GROOM LAW GROUP, CHARTERED

2007 Employee Benefits Seminar

Current Fiduciary & DOL Developments

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Topics: **Qualified Default Investment Alternatives**
DOL Fee Initiatives
Meals, Entertainment, and Gifts
LM-10 and LM-30 Update

DOL Regulatory Update

October 24, 2007

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Default Investments

PPA Adds New ERISA § 404(c)(5)

- **New ERISA § 404(c)(5)** - a participant is treated as exercising control over his or her plan account "in the absence of a direction," if the account is invested according to DOL regulations.

Default Investments: Final Regs

Basic Requirements

DOL Final Regulations (Oct. 24, 2007). Relief provided for investment in the absence of a participant direction if --

1. QDIA: Assets are invested in a "qualified default investment alternative."
2. Failure to Direct: The participant is given the opportunity to direct the investment, but does not.
3. Notice: The participant is given notice
   - at least 30 days before plan eligibility or first investment, or, if participant has right to transfer out, on or before date of plan eligibility, AND at least 30 days in advance of each new year.
4. Information: Certain material is provided to the participant regarding the default fund (prospectus, proxies if applicable).
5. Transfer rights: Right to transfer from the QDIA with same frequency as participant who elected to invest in the QDIA (no less than once within any 3 months)
6. Broad Range: Plan offers a "broad range of investment alternatives"

Default Investments: Final Regs
A "QDIA"

"QDIA" requirements

- Generally does not hold employer securities (exceptions apply)
- Meets transferability rules and fee restrictions
- Must be one of the following:
  - Managed by (1) a section 3(38) investment manager, (2) a trustee that meets section 3(38)(A), (B) & (C), or a (3) plan sponsor that is a "named fiduciary"
  - Registered investment company
  - One of the "limited" principal preservation QDIA funds

Default Investments: Final Regs

Types of QDIAs

- 3 Types of Qualified Default Investment Alternative (QDIA):
  1. Funds/portfolios designed to provide varying risk/return based on participant's age (e.g., lifecycle or target retirement date funds)
  2. Single fund/portfolio providing long-term appreciation and capital appreciation through a mix of equity and fixed income with a level of risk appropriate for the participants as a whole (e.g., a balanced fund)
  3. An investment management service under which a professional ((e)(3)(1) manages the participant's account based on participant's age or target retirement date ("managed account")

Default Investments: Final Regs
Scope of Relief

- No unlimited QDIA status for principal protection vehicles.
- 2 Special QDIA rules for principal protection funds:
- Temporary QDIA status for principal protection funds for up to 120 days after the participant's first elective contribution. Fund must be designed to preserve principal and provide a reasonable return, consistent with liquidity (whether or not guaranteed); offered by a state or federally regulated financial institution.
- "Grandfather" provision for investments made in stable value funds prior to December 24, 2007. Must involve a fund designed to guarantee principal and a return consistent with intermediate investment grade bonds, while providing liquidity for withdrawals/transfers by participants.

Default Investments: Final Regs
Types of QDIAs

- A fund otherwise meeting the requirements for a QDIA won't fail to comply -
  - Even though offered through an annuity contract, bank collective trust or other pooled fund
  - Regardless of whether the fund provides annuity purchase rights, investment guarantees, death benefit guarantees or other ancillary features

Default Investments: Final Regs
Notice

- Immediate Participation Plans
- DOL broadened the notice rule by allowing notices to be provided on or before the date of eligibility, provided the participant has the opportunity to make a permissible withdrawal.

Default Investments: Final Regs

Transition Issues

- Transition Issues: how to transition old defaulted accounts into a QDIA after regulations are effective?
  - Participants must have been given an opportunity to provide investment instructions but failed to do so
  - Difficulty distinguishing default from affirmative investments in an investment option, and concern about liability for prior affirmative investments in the non-QDIA
  - DOL explicitly stated that a participant may be treated as failing to provide investment instructions regardless of whether the participant affirmatively elected or was defaulted into the prior default investment
  - Participant must fail to give investment instructions following the effective date of the regulation

Default Investments: Final Regs
Beyond Auto-Enrollment

- Regs clearly apply to situations beyond automatic enrollment.

- Regulations apply where an investment option has been eliminated, a service provider has changed, rollover contributions, and “whenever the participant has the opportunity to direct the investment of account assets, but does not.”

Default Investments: Final Regs
Disclosure

- Proposed disclosure rule appeared to require the disclosure of a wide range of materials (proxy materials, prospectus', annual reports, prospectus updates, etc.).
- Final disclosure rule makes clear that the required disclosures are no more extensive than those required under current 404(c) regulations.

Default Investments: Final Regs
Preemption

- Preemption rule appears to clarify that state laws that inhibit automatic contribution arrangements will be preempted as to any pension plan regardless of whether the program utilizes a QDIA vehicle.
- Notices that satisfy the default regulations may be used to satisfy the notice requirements of ERISA section 514(e).

Default Investments: Final Regs
Fees

- Fees charged through QDIA vehicles:
- Broad prohibition against transfer, surrender, liquidation, exchange, redemption or withdrawal fees for the first 90 days following a participant's first elective contribution.
- QDIA can charge "ongoing fees" for investment management, distribution, service, 12b-1, administrative fees.
- Following the 90-day period, QDIA can charge transfer or withdrawal fees that are generally charged to participants who elected to invest in the QDIA.

Default Investments: Final Regs
Scope of Relief

- 2 Important Points:
- Regulations are NOT in the form of a safe harbor.
- Relief under section 404(c)(5) operates independently of 404(c)(1).

Recent DOL Activity

- The 3 regulatory initiatives likely to require increased disclosure of (and may discourage) revenue sharing arrangements:
  - Amendments to Form 5500 Schedule C - OMB review completed in August 2007 and expected final October 2007(?)
  - Amendments to 408(b)(2) Regulations – delivered to OMB on September 5, 2007
  - Participant disclosure guidance under 404(c) – RFI comments received July 24, 2007

Recent DOL Activity - Form 5500, Schedule C

- Proposal would require reporting of virtually all “indirect compensation,” i.e., payments to plan service providers by third parties “in connection with that person’s position with the plan or services rendered to the plan” 71 Fed. Reg. 411616, 41649 (Jul. 21, 2006).

Recent DOL Activity - Form 5500, Schedule C

- Examples of Indirect Compensation:
  - Finders' fees
  - Placement fees
  - Commissions on investment products
  - Transaction-based commissions
  - Sub-transfer agency fees
  - Shareholder servicing fees
  - 12b-1 fees
  - Soft-dollar payments
  - Float income (in dollars)
  - Brokerage fees and commissions (whether or not capitalized as investment costs)

DOL Activity - 408(b)(2) Regulations

- DOL is developing Provider "Incentive" to disclose.
- Because a Provider is a "party in interest," its provision of services to the plan requires an exemption.
  - As a party in interest, Provider would be liable for excise tax (pension) or section 502(i) penalties (welfare) if the services are not exempt.
- Current 408(b)(2) regulations require —
  - services are "necessary and appropriate,"
  - the arrangement is "reasonable," and
  - no more than "reasonable compensation" is paid.
    - See 29 CFR § 2550.408b-2.

DOL Activity - Proposed § 408(b)(2) Regulatory Amendments

- Regs. likely to require disclosure of information sufficient to permit plan fiduciary to consider whether –
  - the service provider's total compensation (including third party fees) is “reasonable,” and
  - any conflicts of interest affect the service provider's advice.
- DOL has determined that non-fiduciary service provider conflicts are relevant information to plan fiduciaries because of the influence SPs have on fiduciary decisions.
- Disclosure likely to be required at the commencement of the services relationship and on an ongoing basis.

DOL Activity - Disclosure to Plan Participants

- DOL is considering changes to regulations for participant-directed plans under section 404(c)
- DOL issued a “Request for Information” seeking input regarding:
  - Information relevant to participants;
  - Format; and
  - Costs of disclosure (including who will bear).

DOL Activity - Disclosure to Plan Participants

- Summary of RFI Comments:
  - Disclosure requirements should apply to all participant-directed plans and not just to 404(c) plans.
  - Disclosure requirements should apply to all types of investments and should not create a bias towards certain types of investments.
  - New disclosure requirements should encourage and facilitate the use of electronic technologies.
  - Fee disclosures should include information about asset-based fees, transactional fees and on-going separate fees.
  - Plan sponsors should retain flexibility in the disclosure format.
  - Additional disclosure requirements will increase costs for both plan sponsors and plan participants.

DOL Activity – Allocation of Revenue Sharing Rebates

- ERISA Advisory Council Testimony by Bob Doyle, Director ORI
  - Revenue sharing rebates are plan assets "upon receipt"
  - Allocation may be a matter of plan design
  - Fiduciaries should "consider" targeted allocation methodologies, but can weigh costs.
  - FAB 2003-03
  - Incidental benefit to plan fiduciaries should not raise 406(b) issues.
- Other witnesses (SIFMA, ABC) seek guidance
  - Identified potential SEC and tax issues, particularly with respect to registered investment companies.

Congressional Activity – The 401(k) Fair Disclosure For Retirement Security Act of 2007, H.R. 3185 (The "Miller Bill")

Service Provider Disclosure: Plan Administrator must receive a service provider disclosure prior to entering into any contract for services for $1,000 or more.

- Id all parties performing services under the contract;
- Description of services and total cost;
- Itemized list of services and expenses (i.e. sales commissions, expenses for investment advice);
- Disclosure of any conflicts of interest;
- If applicable, disclosure of impact of share classes and certain free, discounted or rebated services.

Congressional Activity – The 401(k) Fair Disclosure For Retirement Security Act of 2007, H.R. 3185 (The "Miller Bill")

- **Plan Administrator to Provide Notice of Investment Options to Participants:**:
  - Detailed information about each investment option (i.e. investment objectives, level of risk, historical returns);
  - A "Fee Menu" relating to all options under the plan, disclosing potential service fees that could be assessed against participant accounts;
  - Disclosure of potential conflicts of interest.

- **The Participant Annual Benefit Statement**
  - Disclose several subcategories of fees assessed from each participant's account for each investment option selected.

Congressional Activity – The 401(k) Fair Disclosure For Retirement Security Act of 2007, H.R. 3185 (The "Miller Bill")

Additional Requirements

- **Minimum Investment Option**: Participant-directed account investment menu must include at least one nationally-recognized index fund likely to meet retirement income needs at adequate levels of contribution.

October 4, 2007 Hearing

- Witnesses included DOL Assistant Secretary Brad Campbell, and representatives from AARP and ERIC. Although the hearing was cut short to accommodate a series of floor votes, some points of interest:
  - Ass't Sec. Campbell stated that legislative change is not needed at this time, and that congress should let the regulatory process work.
  - Bundled vs. Unbundled arrangements discussed.

Congressional Activity – The Defined Contribution Plan Fee Transparency Act of 2007 (the "Neal Bill")

- Would amend the Internal Revenue Code to impose new disclosure requirements on plan sponsors and service providers. Generally applies to all tax-preferred defined contribution plans.

- Plan sponsors that fail to provide the required disclosures would be subject to a tax of $100 per day per failure to disclose up to an annual maximum of $500,000.

- Service providers that fail to provide the required disclosures would be subject to a tax of $1,000 per day per failure to disclose up to an annual maximum of $1,000,000.

Congressional Activity – The Defined Contribution Plan Fee Transparency Act of 2007 (the "Neal Bill")

- **Plan sponsors** would be required to provide enrollment notices to new participants describing each investment alternative's:
  - Objective, historic rate of return and risk characteristics
  - Management style and structure
  - Fees charged, including asset-based fees, service fees and separate fees

- **Plan sponsors** would be required to provide individual annual notices to participants containing information regarding:
  - Investments selected and investment percentage breakdown
  - Management of investment alternative and rate of return
  - Asset-based fees, sales charges, separate charges for administration and fees for participant-initiated services
  - How to access information for other investment alternatives

Congressional Activity – The Defined Contribution Plan Fee Transparency Act of 2007 (the "Neal Bill")

- **Service Providers** would be required to provide service fee disclosures to plan sponsors:
  - In advance of a contract for plan services
  - Each year a contract for plan services is in place
  - Following any material modification of the contract

- The **Service Provider** disclosure would be required to include:
  - An estimate of total fees and an itemized list of services
  - Fees for bundled services must be separated into investment management fees, administration fees, recordkeeping fees and third party fees
  - Providers must disclose payments expected from third parties and revenue-sharing arrangements

Regulatory and Legislative Outlook

- High profile lawsuits and pressure from Congress make it more difficult to persuade DOL to take into account Provider concerns.
- Schedule C changes will heavily influence 408(b)(2) changes
- Non-fiduciary providers likely to have disclosure duties
- Participant disclosure requirements may apply beyond 404(c) plans
- Future Congressional hearings likely to focus on DOL and provider industry
- It seems unlikely that a new law will be passed in the 110th Congress

What are Sponsors and Providers Doing?

Sponsors

- Understand & negotiate arrangements
  - Benchmarking
- Evaluate alternatives
- Review participant disclosure
- Review allocation among participants
- Review fiduciary process

Providers

- Improve fee disclosure to plan sponsors
- Consider disclosures to participants
- Review contractual authority and procedures for making changes to "401(k) fund platform"
- Review contracts, marketing materials and practices to determine fiduciary status in fund selection

Forms LM-10 & LM-30 Reporting

- LM-10 – Employers (including service providers & financial institutions) reporting things of value given to a labor organization, its officers, employees, agents, shop stewards, or other representatives
  - LM-10 FAQs published September 10, 2006
  - Expect additional LM-10 written guidance
- LM-30 – Officers & employees of labor organizations reporting things of value they receive from employers
  - Final LM-30 regulations published July 2, 2007
  - New LM-30 FAQs published October 9, 2007
- Both are published on the DOL website
- Many exceptions to reporting – highly fact dependant

Why Do We Care?

- Knowing or willful failures to file or inaccurately file are criminal violations under the LMRDA
- Civil enforcement by DOL OLMS – appropriate relief
- Criminal enforcement by DOJ
- ERISA auditors from EBSA review – DOL MOU
- *May* (but does not necessarily) indicate violation of:
  - ERISA § 406(b)(3) – "Zero Tolerance Policy?"
  - Taft-Hartley Act § 302
  - 18 U.S.C. 1954
  - 18 U.S.C. 1001

LM-30 Final Regulation's Impact

- Final LM-30 regulation generally applies to 2008 for filings due March 31, 2009
- Employers can continue to rely on existing LM-10 FAQ's until the Department issues new guidance
- For now, different rules for LM-10 and LM-30 filers even though common terms defined by the LMRDA
- Nonetheless, LM-10 filers are greatly affected by LM-30 rules: whether items are reported on a union officer's LM-30 or an employer's LM-10, it is still published on the internet
- Final LM-30 regulations likely indicate future Form LM-10 filing requirements

LM-30 Final Regulation's Impact

- Union officers must report personal loans (but not credit cards) from financial institutions that do business with their Taft-Hartley plans or union
- Union officers must report reimbursed expenses from Taft-Hartley plans which have employees
- Union officers must report things of value (including reimbursements) from 501(c)(3)&(4) exempt employers
- WAG exception for union officers may not treat management trustees as unrelated to union
- Deminimis - $250 aggregate/ $20 per occurrence
- Compare to LM-10 FAQ exceptions – not the same

Next Steps Going Forward

- Involve Counsel
  - What you do report can hurt you
  - What you don't report can hurt you
  - Convoluted reporting exceptions
  - Whether you must report on LM-10 or LM-30 does not impact the legal analysis under ERISA or other laws
  - Monitor rapidly changing reporting requirements – Forms 5500 / 990 / LM-10 / LM-30
- Record keeping procedures imperative
  - Confirm records with those referenced prior to filing

Business Entertainment & Gifts

- Service providers to plan fiduciaries:
  - Gifts (big and small)
  - Meals and alcohol
  - Entertainment (golf, sports, theater)
  - Charitable contributions
  - Contributions for plan sponsor events
  - Educational, promotional conferences
- Business entertainment provides plan fiduciaries with:
  - Opportunities to learn of products, services and markets
  - Less formal opportunities to assess service provider performance and competence
  - Networking

Business Entertainment & Gifts

- Why now?
  - LM reporting highlights union plan practices
  - SEC/DOL focus on “pay to play”
  - Class actions vs. those in positions of trust (Enron), broker comp litigation, pension consultant investigations
- Recent DOL enforcement activities
  - “Zero tolerance” statement
  - DOL Pension Consultant Project
  - Midwest investigations

Business Entertainment & Gifts

- ERISA § 406(b)(3): Anti-Kickback Rule

  A fiduciary of a plan may not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."

- CRIMINAL: 18 USC § 1954: Kickback Rule

Business Entertainment & Gifts

- Limited caselaw re possible defenses to "kickback" claim
  - Gratuity must be paid "because of" a specific decision (“quid pro quo”)?
  - Must prove that fiduciary was in fact influenced by gratuity?
  - De minimus gratuities can't result in violation?
- “Kirkland: Extravagant entertainment and poor performance
- Chao v. Linder: Trustees receive motorcycles

Business Entertainment & Gifts

- Consequences for Recipient
  - Liable to Plan for losses and value of kickback
  - IRS excise tax - IRC §4975
  - Removal as fiduciary; injunctions
  - Pay 20% of recovery if DOL involved
- Consequences for Payor
  - Co-Fiduciary Liability
  - Non-Fiduciary Liability
  - Reputation
  - Uneven playing field
- Next Steps

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WASHINGTON UPDATE

This presentation provides an overview of recent legislative and other legal developments relating to ERISA-covered employee benefit plans. In particular, the presentation focuses on developments relating to fees and expenses charged in connection with ERISA plans. It also covers some of the more significant Pension Protection Act provisions relating to ERISA's fiduciary and prohibited transaction rules.

Changing attitudes about the responsibilities and influence of plan service providers are resulting in a reassessment of the disclosure requirements in connection with service provider compensation. This reassessment is reflected in current Congressional activity, court cases and DOL initiatives. It is important that in assessing recent legislative activity, we also focus on developments within the Department of Labor and before the federal courts.

I. Legislative Developments

A. The 401(k) Fair Disclosure for Retirement Security Act of 2007, H.R. 3185 (the "Miller Bill") would amend ERISA to require 401(k) plan administrators to obtain fee and conflict of interest disclosures from plan service providers and to give plan participants very detailed disclosures about the investment options available under the plans.

1. Service Provider Disclosure

(a) The Miller Bill would prohibit plan fiduciaries of 401(k) plans from entering into a contract worth more than $1,000 with a plan service provider unless the fiduciary receives in advance a written disclosure statement.

(b) The required service provider disclosure statement must contain the following information:

(1) Identification of all parties performing services under the contract (including the service provider to the plan and any subcontractors, whether or not affiliated with the service provider);

(2) Description of services and total cost;

(3) An itemized list of services and expenses (including an itemized list of sales commissions, start-up fees, investment management expenses, estimated trading costs, administration and record keeping expenses, legal fees, trustee fees, termination or surrender of charges, total asset based fees, SEC Rule 12b-1 fees, soft-dollar payments and any other cost specified by the Secretary of Labor);

(4) Disclosure of any conflicts of interest between the service provider, the plan sponsor, the plan or another plan service provider, including the extent to which a service provider uses its own proprietary investment products, any payments received by a service provider for including certain investment options as part of a menu of investment options, and other conflicts specified by the Secretary; and

(5) If applicable, disclosure of the impact of share classes and certain free, discounted or rebated services.

(c) The plan sponsor must post a copy of the service provider statement on any website maintained by the plan and must provide a copy of the disclosure to a participant or beneficiary within 30 days of a request by the participant or beneficiary. The penalty on plan administrators who fail to provide the disclosure or post it can be up to $100 a day per participant or beneficiary.

(d) Significantly, the Miller Bill does not impose any specific legal obligation on service providers to supply plans with information. Rather, it calls for the DOL to coordinate enforcement with respect to plan service providers with other applicable regulatory authorities, such as the Securities Exchange Commission and the Comptroller of the Currency, and to disseminate to plans the names of service providers who do not cooperate.

2. Notice of Investment Options

(a) The Miller Bill would require plan administrators of participant-directed plans to provide participants or beneficiaries with a detailed disclosure statement regarding the plan's investment options on the first day of the participant's participation in the plan, at least 15 days prior to the beginning of the plan year and 15 days prior to the effective date of any material change in investment options. The investment option disclosure statement must include the following information:

(1) Detailed information about each investment option (i.e., investment objectives, level of risk, historical returns and fees);

(2) A "fee menu" relating to all options under the plan that discloses potential service fees that could be assessed against participant accounts during the plan year (including disclosure of fees that vary based on investment option, asset-based fees that are not investment specific, and administration and transaction-based fees);

(3) A comparison of the option to a nationally recognized market-based index or other industry recommended benchmark retirement investment option;

(4) Where and how additional plan-specific and generally available investment information regarding the option may be obtained; and

(5) Disclosure of potential conflicts of interest that service providers or other parties in interest receiving the identified fees might have in providing services to the plan.

3. The Participant Annual Benefit Statement

(a) The Miller Bill would require plan administrators to provide extremely detailed participant-specific benefit statements within 90 days of the close of the plan year.

(b) The individual annual benefits statement would disclose to participants:

(1) The starting balance of the participant's account;

(2) The participant's vesting status;

(3) Contributions made during the plan year (itemizing separately participant and employer contributions);

(4) Earnings on account balance during the plan year;

(5) Calculation of service fees assessed on participant's account during the plan year identified by individual investment option;

(6) Ending balance of the participant's account;

(7) An asset allocation including current asset value, changes in the asset value during the year, and the net yearly return for each asset during the year;

(8) The service fees charged against the participant's account for the year; and

(9) A comparison of the performance of each participant's investment options selected by the participant during the year with a nationally recognized market-based index.

4. **Additional Miller Bill Requirements**

(a) The Miller Bill would also require that each participant-directed account investment menu include at least one nationally-recognized index fund offering a combination of historical returns, risk, and fees that is likely to meet retirement income needs at adequate levels of contribution.

(b) The Miller Bill requires the DOL to generate a model service provider disclosure statement, a model participant disclosure statement and a model benefit statement and to also assist plan sponsors in meeting the new requirements.

5. In order to enforce the proposed requirements, the Miller Bill would:

(a) Create a new 12-member DOL advisory committee on improving employer-employee retirement practices. Advisory council members would be appointed by the President and Congress. The advisory committee would hold hearings and issue reports, recommendations and advisory statements on employee benefits issues and best practices.

(b) Create a penalty structure authorizing DOL to assess a penalty against Plan Administrators of up to $100 per day for failure to comply with the disclosure requirements.

(c) Require the DOL to conduct annual audits of a representative sample of individual accounts to determine compliance with the disclosure requirements.

(d) Require the DOL to publicly disclose the identity and conduct of noncompliant service providers.

B. Hearing on the Miller Bill was held October 4, 2007 before the U.S. House of Representatives Committee on Education and Labor

1. Witnesses included DOL Assistant Secretary Brad Campbell and representatives from AARP and ERIC.

2. Assistant Secretary Campbell discussed DOL's pending regulatory projects (including Form 5500 regulations and 408(b)(2) regulations) and stated that legislative change is not needed at this time because the regulatory process will address the same issues.

3. Assistant Secretary Campbell also suggested that if the Committee pursues legislative action, the Committee should take into account the regulatory projects pending at DOL.

4. Other witnesses commented on the on-going discussion of bundled vs. unbundled fee disclosure.

5. Overall, we think that while the Miller Bill may make progress through the House, it will not be enacted into law this year. Also, because several provisions in the Miller Bill are controversial, it is likely to undergo modification along the way.

C. The Defined Contribution Plan Fee Transparency Act of 2007, proposed by Representative Neal, ("the Neal Bill") would amend the Internal Revenue Code to impose new disclosure requirements on plan sponsors and service providers. The Neal Bill would generally apply to all tax-preferred, participant-directed defined contribution plans, including 401(k) plans, 403(b) plans and governmental 457(b) plans.

1. The Neal Bill requires that a written enrollment notice containing the following information be provided to new plan participants:

(a) A description of the investment alternatives available to a participant under the plan and the method for making investment decisions;

(b) A general description of each investment alternative's objectives, risk and return characteristics, historic rates of return and the name of the investment manager;

(c) Whether the investment alternative is actively or passively managed;

(d) Whether the investment is a single-alternative investment solution such as lifestyle or target retirement date fund;

(e) Information about annual asset-based fees for each investment alternative, whether such fees pay for services other than investment management and whether there are additional charges associated with a particular investment alternative;

(f) Information about annual fees and expenses for administration and recordkeeping which are deducted from or reduce the income of participants' or beneficiaries' accounts;

(g) A description of fees and expenses in connection with purchases or sales of interests in investment alternatives;

(h) Information about fees and expenses for participant-initiated transactions or services which may be deducted from participants' or beneficiaries' accounts;

(i) A description of any other fees and expenses which may be deducted from participants' or beneficiaries' accounts; and

(j) A statement explaining that investment alternatives should be selected not only on the basis of the level of fees charged by each alternative but also based on other key factors, including the alternative's investment objective, level of risk, historic rates of return and the participant's personal investment objective.

2. The Neal Bill also requires that plan administrators provide an individual annual notice to each plan participant. The annual notice must be provided within 90 days of the end of the plan year and must include a description of:

(a) The investment alternatives selected by the participant and the percentage of the participant's total account invested in each investment alternative;

(b) The total fees and expenses deducted from the participant's or beneficiary's account, including fees and expenses deducted for administration and recordkeeping;

(c) Whether the investment alternative is actively or passively managed;

(d) A general statement of the investment alternative's risk and return characteristics;

(e) Annual asset-based fees for each investment alternative which reduced the investment alternative's rate of return;

(f) Historic rates of return for the investment alternative over the immediately preceding 1, 5 and 10-year periods;

(g) Fees, expenses and any deductions for participant-initiated services;

(h) Any separate charges for plan administration;

(i) A statement explaining that investment alternatives should be selected not only on the basis of the level of fees charged by each alternative but also based on other key factors, including the alternative's investment objective, level of risk, historic rates of return and the participant's personal investment objective; and

(j) A statement telling participants how to access investment characteristic and fee information for alternatives in which they are not invested.

3. The Neal Bill also requires plan providers to give affected plan participants and beneficiaries advance notice of any change in the investment alternatives available under the plan.

4. A tax of $100 per day may be imposed for each failure to provide the required enrollment or annual notice to a participant or beneficiary (up to an annual limit of $500,000).

5. The Neal Bill also requires that services providers give plan administrators a disclosure of fee information in advance of a contract for plan services, within 90 days of the end of each plan year the contract is in place, and following any material modification of the contract. The service provider disclosure must include:

   (a) An estimate of total fees, including separate disclosure of annual fees and expenses for investment management, administration and recordkeeping;

   (b) A detailed and itemized list of all services to be provided under the contract; and

   (c) Disclosure of any payments from third parties and any revenue-sharing arrangements (third parties and estimated amounts must be identified in the disclosure).

6. Employers will be required to post the service provider notice on the web and to provide the information to plan participants upon written request.

7. A tax of $1,000 per day may be imposed for each failure of a service provider to provide the disclosure of plan fees and expenses to a plan administrator (up to an annual limit of $1,000,000).

8. The Neal Bill directs the Secretary of the Treasury to develop model notices and to issue regulations that allow for electronic delivery of the required notices.

9. Like the Miller Bill, it is unlikely that the Neal Bill will be enacted this year. It does, however, set the stage for interesting developments in 2008. It would be our strong preference that Congress postpone consideration of these bills until DOL completes its work on the Form 5500 Schedule C proposal, the Section 408(b)(2) regulations and the Section 404(c) regulations.

II. Litigation – 401(k) Fee Cases

A. One plaintiffs' firm, Schlichter, Bogard & Denton, brought 11 class action cases against major corporations and 3 cases against major corporations *and* a service provider (Fidelity).

1. These cases allege that the corporations' 401(k) plans have been charged excessive and improper fees and have failed to disclose these fees and "revenue sharing" payments to participants.

2. These cases hinge on application of Section 404(a) of ERISA, and raise the following issues.

   (a) *Procedural Prudence* – Did the plan fiduciaries exercise due diligence in their consideration of the plan's compensation arrangement with service providers, including any revenue sharing component?

   (b) *Substantive Prudence* – Did the plan fiduciaries cause the plan to pay excessive compensation to service providers because of revenue sharing or other circumstances?

   (c) *Disclosure* – Did the plan fiduciaries violate ERISA in how and what they disclosed to plan participants about revenue sharing and other fees charged to the plan?

3. To date, the following corporations have been sued:

   (a) Bechtel Corp.; The Boeing Co.; Caterpillar Inc.; CIGNA Corp.; Exelon Corp.; General Dynamics Corp.; International Paper Co.; Kraft Foods Global, Inc.; Lockheed Martin Corp.; Northrop Grumman Corp.; United Technologies Corp.; ABB Inc. (with Fidelity); Deere & Co. (with Fidelity); Unisys Corp. (with Fidelity).

4. Defendants have had some success on motions to dismiss.

   (a) In ***Hecker, et al. v. Deere & Co., et al.***, Civil Action No. 06-C-0719, (W.D. Wis.), plaintiffs had brought suit against Deere & Co. as plan fiduciary and against Fidelity as the plan's administrative service provider. On July 22, 2007, the court entered an order, 2007 WL 1874367, dismissing the action with prejudice for the following reasons.

      (1) Disclosure of revenue sharing was not required under current laws or regulations.

      (2) Participants had the opportunity to choose from numerous investment options (including investment options with very low fees), thus making Deere & Co. not liable pursuant to ERISA § 404(c).

(3) Deere & Co. had sole responsibility for selecting plan investment options, so that Fidelity was not a plan fiduciary subject to liability.

(b) In ***Taylor, et al. v. United Technologies Corp., et al.***, Civil Action No. 3:06-CV-01494 (D. Conn.), the court dismissed the fiduciary breach claims based on failure to disclose, stating that current laws and regulations do not require disclosure of revenue sharing.

(c) In ***Waldbuesser, et al. v. Northrop Grumman Corp., et al.***, Civil Action No. 2:06-CV-06213 (C.D. Cal.), the court dismissed Northrop Grumman and all director defendants from the action, leaving only certain committees as defendants.

5. Defendants' motions to dismiss have been denied in the following cases.

(a) ***Kanawi, et al. v. Bechtel Corp., et al.***, Civil Action No. 3:06-CV-05566 (N.D. Cal.); ***Spano, et al. v. Boeing Co., et al.***, Civil Action No. 3:06-CV-05566 (S.D. Ill.); ***George, et al. v. Kraft Foods Global, Inc., et al.***, Civil Action No. 1:07-CV-01713 (N.D. Ill.); ***Abbott, et al. v. Lockheed Martin Corp., et al.***, Civil Action No. 3:06-CV-00701 (S.D. Ill.).

6. Prayer for investment losses has been struck from the complaint in ***Loomis, et al. v. Exelon Corp., et al.***, Civil Action No. 1:06-CV-04900 (N.D. Ill.).

7. Motion to certify class has been denied in ***Waldbuesser, et al. v. Northrop Grumman Corp., et al.***, Civil Action No. 2:06-CV-06213 (C.D. Cal.). The court stated that the case is better taken care of by administrative agencies.

8. Motion to certify class has been granted in ***Loomis, et al. v. Exelon Corp., et al.***, Civil Action No. 1:06-CV-04900 (N.D. Ill.).

9. Motion to strike jury demand has been granted in the following cases.

(a) ***Spano, et al. v. Boeing Co., et al.***, Civil Action No. 3:06-CV-05566 (S.D. Ill.); ***Loomis, et al. v. Exelon Corp., et al.***, Civil Action No. 1:06-CV-04900 (N.D. Ill.); ***Will, et al. v. General Dynamics Corp., et al.***, Civil Action No. 3:06-CV-00698 (S.D. Ill.); ***Abbott, et al. v. Lockheed Martin Corp., et al.***, Civil Action No. 3:06-CV-00701 (S.D. Ill.); ***Waldbuesser, et al. v. Northrop Grumman Corp., et al.***, Civil Action No. 2:06-CV-06213 (C.D. Cal.); ***Kennedy, et al. v. ABB Inc., et al.***, Civil Action No. 2:06-CV-04305 (W.D. Mo.).

10. The following cases have been stayed in its entirety or in part.

(a) ***Loomis, et al. v. Exelon Corp., et al.***, Civil Action No. 1:06-CV-04900 (N.D. Ill.) (case stayed to await the outcome of the likely appeal of the order dismissing the case with prejudice in ***Hecker v. Deere & Co.***).

(b) ***Will, et al. v. General Dynamics Corp., et al.***, Civil Action No. 3:06-CV-00698 (S.D. Ill.) (case stayed as to class certification pending the outcome of an appeal to the Seventh Circuit of a case holding that defense under ERISA § 404(c) does not defeat commonality or typicality).

(c) ***Beesley, et al. v. International Paper Co., et al.***, Civil Action No. 3:06-CV-00703 (S.D. Ill.) (same as ***Will v. General Dynamics***).

11. The following cases allege that the corporation improperly used plan assets.

(a) ***Nolte, et al. v. CIGNA Corp., et al.***, Civil Action No. 2:07-CV-02046 (C.D. Ill.) (standard claims, plus claim that CIGNA improperly benefited from the sale of its retirement business).

(b) ***Martin, et al. v. Caterpillar Inc., et al.***, Civil Action No. 1:07-CV-01009 (C.D. Ill.) (standard claims, plus claim that Caterpillar improperly benefited from sale of its investment management subsidiary).

B. In addition to the lawsuits against plan sponsors, the following class action lawsuits have been brought against service providers.

1. ***Haddock, et al. v. Nationwide Fin. Services, Inc., et al.***, Civil Action No. 3:01-CV-01552 (D. Conn.)

(a) Lawsuit by 401(k) plan sponsors relating to Nationwide's receipt of fees from funds offered as investment options under variable annuity contracts. Typical service arrangement involved a plan sponsor choosing a group of funds from those Nationwide made available under its annuity contract. Nationwide allegedly selected funds based in part on revenue sharing paid by funds.

(b) The court held that –

(1) Nationwide may have been a plan fiduciary because it retained discretion to add/delete fund options.

(2) Nationwide may have been a fiduciary in choosing funds for its platform.

(3) Revenue sharing payments from funds could constitute "plan assets."

(4) Even if revenue sharing payments are not "plan assets," Nationwide's receipt of revenue sharing could have involved prohibited transactions.

2. ***Ruppert v. Principal Life Ins. Co.***, Civil Action No. 4:07-CV-00344 (S.D. Iowa)

   (a) Lawsuit against Principal attacking revenue sharing payments Principal allegedly received in connection with plan's investments.

3. ***Phones Plus, Inc. v. Hartford Fin. Services, Inc., et al.***, Civil Action No. 3:06-CV-01835 (D. Conn.)

   (a) Lawsuit alleges that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients.

4. ***Columbia Air Services, Inc. v. Fidelity Management Trust Co.***, Civil Action No. 1:07-CV-11344 (D. Mass.)

   (a) Lawsuit alleges that Fidelity obtained revenue sharing payments in addition to amount expressly agreed as compensation without providing any additional services.

5. ***Zang v. Paychex , Inc.***, Civil Action No. 2:07-CV-13410 (E.D. Mich.)

   (a) Lawsuit alleges that Paychex obtained revenue sharing payments in addition to amount expressly agreed as compensation. Lawsuit also challenges the float that Paychex allegedly received from the custodian, JP Morgan.

6. ***Montoya, et al. v. ING Life Ins. and Annuity Co., et al.***, Civil Action No. 1:07-CV-02574 (S.D. N.Y.)

   (a) Lawsuit against ING, New York State United Teachers, and NYSUT Trust brought by participants in 403(b) plan covering teachers throughout New York. Alleges that all defendants breached fiduciary duties to plan participants by charging excessive fees, failing to provide adequate disclosures to participants, and by selecting plan investment options based on the receipt of revenue sharing payments. Alleges that ING used plan assets for its own benefit and received "kickbacks" in the form of revenue sharing payments. Alleges co-fiduciary liability of all defendants.

7. ***Beary v. Nationwide Life Ins. Co., et al.***, Civil Action No. 2:06-CV-00967 (S.D. Ohio)

   (a) Lawsuit not brought under ERISA, but under state common law, and claims that Nationwide breached its fiduciary duties by keeping revenue sharing payments for services provided to Section 457(b) plans.

8. ***Beary v. ING Life Ins. & Annuity Co., et al.***, Civil Action No. 3:07-CV-00035 (D. Conn.)

   (a) Lawsuit not brought under ERISA, but under state common law, and claims that ING breached its fiduciary duties by keeping revenue sharing payments for services provided to Section 457(b) plans.

C. New York Attorney General's Settlement with ING

1. In a settlement with the New York State Attorney General, ING, a 403(b) provider, agreed to pay restitution and implement a standard format for retirement product disclosure. The settlement relates to the New York State Teacher's Union's exclusive endorsement of ING's 401(k) product. ING which competed with other 403(b) product providers had made undisclosed payments to the Union to secure the exclusive endorsement.

   (a) The settlement mandates a "one-page disclosure" to 403(b) participants that (1) states the "all-in" investment cost, as a percentage of the account balance; (2) contains a chart showing the effects of fees on account balances over time; (3) discloses that fund companies may pay 403(b) provider to be included as investment options; and (4) discloses that 403(b) provider and funds are seeking to make a profit.

   (b) The settlement does not require disclosure of the rates or amounts paid by funds to a 403(b) provider, individual fund fees, or contract charges.

III. Recent Department of Labor Activity

A. The Department of Labor is about to issue final rules requiring increased reporting of service provider indirect compensation and will (hopefully) shortly propose 408(b)(2) regulatory amendments and participant 404(c) disclosure requirements. The increased disclosure required by these regulatory initiatives will significantly impact revenue sharing arrangements.

B. Amendments to Form 5500 Schedule C

1. The Department of Labor proposed amendments to the Form 5500, including the disclosure of indirect compensation requirements on Schedule C. 71 Fed. Reg. 41616 (July 21, 2006).

2. The proposed regulations require reporting of virtually all "indirect compensation," i.e., payment to plan service providers by third parties "in connection with that person's position with the plan or services rendered to the plan." 71 Fed. Reg. 41616, 41649.

3. The proposed regulations identify types of indirect compensation that must be reported on Schedule C (71 Fed. Reg. 41616, 41649):

   (a) Finder's fees

   (b) Placement Fees

   (c) Commissions on investment products

   (d) Transaction-based commissions

   (e) Sub-transfer agency fees

   (f) Shareholder servicing fees

   (g) 12b-1 fees

   (h) Soft-dollar payments

   (i) Float income (in dollars)

   (j) Brokerage fees and commissions (whether or not capitalized as investment costs).

4. The proposed regulations require that service providers be separately identified on the Form 5500 Schedule C (71 Fed. Reg. 41616, 41649), including:

   (a) Contract administrators

   (b) Securities Brokers

   (c) Insurance brokers or agents

   (d) Custodians

   (e) Consultants

(f) Investment advisors (to plan participants)

(g) Investment managers

(h) Recordkeepers

(i) Trustees

(j) Appraisers

(k) Investment evaluation service providers.

5. The enumerated service providers are identified in the proposed regulations because the DOL has deemed them to have influence (but not necessarily fiduciary status) over plan decisions.

6. According to DOL, the amended Schedule C disclosure is meant to inform plan fiduciaries of third party payments to enumerated service providers because such payments could represent conflicts that may impact the quality of services provided to the plan.

C. Amendments to the 408(b)(2) Regulations

1. The DOL is developing a provider "incentive" to disclose and is expected to propose regulations with respect to ERISA 408(b)(2) by the end of 2008.

2. Because a service provider is a "party in interest," its provision of services to the plan requires an exemption from the prohibited transaction rules of both ERISA and the Code.

   (a) As a party in interest, a provider would be liable for excise tax (applicable to pension plans) or section 502(i) penalties (applicable to welfare plans) if the services are not covered under an exemption.

3. The current 408(b)(2) regulations in 29 C.F.R. § 2550.408b-2 require:

   (a) Services must be "necessary and appropriate".

   (b) The arrangement must be "reasonable".

   (c) No more than "reasonable compensation" is paid.

4. The new regulations developed by DOL may require disclosure of information aimed at enabling a plan fiduciary to consider whether:

   (a) The service provider's total compensation (including third party fees) is "reasonable;" and

(b) Any conflicts of interest exist that will affect the service provider's advice.

5. DOL has determined that non-fiduciary service provider conflicts are relevant information for plan fiduciaries because of the influence service providers have on fiduciary decisions.

D. Revised Disclosure to Plan Participants

1. DOL is also considering changes to disclosures for participants in individual account plans for participant-directed plans under ERISA § 404(c) or perhaps under ERISA § 404(a).

2. In April 2007, DOL issued a Request for Information ("RFI") (72 Fed. Reg. 20457) in order to obtain information regarding:

(a) What administrative and investment-related fee and expense information participants should consider;

(b) The manner in which that information should be provided or made available for participants; and

(c) Who should provide the information and bear the related cost.

3. The RFI asked 19 specific questions about fee disclosures related to investment options and to administrative fees and expenses assessed against plans and participant accounts. The RFI questions asked:

(a) What specific information participants need to evaluate fees and expenses attendant to investment options;

(b) The extent to which information needed by plan participants is not currently being provided;

(c) Whether participant-directed individual account plans should be required to provide or promote investment education;

(d) Whether there should be a required disclosure format;

(e) What information about expenses charged to individual accounts is currently provided;

(f) How often and in what format information is provided to participants; and

(g) Whether information about administrative expenses should be required in ERISA section 105 benefit statements.

4. Comments on the RFI were due by July 24, 2007. The following suggestions are representative of the comments made in response to the RFI:

   (a) Disclosure requirements should apply to all participant-directed plans and not just to 404(c) plans.

   (b) Disclosure requirements should apply to all types of investments and should not create a bias towards certain types of investments.

   (c) New disclosure requirements should encourage and facilitate the use of electronic technologies.

   (d) Plan sponsors should be required to provide disclosures to participants upon enrollment and to provide annual updates.

   (e) Fee disclosures should include information about asset-based fees, transactional fees and on-going separate fees.

   (f) Plan sponsors should retain flexibility in the disclosure format.

   (g) Plan sponsors should not be under a fiduciary duty to provide investment education.

   (h) Additional disclosure requirements will increase costs for both plan sponsors and plan participants.

5. The material requested in the RFI suggests that the DOL may intend to create a disclosure regime that:

   (a) Provides participants with information intended to help them make better investment decisions, and

   (b) To create a disclosure regime that facilitates greater surveillance of fiduciary and service provider conduct.

6. There is some concern that the information collected through the Request for Information process will be used by regulators and the plantiffs' bar to harass plan sponsors and plan service providers.

IV. Looking Ahead

A. Legislative and Regulatory Outlook

1. While there may be additional Congressional hearings and the proposed bills may make some progress in the House of Representatives, it seems unlikely that a new law regulating plan fees and disclosure will be passed in the 110th Congress.

2. Recent high profile law suits and pressure from Congress appear to have made DOL less responsive to service provider concerns. This may result in new regulatory initiatives that assign disclosure duties to non-fiduciary providers and apply disclosure requirements beyond 404(c) plans.

B. Plan Sponsor Response to Recent Developments

1. Plan sponsors are reviewing current fee arrangements in order to identify direct/indirect compensation to providers, establish better benchmarking on fees and performance, evaluate investment alternatives and develop alternatives to paying recordkeepers with asset-based revenue sharing payments.

2. Plan sponsors are also reviewing current fiduciary process for legal sufficiency and are focusing on plan governance and fiduciary structure, disclosure to participants about payment of plan fees, allocation of fees, adequacy of due diligence and adequacy of documentation.

C. Service Provider Response to Recent Developments

1. In response to increased scrutiny of plan disclosures, service providers are improving disclosure to plan sponsors of direct/indirect compensation, considering improved disclosures to plan participants, reviewing contractual authority and procedures for making changes to 401(k) fund platforms and reviewing marketing materials and marketing practices.

V. Pension Protection Act of 2006 Developments

A. The Pension Protection Act of 2006 ("PPA") is the most sweeping change to the pension law since 1974. Approximately 800 pages of the 900-page Act amend ERISA and the Internal Revenue Code provisions dealing with retirement plans.

B. Some of the features of the PPA are that it: (1) makes changes to the funding rules for single-employer defined benefit plans and multi-employer plans; (2) makes changes affecting cash balance plans and conversions; (3) makes changes, affecting defined contribution plans, including the autoenrollment safe harbor and faster vesting of employee contributions; (4) makes pension provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) permanent including contribution limits and Roth 401(k); (5) addresses issues, arising from the explosive growth of participant-directed plans, including participant advice, mapping, benefit statements, and enrollment; (6) mitigates employer stock risk by increasing the minimum bond and implementing new diversification requirements and participant notice; and (7) includes provisions intended to simplify management of plan assets.

C. In this section, we focus on those provisions that will significantly impact the retirement services community.

D. New ERISA §408(b)(17) – Service Provider Exemption

1. Background: ERISA prohibits virtually every transaction between a plan and a party in interest. As a "party in interest" is broadly defined to include a fiduciary, service provider, employer, union, and affiliates of these persons/entities, plans would be crippled without exemptions from the prohibited transaction rules. Moreover, fiduciaries often cannot know whether a counterparty in a plan transaction is a party in interest. Some existing exemptions provide conditional relief (e.g., PTE 84-14 (QPAM), PTE 75-1, PTE 80-26, PTEs 90-1, 91-38).

2. ERISA § 408(b)(17) exempts many routine (and non-routine) transactions between plans and service providers that are currently prohibited.

   (a) Covers purchases, sales, loans, and transfers of plan assets with service providers.

   (b) Does not apply to –

      (1) Transactions with a fiduciary with discretion over the assets involved in the transaction.

      (2) Transactions with employers or their affiliates.

   (c) Plan may not pay more (or receive less) than "adequate consideration" which is the prevailing exchange price or quoted price, or if there is no market, the fair market value determined in good faith by the fiduciary.

E. "Plan Assets" Definition

1. ERISA does not apply to activities of investment funds in which ERISA plans invest, if these funds are deemed NOT to hold plan assets. A fund is deemed to NOT hold plan assets if "Benefit Plan Investment" in the fund is "not significant."

2. Benefit Plan Investment is not significant if less than 25% of each class of equity interest in a fund is held by "Benefit Plan Investors" (BPIs) (this is known as the "25% Test").

3. The PPA changed the 25% Test in two ways.

   (a) Narrowed the definition of "Benefit Plan Investor" to count only ERISA plans and Internal Revenue Code § 4975 plans (IRAs). Foreign or governmental plans are not counted.

(b) Mandated a "look through" rule so that a fund will itself be a BPI, when it invests in another fund, only to the extent of plan investment.

(1) For example, if 50% of Fund A's equity interests are held by BPIs, only 50% of Fund A's investment in Fund B must be counted as an investment by a BPI when the 25% test is applied to Fund B.

4. The new plan asset definition should increase private investment opportunities for plans.

5. While the new definition is useful to hedge funds, it seems less useful to funds qualifying for exemptions for venture capital operating companies ("VCOC") or real estate operating companies ("REOC").

6. The new definition is effective for transactions occurring after August 17, 2006.

F. ERISA § 408(b)(19) – Cross Trading Exemption

1. Background: ERISA § 406(b)(2) prohibits a fiduciary from representing a plan and another investor in a transaction between them, such as a cross-trade.

2. ERISA § 408(b)(19) exempts the purchase and sale of a security between a plan and any account managed by the same investment manager.

3. Section 408(b)(19) requires –

(a) Advance Approval: The cross trading must be authorized in advance by a fiduciary of each plan, following disclosure by the manager. (The program must be authorized, not each trade.)

(b) Plan Size: More than $100 million in assets.

(c) Pricing (similar to mutual fund rules):

(1) Cash transaction

(2) Security for which market quotations are readily available

(3) Price is determined under SEC Rule 17a-7(b)

(4) No brokerage commission or other fee is charged (except customary and disclosed transfer fees)

(d) Reporting: Detailed quarterly reports of all cross trades to the plan fiduciary.

(e) Annual Compliance Review: Must designate a person to issue an annual compliance report for clients, signed under penalty of perjury.

(f) Policies and Procedures: Must establish and follow written policies and procedures that are "fair and equitable."

(1) DOL published interim final rules establishing requirements for manager policies and procedures. 72 Fed. Reg. 6473 (Feb. 12, 2007).

4. The exemption may not apply –

(a) Where one of the two plans is a plan sponsored by the investment manager or its affiliate (Section 408(b)(19) requires approval of an independent fiduciary). For example, this may be an issue for a collective fund where the investment manager's plan is an investor.

(b) Where the investment manager cannot absorb the commission. (Section 408(b)(19) prohibits any commission or fee). For example, this may be an issue for small managers without broker/trader affiliates.

G. Other Exemptions Added by the PPA Include the Following.

1. ERISA § 408(b)(15) – Block Trading

2. ERISA § 408(b)(16) – Alternative Trading Systems

3. ERISA § 408(b)(20) – Prohibited transaction involving securities, if corrected within 14 days of discovery.

H. Bonding Requirements

1. Background: Pre-PPA ERISA § 412 required that a fiduciary or person who "handles" plan assets be bonded for loss from dishonest acts. The amount of the bond needed to be 10 % of the amount handled, up to $500,000. Banks and insurance companies were exempt.

2. The PPA added a new ERISA § 412(a)(2) which exempts registered broker-dealers subject to fidelity bond requirements of a self-regulatory organization.

3. The PPA increased the bond amount for a plan holding employer securities from $500,000 to $1,000,000. ERISA § 412(a)(3).

(a) This requirement seemingly applies to a fiduciary who is not the manager of the stock.

I. ERISA § 408(b)(14) – Investment Advice Exemption

1. Background: Providing "investment advice" is a fiduciary act. A person who advises plans or participants to invest in an investment product that pays the adviser or its affiliate fees and commissions may violate ERISA's prohibited transaction rules (i.e., section 406(b)).

   (a) Existing approaches to participant advice programs included –

      (1) Reliance on Advisory Opinion 2001-09 (SunAmerica) dealing with independent advice services.

      (2) Reliance on Advisory Opinions 1997-15A (Frost) and 2005-10A (COUNTRY Bank) dealing with fee offsetting or fee leveling so that the advice does not change the adviser's compensation.

      (3) Reliance on class exemptions, e.g., PTE 84-24, 77-4, 75-1.

2. New ERISA §408(b)(14) exempts: (1) the provision of investment advice to a plan participant by a "fiduciary adviser"; and (2) the adviser's receipt of direct or indirect compensation (including sales commissions and other fees) as a result of plan investments pursuant to the advice.

   (a) Only covers advice provided under an "eligible investment advice arrangement."

   (b) Discretionary management programs and advice to plan sponsors (e.g., fund selection) are not covered.

   (c) Available for advice provided after Dec. 31, 2006.

3. There are two types of "eligible investment advice arrangements."

   (a) The adviser's fees do not vary based on the advice.

   (b) The adviser provides advice using a computer model certified by an independent expert.

4. Plan fiduciary must authorize the investment advice arrangement for the plan.

5. Detailed participant disclosure, including all program fees and the fiduciary adviser's compensation arrangement must be provided. (DOL is required to issue a model form).

6. Annual independent audit of the investment advice arrangement is required.

7. The Investment Advice Exemption includes a "Plan Sponsor Shield."

   (a) Plan sponsor or other fiduciary who selects an "eligible investment advice arrangement" does not fail to meet ERISA requirements solely because the sponsor contracts for or arranges for the provision of advice to participants.

      (1) The plan sponsor or other fiduciary has no duty to monitor specific investment advice provided by a fiduciary adviser.

      (2) The plan sponsor or other fiduciary still must prudently select and monitor the fiduciary adviser.

8. Field Assistance Bulletin 2007-01 clarifies some § 408(b)(14) conditions:

   (a) Eligible Advice Arrangements – Fee Leveling

      (1) Clarifies that the "fiduciary adviser" is the financial institution and individuals representing the financial institution who provide the advice.

      (2) Thus, the fees of affiliates may vary. This allows a firm to provide advice about products marketed by its affiliates, even if affiliate's fees could change based on the advice provided.

   (b) Pre-PPA Investment Advice Guidance

      (1) Clarifies that interpretations under DOL Advisory Opinions (SunAmerica, Frost, COUNTRY Bank) are not affected. (The PPA provides that existing exemptions are not altered.)

   (c) Plan Sponsor Shield

      (1) Explains that plan sponsor's duties and liabilities are the SAME when the plan sponsor relies on the new statutory exemption, or follows another approach in engaging an adviser to plan participants.

9. Outstanding Questions / Observations

   (a) May advisers provide "off-model" advice in response to participant questions?

   (b) Models must consider ALL plan options; what about employer stock?

(c) DOL may issue a broader exemption for IRAs if it concludes that computer models are not feasible. In this regard, DOL issued a request for information asking whether computer models are feasible for IRAs.

J. Undirected Account Balances

1. Background: ERISA § 404(c) relieves fiduciaries from liability for losses that are a "direct and necessary" result of participants' exercise of control.

   (a) Regulations require "affirmative" participant directions.

   (b) However, "undirected" participant account balances may result, and plan fiduciaries would have to "direct" the investments, in the following circumstances.

      (1) In autoenrollment plans, because participants are not required to provide investment instructions to enroll.

      (2) If participant account balances were allocated to a deleted investment option (typical in plan conversions).

   (c) Fiduciaries must invest undirected account balances "prudently," giving "appropriate consideration" to relevant facts and acting accordingly. ERISA § 404.

2. PPA extends ERISA § 404(c) protection to fiduciaries with respect to undirected account balances for the following activities.

   (a) Investing participant account balances in "default investments" if the plan provides for such investment in the absence of affirmative investment elections. ERISA § 404(c)(5).

   (b) Performing a "qualified change in investment options" (i.e., mapping), in accordance with DOL regulations. ERISA § 404(c)(4).

3. New ERISA § 404(c)(5) – Default Investments

   (a) Provides that a participant is treated as exercising control over his or her plan account if in the absence of a participant direction, the account is invested according to DOL regulations.

   (b) PPA requires the DOL to issue regulations on the appropriateness of designating default investments that include a "mix of asset classes consistent with capital preservation, long-term capital appreciation, or a blend of both."

(c) DOL proposed regulations defining a "qualified default investment alternative" ("QDIA"). 71 Fed. Reg. 56806 (Sept. 27, 2006).

(1) Three types of QDIA are proposed: target retirement date accounts, balanced accounts, and managed accounts.

(2) Each must be managed by an investment manager or a registered investment company.

(3) Initial and annual notices must be provided to participants about the default investment alternatives and the right of the participants to provide alternative instructions.

(4) The participants must have the right to change investment options without penalty.

(5) The plan must offer a "broad range" of options.

4. New ERISA § 404(c)(4) – Mapping Relief

(a) Provides that a participant is treated as "exercising control" over his or her account when a "qualified change in investment options" occurs if the participant did not provide prior affirmative contrary instructions.

(b) A "qualified change" is a reallocation of the participant's account among other plan options or new plan options, if replacement options (including their risk and return characteristics) are "reasonably similar" to replaced options previously elected by the participant.

(c) Notice to participants at least 30 days and no more than 60 days before change must compare the options and inform participants how their account will be invested if they do not object.

K. <u>New ERISA § 404(c)(1)(A)(ii) – Black-Out Periods</u>

1. Extends 404(c) relief during "black-out" periods to fiduciaries who comply with ERISA requirements in authorizing and implementing a black-out. (Black-out period is defined by ERISA § 101(i)(7)).

L. <u>Employer Stock Provisions</u>

1. Defined contribution plans must permit participants to diversify allocations to employer securities and notify participants at least 30 days before they become eligible to diversify. (Treasury Department is to provide a model notice.)

2. Participants must be able to sell employer stock acquired by elective deferrals at least quarterly.

3. Participants must be able to sell stock acquired with non-elective and matching contributions after 3 years of vesting service. (There is a transition rule for implementing this requirement for participants under age 55.)

M. Benefit Statements

1. Background: Pre-PPA, annual benefit statements were required to be provided to participants only upon request.

2. ERISA § 105(a) requires periodic benefit statements.

   (a) Quarterly statements are required for participant-directed defined contribution plans.

      (1) Statements must include a report of the value of each investment, explanation of the right to change investment allocations and the importance of a diversified portfolio, and a notice that investing information is available on DOL's website.

   (b) Annual statements are required if a defined contribution plan is not participant directed.

   (c) Defined benefit plans must provide benefit statements every 3 years, or provide annual notices of how to request a statement of benefits.

   (d) Field Assistance Bulletin 2006-30 provides interim guidance.

DOL UPDATE

I. Auto-Enrollment And Default Investments

On September 27, 2006, DOL issued proposed regulations implementing the default investment provisions of the Pension Protection Act of 2006, Public Law No. 109-280 ("PPA"). 71 Fed. Reg. 56,806 (Sept. 27, 2006). The regulations, when finalized, would provide fiduciary relief to plan sponsors and other fiduciaries who invest participant account balances in "qualified default investment alternatives" and meet other conditions described in the regulations.

A. Scope of Relief

The proposed regulation implements new ERISA section 404(c)(5), which expands the fiduciary protections available under ERISA section 404(c) regarding participant-directed investments. 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 56,806 n.5. The latter would include a participant's failure to provide instructions following the elimination of an investment alternative or change in service provider (a "conversion"), or following a rollover from another plan.

Fiduciaries that meet the regulation's requirements 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 default investment. Nonetheless, like any other investment option, fiduciaries would remain responsible for prudently selecting and monitoring the default investment (and its investment manager), and would be liable for any losses that result from a failure to do so. 71 Fed. Reg. at 56,808. Investment managers that manage default investments would also remain subject to applicable fiduciary standards under the proposed regulations.

Importantly, 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 qualified default investment alternatives, though not with respect to investment decisions affirmatively made by plan participants.

B. Qualified Default 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 ("QDIA"):

- may not hold employer securities, except if the default investment 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 default investment;

- 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); and

- must be diversified so as to minimize the risk of large losses.

In addition, the relief provided by the regulation is conditioned on the use of one of three types of qualified default investment alternatives:

- Option 1: The first type of QDIA 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 type of investment could be either 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.

- Option 2: This QDIA 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. An example of such an option may be a balanced fund.

- Option 3: A plan could also 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, in the proposal, DOL rejected the use of capital preservation investment products such as stable value and money market funds as QDIAs, stating that those investments would be unlikely to generate a sufficient rate of return to provide adequate retirement savings for participants.

C. Proposed Additional Conditions for Relief

A fiduciary may invest a participant's assets in a QDIA 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 QDIA (e.g., prospectuses,

proxies, account statements) will be provided to the participant. A participant must be able to transfer out of the QDIA 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. Finally, 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 describing the QDIA, the circumstances under which plan accounts will be invested in the QDIA, and the participant's rights with respect to directing assets to other options under the plan.

Although the PPA required final regulations implementing the default investment provisions to be issued within six months of enactment (i.e. no later than February 2007), as of September 1, the final rules were not yet issued. Over 100 comments were filed on a variety of issues, but the most controversial issue—generating correspondence from prominent members of Congress to the Secretary of Labor—has been whether stable value funds should be added to the list of QDIAs. A high-ranking DOL official recently indicated that the final regulations will likely be issued by the end of 2007. Pens. & Ben. Daily (BNA) (Sept 20, 2007).

II. Investment Advice

New ERISA section 408(b)(14) provides conditional exemptive relief for the provision of investment advice by a fiduciary adviser to plan participants, and for certain related transactions. The exemption applies only to participant-level advice provided in individual account plans. To be exempt, the advice must be provided through an "eligible investment advice arrangement," which must either: (1) provide that any fees received by the fiduciary adviser for investment advice, or with respect to the sale of securities or other property, do not vary depending on the investment options selected; or (2) use a computer model meeting detailed conditions to be prescribed.

A. DOL Asks for Help Developing Rules for Investment Advice Exemption

On December 4, 2006, DOL issued two Requests for Information ("RFIs") related to the new investment advice exemption. 71 Fed. Reg. 70,427, 70,429 (Dec. 4, 2006). The exemption requires a computer model to meet certain requirements pursuant to new ERISA section 408(g)(3), including the application of generally accepted investment theories; the utilization of relevant information about the participant, such as age, life expectancy, retirement age, or risk tolerance; and operation in a manner not biased in favor of the adviser's affiliated investment products. The computer model must also be certified by an "eligible investment expert." In addition, certain disclosures must be provided to participants in connection with the advice program, whether advice is provided through a computer model or through a fee-leveling arrangement.

The PPA calls for regulatory guidance from the DOL related to the certification by the "eligible investment expert." One of the RFIs asked for comments related

to this certification requirement and with respect to the model fee disclosure form DOL is developing. The RFI also asks several questions related to fee disclosure. For example, DOL has requested information related to the types of compensation that advice providers and affiliates receive in connection with investment advice. In addition, DOL has also asked for help in presenting fee information in a way that is helpful and understandable to participants.

An additional RFI requested information as to the feasibility of applying the computer model provisions to IRAs and similar accounts that are subject to the prohibited transaction rules of the Internal Revenue Code. On the basis of the information solicited from the public, the DOL is to determine whether any computer model investment advice program may be used to provide advice to the IRA beneficiary. (See Section II.C below).

B. DOL Issues FAB Regarding the Investment Advice Exemption

On February 2, 2007, DOL issued Field Assistance Bulletin ("FAB") No. 2007-01 that addresses a number of issues with respect to the investment advice exemption under new section 408(b)(14). The FAB addressed the so-called "level fees" approach. Under this approach, the fiduciary adviser's fees may not vary depending on the basis of the investment option selected. DOL clarified that the required fee leveling need occur only at the level of the investment adviser fiduciary and that any fees received by affiliates of that fiduciary need not be leveled.

The FAB also clarified that the pre-PPA approaches with respect to investment services purchased by plans remain valid. Prior to the PPA, many plan sponsors already offered various types of investment programs to their plan participants. These programs range from investment education programs to asset allocation services to individualized investment advice. However, the FAB reminds plan sponsors that, under any of the approaches, plan sponsors remain liable for prudent selection and monitoring of fiduciary advisers.

C. DOL Holds Hearing on Computer Model Investment Advice Programs for Individual Retirement Accounts

On July 31, 2007, DOL held a public hearing to obtain information on the feasibility of using computer models to provide investment advice to participants with individual retirement accounts ("IRAs"). See 72 Fed. Reg. 34,043 (June 20, 2007). The PPA directed DOL to determine no later than December 31, 2007 whether using a computer model to provide investment advice to IRA holders was feasible. DOL previously issued a request for information to assist in making this determination. 72 Fed. Reg. 70,427 (Dec. 4, 2006) (see Section II.A above). If DOL determines that the use of a computer model with respect to IRAs is not feasible, the PPA requires DOL to issue a class exemption.

The central issue at the public hearing was the meaning of the PPA requirement that any computer model must "take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the account beneficiary." Some commenters argued that the "full range of investments" language requires a computer model to take into account every single investment available to IRAs, including individual stocks, bonds, and mutual funds. Other commenters interpreted the feasibility provision more narrowly to only require a computer program to consider the full range of asset classes available to IRAs.

Commenters were in accord that no computer model currently in use could take into account all of the individual investments available to IRAs. Use of a computer model would be further complicated because regular monitoring and updating of individual investments would be necessary to provide accurate investment advice. One commenter noted that even if the narrow interpretation of "full range of investments" prevailed, computer models would have significant difficulty considering certain "nonstandard" asset classes available to IRA investors (including options, swaps, negotiated instruments, and limited partnership interests) for which sufficient historical behavior data is not available.

Commenters at the hearing also took the opportunity to urge DOL to issue further regulatory guidance regarding the new investment advice exemption—particularly with respect to the "level fees" approach, which is the alternative to use of a computer model.

III. Participant Disclosure

A. DOL Issues Request for Information Regarding the Disclosure of Fees and Expenses in Participant-Directed Plans

If a plan meets the conditions of the section 404(c) regulations, plan fiduciaries are not responsible for losses caused by participant investment selections. 29 C.F.R. § 2550.404c-1. The regulations currently require automatic disclosure of transaction fees or expenses that affect the value of the participant's account. Disclosure on request is required for annual operating expenses of investment options (as a percent of net assets) and performance net of expenses. 29 C.F.R. §§ 2550.404c-1(b)*(2)*(i)(B)(1) and (2).

On April 25, 2007, DOL issued a Request for Information ("RFI") relating to the disclosure of fees and expenses paid in connection with participant-directed individual account plans. 72 Fed. Reg. 20,457. The RFI is the first public step in DOL's regulatory project to revise the participant disclosure requirements currently applicable to individual account plans under DOL's section 404(c) regulations. Importantly, the RFI solicits information with respect to participant-directed plans—whether or not they are subject to ERISA section 404(c) requirements. Comments were due by July 24, 2007.

The purpose of the RFI is to obtain input from plan sponsors, service providers, and participants regarding what investment and administrative fee information participants should consider, what form fee disclosures should take, and who should provide the information. Specifically, the RFI first sets forth the disclosure requirements that relate to fees and expenses under current section 404(c) regulations and some of the recommendations from the 2004 report of the Working Group on Fee and Related Disclosures to Participants, a task force of DOL's Advisory Council on Employee Welfare and Pension Benefit Plans. The RFI also briefly describes the Government Accountability Office's November 2006 Report entitled "Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees." The RFI asks commenters to consider these reports and their recommendations in reviewing the issues identified in the RFI.

The RFI asks 19 specific questions related to fee disclosure. The questions focus on two specific areas: (1) fees related to investment options, and (2) administrative fees and expenses assessed against plans and participant accounts. Commenters are asked to address DOL's specific questions and any other matters germane to the disclosure of fees and expenses. The RFI also asks more general questions about fee disclosure, including what, if any, distinctions should be made in the information requirements applicable to section 404(c) versus non-section 404(c) plans. The RFI also asks about plan fees paid by plan sponsors and how information about these fees is communicated to plan participants. The submitted comments may be reviewed at http://www.dol.gov/ebsa/regs/cmt-feedisclosures.html.

B. DOL Official Addresses Revenue Sharing Practices

On July 11, 2007, Robert J. Doyle, Director of Regulations and Interpretations of the Employee Benefit Security Administration, testified before a working group of the ERISA Advisory Council regarding revenue sharing. Mr. Doyle testified that revenue sharing does not involve inherent ERISA violations so long as a fiduciary does not use its discretion to cause itself or an affiliate to receive revenue sharing payments in connection with a plan transaction or service. Where a fiduciary receives revenue sharing payments, a prohibited transaction would occur unless the revenue sharing payments are used to reduce or offset the plan's fees to the fiduciary.

Mr. Doyle also indicated that ERISA does not prevent plan fiduciaries from negotiating with a service provider for the return of revenue sharing payments to the plan. Upon return to the plan, these payments would constitute plan assets and would be governed by ERISA's fiduciary rules. Mr. Doyle recognized that ERISA does not provide any methods for allocation of rebates among the plan's participants. Allocations must be made in accordance with the terms of the plan and fiduciaries' obligations to act prudently and in the interest of the plan's participants and beneficiaries. Mr. Doyle explained that in allocating revenue sharing payments plan fiduciaries may rely on the principles of FAB 2003-03,

addressing the allocation of expenses in a defined contribution plan, and FAB 2006-01, addressing the distribution of settlement proceeds relating to late trading and market-timing.

C. DOL Issues FAB on Pension Protection Act Benefit Statements

On December 20, 2006, DOL issued FAB No. 2006-03 providing interim "good faith" guidelines for plan administrators to follow in complying with the PPA's periodic pension benefit statement requirements (ERISA section 105), which are effective for plan years beginning after December 31, 2006. Issued "pending further guidance," the FAB explains that plan administrators will satisfy their obligation to provide periodic benefit statements by acting in good faith based on reasonable interpretations of the requirements of section 105. DOL was required to develop model pension benefit statements by August 18, 2007, however, DOL announced on July 12 that the August deadline would not be met. Pens. & Ben. Daily (BNA) (July 13, 2007).

1. Due Dates for the First Round of Statements: Generally, the due date is 45 days from the end of the quarter or the calendar year for which the statements are required (except for certain defined benefit plans). For example, for a section 401(k) or another participant-directed "individual account plan" with a plan year that is a calendar year, statements must be furnished within 45 days after the end of the first calendar quarter on March 31, 2007. Defined benefit plans that choose the alternative notice provision under section 105(a)(3)(A) of ERISA will need to provide the required notification by December 31, 2007.

2. Multiple Sources for Benefit Statement Information Permissible: Section 401(k) and other individual account plans often have multiple service providers and information required on benefit statements may require information from more than one of these service providers. Pending further guidance from DOL, it will be permissible to deliver benefit statement information in multiple documents from different sources, provided that participants and beneficiaries receive an explanatory notice with information on where they can find the required benefit statements information. The notice must be provided in advance of the due date for the first round of the benefit statements.

3. Use of Electronic Media: DOL regulations already provide a "safe harbor" for disclosing information to participants through electronic media. See 29 CFR 2520.104b-1(c). In the FAB, DOL outlines two additional "good faith" electronic distribution options: (1) statements may be provided in accordance with the recently issued IRS guidance relating to the use of electronic media to provide certain notices and documents to participants and beneficiaries (26 C.F.R. 1.401(a)-21); or (2) through continuous access to one or more secure websites, provided participants receive an explanatory notice explaining how to access the required

pension benefit statement information, as well as the participant's right to request and obtain, free of charge, a paper statement. The notice must be provided in advance of when the first round of the benefit statements would be due, and annually thereafter.

4. Diversification Notice: The PPA added new ERISA section 101(m), which requires a plan administrator to notify each individual account plan participant of his or her right to sell employer securities at least 30 days before the participant is eligible to sell such securities. For plans that, prior to January 1, 2007, provided participants with diversification rights at least equal to the new diversification rights conferred by PPA, the diversification notice obligations will be deemed satisfied when the plan administrator provides the first round of the quarterly pension benefit statements, assuming the statements comply with this FAB and the PPA. DOL recently adopted proposed and final rules—scheduled to become effective on October 9, 2007—that would implement the penalty provisions of ERISA section 101(m). 72 Fed. Reg. 44,970, 44,991 (Aug. 10, 2007).

D. DOL Issues FAB on Benefit Statements for Non-Participant Directed Individual Account Plans

On October 12, 2007, DOL issued FAB 2007-3 providing additional guidance to address the dates for furnishing pension benefit statements for individual account plans that do not permit participants and beneficiaries to direct the investment of assets in their individual accounts. DOL noted that after the issuance of FAB 2006-3, DOL had been informed that many non-participant directed individual account plans might not be able to comply with the 45-day period for providing benefit statements. For such plans, plan administrators will be treated as acting in good faith compliance where statements are furnished to participants on or before the date on which the Form 5500 is filed by the plan.

E. Proposed DOL Rules on Multiemployer Plan Disclosures

The PPA imposes significant new disclosure requirements on multiemployer pension plans, effective for plan years beginning after 2007. In general, new section 101(k)(1) of ERISA requires these plans to provide copies of actuarial, financial and other funding-related information to plan participants, beneficiaries, employee representatives and contributing employers, upon their request, limited to one request per year. Failure to meet these disclosure requirements could result in penalties of up to $1,000 per violation. DOL recently proposed regulations to implement the new disclosure requirements. 72 Fed. Reg. 52,527 (Sept. 14, 2007). The proposal provides a laundry list of documents that may have to be furnished, and allows reasonable charges to be imposed for some (but not all) of them. Comments were due by October 15.

IV. Form 5500

A. Electronic Filing Rules

On July 21, 2006, DOL published a final regulation that requires electronic filing of Form 5500 annual reports (including the required statements, schedules, and attachments). 71 Fed. Reg. 41,359 (July 21, 2006). Pursuant to the 2006 rule, the electronic filing requirement would have applied to plan years beginning on or after January 1, 2008. However, on May 25, 2007, DOL announced a one year extension of the electronic filing requirement effective for plan years beginning on or after January 1, 2009. Pens. & Ben. Daily (BNA) (May 29, 2007). Accordingly, the first filings subject to the mandatory electronic filing requirement will not be due until 2010.

The technical specifications of the new electronic filing system have not been set, but DOL did announce certain intentions in the preamble to the final rule. First, DOL intends that the only method of filing electronically will be via the internet. Second, DOL stated that the new system would give plan administrators the option of either filing directly through a secure web site or using approved software created by third-party service providers. Finally, DOL announced that the new filing system will be platform- and browser-neutral; that is, that it will support all major operating systems and web browsers.

Electronic filing will be mandatory only for those annual reports filed under Part 1 of Title I of ERISA. Thus, filings required by the PBGC or the IRS need not be filed electronically. However, PBGC has informed DOL that to the extent a Form 5500 is filed to satisfy the annual reporting requirements under section 4065 of Title IV of ERISA, an electronically filed Form 5500 will be treated as satisfying those requirements. Similarly, the IRS has stated that an electronically filed Form 5500 will be treated as satisfying the annual filing and reporting requirements of sections 6058(a) and 6059(a) of the Internal Revenue Code. Finally, the administrators of certain plans that currently file Form 5500-EZ with the IRS will be given the option of continuing to file Form 5500-EZ directly with the IRS (in paper form) or filing the new Form 5500-SF electronically with DOL.

B. Proposed Changes to Form 5500, Schedule C

On July 21, 2006, DOL published proposed amendments to its regulations governing annual reporting and it proposed revisions to the Form 5500 Series forms and instructions. 71 Fed. Reg. 41,392, 41,616 (July 21, 2006). Assuming the proposals are finalized, the reporting changes announced by DOL would go into effect for plan years beginning on or after January 1, 2009. 34 Pens. & Ben. Rep. (BNA) 1357, at 1362 (June 12, 2007).

Perhaps the most important of the proposed changes are the major revisions to Schedule C, the schedule that requires plan administrators to disclose compensation paid to service providers. Not only are these proposed changes

significant in their own right, but it is also clear that they also constitute the first wave of DOL's initiatives regarding disclosures of third-party compensation. As proposed, Schedule C would require the plan administrator to identify all persons receiving more than $5,000 in total compensation (whether "direct" from the plan or plan sponsor, or "indirect" from any other source) in connection with services provided to the plan or the person's position with the plan. For fiduciaries and other "enumerated service providers," (including, contract administrators, brokers, consultants, custodians, insurance agents and brokers, investment advisors, investment managers, money managers record keepers, trustees and appraisers) who received more than $1,000 in indirect compensation from one or more payors, filers would have to provide an additional level of information, including the identity of each payor, the amount of the compensation received, and the nature of the compensation.

The proposal treats as a service provider any person receiving compensation "in connection with services rendered to the plan or their position with the plan." This definition could include persons with no direct relationship to the plan, including a sub-contractor to plan service providers (sometimes known as a service provider to a service provider) whose compensation was not previously reportable. For example, a securities broker who receives commissions in connection with plan transactions, but whose contractual relationship is with the plan's investment manager would, under the proposal, be deemed a plan service provider.

The proposal's definition of compensation includes "money, gifts or anything else of value." Compensation is "indirect" if it is paid by anyone other than the plan or plan sponsor. Examples of indirect compensation in the proposal include, among others, "float" and brokerage commissions. Indirect compensation is reportable if it is paid to a fiduciary or other enumerated service provider "in connection with person's position with the plan or services provided to the plan." An example contained in the proposal indicates that a gift which is even partially attributable to an enumerated service provider's relationship with a plan is compensation "in connection with" that person's position with the plan. Determining the amount of reportable indirect compensation a person receives depends on whether the compensation can be allocated among plans. Where an amount cannot be reasonably allocated among plans, each plan must report the entire amount. With respect to reportable "indirect" compensation, the proposal would require filers to report either the actual dollar amount of compensation or an estimate of the compensation received during the reporting period. Estimates must include an explanation of the formula used for calculating the payments.

A closely related matter is DOL's upcoming proposed regulation regarding the exemption for plan service providers under ERISA section 408(b)(2), which is currently pending review by the Office of Management and Budget. According to DOL officials, the proposed regulations will likely require service providers to disclose specific services, fees, and potential conflicts of interest, and will include a class exemption for plan fiduciaries who did not know a service provider was

not in full compliance so long as the plan fiduciaries were not negligent. Pens. & Ben. Daily (BNA) (Oct. 5, 2007). As a party in interest to the plan, a plan service provider whose arrangement fails to satisfy the conditions of the new regulations could be subject to excise taxes on the non-exempt prohibited transaction (i.e., the provision of services by a party in interest to a plan). Pens. & Ben. Daily (BNA) (Sept. 20, 2007).

C. Pension Protection Act Changes to Form 5500

The PPA overhauled the funding rules for single-employer and multiemployer defined benefit pension plans and requires increased disclosure of pension plan information. In response, DOL, IRS, and PBGC proposed changes to the Form 5500 for 2008 plan years. 71 Fed. Reg. 71,562 (Dec. 11, 2006).

1. Form 5500, Schedule B: Current Schedule B would be replaced with two, separate actuarial schedules: Schedule SB ("Single-Employer Defined Benefit Plan Actuarial Information") and Schedule MB ("Multiemployer Defined Benefit Plan and Money Purchase Plan Actuarial Information"). If a plan is "at-risk," the Schedule SB requires additional information regarding the plan's increased liabilities.

2. Form 5500, Schedule R: Schedule R would be modified to (1) require plans to provide a list of employers contributing more than five percent of the total contributions for the year; (2) expand the disclosure of information relating to participants for whom no employer contributions were made for the current plan year and the two preceding plan years, and information regarding the number of employers withdrawing from the plan and the assessed and estimated withdrawal liability; and (3) collect information relating to a plan's funded percentage resulting from liabilities arising from mergers and transfers of assets.

3. Simplified Annual Reporting for Plans With Less Than 25 Participants: The PPA requires a simplified annual return for retirement plans with fewer than 25 participants. The proposed revisions allow certain small plans (other than multiemployer plans) to file a two-page Form 5500-SF. The PPA's simplified reporting requirement is effective beginning in 2007. However, because the supplemental proposed changes are effective for 2008 plan years, plans that would otherwise be permitted to file a simplified form may file an abbreviated version of the current 5500 for 2007. Specific guidance regarding this simplified reporting option will be included in the instructions to the 2007 Form 5500.

V. Prohibited Transactions

A. DOL Issues Rules Under New Cross Trading Exemption

Occasionally, an investment manager may wish to buy a security for one account at the same time it is selling the same security for another account. Although

"crossing" those transactions (a private transaction between the two accounts) could result in lower transaction costs for both accounts, ERISA section 406(b)(2) prohibits the manager from causing a client plan to engage in a direct purchase or sale of securities with another client of the manager. Under new section 408(b)(19), added by the PPA, the purchase and sale of a security between a plan and any account managed by the same investment manager is exempt from ERISA's prohibited transaction rules. The new exemption is subject to a number of conditions. For example, the plan must have at least $100 million in assets and a fiduciary independent of the manager must approve the manager's cross-trading program. In addition, the manager must adopt policies and procedures and provide an annual compliance report to clients.

On February 12, 2007, DOL issued interim final regulations addressing the required policies and procedures. 72 Fed. Reg. 6473 (Feb. 12, 2007). Effective April 13, 2007, the regulations address the requirement that the manager adopt and provide to clients written cross-trading policies and procedures that include the manager's pricing policies, and its policies for allocating cross-trades among clients in an objective manner. The manager is not required to use any particular format for its procedures, though they must be written in a manner calculated to be understood by the client, and must be sufficiently detailed to facilitate a periodic review by the manager's compliance officer and a determination by the officer that the cross-trades comply with the manager's policies and procedures. In addition, the manager's policies and procedures must be "fair and equitable" to all participating accounts and include specific provisions indicating how the conditions of the exemption will be met.

B. Union's Advances Deemed a "Service" Covered by Section 408(b)(2) Exemption

In Advisory Opinion 2007-04A (July 18, 2007), DOL considered an apprenticeship plan under which participants were provided with certain training by enrolling in training courses sponsored by third parties. DOL considered the PT implications of two scenarios. Under the first, a participant's local union would pay the tuition for the training program and be reimbursed by the plan when the participant successfully completed the course. Under the second scenario, the "benefit" under the plan was the tuition and the participant directed the plan to pay this benefit to his local union as reimbursement of the tuition advance by the union.

As to the first scenario, DOL characterized the local union's advance of the tuition as a "service" to the plan exempt under section 408(b)(2), if the other conditions of that "reasonable services" exemption were met. (Interestingly, DOL apparently would not view the arrangement as an "extension of credit" prohibited under section 406(a) until the plan fails to make the payment following submission of required documentation.) DOL did not consider possible section 406(b) implications where an official of a local union sat on the plan's board of trustees,

but noted that, provided there is a pre-existing reimbursement agreement, there should be no section 406(b) violation.

DOL applied the same analysis and reached the same conclusion as to the second scenario (wherein the "benefit" under the plan is the tuition reimbursement, not the training itself). In addition, citing to Interpretive Bulletin 78-1, DOL stated that the plan's payment to the local union of a benefit due the participant, would not be a prohibited transaction if made at the participant's direction.

C. DOL Issues Guidance on Bank Collective Fund Exemptions

Section 408(b)(8) provides exemptive relief for a plan's investment in interests in a common or collective trust fund if, *inter alia*, the fund is maintained by "a bank or trust company supervised by a State or Federal agency." Prohibited Transaction Class Exemption 91-38 provides relief for transactions engaged in by a "collective investment fund" maintained by a "bank or trust company." In DOL Adv. Op. 2007-03A (June 8, 2007), DOL concluded that a U.S. branch of a non-U.S. bank that has been licensed to engage in banking and trust business by a state regulator and this is subject to the same level of oversight and regulation as any other comparable banking entity established in that state would qualify as a "bank or trust company" for purposes of the exemptions provided under section 408(b)(8) and PTE 91-38.

Lastly, in Advisory Opinion 2006-07A (Aug. 15, 2006), DOL concluded that a trust company would be considered a bank for purposes of PTE 91-38 when it acts as trustee of certain collective investment funds ("Funds"), notwithstanding its delegation of investment authority over the Fund to an affiliate. The trust company had exclusive authority and control over all aspects of the management and operation of each Fund's assets and remained fully responsible for the management and operation of the Funds. Although the trust company delegated certain investment functions for the Funds to an indirectly, wholly owned subsidiary which is a registered investment adviser, the trust company remained liable under ERISA for the consequences of the investment decisions of its affiliate. The trust company was subject to regulation by the Office of the Comptroller of the Currency ("OCC") in the same manner as national bank trust departments, and both the Office of Thrift Supervision and OCC regulate the trust company as a bank or trust company. The DOL expressed its view that, under these circumstances, the trust company would be considered a bank and the Funds would be considered to be maintained by a bank for purposes of PTE 91-38.

D. Two DOL Advisory Opinions Clarify the "QPAM Exemption"

Prohibited Transaction Exemption 84-14, the "QPAM exemption," exempts certain transactions between a plan (or investment fund) and a party in interest provided certain conditions are met. These conditions include the condition that the party in interest be unaffiliated with the entity with authority to appoint the QPAM or negotiate the terms of its appointment. In Advisory Opinion 2007-01A

(Jan. 22, 2007), DOL concluded that this condition (section I(a) of the exemption) will not fail to be satisfied in a transaction between a plan and a party-in-interest broker dealer even though an affiliate of the broker dealer provides investment advice to plan participants in selecting investment accounts under the plan, one of which is the account managed by the QPAM.

There is an exception to this "appointing authority" condition for funds in which two or more unrelated plans invest (Collective Funds) if the assets of each plan (when combined with related plans) represents less than 10% of the collective fund. In Advisory Opinion 2007-02A (Jan. 22, 2007), DOL considered how this 10% test applied when a plan invests in a collective fund both directly and indirectly through a second collective fund. (For example, assume a plan's direct interest in the Collective Fund is 4%. Plan also owns 50% of a second fund (Investor Fund) which itself owns 30% of the Collective Fund. Assuming that the Collective Fund and Investor Fund are unrelated and managed by unrelated QPAMs, DOL concluded that in applying the 10% limit to each investor in the Collective Fund, the Collective Fund's QPAM is not required to count the investor's indirect interests in the Collective Fund, i.e., though held through the Investor Fund.

E. DOL Revises Class Exemption for Securities Lending

On October 31, 2006, DOL finalized Prohibited Transaction Class Exemption ("PTE") 2006-16, which consolidates and restates PTEs 81-6 and 82-63, and applies to securities lending transactions entered into on or after January 2, 2007. 71 Fed. Reg. 63,786 (Oct. 31, 2006). The restated exemption does not change the conditions of PTE 82-63, which provides relief from self-dealing under ERISA section 406(b)(1) for the lending agent's compensation arrangement. However, the final exemption provides relief from the party-in-interest and other section 406(a) prohibitions by expanding the types of collateral that a plan may accept, and enabling plans to loan securities to certain foreign banks and foreign broker-dealers. In the latter respect, it goes well beyond the proposed exemption and PTE 81-6. The consolidated exemption also clarifies that "fee-for-hold" arrangements, as well as loans structured as repurchase agreements, can qualify for the relief.

There are some remaining issues including whether (or to what extent) pledged collateral is considered to be a "plan asset" of the lending plan and whether (or to what extent) plans and their lending agents actually will use the revised class exemption in light of the adoption of the new statutory "service provider exemption," which provides broad exemptive relief for a variety of transactions (including securities loans) between the plan and specified parties-in-interest, without imposing many of the conditions of PTE 2006-16. See ERISA section 408(b)(17) and Code section 4975(c)(20).

F. DOL Clarifies Application of PTE 77-3 to In House Plan's Investment in Proprietary Mutual Funds

In Advisory Opinion 2006-06A (July 26, 2006), DOL responded to an inquiry regarding whether the prohibition on the payment of sales commissions in PTE 77-3 applies to the payment of distribution-related expenses (12b-1 fees) by a proprietary mutual fund to an unrelated broker. PTE 77-3 exempts from the prohibited transaction restrictions a plan's acquisition and sale of mutual fund shares when the plan covers employees of the mutual fund or the mutual fund's investment adviser, principal underwriter, or employees of any affiliates of the investment adviser or principal underwriter. One of the conditions that must be satisfied in order to rely on PTE 77-3 is that the plan does not pay a sales commission in connection with the acquisition of the mutual fund shares.

In the fact pattern addressed by DOL, Company A was an investment advisor to a mutual fund. Employees of Company A participated in a 401(k) plan with an open brokerage account through which participants could invest in mutual funds advised by Company A. DOL stated that, in connection with the plan's purchase of the affiliated mutual fund's shares, the payment of 12b-1 fees to a broker who is unrelated to Company A would not constitute the payment of a sales commission and therefore PTE 77-3 would be available, provided the other conditions of the exemption were satisfied. This opinion extends to PTE 77-3 the DOL's holding in Advisory Opinion 2002-05A (June 7, 2002) in which DOL found that the payment of 12b-1 fees to an unaffiliated broker would not constitute a payment of a sales commission in connection with the purchase of mutual fund shares where the mutual fund's investment manager was also a fiduciary to the plan purchasing the shares. See PTE 77-4.

G. DOL Eliminated 3-Day Limit for "Incidental Loans" Under PTE 80-26

PTE 80-26 provides relief from the provisions of sections 406(a)(1)(B) and (D) and 406(b)(2) of ERISA for a loan by a "party in interest" (such as the sponsoring employer or a service provider) to a plan if, among other conditions, no interest or fee is charged to the plan in connection with the loan. Under the prior version of PTE 80-26, a distinction was made between loans for "ordinary operating expenses" (including benefit payments), which were permitted to be of unlimited duration, and loans made for a purpose "incidental to the ordinary operation of the plan," which could be no longer than 3 days.

On April 7, 2006, DOL amended PTE 80-26. 71 Fed. Reg. 17,917 (Apr. 7, 2006). The final amendment eliminates the duration limitation for "incidental" loans, providing exemptive relief for both types of loans regardless of the duration, if the other conditions of the exemption are met. In addition, under the amended exemption, a loan of 60 days or longer requires a written agreement. The final amendment also states that PTE 80-26 does not cover a loan to an ESOP to the extent that the loan relates to the acquisition by the ESOP of employer securities.

VI. Miscellaneous Guidance

A. DOL Guidance on Defined Contribution Plan Annuity Selection

DOL recently issued guidance clarifying the rules for the selection of annuity contracts for defined contribution plans. 72 Fed. Reg. 52,004, 52,021 (Sept. 12, 2007). The guidance consists of an Interim Final Rule amending Interpretive Bulletin 95-1 (IB 95-1) to limit the application of the "safest annuity" standard to defined benefit plans, and a Proposed Rule creating a "safe harbor" under the ERISA fiduciary rules for the selection of annuity providers and contracts for purposes of benefit distributions from individual account plans. Comments on the Proposed Rule will be accepted by the DOL until November 13.

The Proposed Rule—which implements a PPA mandate—makes clear that plan fiduciaries must discharge their duties with respect to the plan solely in the interest of participants and beneficiaries under ERISA section 404(a)(1)(A), and act with the care, skill, prudence, and diligence that a prudent person would use in accordance with ERISA section 404(a)(1)(B). A fiduciary will be deemed to have satisfied the prudence requirements of ERISA when selecting an annuity contract as a distribution option for a defined contribution plan if the fiduciary (a) engages in an objective, thorough, and analytical search for annuity providers; (b) uses a qualified expert, if necessary; (c) assesses the ability of the annuity provider to make all future payments under the annuity contract and the cost of the annuity contract in relation to the benefits and administrative services to be provided; and (d) in the case of an annuity provider selected to provide multiple contracts over time, periodically revisits the conclusion that the annuity provider is financially able to make all future payments and its costs that are reasonable in relation to the benefits and services provided.

The Proposed Rule thus provides a lengthy checklist to help fiduciaries comply with their duties in the selection of annuity providers for distributions from 401(k) and other defined contribution plans. Whether these guidelines are clear and comforting enough to prompt plan sponsors to add annuity options to their plans remains to be seen. Also, the guidelines may not necessarily be well-suited to the selection and review of the "new generation" of annuity options and products that insurers have been developing for the 401(k) market. For example, several new products are more like investment options (*e.g.*, providing for the periodic purchase of annuity segments, guaranteed withdrawal rights, etc.) which may be more appropriately analyzed under the rules for participant-directed investment options (ERISA sec. 404(c)) or possibly a combination of the two sets of guidelines.

B. DOL Guidance on Impact of Final IRS Rules on Non-ERISA Programs

Under DOL's longstanding safe harbor regulation (29 C.F.R. § 2510.3-2(f)), annuity programs under Code section 403(b) that are funded entirely through salary reduction agreements are not subject to the provisions of ERISA if (i)

employee participation in the arrangement is completely voluntary, (ii) all rights under the annuity contract or custodial account are enforceable solely by the employee (or beneficiary or representative of either), (iii) involvement by the employer is limited, and (iv) the employer does not receive consideration other than reasonable amounts to cover proper expenses.. DOL issued FAB 2007-02 to address the status of 403(b) programs under this safe harbor in light of final 403(b) regulations published by the IRS and Treasury Department on July 26, 2007. 72 Fed. Reg. 41,128 (July 26, 2007). The FAB emphasizes that compliance with the new Treasury regulations will not necessarily cause an annuity program to become covered by Title I of ERISA and confirms that the determination whether a 403(b) program is subject to ERISA will continue to be made on a case-by-case basis.

The FAB recognizes that the final 403(b) regulations require employers to engage in certain administrative activity that raises concerns regarding compliance with the safe harbor. Consistent with its past position on permissible activities to ensure IRS operational compliance, DOL notes that an employer may remain within the safe harbor while performing certain required administrative functions, such as testing for compliance with nondiscrimination rules and contribution limitations. However, an employer's assumption of responsibility for or exercising certain discretionary authority in areas such as plan-to-plan transfers, processing distributions, negotiating the program's terms with annuity providers, and making hardship distribution, qualified joint and survivor, loan eligibility, and QDRO determinations, would not be consistent with the safe harbor.

The FAB also generally confirms that employers may comply with the new written document requirement without violating the conditions of the safe harbor. DOL points out that a plan document may incorporate other documents, including insurance policies and custodial account agreements, by reference. DOL expects that the written plan document requirement will be satisfied in this manner and specifies that an employer's development and adoption of a single document to coordinate administration among different issuers (without reference to a particular contract or account) would not conflict with the safe harbor. Plan documents should identify the parties responsible for administrative functions, describe the employer's limited role, and allocate discretionary authority to the provider(s), participants, or another third party.

Written plans may limit employees to exchanges of contract funds only among providers who have adopted the written plan, or transfers from the program of a former employer to that of a current employer. An employer may limit the number of providers to which it will forward salary reduction contributions provided that employees are permitted to transfer some or all of their contributions to any provider whose annuity contract or custodial account complies with the requirements of the Code and who agrees to the plan's division of tax compliance responsibilities between the employer and the provider.

C. QDROS Under the Pension Protection Act

The PPA directed DOL to issue regulations clarifying the treatment of domestic relations orders that modify previously issued QDROs as well as the treatment of orders issued at various times other than at the time of the divorce itself. Interim final rules were issued on March 7, 2007. 72 Fed. Reg. 10,070 (Mar. 7, 2007). Effective April 6, 2007, the rules contain helpful examples on various scenarios including: (1) orders that revise an existing order for the same participant and spouse or a different alternate payee; (2) orders issued after the participant's death; (3) orders issued after the date of divorce; and (4) orders issued after the participant's annuity starting date.

The general thrust of the rules is that none of the above situations in and of itself prevents the order from being a QDRO—as long as it meets all of the other applicable requirements. This principle is also illustrated with several examples confirming that, among other restrictions, QDROs cannot assign rights to benefits already awarded under a QDRO or require payments in a form not otherwise provided by the plan.

D. DOL Addresses MEWA Issues, Again

In Advisory Opinion 2007-06A (August 16, 2007), DOL applied its long-standing analysis to determine whether an arrangement for the provision of welfare benefits to employees of employer members of an association was itself an employee benefit plan (a multiple employer plan) or simply a vehicle for the provision of benefits to separate plans maintained by each of the participating employers. Citing the requirement that a plan be maintained by an "employer" or by "a group or association of employers acting for an employer," DOL found that, provided its membership was limited to employers (not individuals or sole proprietors) and that control of the plan sponsored by the association was vested solely in its employer members, the association at issue was a bona fide employer association that could maintain a multiple employer plan.

Notwithstanding the fact that the association's plan was deemed a single ERISA plan, DOL recognized that it was a MEWA and considered whether the plan was "fully insured" (e.g., the amount of benefits are guaranteed under an insurance contract) for purpose of the MEWA preemption rules under section 514(b)(6)(D). Finding that a "financial guaranty running to the plan" was not sufficient, it required "the issuance company or organization that issued the insurance contract to unconditionally guarantee, upon receipt of the required premium or consideration, to pay all benefits due under the plan, and each participant must have a right to those guaranteed benefits which is legally enforceable directly against the insurance company or organization." In the case of the association's insurance arrangements, this participant guaranty was missing.

E. DOL "Approves" Risk Management Strategies for Defined Benefit Plans

In Advisory Opinion 2006-08A (Oct. 3, 2006), DOL addressed the issue of whether a fiduciary of a defined benefit plan may consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan without violating the fiduciary obligations imposed by section 404 of ERISA. The plan fiduciary proposed to "risk manage" the plan's assets by matching the risks of the plan's investment portfolio with the risks associated with the plan's benefit liabilities, with a goal toward reducing the likelihood that liabilities would rise at a time when the assets declined.

Sections 403(c) and 404(a)(1)(A) of ERISA require plan fiduciaries to discharge their duties solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of plan administration. ERISA section 404(a)(1)(B) requires plan fiduciaries to act with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Citing its own longstanding investment regulation (29 C.F.R. 2550.404a-1), DOL expressed its opinion that plan fiduciaries have "broad discretion in defining investment strategies appropriate to their plans." Thus, a fiduciary would not violate ERISA solely because its investment strategy takes into account the plan's liabilities and the risks associated with those liabilities and "results in reduced volatility in the plan's funding requirements."

GROOM LAW GROUP

MEMORANDUM

October 25, 2007

TO: **Financial Institution Clients**

FROM: Stephen M. Saxon
Ellen M. Goodwin

RE: Final Default Investment Regulations

The Department of Labor's anxiously awaited final "Qualified Default Investment Alternative" ("QDIA") regulations appear in today's Federal Register. The regulations become effective on December 24th, 2007. The fundamental structure and conditions of the final regulations closely follow those of the proposed regulations. In addition, the final regulations continue to authorize the use of the same investment strategies that were described in the proposal. Nonetheless, the Department did accommodate many of the requests made by commenters and relax several restrictive aspects of the proposal. This memorandum summarizes some of the most significant changes that the Department made in response to comments from the public.

1. Principal Preservation Vehicles: Many commenters asked the Department to extend unlimited Qualified Default Investment Alternative ("QDIA") status to principal preservation products, such as stable value and money market funds. The Labor Department declined to do this, but the Department did undertake a number of suggestions to address these issues.

a. Grandfather Relief for Prior Default Investments: A number of commenters asked the Department to provide "grandfather" relief for default investments that were made in principal protection vehicles prior to the effective date of final regulations.

The final regulation contains a very significant grandfather provision that applies only to stable value fund investments. The provision provides that investments made prior to the effective date of the regulation (prior to December 24, 2007) into stable value products may qualify for QDIA status. This provision does not apply to contributions made after the effective date of final regulations. For purposes of this rule, investments must have been made into a product that is designed to guarantee principal and provide a rate of return consistent with bond funds, while providing liquidity for participant initiated withdrawals and transfers. This grandfather rule does not apply to other principal protection funds that do not guarantee principal, such as bond or money market funds.

b. Transitional Relief: - Not surprisingly, the Department did not choose to extend unlimited QDIA status to principal protection vehicles. Instead, these vehicles were given short-term QDIA status. The regulation provides that a participant's account may be defaulted into a capital preservation vehicle for up to 120 days after the participant's first elective contribution.

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However, assets defaulted into a capital preservation vehicle for this purpose must be moved into one of the other QDIA vehicles after the 120-day period ends. The Department explained that this rule should ease plan administration since the tax code permits participants to opt out of automatic enrollment within 90 days. For this purpose, the capital preservation product must seek to maintain principal and must be offered by a regulated financial institution.

2. Investment Manager or RIC Requirement: The proposed rule contained a requirement that a QDIA must either be (1) managed by an investment manager within section 3(38) of ERISA, or (2) a registered investment company. The Department received a number of comments asking that this requirement be loosened. Plan sponsors requested that they be permitted to maintain their own default asset allocations. Members of the banking industry asked for clarification that bank collective funds could qualify as QDIA vehicles notwithstanding the bank's status as a plan trustee. They argued this clarification was necessary because parenthetical language in section 3(38) provides that a fiduciary other than a trustee or named fiduciary may serve as an investment manager. In addition, members of the insurance industry asked for clarification that investments made in separate accounts under group annuity contracts, or in other pooled investment vehicles, would qualify for QDIA treatment as long as the conditions of the regulation were satisfied.

The final regulation significantly broadens the range of entities that may qualify as QDIAs. In this regard, subsection (e)(3) of the final regulation provides that a QDIA must be (1) managed by a 3(38) manager, a trustee of a plan that meets the requirements of section 3(38)(A), (B) and (C), or a named fiduciary, (2) a registered investment company, or (3) one of the principal preservation vehicles entitled to limited QDIA status. In addition, preamble language clearly states that the regulation is intended to permit investments made in separate accounts under group annuity contracts, as well as common and collective trust funds or other pooled investment funds that satisfy all of the conditions of the regulation. The preamble also clarifies that the entity that is responsible for the asset allocation decisions that affect the vehicle is the entity that is to be analyzed for purposes of meeting the requirements of paragraph (e)(3).

3. Preemption: Section 514(e) of ERISA provides a preemption provision that broadly preempts any state laws that would directly or indirectly restrict a plan from offering an automatic contribution arrangement. The regulation contains a preemption provision that clarifies that any state laws that would inhibit automatic contribution arrangements are preempted regardless of whether the investment chosen as the plan's default investment qualifies as a QDIA. The preemption rule also clarifies that the notice requirement of section 514(e) will be satisfied by a notice that meets the requirements of the final default regulations.

4. Disclosure Requirement: The proposed regulation contained a disclosure rule that would have required participants whose accounts were invested by default to be provided greater information than participants who provide affirmative investment instructions under 404(c) plans. In addition, the proposed rule arguably would have required plans to be amended to describe the disclosure rights of defaulted participants.

The Department relaxed the disclosure rule in the final regulations. The disclosure rule of the final regulation makes clear that participants whose account balances are invested by

default are entitled to the same disclosures that must be provided in connection with affirmative participant instructions under 404(c) plans. Preamble language makes clear that these disclosures may be provided directly to the participant by the provider of the investment alternative or by a third party. In addition, the Department eliminated the language that appeared to require plan terms to describe the disclosure rights of defaulted participants.