PPA Series Webcast: Defined Contribution Plans

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September 26 & 28, 2006

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Investment Advice

- PPA establishes an exemption permitting an advisor (acting as a fiduciary) to provide participant-level advice to plan participants for an additional fee
  - Even if the advisor is affiliated in some fashion with the underlying investments made available under the plan
- The term “advisor” is broadly defined for these purposes (banks, insurance companies, registered broker-dealer, their affiliates, etc.)

Investment Advice

- Advice must be provided pursuant to an "eligible investment advice arrangement"
  - Plan sponsors/fiduciaries who make an eligible investment advice arrangement available are eligible for some measure of relief from liability for offering the arrangement
  - Exemption does not extend to "plan-level" advice

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Investment Advice – Prior Law

- Provision of investment advice for a fee is a fiduciary act that is subject to ERISA
- ERISA's self-dealing, prohibited transaction provisions generally would prohibit an arrangement pursuant to which an advisor provided investment advice for a fee if the advisor (or an affiliate thereof) would receive additional fees as a result
- DOL issued regulatory relief indicating:
  - Fee-offset arrangements that eliminate financial incentives would not run afoul of ERISA
  - An advisor could provide advice through an independently developed computer model that provides investment recommendations (the *SunAmerica* ruling)

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Investment Advice – Prior Law

- Even if an investment advice arrangement fits within one of these regulatory exceptions, a plan fiduciary still has fiduciary responsibility for prudent selection and monitoring of advisors
- Technical explanation of PPA indicates that new investment advice provisions are not intended to displace existing guidance

Eligible Investment Advice Arrangements

- There are two recognized eligible investment advice arrangements:
  - Fee neutral arrangement
  - Computer model arrangement
- Fee-neutral eligible investment advice arrangement:
  - Advisor’s fee is not affected by the actual investment allocation
  - On its face, somewhat similar to existing fee-offset arrangements
  - Not clear at this point how the fee-neutral approach will be interpreted by the DOL - to apply only to direct compensation received by the advisor providing the advice or does it also extend to the indirect compensation received by the advisor’s affiliates

Eligible Investment Advice Arrangements

- Computer model eligible investment advice arrangement must:
  - Apply generally accepted investment theories that take into account the historic returns of different asset classes
  - Use relevant information about the participant or beneficiary, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income and preference
  - Use prescribed objective criteria to provide asset allocation portfolios comprised of investment options offered under the plan
  - Operate in a manner that is not biased in favor of investments offered by the adviser or a related person
  - Take into account all investment options under the plan in specifying how a participant's or beneficiary's account should be invested (without inappropriate weighting of any investment option)

Eligible Investment Advice Arrangements

- An "eligible investment expert" must certify (in accordance with rules prescribed by the DOL) that the computer model meets the five requirements
- If the computer model approach is chosen, then the only advice permitted is the advice generated by the computer model
  - A transaction must occur solely at the direction of the participant or beneficiary
  - The participant or beneficiary may seek investment advice that is outside of the computer model, but only if advice was not solicited
- Computer model approach does not yet apply to IRAs and other individual account arrangements (pending DOL study)

Eligible Investment Advice Arrangement

- In addition to the specific requirements for the computer model and fee-neutral exemptions, there are also general requirements that apply to the use of both exemptions:
  - Use of an exemption must be authorized by an independent plan fiduciary
  - Independent expert must audit the arrangement (at least annually) and confirm that it fits within one of the statutory exemptions
  - Detailed disclosure requirements must be satisfied both before the advice is first provided and at least annually thereafter
  - Other general requirements (compliance with applicable securities disclosure laws, compensation received by advisor must be reasonable and transaction must be arm's length)

Eligible Investment Advice Arrangements

- A plan sponsor or other fiduciary that makes an eligible investment advice arrangement available under a plan (assuming it satisfies all of the applicable requirements) will not be treated as failing to satisfy ERISA's fiduciary requirements by offering such an arrangement
- The plan sponsor or other fiduciary is still responsible for the prudent selection and monitoring of the advisor, but there is no duty to monitor the specific investment advice given by the investment advisor
- New provisions apply to advice provided after December 31, 2006

Fiduciary Safe Harbors

- PPA establishes new fiduciary safe harbors for “mapping” and “blackout” scenarios
- Under prior law, even if a plan sponsor or fiduciary satisfied ERISA’s “404(c)” participant-directed investment requirements, the plan sponsor or fiduciary would not have any fiduciary protection during mapping and blackout scenarios
- Mapping safe-harbor - plan sponsors or fiduciaries will continue to have 404(c) protection if:
  – Between 30 and 60 days before the change, participants are notified of the impending change, given information about the existing and new investment options, and are given a description of the investment mapping process

Fiduciary Safe Harbors

  - No contrary investment instructions from the participant
  - A participant's account is reallocated among remaining or new investment options that have reasonably similar investment characteristics (not clear what to do if there are no reasonably similar investment options)

- Blackout safe-harbor provides that a fiduciary will not have any liability for losses during a blackout as long as the blackout notice requirements have been satisfied
- Effective for plan years beginning after 2007 and subject to DOL regulations that are to be issued

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Fiduciary Relief for Default Investments

- ERISA 404(c) for default investments
  - Currently provides fiduciary relief in the case of a defined contribution plan that permits participants to exercise control over the investment of amounts credited to their plan accounts
    - Must have at least three different investment options each of which is diversified and has materially different risk and return characteristics
    - Must be able to change investments at least once every three months
    - Must be provided with detailed information regarding investments
    - Special rules for employer stock

Fiduciary Relief for Default Investments

- PPA expands ERISA 404(c) fiduciary relief for investment in a default investment fund
  - Effective for plan years beginning after December 31, 2006
  - Applies only to plans that meet ERISA 404(c) requirements
- Notice requirement
  - Within a reasonable period before first automatic investment in default fund and before each plan year
  - Of rights and obligations under the plan
  - Including the right to elect control over plan assets in the participant’s account
- DOL to issue regulations within 6 months (mid-February 2007)
  - Asset classes expected to be consistent with long-term capital appreciation, capital preservation or both
    - Likely to use lifecycle funds as default investment

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401(k) Plan
Automatic Enrollment

- Encourages 401(k) participation through automatic enrollment in two separate ways
  – Clarification of rules applicable to current automatic enrollment arrangements
  – New automatic enrollment safe harbor for nondiscrimination testing
    - Different rules apply to each

401(k) Plan
Automatic Enrollment

- Automatic enrollment arrangements
  – Compensation reductions occur unless participant elects otherwise
    - Reductions at a set uniform percentage of compensation
    - Participants must be given the opportunity to change the percentage election at any time
    - Reasonable notice must be given prior to first automatic reduction and prior to the beginning of each year

401(k) Plan
Automatic Enrollment

- Notice must explain:
  - Employees right to opt out or have a different deferral percentage applied
  - Process for opt-out/change of deferral percentage
  - Default investment

– PPA clarifies that ERISA preempts any state wage withholding laws

- Effective date August 17, 2006

401(k) Plan
Automatic Enrollment

- Automatic enrollment
  - May be used only for new hires or for all employees
  - May be used with Roth contributions
  - May be structured to increase the deferral percentage automatically

401(k) Plan
Automatic Enrollment

- Unwind of automatic enrollment
  - Within 90 days after first automatic deferral
- Must apply to all deferrals (plus earnings)
- Any matching contributions will be forfeited
- Refunded deferrals:
  - Not counted for ADP testing
  - Exempt from 401(k) distribution restrictions and early withdrawal penalties
  - Taxable in year of distribution

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Qualified Automatic Contribution Arrangement

- New nondiscrimination safe harbor
  - Effective for plan years beginning after December 31, 2007
  - Qualified automatic contribution arrangements exempt form ADP deferral testing and ACP match testing
  - Must provide all NHCEs with either
    - Match of 100% of first 1%, plus 50 % of next 5% (3.5% total) or
    - 3% non-elective contribution

Qualified Automatic Contribution Arrangement

- Qualifying contributions must
  - Be fully vested after 2 years
  - Comply with 401(k) withdrawal restrictions
- Coverage
  - Must cover all eligible employees except current employees who previously made elections to participate or opted out

Qualified Automatic Contribution Arrangement

– Deferral Rates
  - Not more than 10%
  - Not less than 3%
    – Must be at least 3% for the first year a qualified automatic contribution is made for an employee
      » Must increase 1% annually until 6% deferral rate is achieved for the 4th year
    – Consider using 6% as default deferral rate to avoid administrative burden of annual increases

Notice Requirement

- Reasonable notice period must be provided
  - Allow participants to make alternate decisions before first deferral
  - Provide information about how investment elections may be made and the default investment in the absence of investment elections

EGTRRA Permanence

- Age 50 catch-up contributions
- Roth 401(k) contributions
  - May increase interest in Roth 401(k) arrangements
- Increased contribution limits
  - Compensation limits
  - Deferral Limits
  - Benefit/Contribution limits
- Hardship distributions
- Elimination of 401(k) same desk rule
- Expanded rollover rules
- Automatic rollovers for mandatory cash-outs
- ESOP dividend deduction

Excess Contributions

- No 10% excise tax on corrective distributions if made within applicable correction period
  - 2-1/2 months after close of the plan year
  - 6 months after close the of plan year, in the case of an automatic enrollment arrangement
- Any corrective distributions distributed within correction period are treated as received and taxable in the year of distribution
- Corrective distributions do not have to include gap period income if distributed within applicable correction period
- Effective for plan years beginning after December 31, 2007

Synchronized Vesting Provisions

- Plans (other than leveraged ESOPs) must vest all employer non-elective contributions according to schedule that currently applies to employer matching contributions
  - If plan uses cliff vesting, then accrued benefits derived from all employer contributions must vest after 3 years of service
  - If plan uses graduated vesting, then accrued benefits derived from all employer contributions must vest at the rate of 20% per year, beginning with the second year of service

Synchronized Vesting Provisions

- Effective for contributions made in plan years after December 31, 2006 for employees with at least 1 hour of service after such effective date
  - Effective for contributions to leveraged ESOPs after loan is repaid

	Matching Contributions	Non-Elective Contributions
Before New Law	Up to: 3-year cliff; or 6-year graded	Up to: 5-year cliff; or 7-year graded
After New Law	Up to: 3-year cliff; or 6-year graded	Up to: 3-year cliff; or 6-year graded

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Portability of Retirement Benefits – Rollover by Non-Spouse Beneficiaries

- Non-spouse beneficiary may roll over distributions from a tax-favored retirement plan tax-free into an IRA via a direct trustee-to-trustee transfer
  - Transfer is treated as an eligible rollover distribution
  - Transferee IRA treated as an inherited account
    - Non-spouse beneficiary is not owner of rolled over assets
    - No further rollover of assets
  - Apply required minimum distribution rules; special rules for surviving spouse beneficiaries do not apply
- Effective for distributions after December 31, 2006

Portability of Retirement Benefits – Direct Rollovers to ROTH IRAs

- Tax-favored retirement plan distributions can be rolled over directly to ROTH IRAs
  - Amount rolled over is includible in gross income
  - 10% tax on early distributions not applicable
- Before January 1, 2010, the $100,000 AGI limit and filing status requirement will apply (i.e., married taxpayers filing separate returns and taxpayers with AGI over $100,000 cannot roll over amounts to ROTH IRAs)
- On and after January 1, 2010, no $100,000 AGI limit or filing status requirement
- Effective for distributions after December 31, 2007

Portability of Retirement Benefits – Rollovers of After-Tax Contributions

- After-tax contributions can be rolled over not only to a defined contribution plan or an IRA, but also to a defined benefit plan or a 403(b) tax-sheltered annuity
  - Must be accomplished by a direct trustee-to-trustee transfer
  - Transferee plan must separately account for after-tax contributions and earnings thereon
- Effective for distributions after December 31, 2006

Employer Stock Diversification and Notice

- Plans must permit employees to diversify out of publicly-traded employer securities
  - Not applicable to "pure" ESOPs or one-participant plans
  - Any employee may direct plan to diversify out of employer securities in which a portion of employee contributions and elective deferrals are invested
  - An employee with at least 3 years of service may direct plan and diversify out of employer securities in which a portion of employer matching and non-elective contributions are invested
  - Plan must provide at least 3 alternative investment options other than employer securities
    - Each option must be diversified
    - Each option must have materially different risk and return characteristics

Employer Stock Diversification and Notice

- Effective for plan years beginning after December 31, 2006
  - 3-year phase-in transition period for diversifying employer contributions invested in employer securities prior to January 1, 2007
    - 33% in first plan year;
    - 66% in the second plan year; and
    - 100% in the third and following plan years

Employer Stock Diversification and Notice

- Plan must provide notice to employees who have a right to diversify out of employer securities
  - At least 30 days before employee has right to diversify
  - Set out right to diversify out of employer securities and describe importance of diversifying account assets in investments
  - Treasury is required to issue a model notice
- Penalty of up to $100 a day from date of noncompliance for each individual or beneficiary who did not receive notice
- Effective for plan years beginning after December 31, 2006

Periodic Benefit Statements

- Plan must furnish periodic benefit statements
  - At least once each calendar quarter to participants who have right to direct investment of assets in their accounts
  - At least once each calendar year to participants who do not have right to direct investment of the assets in their accounts
  - Upon written request to plan beneficiaries not described above
- Benefit statement must include the following information, based on the latest information available:
  - Total benefits accrued and nonforfeitable benefits, if any, that have accrued or the earliest date on which the benefits will become nonforfeitable
  - Explanation of any permitted disparity or any floor-offset arrangement that may be applied in determining any accrued benefits

Periodic Benefit Statements

- Value of each investment to which account assets have been allocated, determined as of most recent valuation date
- Additional information for quarterly statements to participants with right to direct investment of account assets
  - Explanation of limitations or restrictions on right to direct investments
  - Explanation regarding importance of a well-balance and diversified investment portfolio
  - Statement of risk with respect to holding more than 20% of a portfolio in securities of one entity

- DOL is required to issue one or more model benefit statements
- Effective for plan years beginning after December 31, 2006

Other Provisions

- Treasury is required to expand definition of hardship to include hardship of a non-spouse or non-dependent beneficiary
  - No later than 180 days after August 17, 2006
- DOL is required to clarify status of certain domestic relations orders
  - Domestic relations order that otherwise qualifies as a QDRO will not fail to be treated as a QDRO solely because of the time it is issued or because it is issued after or revises another domestic relations order or QDRO
  - No later than one year after August 17, 2006

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