LEGISLATIVE AND REGULATORY UPDATE

PREPARED BY

PATRICK S. McELHONE, JD
PRINCIPAL
MERCER (US) INC.
700 AEGON CENTER
LOUISVILLE, KENTUCKY 40202

LOUISVILLE EMPLOYEE BENEFITS COUNCIL
LOUISVILLE, KENTUCKY
April 9, 2013

New guidance explains MAP-21 disclosures for pension plans' annual funding notices: New Labor Department guidance addresses the MAP-21 disclosures that many pension plans must include in their annual funding notices (AFNs), due by April 30, 2013, for calendar-year plans. **Field Assistance Bulletin 2013-1 (FAB 2013-01)** answers many outstanding questions and provides a model supplement that may be attached to the AFN. This article briefly summarizes FAB 2013-01.

Certain calculations clarified. The FAB clarifies several calculations required for the new disclosures, most importantly:

- Plan sponsors needn't calculate a separate actuarial asset value without regard to MAP-21 solely for the AFN. But if a sponsor is required to determine such an asset value (such as for a PBGC 4010 filing), then that asset value must be reflected in certain AFN calculations.
- The disclosure of certain items (funded percentages, funding targets, and minimum required contributions) without regard to MAP-21 needn't reflect hypothetical shortfall amortizations, credit balance elections, or contributions for prior years. This will substantially reduce the amount of effort required to prepare the additional disclosures.
- Plans that aren't at-risk don't need to do any at-risk calculations, even if they would be at-risk without regard to MAP-21.

Delayed PPA effective dates. Plans subject to delayed PPA effective dates need not provide MAP-21 disclosures, even though these plans have to use the MAP-21 third segment rate for current liability. But the bulletin cautions that these plans must still provide the AFN itself.

Exceptions. Plans that don't need to provide MAP-21 disclosures for 2012 — such as plans that meet the three-part exemption test or don't reflect MAP-21 rates — may still need to provide the new disclosures in future years. But these plans won't have to calculate hypothetical amounts for prior years when the new disclosures did not apply.

Model supplement. The model supplement includes all the required calculated items and additional explanatory text. Plan sponsors are not required to use the model, but use of the model supplement and the model notice will satisfy the AFN requirements in ERISA Section 101(f). Plan sponsors that issued their 2012 AFN prior to the release of the model supplement on March 8 will be deemed to comply if they met a reasonable, good faith interpretation of the statute.

New FAQ exempts insured expatriate plans from ACA mandates to 2015:
Certain expatriate health plans are largely exempt from the Affordable Care Act (ACA) through the close of the plan year ending in 2015, regulators say in a new FAQ. This relief applies to insured plans covering only employees residing outside their home countries for at least half of a plan year and dependents. These plans may delay complying with ACA's first-dollar preventive care, adult child coverage, ban on dollar limits for essential health benefits, and similar requirements. Such plans must still observe other Code or ERISA mandates, including HIPAA portability and mental health parity. **Full text of ACA FAQ on expatriate health plans (8 Mar 2013)**

Court confirms Section 409A applies to stock options, if discounted: Discounted stock options may be subject to Code Section 409A penalty taxes, the US Court of Federal Claims has ruled ***(Sutardja v. US (Fed. Cl. Feb. 27, 2013))***. The lawsuit now heads to trial to determine whether the options were, in fact, granted at a discount.

409A and stock options. ***IRS Notice 2005-1*** and subsequent regulations exempt nonqualified options from 409A if the exercise price equals or exceeds the fair market value of the underlying stock on the grant date and certain other conditions are met. Discounted options must either (i) comply with 409A's requirements relating to deferrals, acceleration, and payment; or (ii) qualify as a short-term deferral. If an option subject to 409A is noncompliant, the employee must include the "spread" in income (when vested) and pay a 20% penalty and interest.

ISS assesses hefty penalties. In this case, a senior executive sought a refund of 409A penalty taxes and interest paid on company stock options exercised in January 2006. Originally granted with an exercise price equal to the stock price in December 2003, the options were re-priced after May 2006 when the board reviewed its grant practices for possible backdating issues. The taxpayer paid the higher exercise price after the board determined that the proper measurement date was Jan. 16, 2004 (when the options were ratified). In 2010, the IRS asserted that the options were granted at a discount and assessed millions of dollars in 409A penalty taxes.

Court upholds IRS guidance. The taxpayer had argued the options — whether discounted at grant or not — weren't deferred compensation subject to 409A. The court hasn't yet decided whether the options were discounted; that question will be resolved later at trial. But the court agreed with the IRS's view that, if the options were discounted, they would fall within the purview of 409A.

The court disagreed with the taxpayer's claim that he had no legally binding right to the shares until the exercise date, so no compensation was deferred. (Interestingly, the decision suggests the legally binding right arose at vesting, not at grant as most practitioners believe. But in any event, penalties wouldn't apply before vesting.) The court also rejected the taxpayer's arguments that (i) options can't be taxed before exercise under a 1945 US Supreme Court case; (ii) the 409A definition of deferred compensation should match the FICA tax definition, which excludes option grants; and (iii) the award should qualify for the short-term deferral exemption because the taxpayer exercised his options within the short-term deferral period.

New ACA rules resolve uncertainties about affordability of family coverage: Recent Affordable Care Act guidance clarifies how affordable employer health coverage will affect an employee's family members' eligibility for public exchange subsidies and liability for individual mandate penalties. While focused on individuals, the new IRS rules resolve some affordability issues that may influence benefit planning for 2014 and later. In particular, how employers design and price spouse and dependent coverage could affect whether an employee's family members can receive subsidized exchange coverage and what penalty they may face for going without suitable coverage. **Full text of final IRS regulations on affordable employer coverage for family members and eligibility for exchange subsidies (Federal Register, 1 Feb 2013); Full text of proposed IRS regulations on affordable employer coverage for family members and individual mandate penalties (Federal Register, 1 Feb 2013)**

ACA's out-of-pocket maximums to apply to all nongrandfathered health plans: With the Affordable Care Act (ACA)'s annual cost-sharing limits on essential health benefits taking effect in 2014, employers with nongrandfathered group health plans need to begin planning how to comply. Unlike the ACA's limits on annual deductibles, the caps on out-of-pocket expenses will apply to all sizes of nongrandfathered plans, whether insured or self-insured. Employers need to understand which expenses will count toward the caps, what relief will apply in 2014 for plans with multiple limits for benefits administered by different vendors, and what steps they can take to prepare. **Full text of final HHS rule on EHBs, actuarial value, and accreditation (Federal Register, 25 Feb 2013); Full text of interagency ACA FAQs, set 12 (DOL, 20 Feb 2013)**

401(k) fiduciaries liable for failure to investigate retail funds, 9th Circuit rules: Offering retail funds in a 401(k) investment lineup doesn't necessarily violate fiduciary duties, but fiduciaries are accountable for failing to investigate the merits of three specific funds, the 9th US Circuit Court of Appeals has ruled ***(Tibble v. Edison Int'l (9th Cir. March 21, 2013))***. The court also endorsed the Labor Department's view that ERISA Section 404(c) doesn't protect a fiduciary from claims it imprudently selected investments. However, the fiduciaries in this case prevailed on several other investment-related claims, including the plan's involvement in revenue-sharing practices and administration of a unitized company stock fund. The ruling highlights certain governance processes and plan details that worked for and against plan fiduciaries.

Fee dispute focuses on retail funds

The litigation involved a 401(k) plan with $3.8 billion in assets and roughly 20,000 participants. In response to a study and union negotiations, the plan's investment menu was expanded in 1999 from six choices to more than 50 — including 10 institutional or comingled pools, 40 retail-class mutual funds, and a unitized company stock fund. Some of the mutual fund arrangements involved revenue sharing, meaning fees paid from fund assets were disbursed to the plan service provider, which in turn gave the plan sponsor a discount for recordkeeping and other services.

Participants claimed the fiduciaries acted imprudently by offering retail funds, a short-term investment fund, and the unitized stock fund. The claim also alleged that revenue sharing violated the plan document and ERISA. The trial court found fiduciaries generally had appropriate processes for selecting and monitoring the plan's investment lineup but dropped the ball when selecting three particular retail funds, resulting in a $370,000 damage award.

The 9th Circuit has now affirmed that ruling, offering these key lessons for plan fiduciaries:

- Retail funds offer some advantages that could suit a 401(k) lineup, but fiduciaries must investigate each fund's merits and cannot blindly rely on investment advisers.

- Fiduciaries can't count on ERISA Section 404(c) to protect them if a participant claims they imprudently selected investment options, but fiduciaries are still likely to prevail as long as they use a prudent decision-making process to select and monitor investments.

- In plans offering a unitized company stock fund, fiduciaries should be proactive in managing the cash buffer as conditions change.

- Language in the plan document and summary plan description (SPD) may factor into a court's determination of whether revenue sharing violates ERISA.

The decision is binding in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington.

Retail funds require investigation

No outright ban on retail funds. Rejecting participants' claim that including any retail funds in a plan's investment menu is imprudent, the 9th Circuit said, "There are simply too many relevant considerations for a fiduciary, for that type of bright-line approach to prudence to be tenable." The court highlighted several potential benefits of "brand name" funds:

- Performance is generally easy to track via newspapers or the web.

- Mutual funds are subject to reporting, governance, and transparency requirements, but commingled pools are not.

- Unlike commingled pools or separate accounts, retail funds offer a mark-to-market benchmark for evaluating performance and fees.

The court said the retail funds' expense ratios — ranging from 0.03 to 2.00% — were not "out of the ordinary enough to make the funds imprudent," given that participants could choose from roughly 40 mutual funds.

The court cautioned that fiduciaries could face liability under different facts — for example, where revenue sharing drove up a fund's 12b-1 marketing fee (and expense ratio), or where evidence showed that the financial benefit of revenue sharing influenced fiduciaries' selection of funds. Some high-profile settlements in other jurisdictions have required fiduciaries to remove retail funds from 401(k) plan lineups, but at least two other appellate courts have ruled in fiduciaries' favor on the retail fund issue.

Fiduciaries still must investigate. Despite the 9th Circuit's seeming embrace of retail funds in concept, plan fiduciaries were found to have acted imprudently in offering three specific retail funds. "Unchallenged findings" showed that all three funds offered institutional options 24–40 basis points cheaper, with "no salient differences" in investment quality or management. The court was unswayed by fiduciaries' contention that they reasonably relied on monthly, quarterly, and annual reports from an investment consultant. The court emphasized that

fiduciaries cannot "reflexively and uncritically adopt investment recommendations," just as they cannot blindly rely on counsel or credit-rating agencies. Under the 9th Circuit's standard, fiduciaries needn't duplicate an expert's analysis, but they must engage in a prudent process in considering share classes. In this case, an experienced investor would have reviewed all available share classes and relative costs, the court said.

Prudent process is paramount

Though participants prevailed on the three specific retail fund claims, their other investment challenges were unsuccessful. The difference in outcomes is explained by one key factor: evidence of a prudent decision-making process.

Short-term investment fund. The fiduciaries did *not* breach their duty of prudence by investing in the plan's short-term investment fund (akin to a money market fund) rather than a stable value fund, the 9th Circuit concluded. The court cited uncontroverted evidence that fiduciaries considered the pros and cons of a stable value alternative.

Company stock fund. Another challenge involved fiduciaries' decision to offer a company stock fund in which participants own units of the fund — a design the 9th Circuit called "an industry standard" among large 401(k)s — instead of actual shares of stock. Because a portion of the fund was held in cash, a 77% gain in stock price yielded plan investors only a 67% return. The court acknowledged the advantages of a cash buffer in terms of increasing liquidity and hedging against declining stock values. However, the court also emphasized fiduciaries' duty to minimize investment drag (from lower returns in a rising market) and transactional drag (from disproportionate allocation of commissions and fees). In this case, the 9th Circuit found that the decision to unitize was "objectively reasonable as well as informed" and fiduciaries periodically monitored the cash buffer as conditions changed.

Offering range of funds is not a fiduciary free pass

Beyond the appropriateness of retail or unitized funds, appellate courts have considered whether offering a wide range of funds within the structure of ERISA Section 404(c) shields fiduciaries from liability for excessive fees or other investment-related losses. After reviewing other appellate decisions and the Department of Labor (DOL)'s position, the 9th Circuit concluded that selecting funds for a plan's investment menu is outside a participant's control. Compared with participants, a fiduciary is better situated to prevent losses that could result from having unsound options in a plan's lineup, the court reasoned. As a result, the court held 404(c) doesn't shield a fiduciary from claims it imprudently selected investments.

With this decision, the 9th Circuit is now on record that a plan lineup offering more than 50 options will not immunize fiduciaries from the duty to screen investments. Several other courts, including the 4th, 6th, and 7th Circuits, have similarly concluded that selecting and monitoring 401(k) investment alternatives are fiduciary functions that fall outside ERISA Section 404(c) protections.

These rulings bolster DOL's stance that fiduciaries are responsible for prudently choosing and monitoring a plan's service providers and investment alternatives. This position now appears in the participant fee disclosure and 404(c) regulations.

Revenue sharing does not violate ERISA

The 9th Circuit looked at ERISA's prohibited transaction provisions and the plan document to conclude the revenue-sharing arrangements did not breach fiduciary duties. First, the court cited DOL's long-standing interpretation that revenue-sharing payments fall outside the reach of prohibited transaction rules if certain conditions are met. Next, the court rejected participants' claim that plan terms obligated the company to pay expenses before any revenue-sharing offsets. Although the plan document provided that the company would pay administrative costs, the court concluded that "costs" are simply whatever bills the recordkeeper presents. So the company had an affirmative obligation to pay any recordkeeping costs, but nothing in the plan prohibited a third party from first paying those charges.

It's worth noting a later plan revision provided that "[t]he cost of administration of the Plan, net of any adjustments by service providers, will be paid by the Company." The court pointed out that both parties agreed that revenue-sharing offsets after the plan amendment date were perfectly appropriate — suggesting a drafting tip for other employers to consider.

Besides the plan document, other communications may have helped the employer prevail on the revenue-sharing claims. Participants were informed on at least 17 occasions that mutual funds were being used to reduce administrative costs. For example, SPD language spelled out how fees were used to reduce the company's costs.

The 9th Circuit's position on revenue sharing adds to the mixed bag of federal court decisions since the early days of fee litigation. Even courts that consider revenue sharing an acceptable practice may question whether fiduciaries acted prudently in negotiating the arrangements. As noted above, the 9th Circuit observed that fiduciaries should consider revenue sharing's impact on 12b-1 fees and avoid selecting funds because of the financial benefit of revenue sharing.

Clock starts ticking when funds are chosen

A considerable part of the 9th Circuit's decision focused on legal process and judicial review standards. One issue with implications for plan fiduciaries facing fee lawsuits is the question of how long participants have to file a lawsuit.

The 9th Circuit concluded that claims of imprudence in selecting the plan's investment menu are subject to ERISA's six-year statute of limitations, which starts when the investment is first designated for inclusion. The court rejected the "continuing violation" theory, under which claims are considered timely as long as the underlying investments remain in the plan. However, if plaintiffs can prove that changed circumstances warranted a full due-diligence review of the funds, that could qualify as a new breach that starts a new limitations period.

IRS issues final report on 401(k) questionnaire, outlines next steps: A final report on the IRS 401(k) "compliance check" questionnaires details the prevalence of different design features and the agency's plans to enhance compliance tools, improve voluntary correction programs, and refine enforcement activities. The report expands on interim findings published last year by highlighting differences based on plan size and presenting details about automatic contribution arrangements. Plan sponsors may find the prevalence data of interest, but the report offers few insights into best practices or reasons for defects or noncompliance.

Focus on plan design and operation. Sent to a random sample of 1,200 sponsors as part of an Employee Plans Compliance Unit initiative, the questionnaire requested data for the 2006–2008 plan years. The survey was designed to help the IRS measure the "health" of 401(k) plans in terms of compliance and risk practices.

The final report presents data across a broad spectrum of plan features: eligibility and participation, contributions and deferrals, nondiscrimination testing, distributions and loans, safe harbor plans, company stock, automatic contribution arrangements, and Roth contributions. The report also outlines the extent to which employers corrected errors and used IRS-developed compliance tools.

What's next? After reviewing the data to gain a better understanding of how 401(k) plans operate, IRS officials plan to optimize education, self-correction, and enforcement programs. Feedback from the survey will influence future revisions to voluntary correction programs and the development of web-based education products, including an updated questionnaire that plan sponsors can use as a self-audit tool. The IRS is also developing a new risk-based model to select 401(k) plans for audit. **Full text of final report on 401(k) compliance check questionnaire (IRS, 29 Mar 2013)**

PBGC reproposes rules on pension plans' reportable-event obligations: A new set of **proposed PBGC regulations** (which can be found at: **http://federalregister.gov/a/2013-07664**) would align reportable-event rules for defined benefit pension plans with changes made by the Pension Protection Act. PBGC's initial attempt to do so in 2009 drew heavy fire that focused on data-gathering burdens and the credit-market implications of eliminating certain reporting waivers. Those objections ultimately led to this new proposal, which takes a more targeted, risk-based approach. PBGC expects the proposal to exempt or waive more than 90% of plans and sponsors from many reporting requirements. Below are some highlights.

Waivers for financially sound companies or plans. Post-event reporting for five events — reduction in active participants, distribution to a substantial owner, change in the controlled group, extraordinary dividend, and transfer of benefit liabilities — would be waived if the company or plan was "financially sound." A company is financially sound if it passes a "credit report" test and meets four other criteria (positive net income, no loan defaults, etc.). Plans are financially sound if they are fully funded on a termination basis or 120% funded on a PBGC premium basis.

Many existing waivers retained or expanded. In contrast to the 2009 proposal, PBGC now proposes to keep or expand post-event reporting waivers for (i) missed contributions paid within 30 days after the due date and (ii) certain corporate transactions involving controlled-group members that are *de minimis* or noncontributing foreign entities. PBGC is also modifying and expanding waivers for events affecting small plans (fewer than 100 participants).

Active-participant reductions. The 2009 proposal would have eliminated reporting extensions for active-participant reductions, raising concerns about the need for daily monitoring of plan participation levels. In response, PBGC has crafted new measurement rules focusing on large reductions in active participants in a single 30-day period or due to a single cause. Reductions from normal attrition would be measured only at plan year-end.

No new reportable events. PBGC is withdrawing its original proposal to create two new reportable events: one for plans less than 60% funded, and the other for transfers of excess assets to a health account to pay current and future retiree medical benefits.

Mandatory e-filing. Electronic filing of reportable event notices would be mandatory.

Comment period. Comments are due June 3. The new rules won't take effect before Jan. 1, 2014. For now, PBGC Technical Update 13-1 remains in effect.

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