



# AMERICAN BENEFITS COUNCIL

## DEFINED CONTRIBUTION PLAN ISSUES IN PENSION REFORM LEGISLATION

The pending pension reform legislation contains critical reforms of the rules relating to defined benefit plan funding, hybrid plans, and defined contribution plans. This document focuses on a broad range of issues related to defined contribution plans and is intended to serve as a checklist with respect to those issues.

Our highest priority in the defined contribution plan arena is the provision that makes the retirement savings provisions of EGTRRA (including the Saver's Credit) permanent. Our views on that issue have been communicated previously; accordingly, this document does not address that provision.

**Automatic Enrollment** (section 903 of the House bill and section 1108 of the Senate bill): Support the House and Senate provisions, subject to the following modifications.

### 1. **Preemption.**

- a. The bills generally condition ERISA preemption on satisfaction of certain notice and investment requirements. ERISA preemption should apply without regard to whether a plan satisfies any requirements, which is how ERISA preemption applies in all other contexts.
- b. The ERISA preemption provision should apply not only to automatic enrollment arrangements, but also to plans that require employees to contribute to a plan as a condition of employment.
- c. State law should be preempted to the same extent with respect to non-ERISA 403(b) plans and non-electing church plans. Otherwise, such plans may not be able to maintain automatic enrollment arrangements (or condition of employment arrangements).

### 2. **Default investments.**

- a. The direction to DOL regarding default investments should reference a broad range of asset classes consistent with capital preservation, long-term capital appreciation, and/or a blend of both. Limiting the default investments to long-term capital appreciation or to capital preservation

would not be appropriate for many classes of participants and in many circumstances.

- b. The fiduciary protection for default investments should not be conditioned on satisfying the myriad of rules under section 404(c). Limiting the fiduciary protection in this way would significantly undermine the attractiveness of automatic enrollment arrangements.
- c. As under the Senate bill, the DOL should have a 6-month deadline for issuing the default investment guidance.
- d. The default investment rule should apply to non-ERISA 403(b) plans and non-electing church plans so that if the DOL default investments are used, participants are deemed to have exercised control over the assets for purposes of State fiduciary rules.

### **3. Corrective distributions.**

- a. Corrective distributions should be limited to the first three months of automatic contributions, but should not be limited to \$500. Greater amounts can easily be contributed inadvertently. And, as discussed below, the bill needs to permit the distributed amount to include earnings or losses on the contributions, which can easily cause the total amount to be over \$500.
- b. It should be clarified that corrective distributions are not treated as plan distributions for any purpose. Otherwise, issues will arise regarding, for example, rollover rules, section 415, basis recovery, etc. And, as under the Senate bill, it should be clarified that the distributions are taxable in the year of receipt.
- c. The corrective distribution rules should not be a required part of the nondiscrimination safe harbor (which they are under the Senate bill). Many employers will prefer to take extra steps to ensure that participants are aware of the automatic contributions, rather than set up the administrative system to provide corrective distributions.
- d. Participants should have at least three months to request a corrective distribution (rather than 60 days as under the Senate bill).
- e. As noted above, the bills should permit the distribution of up to the first three months of automatic contributions, adjusted by earnings or losses attributable to such contributions. The House bill currently would not permit the adjustment by earnings or losses, which would be unfair to the participant and burdensome for the plan.
- f. The corrective distribution mechanism should not be limited to plans using the DOL default investments (which it is under the Senate bill). If an employer decides to assume fiduciary responsibility for participant investments, the corrective distribution mechanism should not be rendered unavailable.

#### 4. Nondiscrimination safe harbor.

- a. As under the House bill, a separate reference to section 403(b) plans is not needed since any section 401(m) safe harbor automatically applies to section 403(b) plans. The Senate bill would inadvertently imply that the existing section 401(m) safe harbor is not applicable to section 403(b) plans under current law, which is not the case.
- b. There should not be a rule prohibiting automatic contributions above a specified level. The 10% limit in the House bill could well send a message that deferrals in excess of 10% are not appropriate, which is not the case. In addition, as under the Senate bill, the automatic increases should be permitted to coincide with pay increases.
- c. As under the House bill, the safe harbor should permit but not require the automatic contribution feature to apply to existing employees. Employers need to be able to make judgments about the employee relations effects of applying new rules to existing employees. (As a matter of fact, many employers are currently applying their automatic contribution features to existing employees, but other employers are making different decisions based on their workforce.) One example of the potential awkwardness of applying these rules to existing employees involves existing employees who have elected deferrals above the initially required 3% level, such as 4%. When the automatic increase level exceeds 4%, such employees will have their deferrals adjusted even though they affirmatively elected a specific deferral level.
- d. The definition of compensation used for purposes of this safe harbor (as well as the current 401(k)/401(m) safe harbor and defined benefit plan nondiscrimination safe harbor) needs to be made more flexible to accommodate the fact that most large plans base benefits on base pay. (A separate paper is available on this issue.)
- e. Under the safe harbor, the Senate bill requires employees to be eligible to participate on the first day of the first quarter following employment (unless excluded for a non-service related reason, such as job classification). This rule will prevent many companies from using the safe harbor. Traditionally, most employers required one year of service as a condition of plan eligibility. Many employers changed that rule to permit employees to make elective deferrals immediately, but many of the same employers preserved the one-year waiting period for eligibility for matching contributions. The above element of the Senate bill would force employers to make matching contributions available to new employees. Most employers will not incur this significant expense on behalf of employees who have not yet demonstrated that they will remain with the company beyond the very short-term.
- f. The matching contribution required under the Senate bill is very close to the matching contribution required under the current-law 401(k)/401(m)

safe harbor. This weakens the incentive to adopt the new automatic contribution safe harbor, since employers will incur significant additional matching costs under the automatic contribution arrangement (by reason of attaining a higher level of participation).

**Fiduciary Relief in Connection with Investment Option Changes** (section 308 of the House bill). Support the House provision. However, the following changes are needed with respect to this “mapping” provision:

1. The House provision generally requires that each option under the old menu be mapped to a comparable new option under the new menu. This requirement should be deleted. There are many situations where a type of investment is not being replaced. For example, the employer stock fund of an acquired company may be eliminated by the buyer, but the buyer may not maintain a comparable fund to replace it. Thus, there should not be a “comparability” requirement and there should not be a requirement that the replacement option be a “new” option. Plans should be permitted but not required to use default investments described in the DOL regulations (see discussion on pages 1-2 of this document) as their replacement option.
2. The House provision requires notice 60 days before an investment option change. This is earlier than the 30-day notice required under the blackout period rule. (In fact, blackout period notices are not permitted to be given more than 60 days in advance.) Since investment option changes often occur in conjunction with blackout periods, the 60-day rule in the House bill should be conformed to the 30-day rule applicable to blackout periods, so that a single notice can be provided. Also, the same exceptions (*e.g.*, regarding unforeseeability) to the 30-day rule that apply under the blackout period rules are needed here.
3. Under the House provision, in order to obtain the fiduciary protection for moving participants’ investments, one requirement is that the former investment must have been the product of the participant’s exercise of investment control. It should be clarified that for this purpose, former investments made under the default investment provision, under this mapping provision, or under the blackout provision are treated as the product of the participant’s exercise of investment control.

**Fiduciary Rules in Connection with Blackout Periods** (section 102 of H.R. 1000 and section 706 of the Senate bill): There is a need for a general “mapping” provision (like the House provision referenced above), rather than a mapping provision limited to blackout periods. This could be achieved by adopting the House mapping provision (with the recommended changes) or by making the blackout period rules applicable to any change in investment options.

**Diversification.** (section 104 of H.R. 1000 as it passed the House in 2003 and section 701 of the Senate bill):

1. Under the House bill, employees become eligible to diversify employer securities three years after the securities are allocated. This enables employers to require all matching contributions to remain invested in the company for a brief period. This will help convince companies to maintain higher levels of matching contributions.
2. There needs to be a broader securities law exception from the diversification rules. In order to be conservative and avoid potential violations, many companies impose restrictions on the sale of employer securities that are slightly broader than those technically required by the securities law. This should be permitted.
3. As under both bills, Treasury should be given authority to exempt private companies with public affiliates. However, Treasury should be given a deadline for issuance of such exemptions. Also, Treasury should be required to consult with DOL, but the regulatory authority should not be given jointly to Treasury and DOL (which is how H.R. 1000 is structured). Joint regulatory authority can result in extensive delays.
4. Under both bills, if a non-public company goes public, the diversification rules would suddenly apply in full, which could cause problems. A natural solution would be to apply the same phase-in (five years under H.R. 1000; three years under the Senate bill) that applies when a plan first becomes subject to these rules.
5. The House bill provides a five-year transition rule with respect to all existing amounts held in employer securities, which is needed. The Senate bill provides only a three-year transition rule, and that transition rule does not apply to certain employees or to amounts attributable to employee contributions or elective deferrals. The Senate's more limited transitional rule would be problematic.
6. Both bills would apply to individual account plans without regard to whether they provide for participant investment direction.
  - a. These provisions could be particularly problematic for multiemployer plans. Many multiemployer defined contribution plans do not permit participant investment direction, but provide instead for a trustee to manage the assets and each participant to benefit from a proportionate share of the trust assets. The investments of the trust often include shares of publicly traded stock - - which could include securities of one or more participating employers - - and it makes little sense to give participants the right to diversify in this context. An exception from the diversification rules is needed for multiemployer plans that do not provide for participant investment direction.
  - b. In the context of other plans that do not provide for participant investment direction, an exception is needed for indirect investment in employer securities that are held in diversified fund. For example, if a company in the S&P 500 holds an S&P 500 index fund in its plan, diversification rights should not be triggered.

**Notice of Right to Diversify** (section 702 of the Senate bill): The Senate bill rule requiring 30-day notice of the right to diversify does not include an exception under which a notice provided within a reasonable period after commencement of employment will be deemed to satisfy the rule. As a result, plans that permit immediate participation generally will not be able to comply with the rule.

**Investment Education Requirements** (section 801 of the Senate bill):

1. The Senate bill requires plan administrators to provide a notice regarding basic investment guidelines. The effective date of this provision should be coordinated with the development of the DOL model notice and the required Internet sites.
2. It would be very helpful if DOL Interpretive Bulletin 96-1, which provides guidelines regarding investment education, could be deemed to have the force of a regulation (subject to future DOL modifications), so that employers could rely on it. Currently, some employers have not adopted a 96-1 type program because 96-1 would not have the force of law in court.

**Benefit Statements** (section 101 of H.R. 1000 and section 703 of the Senate bill):

1. H.R. 1000 would require companies to provide updated vesting information on a quarterly basis, which could be burdensome. In contrast, the Senate bill would permit annual updating of vesting information.
2. It is not clear under the bills whether the periodic benefit statement requires merely a description of investment restrictions imposed by the plan, or also requires a description of restrictions imposed by the issuer of the investment. The latter restrictions are described at length in the prospectuses and other investment materials and could be difficult to incorporate into the benefit statement.
3. There appears to be a glitch in the quarterly statement requirement in the Senate bill to the extent that it requires a notice that investments that exceed 20% of the total fair market value of a participant's account, even if those investments are adequately diversified, *e.g.*, an investment of 50% of the total fair market value of an account in a balanced fund.
4. Both bills would require affirmative delivery of the benefit statements and related notices, and would not permit, for example, updating of company websites to substitute for certain required disclosures. Provision of any required notice or benefit statement should be permitted through a company website (with the appropriate security protections).
5. For small companies, the penalties for failure to provide the benefit statement under the bills seem excessive. Even for large companies, there should be a limit, such as \$500,000, for inadvertent violations.

**Investment Advice** (sections 601 and 602 of the House bill and section 802 of the Senate bill): With the continuing trend from defined benefit plans to participant-directed defined contribution plans, participants have a very acute need for investment advice. Unfortunately, under the current system, those experts who are most familiar with particular investments and can provide needed advice the most efficiently cannot share their expertise with participants. The House bill would extend the availability of investment advice to the greatest number of participants.

**Rollover of After-Tax Amounts** (section 1002 of the Senate bill): Support the Senate provision.

**Rollovers by Nonspouse Beneficiaries** (section 909 of the House bill and section 1005 of the Senate bill): Support the House and Senate provisions.

**Direct Rollovers from Retirement Plans to Roth IRAs** (section 1007 of the Senate bill):

1. Support the Senate provision.
2. An additional Roth IRA rollover issue needs to be addressed. Under current law, if an involuntary distribution exceeds \$1,000 and the participant does not make a direct rollover or cash distribution election, the distribution must be directly rolled over. The purpose of the \$1,000 requirement was to avoid forcing direct rollovers of small amounts. To effectuate that intent, it should be clarified that the \$1,000 rule applies separately to pre-tax amounts and Roth 401(k)/403(b) amounts; otherwise, the rules could force separate direct rollovers of less than \$1,000. For example, a participant with \$700 of pre-tax assets and \$400 of Roth 401(k) assets would currently have to have two under-\$1,000 rollovers made on his or her behalf, since pre-tax assets and Roth 401(k) assets have to be rolled over to separate arrangements.
3. Under the proposed Roth 401(k) regulations, hardship withdrawals would be treated as pro rata distributions of basis and income, even though the distribution is limited to the contributions themselves, which are all basis. It should be clarified that a hardship distribution of Roth 401(k) contributions is simply a return of basis.

**Expanded Notice and Consent Period** (section 206 of H.R. 1000 and section 1102 of the Senate bill): Support the House and Senate provisions.

**Transfer of Involuntary Distributions to the PBGC** (section 1011 of the Senate bill):

1. Support the Senate provision.
2. It should be clarified that any charges imposed by the PBGC for accepting a transferred account would be applied against the transferred account, not against the transferor plan's other accounts.

3. Current law provides a fiduciary safe harbor with respect to automatic rollovers to an IRA. A similar fiduciary safe harbor should apply with respect to transfers to the PBGC under this provision.
4. This provision should be expanded to permit transfers to the PBGC of accounts in excess of \$5,000 where the employee (a) has not elected a distribution, (b) has been notified in advance of the transfer and of his or her right to elect to retain the assets in the plan, and (c) has not made such an election. See section 503 of H.R. 1960.
5. A conforming change is needed to Code section 401(a)(34) clarifying that transfers under this provision will not cause a plan to fail to qualify under Code section 401.

**Direct Payment of Tax Refunds to IRAs** (section 907 of the House bill): Support the House provision.

**Saver's Credit** (section 902 of the House bill): The provisions permitting the Saver's Credit to be transferred directly to a plan or IRA needs a technical modification. The provision limits the transfer to an "overpayment under section 6401(b)". An overpayment under section 6401(b) equals the excess of any refundable tax credits over the tax otherwise due. Since the Saver's Credit is not refundable, this provision does not work correctly.

**Early Withdrawal Tax on Certain SIMPLE IRA Distributions** (section 1008 of the Senate bill): Support the Senate provision.

**SIMPLE IRA Portability** (section 1009 of the Senate bill): Support the Senate provision.

**Tribal Plans** (sections 1311 and 1313 of the Senate bill):

1. Support the Senate provisions.
2. Conforming changes are needed to other bill provisions, clarifying that tribal governments are to be treated in the same manner as State or local governments. See section 905 of the House bill and section 1004 of the Senate bill (relating to an exemption from the 10% early distribution tax for certain distributions to public safety officers); and section 1003 of the House bill (relating to distributions from government retirement plans for health and long-term care insurance for public safety officers).

**Qualified Retirement Planning Services** (section 107 of H.R. 1000 and section 803 of the Senate bill). Both provisions would be very helpful. The sunset provision in the Senate bill should be deleted so that this provision remains in effect indefinitely.

**Excess Contributions** (section 1339 of the Senate bill): Support the Senate provision, subject to one important change. The provision extends the period for distributing

excess contributions from 2½ months after the end of the year to 6 months after the year-end, but only for automatic contribution arrangements. The limitation to automatic contribution arrangements should be deleted. The problem is that the 2½ month period is too short and results in unnecessary errors and inaccuracies. This problem exists without regard to whether the plan contains an automatic contribution feature.

**Form 5500 Simplification** (section 202 of H.R. 1000 and section 1103 of the Senate bill): Support the House and Senate provisions.

**Safest Available Annuity** (section 309 of the House bill and section 1110 of the Senate bill): Support the House and Senate provisions, subject to clarification in the legislative history that the fiduciary standard applicable to the choice of an annuity provider is the generally applicable fiduciary standard rather than a heightened standard. The clarification should also state that the six factors listed in DOL Interpretive Bulletin 95-1 reflect the type of heightened standard that is not intended. (A separate paper is available on this issue).

**DB/k** (section 1336 of the Senate bill): Innovative plan designs should be encouraged so that employers have flexible rules that allow them to combine the best features of different types of plans including the combination of 401(k) plans and defined benefit pension plans, as under the Senate bill.

**QDRO reforms** (section 901 of the Senate bill): The Senate bill permits QDROs (1) to be issued after, or revise, another domestic relations order or QDRO, and (2) to be valid regardless of when issued. It should be clarified that such QDROs are to be applied prospectively.