MEMO# 16087

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# HOUSE OF REPRESENTATIVES PASSES ERISA REFORM BILL, INCLUDING INVESTMENT ADVICE LEGISLATION

[16087] May 19, 2003 TO: PENSION MEMBERS No. 22-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 27-03 RE: HOUSE OF REPRESENTATIVES PASSES ERISA REFORM BILL, INCLUDING INVESTMENT ADVICE LEGISLATION On May 14, 2003, the House of Representatives passed H.R. 1000, the "Pension Security Act of 2003," by a vote of 271 to 157.1 The bill, introduced by Chairman John Boehner (R-OH) of the House Education and the Workforce Committee, was previously approved by that Committee on March 6 and is substantially similar to the ERISA reform legislation passed by the House last year, H.R. 3762. The bill contains the provision supported by the Institute that would allow financial institutions providing investment options to retirement plans also to provide investment advice to plans and participants. Additionally, the bill would (1) require the provision of quarterly benefit statements to plan participants, (2) limit and clarify the fiduciary responsibilities applicable during pension blackout periods, (3) provide liberalized diversification rights with regard to employer securities, and (4) enact various ERISA provisions that were excluded from the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") for procedural reasons. This memorandum provides a summary of the provisions of interest to the mutual fund industry. I. Periodic Pension Benefit Statements Quarterly Benefit Statements Under ERISA. The bill would amend section 105(a) of ERISA to require plan administrators to provide quarterly benefit statements to participants and beneficiaries of applicable individual account plans.2 The required notice would (1) indicate, on the basis of the latest available information, the total benefits accrued and the nonforfeitable benefits accrued, if any, or the earliest date on which benefits will become nonforfeitable, (2) be written in a manner calculated to be understood by the average plan 1 The text of the bill is currently available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h1000eh.txt.pdf. 2 The term "applicable individual account plan" would mean any individual account plan under ERISA, excluding (1) employee stock ownership plans under Code section 4975(e)(7) unless contributions subject to Code sections 401(k)(3) or (m)(2) are made to such plan, and (2) one-participant retirement plans. 2 participant, and (3) be provided in written form or in electronic or other appropriate form to the extent that such form is reasonably accessible to the recipient. Statements for applicable individual account plans also would be required to include the following: (1) the value of investments allocated to the individual account, including the value of any assets held in the form of employer securities, without regard to whether such securities were contributed by the plan sponsor or acquired at the direction of the plan or of the participant or beneficiary, (2) an explanation, written in a manner calculated to be understood by the average plan participant, of any limitations or restrictions on the right to

direct an investment, and (3) an explanation, written in a manner calculated to be understood by the average plan participant, of “the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a discussion of the risk of holding more than 25 percent of a portfolio in the security of any one entity, such as employer securities.” Plan administrators that fail to comply with the quarterly statement requirement could be subject to a civil penalty of an amount up to $1,000 a day for each day of the violation. DOL Guidance. The bill would direct the Secretary of Labor to issue initial guidance and a model benefit statement that may be used by plan administrators not later than 180 days after the date of enactment. In addition, the Secretary would be directed to promulgate interim final rules necessary to carry out the amendments made by the legislation within 75 days after the date of enactment. Investment Education Notices Under the Internal Revenue Code. The bill also would amend the Internal Revenue Code to require plan administrators of certain plans not subject to ERISA section 105 (which governs plans subject to the quarterly statement requirement discussed above) to provide investment education notices that set forth (1) an explanation of generally accepted investment principles, including principles of risk management and diversification, and (2) a discussion of the risks of holding substantial portions of a portfolio in the security of any one entity, such as employer securities.3 These investment education notices, which must be written in a manner calculated to be understood by the average plan participant, would be provided to participants at the time of enrollment and not less than annually thereafter. Failure to provide such notices could result in a penalty assessment by the Secretary of the Treasury of an amount equal to $100 for each failure, up to a maximum of $50,000 per calendar year. Bill Section 101. II. Inapplicability of Relief from Fiduciary Liability During Blackout Periods In General. The bill would amend section 404(c) of ERISA to provide that relief from fiduciary liability would not apply in connection with the direction or diversification of assets credited to the account of any participant or beneficiary during a blackout period if, by reason 3 While the investment education notice requirement under the Code would generally apply to section 401(a) qualified plans, section 403(a) plans, section 403(b) arrangements, and governmental section 457 plans that also allow participants to direct their plan investments (or hypothetical investments), the bill expressly exempts plans subject to ERISA section 105 — which include ERISA-covered individual account plans — and one-participant retirement plans from this Code requirement. 3 of the imposition of the blackout period, the ability of a participant or beneficiary to direct or diversify such assets is suspended, limited or restricted. The provision would incorporate by reference the definition of blackout period set forth in ERISA section 101(i)(7), as enacted by the Sarbanes-Oxley Act of 2002. Clarification of Fiduciary Duties. To the extent that a fiduciary authorizing a blackout period meets the requirements of Title I of ERISA in connection with such authorization, no fiduciary would be liable for any loss occurring during the blackout period as a result of any exercise by the participant or beneficiary of control over account assets prior to the blackout period. Relevant factors in determining whether a fiduciary has met such requirements include whether the fiduciary (1) has considered the reasonableness of the expected length of the blackout period, (2) has provided the notice required under ERISA section 101(i)(2), and (3) has acted in accordance with ERISA section 404(a) (containing the general fiduciary duties) in determining whether to enter into the blackout period. The bill also clarifies that where a blackout period arises in connection with a change in the plan’s investment options, a participant would be deemed to have exercised control over his or her account assets prior to the blackout period, if, after reasonable notice of the change in investment options is given to the participant prior to the blackout period, assets in the account are transferred (1) to plan investment options in accordance with the affirmative election of the participant or (2) in the manner set forth in the notice, if no election was made. Furthermore, any limitation or restriction that may govern the frequency of transfers between investment vehicles would not be treated as an imposition of a blackout period to the extent the limitation or restriction is disclosed to participants or beneficiaries through a summary plan description or materials describing specific investment alternatives under the plan. DOL Regulatory Guidance. The bill would direct the Secretary of Labor to issue interim final regulations no later than December 31, 2004 providing how plan sponsors and other affected fiduciaries can satisfy their fiduciary responsibilities during blackout periods. III. Informational and Educational Support for Pension Plan Fiduciaries The bill would direct the Secretary of Labor to establish a program under which information and educational resources would be made available on an ongoing basis to fiduciaries to assist them in “diligently and effectively carrying out their fiduciary duties.” Information on prudent investment procedures and investment considerations for defined benefit and defined contribution plans, including investment in employer securities by plans, would be provided under this program. Bill Section 103. IV. Diversification Rights for Defined Contribution Plans that Hold Employer Securities In General. The bill would provide participants and beneficiaries of individual account plans expanded rights to divest their accounts of employer securities (as defined in ERISA section 407(d)(1)). Plans subject to this requirement would be any individual account plan, except employee stock ownership plans (ESOPs) under Code section 4975(e)(7) unless the ESOP holds employee elective deferrals or employer matching contributions. Additionally, the rules 4 would not apply to employer securities that are not readily tradable on an established securities market. Bill Section 104.4 Employee Contributions Invested in Employer Securities. In the case of employer securities attributable to employee contributions and elective deferrals, plans would be required to allow individuals to divest their accounts of such securities immediately and direct them into other investment alternatives — which must consist of no less than 3 investment options, each of which is diversified and has materially different risk and return characteristics. The plan would also be required to permit participants and beneficiaries to direct their plan investments, subject to plan restrictions that may limit the frequency of transfers (but no less frequently than on a quarterly basis). Employer Contributions Invested in Employer Securities. For employer contributions invested in employer securities, the bill would require plans to adopt one of two alternatives. First, a plan could allow individuals with a benefit based on 3 years of service to divest their accounts of any employer securities. Alternatively, a plan could allow divestment of employer securities 3 years after the end of the plan year in which the employer securities were allocated to the account. As with employee elective deferrals, plans must offer at least 3 investment options (each of which is diversified and has materially different risk and return characteristics) to which proceeds attributable to employer securities may be directed. Effective Date and Transition Rule. The provision generally would apply to plan years beginning after December 31, 2003 and with respect to employer securities allocated to accounts before, on, or after the date of enactment. Employer securities held by an employee stock ownership plan acquired before January 1, 1987, however, would not be subject to the provision. The bill also would direct the Secretary of the Treasury to prescribe regulations under the diversification rules in consultation with the Secretary of Labor. For employer securities that are held by applicable individual account plans on the bill’s effective date, the bill would provide a transition rule under which plans would be required to allow diversification out of such employer securities. Specifically, the diversification rights with regard to the number of employer securities held in the account would be phased in according to the following schedule: 1st plan year: 20 percent; 2nd plan year: 40 percent; 3rd plan year: 60 percent; 4th plan year: 80 percent; and 5th plan year and thereafter: 100 percent. V. Prohibited Transaction Exemption for the Provision of Investment Advice In General. The bill would provide a statutory exemption from ERISA’s prohibited transaction rules for the provision of investment advice and related transactions. Under the exemption, “fiduciary advisers,” who by definition would be ERISA fiduciaries, would be permitted to provide investment advice to participant-directed plans and participants and beneficiaries of such plans. Bill Section 105. Scope of Exemption. Under the bill, the statutory exemption would permit (1) the provision of advice to the plan, participant, or beneficiary, (2) the sale, acquisition, or holding of a security or other property (including any lending of money or other extension of credit 4 The bill’s amendments to the Internal Revenue Code on diversification rights generally conform to the ERISA amendments. 5 associated with the sale, acquisition, or holding of securities or other property) pursuant to the advice, and (3) the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative of the fiduciary adviser or affiliate) in connection with the provision of the advice or in connection with a sale, acquisition, or holding of a security or other property pursuant to the advice. The bill includes a parallel exemption under the Internal Revenue Code from the Code’s prohibited transaction rules. Elements of the statutory exemption’s requirements are described below. Definition of Fiduciary Adviser. Under the bill, an adviser would be required to qualify as a fiduciary adviser, defined as “a person who is a fiduciary of the plan by reason of the provision of investment advice” and who qualifies as one of the following entities: (1) a registered investment adviser under the Investment Advisers Act of 1940 or applicable state law, (2) a bank or similar financial institution (referred to in ERISA section 408(b)(4)) or a savings association (defined in section 3(b)(1) of the Federal Deposit Insurance Act), but only if the advice is provided through a trust department of the bank or similar financial institution which is subject to periodic examination and review by Federal or State banking authorities, (3) an insurance company qualified to do business under the laws of a state, (4) a registered broker or dealer under the Securities Exchange Act of 1934, (5) an “affiliate,” as defined in section 2(a)(3) of the Investment Company Act of 1940, of these qualifying institutions, or (6) an employee, agent, or registered representative, as described in section 3(a)(18) of the Securities Exchange Act of 1934 or section 202(a)(17) of the Investment Advisers Act of 1940, of the qualifying institutions. Disclosure Requirements. At a time reasonably contemporaneous with the initial provision of advice, the fiduciary adviser must provide to the recipient of the advice a written notification (which may be delivered electronically) of: (1) all fees or other compensation relating to the advice that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with the provision of such advice or in connection with the sale, acquisition or holding of the security or other property, (2) any material affiliation or contractual relationship of the fiduciary adviser or its affiliates in such security or other property, (3) any limitation placed on the scope of the investment advice to be provided by the fiduciary adviser with respect to any such sale or acquisition, and (4) the types of services provided by the fiduciary adviser in connection with the provision of investment advice. Additionally, the fiduciary adviser must notify the advice recipient that (1) it is acting as a fiduciary of the plan in connection with the provision of the advice, and (2) the advice recipient may separately arrange for the provision of advice by another adviser that may have no material affiliation with and receive no fees or other compensation in connection with the security or other property. The fiduciary adviser also must provide appropriate disclosure in accordance with all applicable securities laws. The notification provided to participants and beneficiaries would be required to be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant. It must also be sufficiently accurate and comprehensive to reasonably apprise participants and beneficiaries of the information required to be provided in the notification. The bill directs the Secretary of Labor to issue a model form for the disclosure of fees and other compensation required under the exemption. 6 During the provision of advisory services to the plan, participant or beneficiary, the fiduciary adviser must (1) maintain the information described above in currently accurate form, (2) provide, without charge, the currently accurate information to the advice recipient no less than annually, (3) make such information available, upon request and without charge, to the advice recipient, and (4) in the event of a material change to the information in the required disclosures, provide the currently accurate information to the advice recipient at a time reasonably contemporaneous to the material change in the information. Other Requirements. A fiduciary adviser would have to satisfy a number of other conditions in order to qualify under the statutory exemption: (1) the sale or acquisition of a security or other property relating to the advice must occur solely at the direction of the recipient of such advice, (2) the compensation received by the fiduciary adviser and its affiliates in connection with such acquisition, sale or holding must be reasonable, (3) the terms of the acquisition, sale or holding of the security must be at least as favorable to such plan as an arm's length transaction would be, and (4) the fiduciary adviser must maintain for a period of at least 6 years after the provision of advice any records necessary for determining whether the requirements of the statutory exemption were met (subject to an exception for records lost or destroyed due to circumstances beyond the control of the fiduciary adviser). Clarification of Employer Role. The bill would clarify the extent of a plan sponsor's responsibilities under ERISA if it engages a fiduciary adviser to provide advice under this exemption. Specifically, a plan sponsor (or other person who is a fiduciary) would not be treated as failing to meet the requirements of Part 4 of ERISA (which includes the fiduciary duties under ERISA section 404) "solely by reason of the provision of investment advice . . . (or solely by reason of contracting for or otherwise arranging for the provision of such investment advice)" if (1) the advice is provided by a fiduciary adviser pursuant to an arrangement between the plan sponsor or other fiduciary and the fiduciary adviser, (2) the terms of the arrangement require the fiduciary adviser to comply with the requirements of the statutory exemption, and (3) the terms of the arrangement include a written acknowledgment by the fiduciary adviser that the adviser is a fiduciary of the plan with respect to the provision of the advice. Furthermore, the plan sponsor or other fiduciary would have no duty to "monitor the specific investment advice given by the fiduciary adviser to any particular recipient of such advice." The plan sponsor or other person who is a fiduciary, however, would be responsible for the prudent selection and periodic review of a fiduciary adviser that it has engaged for the provision of advice. Use of Plan Assets. The bill would clarify that plan assets may be used to pay for "reasonable expenses in providing investment advice referred to in section 3(21)(A)(ii)" of ERISA. Effective Date. The provision would be effective for advice provided on or after January 1, 2005. 7 VI. Tax Treatment of Qualified Retirement Planning Services The bill would amend section 132(m) of the Code, which defines "qualified retirement planning services," to provide that employees could choose to pay for the cost of retirement planning services on a pre-tax basis. Highly compensated employees would be permitted to make use of the provision only if the choice were available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's plan. The provision would be effective for plan years beginning after December 31, 2003. Bill Section 107. VII. Study Regarding Impact on Retirement Savings of Participants and Beneficiaries by Requiring Consultants to Advise Plan Fiduciaries of Individual Account Plans The bill would require the Department of Labor, no later than 1 year after the date of enactment, to report the results of a study on the costs and benefits to participants and beneficiaries of requiring independent consultants to advise plan fiduciaries in connection with individual account plans. Factors to be considered in the study would include the benefits to participants of engaging independent advisers to provide investment and other advice regarding plan assets to plan fiduciaries, the extent to which independent advisers are currently retained by plan fiduciaries, and the availability of qualified independent consultants to serve the needs of fiduciaries of individual account plans. Bill Section 106. VIII. Special Effective Date Provision Bill section 108 would provide that the amendments made by the bill apply to plan years beginning on or after 1 year after the date of the bill's enactment, except (1) as otherwise provided in Title I of the bill (i.e., bill sections 101-107, which are described above), (2) for collectively-bargained plans (subject to special effective dates), and (3) for amendments related to investment advice (which, as noted above, are effective for advice provided on or after January 1, 2005). Bill Section 108. IX. Other Pension Provisions (Title II) Simplified Annual Filing Requirement for Owners and Their Spouses. The bill would direct the Secretaries of Treasury and Labor to eliminate the annual filing requirements for one-participant retirement plans with $250,000 in assets or less. The provision would be effective for plan years beginning on or after January 1, 2003. Similarly, retirement plans that cover less than 25 employees would need to file only a simplified form substantially similar to that presently required of one-participant plans, effective for plan years beginning after December 31, 2004. Bill Section 202. Improvements to Employee Plans Compliance Resolution System (EPCRS). The bill would direct the Secretary of Treasury to update and improve EPCRS by (1) increasing the awareness and knowledge of small employers concerning the availability and use of the program, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures, (3) extending the duration of the self-correction period under existing self-correction programs for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under such 8 programs during audit, and (5) assuring that any tax, penalty or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure. The Treasury Department would have full authority to effectuate such changes under EPCRS, including the authority to waive income, excise or other taxes to ensure that they are not excessive and bear a reasonable relationship to the nature of the failure. Bill Section 203. Flexibility in Nondiscrimination, Coverage, and Line of Business Rules. The bill would direct Treasury to modify its regulations to permit plans to satisfy the Code section 401(a)(4) nondiscrimination and Code section 410(b) coverage requirements using "facts and circumstances" tests in cases where the current mechanical tests are not satisfied. Under the regulations, a plan would be submitted to the IRS for a determination of whether the test has been met. The regulations would apply in years beginning after December 31, 2004. Similarly, on or before December 31, 2004, the bill would direct Treasury to modify existing line of business regulations to allow plans to meet a facts and circumstances test. Bill Section 204. Extension to All Governmental Plans of Moratorium of Certain Nondiscrimination Rules Applicable to State and Local Government Plans. The bill would exempt all governmental plans as defined in Code section 414(d) from the nondiscrimination and minimum participation rules. Currently, governmental plans that are not qualified plans maintained by a state or local government are not exempt from these rules. The provision would be effective for plan years beginning after December 31, 2003. Bill Section 205. Notice and Consent Period Regarding Distributions. The bill would extend the period during which an explanation of the qualified joint and survivor annuity (QJSA) option must be provided (to participants of plans that are subject to the QJSA requirement). Specifically, the explanation would be required to be provided no less than 30 days and no more than 180 days (rather than 90 days) before the date distribution commences. The bill also would direct Treasury to modify the regulations under Code sections 402(f), 411(a)(11), and 417 to substitute "180 days" for "90 days" in existing Treasury regulations. The provision would apply to years beginning after December 31, 2003. Bill Section 206. Annual Report Dissemination. The bill would amend ERISA section 104(b)(3) by providing that the requirement to furnish annual report information to participants and beneficiaries would be satisfied “if the administrator makes such information reasonably available through electronic means or other new technology.” The provision would apply to reports for years beginning after December 31, 2003. Bill Section 207. Missing Participants. The bill would allow plan administrators of defined contribution plans to elect to transfer the benefits of missing participants of terminated plans to the Pension Benefit Guaranty Corporation (PBGC). The bill also would direct PBGC to prescribe rules similar to the current program for multiemployer plans. The provision would be effective after final regulations have been prescribed. Bill Section 209. Benefit Suspension Notice. The bill would direct the Secretary of Labor to modify the regulation under ERISA section 203(a)(3)(B) to provide that (1) the notification required to suspend benefit payments, in the case of an employee who returns to work for a former employer after commencement of benefit payments under the plan, shall be made during the 9 first calendar month or the first 4 or 5-week payroll period ending in a calendar month in which the plan withholds payments, and (2) the notice, in the case of any other employee, may be included in the summary plan description, rather than in a separate notice. The modification made by the provision would apply to plan years beginning after December 31, 2003. Bill Section 214. Studies Regarding Model Small Employer Group Plans and Effect of Legislation. The bill would require the Secretary of Labor, in consultation with the Secretary of the Treasury, to conduct a study on a “model small employer group plan,” to be reported no later than 18 months after the date of enactment. Furthermore, the bill directs the Secretary of Labor to report, no later than 5 years after the date of enactment, the effects of the bill, including any change in (1) the extent of pension plan coverage for low and middle-income workers, (2) the levels of pension plan benefits generally, (3) the quality of pension plan coverage generally, (4) workers’ access to and participation in pension plans, and (5) retirement security. Bill Section 215. Provisions Relating to Defined Benefit Plans. The bill includes a number of provisions that primarily relate to defined benefit plans: (1) amendments to the Retirement Protection Act of 1994 regarding certain specific funding rules (Bill Section 201); (2) reduction of PBGC premium for new plans of small employers (Bill Section 210); (3) reduction of additional PBGC premium for new and small plans (Bill Section 211); (4) authorization for PBGC to pay interest on premium overpayment refunds (Bill Section 212); (5) substantial owner benefits in terminated plans (Bill Section 213); and (6) interest rate range for additional funding requirements (Bill Section 216). X. Plan Amendments (Title III) The bill would provide that plan amendments required as a result of the bill, as well as EGTRRA, would not be required to be made before the last day of the first plan year beginning on or after January 1, 2006, provided that the plan or contract is operated as if such plan or contract amendment were in effect and the amendments thereto apply retroactively for such period. Subject to the same conditions, the amendment date for governmental plans would be extended to the first plan year beginning on or after January 1, 2008. Bill Section 301. Thomas T. Kim Associate Counsel

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