CAA/IPEBLA JOINT PENSIONS Conference
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1:45-2:45 p.m.

Plenary #3: Pension Regulation Key Issues
Moderator: Jeffrey D. Mamorsky (USA)

We all live in a "Global Pension World." We all share common challenges and concerns of great importance to us all in ensuring the security and continued viability of our pension systems. The glue that binds us all together is the need that our clients have for us to help them establish "best practice" pension governance standards. There have been horror stories all over the world. They started of course, in the U.S. with Enron, Worldcom and other scandals that led us to Sarbanes-Oxley ("SOX"), Dodd-Frank and the new emphasis on the establishment of internal control procedures on all material items in the financial report including pensions. And now recently we have been confronted with transparency issues such as hidden and bundled service provider expenses and self-dealing conflict of interests that sometimes exist with plan vendors.

All this happened in the U.S. despite the fact that our federal pension law, the Employee Retirement Income Security Act of 1974 ("ERISA"), contains rules that require plan sponsors to establish internal control procedures to monitor compliance with the fiduciary responsibility requirements of ERISA and tax law requirements of the Internal Revenue Code. These rules continue to be updated and strengthened by the Internal Revenue Service ("IRS") and Department of Labor ("DOL").

The IRS has established an Employee Plans Examination Program that imposes monetary sanctions on employer plan sponsors for failure to adopt "self-audit" control procedures that identify and correct compliance defects under the IRS' Employee Plans Compliance Resolution System ("EPCRS"). The DOL has also heightened its oversight of ERISA compliance with a Voluntary Fiduciary Correction Program ("VFC") and increased fiduciary and plan expense audits that can result in personal liability and the imposition of ERISA civil penalties.

I. IRS Employee Plans Examination Program

Under the IRS Employee Plans Closing Agreement Program ("CAP"), the IRS may impose monetary sanctions on employer plan sponsors for failure to operate retirement plans in accordance with IRS qualification requirements and for failure to follow the terms of the plan documents even if plan operation is within compliance with IRS qualification requirements. The IRS EPCRS Program requires employers to establish self-audit internal control procedures to qualify for self-correction and mitigate the amount of IRS monetary sanctions.

Sanctions may be imposed by the IRS on audit even if failures are unintentional discrepancies between plan operation and plan documents that result in no harm to plan participants. The amount of sanctions can be draconian since the maximum payment amount ("MPA") is the total amount of tax that would apply if the plan were disqualified. For example, the starting point for negotiations with the IRS on the amount of the sanction is often 20% of plan assets.

If an IRS auditor identifies any defects in the plan's operational compliance with the qualification requirements of the Internal Revenue Code ("Code"), the auditor will require retroactive correction of the defects and ask the employers as "responsible fiduciaries" to make a CAP monetary sanction non-deductible payment to the IRS, the amount of which is generally based on the total amount of tax that would be imposed on the contributing employers, trust and participants if the plan were disqualified. In many instances this can be a substantial amount (possibly millions of dollars). The IRS has already concluded over thousands of CAP audits and has imposed monetary sanctions as high as $26 million for failure to comply operationally with the Code's qualification requirements. Hundreds of additional cases are currently being negotiated with IRS under the CAP program.

There is also a new IRS audit initiative targeting "large" retirement plans with 2500 or more participants. This large retirement plan audit initiative is different in size, scope and intensity than previous audits of qualified plans. An IRS audit team typically consists of 6-8 professionals (including a revenue agent, benefits and computer audit specialists, benefits attorney and actuary). The typical large plan IRS audit exam is expected to last 200-300 staff days. Large 401(k), ESOPs and multiemployer union plans and other risk profilers are specifically targeted.

Also, there has been a change in focus of the IRS audit initiative. Under the new IRS

Employee Plans "focused audit" program, the IRS has modified their auditing procedures to focus on whether the employer plan sponsor has established internal controls to ensure that the plan is operationally compliant with the plan document and Code requirements. If the IRS auditor is satisfied that such internal controls are in place, the plan examination may be limited and/or curtailed.

II. DOL Enforcement Efforts

DOL closed 3,472 civil cases and obtained monetary results of nearly $1.39 billion in 2011. It also closed 302 criminal cases that resulted in 129 individuals being indicted and 75 cases being closed with guilty pleas and/or convictions. DOL is also increasing the number of its enforcement personnel from 913 to 1,003 in 2012. These DOL enforcement numbers indicate that there are very high levels of non-compliance with ERISA fiduciary duties. According to DOL, this is because many advisors are surprisingly still unaware that the DOL has jurisdiction over them and many plan sponsors are unaware of their responsibilities as ERISA fiduciaries.

III. DOL Voluntary Fiduciary Correction Program

The DOL VFC Program enables ERISA fiduciaries to identify and correct prohibited transactions and other ERISA violations before an audit by DOL. Such self-correction is important since ERISA Section 502(l) imposes a civil penalty of 20% of the amount recovered in the case of a breach of fiduciary responsibility including the requirement to administer the plan in accordance with the documents and instruments governing the plan and the requirements of ERISA.

IV. DOL Plan Expense Audit Initiative

The failure of plan service providers to disclose retirement plan expenses to plan participants is the responsibility of the employer plan sponsor. The DOL has established an aggressive plan expense audit initiative that imposes personal liability on employers and other plan fiduciaries for failure to monitor the reasonableness of plan expenses. The DOL has also undertaken an audit of plan auditors to make sure that there is an adequate review of internal control procedures.

V. DOL Initiatives on Undisclosed 401(k) Plan Expenses

Under "bundled" service arrangements, which are common with large 401(k) plans, it is extremely difficult to locate hidden revenue sharing fees and compensation. Often the bundled recordkeeper will receive payments (otherwise known as revenue sharing) from the plan's investments and employer plan sponsors are unaware of such hidden costs. The recordkeeper normally discloses only "hard dollars" received for administration, but often does not disclose to plan fiduciaries the "soft dollars" or hidden fee arrangements between their entity and the investment fund which holds the assets. Employer plan sponsors as Plan fiduciaries are required to probe those hidden costs to find out if revenue sharing is occurring and, if so, what those hard dollars are and what relationships might exist between the parties. It is not permissible or in the best interests of the plan participants if assets are being steered toward an investment manager purely because fees will be "kicked back" to the recordkeeper.

The DOL has issued final regulations (effective July 1, 2012) requiring disclosure of plan service provider direct and indirect compensation to qualify for the statutory exemption for services under ERISA Section 408(b)(2). Qualifying for this exemption is required as a condition for the service provider's contract or arrangement avoiding characterization as a prohibited transaction resulting in the imposition of excise taxes on the service provider and potential breach of fiduciary liability on the employer plan sponsor.

The "responsible plan fiduciary" prohibited transaction exemption depends upon the fact that the fiduciary did not know that the service provider failed to make the required disclosures and "reasonably believed" that such disclosures were made. Moreover, discovery of a disclosure failure requires notification of such failure by the responsible plan fiduciary to DOL. This puts the fiduciary in a "catch 22" because such disclosure failures often result in the discovery of "revenue sharing" between the service provider and sub-advisers which not only affects the fiduciary's determination of "reasonableness" of compensation but also highlights the fiduciary's failure to prudently monitor and avoid the payment of excessive compensation from investments in participant-directed accounts. Failure to monitor is a violation of the ERISA Section 404 prudence requirements and the DOL emphasizes in the final regulations that despite the responsible plan fiduciary prohibited transaction exemption determinations in this area (including termination and possibly other actions against the service provider) continue to be governed by the prudence provisions of ERISA Section 404.

The burden of requiring the responsible plan fiduciary to have "reasonably believed" that service providers disclosed the requisite information is of great concern. Availability of the exemption should not be determined based upon whether a responsible plan fiduciary can recognize disclosure omissions or errors. The exemption should be available if the fiduciary did not "know or have reason to know" that the covered service provider failed to make required disclosures. However, the DOL considered this position and decided that it "does not believe that responsible plan fiduciaries should be entitled to relief provided by the class exemption absent a reasonable belief that disclosures required to be provided to the covered plan are complete" and that in this regard "responsible plan fiduciaries should appropriately review the disclosures made by covered service providers." Moreover, the DOL emphasizes that: "Fiduciaries should be able to, at a minimum, compare the disclosures they receive from a covered service provider to the requirements of the regulation and form a reasonable belief that the required disclosures have been made."

This comparison of service provider disclosures to the detailed requirements of the DOL regulations and then having to "form a reasonable belief" that the appropriate disclosures have been made is a very high standard for plan fiduciaries to achieve and, it in effect, requires them to retain experts working under the direction of independent counsel to ascertain compliance with the regulations and identification of all "hidden" fees to maintain the confidentiality of lack of monitoring that may lead to DOL or participant litigation.

The DOL has also issued regulations requiring the reporting of almost all indirect compensation in Schedule C to the plan's Form 5500 Annual Financial Report. Some examples of indirect compensation are the following: finders' fees, soft dollar payments, placement fees, shareholder services fees, 12b-1 fees and float dollars. Schedule C places the onus on employer plan sponsors to actively inquire about those fee arrangements, and legally binds the plan's service providers to disclose such hidden fee arrangements because employers or their plan administrators complete the Schedule C under penalties of perjury.

VI. DOL Participant Fee Disclosure Rules

The DOL has published final regulations (effective 1/1/12 for calendar year plans) that require the plan sponsor to disclose certain fee and investment information to participants in ERISA covered participant-directed individual account plans such as 401(k) and 403(b) plans.

The new participant disclosure rules are intended to help ensure that all participants in participant-directed individual account plans have the information necessary to make informed decisions about plan participation and selection of investment choices for their accounts. The information required to be disclosed to participants falls into two broad categories: 1) plan-related information; and 2) investment-related information.

1) Plan-related Information

Plan sponsors must disclose the types of plan-related information described below.

- Investment Direction. Explanations must be provided regarding how participants and beneficiaries may give investment instructions, any limitations on such instructions under the plan, and plan provisions relating to the exercise of voting, tender, and similar rights. The plan's investment options must also be identified.

- Plan-Level Administrative Expenses Charged Against Participant Accounts. An explanation must be provided of plan-level administrative service expenses charged against participant accounts (e.g., annual per-participant fees) and how charges are allocated to participant accounts (e.g., per capita, pro rata).

- Individual Expenses Charged Against Participant Accounts. An explanation of fees that may be charged against participant accounts on an individual, rather than plan-wide basis (e.g., loan initiation fees, fees for use of brokerage windows, fees for investment advice programs) must be provided.

- Quarterly Disclosure of Amounts Deducted from Participant Accounts. At least quarterly, the plan sponsor must disclose the dollar amount of fees and expenses that are actually charged during the preceding quarter to the participant's account and must describe the services to which the charges relate (e.g., plan administrative services, individual transactions, such as loans, etc.).

2) Investment-related Information.

Certain types of performance and fee information on plan investment options must be disclosed in a comparative format to help participants make an apples-to-apples comparison across the menu. DOL has provided a safe harbor model chart for use in meeting this comparative format requirement, which can be viewed at www.dol.gov/ebsa/participantfeerulemodelchart.doc

VII. DOL Proposes New Definition of Fiduciary With Respect to Providing Investment Advice

The biggest area DOL is zeroing in on is fiduciary negligence. In this regard, DOL, after withdrawing a proposed regulation to expand the definition of a fiduciary investment adviser, has announced that they will re-propose the regulation in May of 2012. The proposal will be reintroduced with language providing what DOL said will be even stronger consumer protections. The proposal replaced an existing 37 year old five part test which is included in 1975 DOL regulations interpreting when offering advice resulted in fiduciary status. Under the current 1975 regulations, in order to be deemed a fiduciary as a result of providing investment advice, the advisor must:

1. Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property;

2. Provide the advice on a regular basis;

3. Provide the advice pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary;

4. The advice will serve as a primary basis for investment decisions with respect to plan assets; and

5. The advice will be individualized based on the particular needs of the plan.

In the preamble to the proposed regulations, the DOL emphasized that in the 37 years since the regulations were published there has been significant change in retirement plans, including defined contribution plans replacing defined benefit plans as the predominant form of retirement savings vehicles. They also noted that in order to be deemed a fiduciary under the 1975 regulations, an advisor must meet all five of the criteria outlined in the test, limiting the applicability of the original regulations.

DOL's October 2010 proposed fiduciary definition regulation incorporated elements of the old test but expanded upon who may be considered a fiduciary. Under the proposal, the types of activities related to providing advice that could result in fiduciary status include:

1. Provide advice or make recommendations pursuant to an agreement, arrangement or understanding, written or otherwise, with the plan, a plan fiduciary or a plan participant or beneficiary, where the advice may be considered in making investment or management decisions with respect to plan assets, and the advice will be individualized to the needs of the plan, a plan fiduciary or a participant or beneficiary. While this language is similar to the old test, under the proposal the advice no longer needs to be offered on a regular basis - offering advice on a single occasion could result in fiduciary status. Also, the advice no longer needs to be offered as part of a mutual understanding that the advice will serve as the primary basis for investment decisions - the advice could be part of several factors that the plan sponsor considers and still result in fiduciary status.

2. Acknowledgement of fiduciary status for purposes of providing advice. This provision is significant because under the old test, a party could acknowledge fiduciary status, and still fail to be held liable if they did not meet all five parts of the old test.

3. Is an investment advisor under Section 202(a)(11) of the Investment Advisors Act of 1940.

4. Providing advice, appraisals or fairness opinions as to the value of investments, recommendations as to buying, selling or holding assets, or recommendations as to the management of securities or other property. The DOL noted that part of the intent of this portion of the test is to establish fiduciary responsibility on parties who provide valuations of closely held employer securities and other hard to value plan assets.

DOL recently launched an expanded “regulatory impact analysis” to assess the impact of the DOL’s re-proposed fiduciary rule on ERISA plans. In re-proposing its new definition of fiduciary, DOL is conducting a more robust economic analysis and requesting a significant amount of information from industry groups on client accounts and trades within those accounts over the last decade. The DOL is also requesting information about current and former ERISA plan account holder’s economic attributes, financial literacy, length of time with their broker or adviser and various other points of personal information about account holders and their broker or adviser. DOL is using the data from these groups to determine the relationship between the quality of advice provided an individual investor, the specific fees being charged, and the performance of the account. This robust analysis is an example of DOL’s new increased enforcement efforts.