasis added). Congress' use of the term "time" appears calculated to provide plans with some flexibility in defining retirement age based upon a period of time, such as years of service. This flexibility is limited only by the statute's requirement that a plan not designate a time after the later of "the time a plan participant attains age 65" or "the 5th anniversary of the time a plan participant commenced participation in the plan." ERISA § 3(24)(B). Thus, this statutory limit expressly incorporates a service component based upon years of participation in the plan. Further, the definition of "uniform normal retirement age" in the IRS' nondiscrimination regulations specifically states that "a uniform normal retirement age could be based on the earlier of the fifth anniversary of the commencement of participation and the completion of five years of vesting service." Although this regulation addresses post-65 normal retirement age, it is inconsistent with the Laurent court's notion that a normal retirement age that depends upon a participant's years of service is not a "certain specified age."

Moreover, other courts have upheld a definition of normal retirement age that, like PWC's plan, is based upon service based component. In Ryan v. Asbestos Workers Union, 27 Fed. Appx. 100, 2002 WL 90976 (3d Cir. 2002), the Third Circuit upheld a plan definition that defined normal retirement age as the earlier of 65 or 25 years of service, even though various participants had different retirement ages. See also Nichols v. Board of Trustees, 1 E.B.C. (BNA) 1868 (D.D.C. 1979) (enforcing plan provision defining normal retirement age as earlier of age 65 or tenth year of service).

The court's reliance upon decisions interpreting vesting provisions is also questionable. In Duchow v. New York State Teamsters Conference Pension and Retirement Fund, 691 F.2d 74 (2d Cir. 1982), the Second Circuit merely held that a plan cannot impose a service-based vesting requirement that is later than age 65. In interpreting existing 1982 statutory provisions, the court held "we are persuaded that Congress intended that an employee's pension rights would vest, irrespective of

the length of service, either on his 65th birthday or on the tenth anniversary of his joining the plan, whichever occurred later, unless the plan allowed earlier vesting." That result is congruent with the statutory requirement that participants be vested when they reach normal retirement age.

In short, Laurent is questionable, but it may have an impact on some plans. In particular, Laurent could affect cash balance plans that credit interest at rates other than those permitted under Code section 417(e)(3) or IRS Notice 96-8. Significantly, the impact of the decision may be limited to periods prior to the enactment of the Pension Protection Act of 2006 (the "PPA"). Under the PPA, the whip saw calculation reflected in IRS Notice 96-8 (which has been confirmed in several cases) no longer applies. Further, the PPA now requires that cash balance plans provide interest credits at a rate "not greater than a market rate of return." While IRS guidance is needed on this new market-rate standard, these PPA changes may help make the participant-directed cash balance design a viable option in the future.

7. DOL Explores Changes in "Independent" Accountant Rule

The DOL recently issued a request for information ("RFI") concerning Interpretive Bulletin ("IB") 75-9, which provides rules for determining the independence of accountants retained by employee benefit plans. 71 Fed. Reg. 53348, Sept. 11, 2006. In particular, DOL has requested comment as to whether its rules for determining auditor independence should be consistent with auditor independence rules adopted by the Securities and Exchange Commission ("SEC") and standards published by the American Institute of Public Accountants ("AICPA").

DOL originally adopted IB 75-9 soon after ERISA's enactment to clarify one of the then new requirements that ERISA plans engage an *independent* qualified public accountant for annual audits of plans' financial statements. IB 75-9 describes three types of relationships that will cause an accountant not to be independent. Specifically, during the audit engagement *and* during the period covered by the audit, the accountant, his or her firm, and any member of the firm cannot:

- have or be committed to acquire any direct financial interest or any material indirect financial interest in the plan or the plan sponsor;

- have a connection to the plan or plan sponsor as a promoter, underwriter, investment advisor, voting trustee, director, officer or employee of the plan or plan sponsor, or
- maintain financial records for the employee benefit plan.

Under the rule, a "direct or indirect" financial interest could include having an interest in a plan as a plan participant, and would include any interest attributable to a family member of the accountant or other members of his or her firm.

In the RFI, DOL recognizes that the financial and accounting services' world has changed since 1975 in a number of ways. Specifically, accountants are subject to more scrutiny than ever and are subject to a variety of independence rules that may apply on federal and state levels, including rules issued by the SEC as a result of the Sarbanes-Oxley Act of 2002; rules issued by the Public Company Accounting Oversight Board; rules issued by the U.S. Government Accountability Office; and standards published by the AICPA. The nature of the accounting business has also changed with accounting firms now providing certain non-accounting type services to a variety of clients. DOL asks whether inconsistent independence standards create obstacles for accountants to service their plan clients and make it difficult for plans to procure services of an accountant "independent" under ERISA standards. In our experience, many companies have decided to retain accounting firms for plan audits that are different from their regular outside firm.

Given changes (and consolidation) in the accounting industry, one particular concern is the question of whether a family member's interest in a company (or in a plan) should be attributed to the accountant or his or her auditing firm and whether the relevant period should be limited to the period of professional engagement (as opposed to being extended for the entire audit period). Under the SEC's current auditor independence rules (17 CFR Part 210), an auditor meets the "independence" requirement even when the auditor's immediate family member (most typically a spouse) is employed by an audit client in a position other than an "accounting role or financial reporting oversight role" (the employment relationship test). 17 C.F.R. § 210.2-01(c)(2)(ii). Further, an auditor is not disqualified under the direct financial interest or material indirect financial interest test ("financial relationship" test) when an immediate family

member of a member of the firm (other than the auditing member) acquires an interest in an audit client if the immediate family member works for the audit client and acquires the interest as an "unavoidable consequence" of employment (e.g., the interest is part of the total compensation package, such as, for example, stock options in the employer). 17 C.F.R. § 210.2-01(c)(1)(iii)(C). In such cases, the family member is required to dispose of the financial interest as soon as practicable once he or she has the right to do so. The SEC's rationale for adopting the two exceptions was to accommodate the growth of dual career families and the increasing mobility among the professionals. See SEC Release No. 33-7919, *32 (rule preamble) Final Rule: Revision of the Commission's Auditor Independence Requirements, 17 C.F.R. Part 210 (Feb. 5, 2001). Arguably, the same rationale and the same exceptions should apply for auditors of ERISA plans. However, in a recent informal discussion, DOL staff stated that these exceptions discussed above are not currently allowed by IB 75-9.

Comments to DOL are due by December 11.

8. IRS Allays Concerns About Effective Date of Final 403(b) Rules

Taking a rather unusual – but helpful – step, the IRS has announced (IR-2006-136, Aug. 29, 2006) that the general effective date of the 403(b) regulations generally will not be earlier than January 1, 2008. This is a major relief because employers, insurers and mutual fund providers have been concerned that compliance with the massive changes that would be required by the proposed rules (Qualified Plans 2004-11) would be impossible if the 2007 effective date were retained.

In informal comments since the Announcement was released, IRS officials have indicated that the final rules are likely to include transition rules for governmental plans and possibly other arrangements, recognizing that full compliance as of January 1, 2008 may impose onerous burdens in some cases. We suspect that, even if the final rules are issued very soon, the major changes required will be very difficult to implement – even with the January 1, 2008 deadline.

9. Final IRS Rules on Stock Redemptions and the ESOP Dividend Deduction

IRS recently issued final regulations under Code sections 162(k) and 404(k) that resolve a hotly disputed issue relating to the deductibility of dividends paid on employer securities held by an ESOP. 71 Fed. Reg. 49897 (Aug. 30, 2006). Specifically, the final rules provide that a corporation paying a dividend on the redemption of stock to a terminating ESOP participant may not take a deduction for such payment under Code sections 404(k). In Rev. Rul. 2001-6, the Service concluded that Code section 162(k) bars a deduction under Code section 404(k) for payments made in redemption of stock from an ESOP. Code section 162(k) disallows a deduction for amounts paid or incurred by a corporation in connection with the reacquisition of its own stock. The Service reasoned that, because the redemption of stock from an ESOP was equivalent to the reacquisition of a corporation's stock, Code section 162(k) bars any deduction for the payment of such dividends.

Rev. Rul. 2001-6 was called into question by the Ninth Circuit in Boise Cascade v. U.S., 329 F.3d 751 (9th Cir. 2003), where the court ruled that dividends paid on the redemption of stock to a terminating ESOP participant were deductible under Code section 404(k). Specifically, the court ruled that the dividend distributions from the ESOP to participants were not triggered by the redemption of the stock; rather the payment of the dividend and the redemption of the stock were two separate events. As a result, the court concluded that the distribution was not paid in connection with the reacquisition of the plan sponsor's stock and, therefore, was deductible under Code section 404(k) (if it otherwise was a dividend under federal tax principles).

Notwithstanding Boise Cascade, the final regulations confirm that the Service believes that payments made to reacquire stock held by an ESOP are not deductible under Code section 404(k), and that Code section 162(k) generally bars any deduction for dividends paid on the redemption of stock to a terminating ESOP participant (even if it would be treated as a dividend under the rules of Code sections 301-316). The final regulations are effective on the date issued, *i.e.*, August 30, 2006.

The final rules do not address a second issue raised in proposed rules released in August 2005, *i.e.*, which corporation is entitled to the 404(k) dividend deduction where the payor and the

employer are different entities. The proposed regulations would clarify that the payor of the applicable dividend is entitled to the deduction, and therefore, in the parent-subsidary context, only the parent (as payor of the dividend) would be entitled to the deduction. Apparently, Treasury and IRS want to mull that issue over further.