INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

November 12, 2008

ICI Letter to Employee Benefits Security Administration on Relief Requested from Form 5500 for 403(b) Plans

Via Electronic Delivery

November 12, 2008

Mr. John J. Canary
Deputy Director, Office of Regulations and Interpretations
Employee Benefits Security Administration
200 Constitution Avenue, NW
Room N-5669
Washington, DC 20210

Re: Transition Issues for 403(b) Plans

Dear Mr. Canary:

I am writing on behalf of the Investment Company Institute (the "Institute") [1] to urge the Employee Benefits Security Administration ("EBSA") to (i) provide relief from the 2009 Form 5500 annual report for 403(b) plans and (ii) issue guidance that addresses the extent to which certain section 403(b) annuity contracts and custodial accounts are plan assets subject to the Employee Retirement Income Security Act of 1974 ("ERISA").

As you know, the Internal Revenue Service's final regulations on section 403(b) plans are scheduled to be effective on January 1, 2009. The new regulations are the first rewrite of the section 403(b) regulations since 1964, and it is apparent that the regulations will have an enormous impact on the structure and operation of these plans. At the same time, EBSA published a substantially revised Form 5500 annual report for 2009 that dramatically changes the reporting requirements for 403(b) plans. Today, the Form 5500 reporting requirements for a 403(b) plan subject to ERISA are extremely limited. In contrast, under the revised Form 5500 report, 403(b) plans would be subject to all of the reporting requirements that apply to 401(k) and other individual account plans, including a financial statement requirement and, for large plans, an audit requirement.

I. EBSA should delay the effective date of the changes to the Form 5500 annual return for 403(b) plans for one year.

The Institute appreciates EBSA's perspective on the need to extend the full range of reporting requirements to 403(b) plans, but is concerned about the practicalities associated with new Form 5500 annual reporting requirements for 403(b) plans. These issues are important to the Institute's members because they will be asked, as providers of section 403(b) custodial accounts and annuity contracts, to provide much of the information that will be needed to complete the Form 5500 annual report. Moreover, many of the Institute's members provide significant services in connection with the preparation of Form 5500 annual reports.

There are a number of reasons for our concern. First, some plans have allowed employees and retirees to transfer their savings (in something called a 90-24 transfer) to financial institutions that are not eligible to receive contributions from the employer. Others have discontinued contributions to certain financial institutions and these employers may not have an ongoing relationship with a discontinued vendor. It is enormously challenging for employers to locate and identify these contracts and, in fact, the IRS has issued significant transition relief for these contracts for this reason. [2] Second, even where the plan administrator is able to locate all of the contracts and accounts, there will be significant data collection challenges. Section 403(b) plans are often funded through individually-owned assets and the plan administrator may have a very limited relationship with the provider. Service agreements between plan administrators and providers are far from common today and plan administrators often have little control over the contracts and accounts. In short, administrators often have little leverage, particularly where ongoing contributions are not being made to a provider and it may be difficult for plan administrators to obtain the necessary information. Third, 403(b) plans are often funded through a number of different financial institutions. As a result, plan administrators will need to solicit the information from all of the different vendors and aggregate the information, which will be a complicated task.

More generally, there inevitably will be challenges as the section 403(b) community gains experience with the Form 5500 annual return. In particular, we expect challenges for large plans as they seek to obtain an opinion from a qualified independent accountant as to the status of the plan in light of the very limited exposure that most accountants have had to 403(b) plans. Further, the interaction between the effective date of the final 403(b) regulations and the new Form 5500 is unfortunate. The final 403(b) regulations are scheduled to be effective January 1, 2009 – the very point at which recordkeeping for the 2009 Form 5500 will need to begin. As you can imagine, the 403(b) community is in a time of significant transition and resources are already strained, even without regard to the new Form 5500.

For these reasons, we strongly recommend that EBSA defer the new reporting rules for 403(b) plans until the 2010 reporting year at the earliest. For the 2009 reporting year, section 403(b) plans should be allowed to follow the reporting rules that were in effect for the 2008 plan year. This modest delay in the effective date will allow for a more orderly transition and for the 403(b) marketplace to settle before the new reporting requirements become effective. It will also have the virtue of allowing plan administrators, qualified independent auditors, and 403(b) plan service providers an opportunity to develop familiarity with one another.

We also suggest that EBSA consider broader relief from the audit requirement for large plans. We are doubtful that a one-year delay in the expanded Form 5500 reporting requirement for 403(b) plans will entirely smooth out the inevitable auditing issues. There are simply too many challenges associated with identifying all of the contracts and accounts that are part of the plans and we are skeptical that plans will be able to obtain unqualified opinions. Accordingly, we recommend that EBSA announce that it will not reject a 403(b) plan’s annual report solely because it does not have an unqualified opinion as a result of contracts issued by vendors that do not receive contributions after January 1, 2010. We suggest January 1, 2010, rather than January 1, 2009, simply because we anticipate continued upheaval in the 403(b) marketplace during 2009.

II. EBSA should clarify that certain 403(b) contracts are not plan assets.

While we believe that transition relief from the Form 5500 requirement is critical, we are also concerned that the Form 5500 is just the tip of the iceberg. EBSA has a number of guidance projects in process that have the potential to greatly impact section 403(b) plans and the financial institutions that provide services to these plans. In particular, it is apparent that EBSA’s pending final regulations under section 408(b)(2) of ERISA (the “service provider disclosure regulations”) will require material disclosures that will run from plan service providers, such as the Institute’s members, to plan fiduciaries. Similarly, the pending final regulations on participant-level fee disclosure will require significant coordination between 403(b) service providers and plan administrators. Our concern is that many of the same issues that make the Form 5500 annual return daunting will also appear in these other contexts. For that reason, we believe a more comprehensive approach is appropriate.

Perhaps the most fundamental issue that 403(b) plans will need to address is the extent to which ERISA applies to particular section 403(b) contracts and accounts. This issue has been around for many years but the new Form 5500 will put a fine point on it, and the pending service provider disclosure and participant-level fee disclosure regulations will put enormous pressure on this determination, particularly since the service provider disclosure regulations will have prohibited transaction consequences. The issue arises because, as mentioned above, ERISA-covered 403(b) plans are sometimes funded through individual annuity contracts and individual custodial accounts, rather than group contracts or trusts. The plan administrator will typically have very limited rights over the contracts and the question arises whether the individual annuity contracts and custodial accounts should be considered part of the ERISA plan. [3]

EBSA’s regulations strongly suggest that many of these individual annuity and custodial accounts are not plan assets. In this regard, the relevant regulation (the “participant regulation”) provides that:

An individual is not a participant covered under an employee pension plan or a beneficiary receiving benefits under an employee pension plan if –

(A) the entire benefit rights of the individual –

(1) are fully guaranteed by an insurance company, insurance service or insurance

organization licensed to do business in a State, and are legally enforceable by the sole choice of the individual against the insurance company, insurance service or insurance organization; and

(2) a contract, policy or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual; or

(B) the individual has received from the plan a lump-sum distribution or a series of distributions of cash or other property which represents the balance of his or her credit under the plan.

29 C.F.R. § 2510.3-3(d)(2)(ii). Taken at face value, this regulation suggests that any individually owned annuity contract is not a plan asset.

EBSA has clarified the scope of the participant regulation, however, by indicating that the “entire benefit rights” of an individual are not guaranteed or distributed for purposes of the regulation if an employee is continuing to accrue benefits. See 44 Fed. Reg. 23527 (April 20, 1979) (preamble to 29 C.F.R. § 2510.3-2(f)); Advisory Opinion 77-10 (June 2, 1977). Instead, the regulation is “directed to situations where employment has been severed, where the employee is fully vested and changes to employment not covered by the plan, or where the employee has earned the maximum benefit he can earn under the plan.” Adv. Op. 77-10. As a result, the mere fact that a retirement plan is funded through individual annuity contracts does not mean that the plan has no assets. It is only after contributions are discontinued that the individual assets are effectively treated as distributed from the plan.

Taken as a whole, existing guidance provides that a former employee holding section 403(b) contracts that are individual annuity contracts is not a “participant” in a pension plan for purposes of ERISA. See, e.g., 44 Fed. Reg. 23527 (indicating that not all employees who take part in a 403(b) plan are participants). As a result, an individual annuity contract held by a former employee is not a plan asset. It follows that these contracts would not need to be taken into account for Form 5500 reporting purposes.

We believe that a similar analysis logically applies to individual custodial accounts held by former employees, and we urge EBSA to issue guidance to this effect. EBSA’s regulations provide two different grounds under which an individual ceases to be a participant: (i) participants are paid their entire benefit in the form of an annuity or (ii) participants are paid their entire benefit in cash or other property. Both grounds suggest that individual custodial accounts held by former employees are not plan assets.

Under the first prong, individual custodial accounts should be viewed as equivalent to annuities and should be covered by the participant regulation. Section 403(b)(7) of the Internal Revenue Code provides that amounts contributed to a custodial account shall be treated as amounts contributed to an annuity contract if the applicable 403(b) requirements are satisfied. Further, the final 403(b) regulations state that “under section 403(b)(7), a custodial account is treated as an annuity contract” for all purposes under the 403(b) regulations. [4] We appreciate that this is a tax, not an ERISA, concept. However, we believe that it is highly relevant to whether an analogous approach should be taken in the context of ERISA, at least as it applies to section 403(b) plans. Moreover, a custodial account has the same key characteristics as an annuity contract for this purpose, in particular, that all of the rights are vested in the participants and the employer does not have material retained rights. In this regard, the Department has treated a group annuity contract as distributed from a plan in cases where the employer does not have any material retained rights under the group contract. See Advisory Opinion 81-60A (July 21, 1981).

The second prong of the participant regulation also offers a basis for concluding that individual custodial accounts in the hands of a former employee are not plan assets. A custodial account is a form of property. The mere fact that a custodial account is tax-deferred does not cause the account to be other than property. It should be possible, therefore, to conceptualize an individual custodial account as a distribution of property and, therefore, a distribution of the individual's entire benefit rights. In such a case, the account should not be a plan asset. See, e.g., Field Assistance Bulletin 2004-2 (Sept. 30, 2004) ("the distribution of the entire benefit to which a participant is entitled ends his or her status as a plan participant and the distributed assets cease to be plan assets under ERISA").

A separate issue is whether an individual annuity contract or custodial account held by a vendor that is no longer authorized to receive contributions is a plan asset, if the individual is a current employee eligible for ongoing contributions to another vendor. As mentioned above, guidance interpreting the "participant" regulation generally provides that it applies if contributions are not being made, but not if contributions are being made on behalf of an individual. The question is whether the regulation applies to the extent that contributions are not being made to a discrete annuity contract or custodial account. The existing guidance does not address the situation unique to section 403(b) plans where contributions may be made to multiple funding vehicles. It is perfectly logical, however, to conclude, for example, that an individually owned annuity contract remains a plan asset only as long as contributions are being made to the annuity contract. It is quite different to hold that an annuity contract that is not receiving contributions is a plan asset simply because contributions are being made to another funding vehicle. Accordingly, we believe that EBSA could very reasonably construe its existing guidance to support the proposition that contracts held by discontinued vendors are not ERISA plan assets, even if contributions are being made on behalf of an individual to another vendor, and we recommend guidance to this effect.

More generally, the approach to plan assets that we suggest has the virtue of recognizing the absence of effective fiduciary control over individually-owned annuity contracts and custodial accounts. Except in situations that are not relevant to this discussion, the assets of an ERISA plan are to be identified on the basis of ordinary notions of property rights. See, e.g., Advisory Opinions 2003-05A (Apr. 10, 2003), 99-08A (May 20, 1999) and 94-31A (Sept. 9, 1994). This requires an analysis of whether the plan has a beneficial interest in particular property. Id. It should be apparent that a 403(b) plan should not be considered the owner of individual annuity contracts and custodial accounts under ordinary notions of property rights in situations where the contracts and accounts do not reserve any material rights for the plan fiduciary. [5]

For these reasons, we believe the guidance we suggest is technically sound. It would also provide for a very clean and logical rule under which all contracts held for participants for whom contributions are being made on or after January 1, 2009 are ERISA plan assets. As a result, only these contracts receiving contributions would be plan assets subject to the Form 5500 reporting rules, and the other rules of ERISA. [6] This approach would have the virtue of addressing many of the issues raised by contracts that will not be receiving contributions on or after January 1, 2009. It would ensure that plan administrators have the leverage they need to gather information necessary to satisfy the new Form 5500. Further, this approach would recognize the very significant consolidation of vendors that we are seeing in the 403(b) marketplace, which would have the beneficial effect of making fiduciary oversight much more manageable.

We are sensitive to concerns that the analysis we suggest could materially narrow the application of ERISA with respect to arrangements that are funded through individual contracts and accounts. However, the final 403(b) regulations issued by the Internal Revenue Service require that all contracts be held pursuant to an employer's written plan document. The Internal Revenue Service's plan document requirement necessitates significant integration between the employer's plan and the individual custodial account and annuity contracts held under the plan. As a result, we expect that employers will retain significant rights under annuity contracts and custodial accounts after the final 403(b) regulations are effective. The significant rights that employers are likely to retain under contracts and accounts on or after January 1, 2009 may be incompatible with the notion that these contracts have been distributed from the plan. See Advisory Opinion 81-60A (employer's retained rights under a group contract may or may not be consistent with the participant regulation). For this reason, we believe it would be reasonable to differentiate between contracts that stop receiving contributions before January 1, 2009 and those that stop receiving contributions sometime after the final 403(b) regulations are effective. As a result, the rule we suggest does not logically have to be a permanent rule but rather could operate in effect as a transition rule.

Finally, there is an underlying issue of whether it is prudent and appropriate for an ERISA plan to be funded through individual annuity contracts and custodial accounts, at least where the plan fiduciary does not retain material rights over the contracts and accounts. Our letter does not address this issue and we are not aware of any guidance on point. It is important, however, for EBSA to recognize that, regardless of its view of this issue, there are numerous individual annuity contracts and custodial accounts held by ERISA plans. The reasons for this are myriad and it would be inappropriate to conclude or assume that these contracts are in plans as a result of fiduciary oversight. The use of individual contracts is part of the fabric of section 403(b) and, for many years, it would have been extraordinary to see a 403(b) arrangement funded through a group contract. The notion of section 403(b) arrangements as employer-maintained plans has also evolved slowly. Many plans originated as non-ERISA salary-reduction-only arrangements that satisfied EBSA's safe harbor in 29 C.F.R. § 2510.3-2(f) and migrated into ERISA plans, for example, with the addition of an employer contribution or a decision by the employer to exercise oversight of the program. Our point is simply that it is not possible to "unscramble the egg" and there is a need for a more systemic solution. This solution needs to deal with existing contracts and we urge EBSA to adopt the plan assets-based approach discussed above. [7]

We greatly appreciate your attention to these issues and look forward to working together on these issues.

Sincerely,

/s/ Elena C. Barone
Elena C. Barone
Associate Counsel – Pension Regulation

cc: Lisa Alexander
Elizabeth Goodman
Susan Rees

endnotes

[1] The Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). The Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds and their shareholders, directors and advisers. Members of the Institute manage total assets of $11.2 trillion and serve almost 90 million shareholders.

[2] See Revenue Procedure 2007-71, 2007-51 I.R.B. 1184.

[3] For convenience, this letter assumes that individual annuity contracts and individual custodial accounts do not reserve material rights for plan fiduciaries and, in contrast, that group contracts and accounts have retained rights. It is, however, not the form of the contract or account that is dispositive; it is the terms of the contract or account and, in fact, it is possible to issue individual certificates under a group contract that operate just like individual annuity contracts or to issue individual contracts that retain significant rights to the plan fiduciary.

[4] Treas. Reg. § 1.403(b)-8(d)(1).

[5] The mere fact that an employer would continue to have ministerial responsibilities under the contract, for example, certifying to an employee’s severance from employment, should not affect the plan asset question. These responsibilities are generally required under the final 403(b) regulations and, more generally, do not constitute ongoing employer involvement sufficient to undermine the characterization we suggest.

[6] It appears that the participant protection provisions of ERISA would continue to adhere to an individual contract that ceases to be a plan asset. In this regard, for example, regulations that interpret the spousal consent provisions of the Internal Revenue Code and ERISA state that spousal rights provisions, to the extent otherwise applicable, apply to payments from a distributed annuity contract. Treas. Reg. § 1.401(a)-20, Q&A-2. Similarly, the applicable anti-cutback regulations state that the prohibitions against reductions of accrued benefits apply to distributed annuity contracts. Treas. Reg. § 1.411(d)-4, Q&A-2(a)(3)(ii).

[7] It may be appropriate for EBSA to consider issuing guidance on the use of individual contracts and accounts to fund an ERISA plan.
