AMERICAN BENEFITS COUNCIL

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Dear Tom:

The American Benefits Council (the Council) would like to highlight an important issue with respect to the new defined benefit plan funding rules. Specifically, we want to address the asset smoothing rules applicable under the funding provisions of the Pension Protection Act of 2006 (the "PPA"). We appreciate the hard work and effort that the Treasury Department and the Internal Revenue Service are committing to the issuance of sound guidance under the Pension Protection Act. We hope this analysis is helpful to that process.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

In General

New Code section 403(g)(3) and new ERISA section 303(g)(3) provide the following rules with respect to the valuation of plan assets for purposes of the new funding rules:

> For purposes of this section –
>
> "(A) IN GENERAL. – Except as provided in subparagraph (B), the value of plan assets shall be the fair market value of the assets.
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> "(B) AVERAGING ALLOWED. – A plan may determine the value of plan assets on the basis of the averaging of fair market values, but only if such method –
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> "(i) is permitted under regulations prescribed by the Secretary of the Treasury,

"(ii) does not provide for averaging of such values over more than the period beginning on the last day of the 25th month preceding the month in which the valuation date occurs and ending on the valuation date (or a similar period in the case of a valuation date which is not the 1st day of a month), and

"(iii) does not result in a determination of the value of plan assets which, at any time, is lower than 90 percent or greater than 110 percent of the fair market value of such assets at such time.

Any such averaging shall be adjusted for contributions and distributions (as provided by the Secretary of the Treasury).

A review of the legislative history with respect to the PPA indicates very clearly that:

1. Congress intended Treasury to exercise its regulatory authority to permit asset "averaging".
2. Congress intended that the statutory reference to "averaging" be interpreted to mean "smoothing".
3. Congress intended the current-law smoothing rules - - as reflected in Revenue Procedure 2000-40 - - to continue to apply, subject to the reduction in the smoothing period and the contraction of the corridor around fair market value.

This letter addresses these three points as well as two further points: (1) the mechanics of smoothing in the context of the new funding rules, and (2) an analysis of why the Congressional reports cited below constitute legislative history with respect to the PPA.

<u>Present Law</u>

Under current law, Code section 412(c)(2)(A) and ERISA section 302(c)(2)(A) provide as follows:

For purposes of this section, the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations permitted by the Secretary of the Treasury.

Treasury Regulation § 1.412(c)(2)-1 provides further guidance under the above provision. In general, the regulation permits any actuarial asset valuation method that:

(1) is consistently applied, (2) is specified in detail in the plan's actuarial report, (3) uses consistent valuation dates, (4) is based on either fair market value or average value (as defined in the regulations), (5) is not designed to produce a result consistently above or below fair market value and average value, and (6) does not result in a value that is more than 120% or less than 80% of fair market value.[1]

Revenue Procedure 2000-40, 2000-2 C.B 357, provides further guidance with respect to asset smoothing. Generally, Revenue Procedure 2000-40 describes certain asset smoothing methods that can, under certain circumstances, be adopted by a plan without further IRS approval. Specifically, Revenue Procedure 2000-40 permits the use of fair market value, average value, or "smoothed market value". In practice, plans generally use either fair market value or smoothed market value; use of average value is relatively uncommon. Watson Wyatt's "2005 Survey of Actuarial Assumptions and Funding" indicates, for example, that in the case of final average pay plans, 64% use smoothed market value, 15% use fair market value, 6% use average value (as defined under the Revenue Procedure), and the remaining 15% use other valuation methods permitted under the regulations.[2]

Revenue Procedure 2000-40 describes "smoothed market value" as follows. The "smoothing" period can be up to five years; for illustrative purposes, we assume a five-year period is chosen. A plan using a smoothed market value recognizes 20% of any unexpected gain or loss each year for five years. For example, assume that on January 1, 2000, a plan has $100 of assets. Assume further that the plan's interest rate for valuation purposes - - i.e., the plan's expected rate of return - - is 8%. For convenience of presentation, assume that there are no contributions or disbursements with respect to the plan during 2000. In that case, plan assets are "expected" to be $108 as of January 1, 2001. If the fair market value of plan assets were, for example, $118 on January 1, 2001, there would be an unexpected gain of $10; only $2 (i.e., 20%) of this unexpected gain would be reflected in the plan's smoothed market value as of January 1, 2001, for an asset value of $108 + $2 = $110. As of January 1, 2002, another $2 of that unexpected $10 gain would be recognized in the plan's smoothed market value. This would continue in 2003, 2004, and 2005 until all $10 were included.

If instead the fair market value of plan assets were, for example, $103 on January 1, 2001, there would be an unexpected "loss" of $5 (compared to the plan's expected rate of return), only $1 of which would be reflected in the plan's smoothed market value as of January 1, 2001, for an asset value of $108 - $1 = $107. As with gains, an additional $1 of loss would be recognized during each of the next four years.

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[1] The regulations provide an alternative permitted corridor around average value, substituting 115% and 85% for 120% and 80%, respectively. However, pursuant to section 9303(c) of the Omnibus Budget Reconciliation Act of 1987, this alternative corridor only applies to multiemployer plans.

[2] This survey is based on responses from 412 U.S. plans covering 1,000 or more active participants. The information is based on plan valuations for 2003 (13%), 2004 (49%), and 2005 (38%).

Congressional Intent

The PPA legislative process began with H.R. 2830, which was reported out of the House Education and the Workforce Committee (the "E & W Bill"). See House Report 109-23 - Part 1, September 22, 2005. The E & W Bill included new ERISA section 303(g)(3) and new Code Section 430(g)(3), which provided the following rules with respect to the valuation of plan assets for purposes of the new funding rules:

> For purposes of this section, the value of plan assets shall be determined on the basis on any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary of the Treasury, except that –
>
> (A) any such method providing for averaging of fair market values may not provide for averaging of such values over more than the 3 most recent plan years (including the current plan year), and
>
> (B) any such method may not result in a determination of the value of plan assets which, at any time, is lower than 90 percent or greater than 110 percent of the fair market value of such assets at such time.

This provision is broader than the version enacted by the PPA; this provision would have authorized any reasonable valuation method permitted by Treasury. However, in one critical respect, this provision is the same as the PPA provision; this provision specifically refers to "averaging" as a valuation method that Treasury may permit. Thus, the E & W Bill Committee report can provide valuable guidance with respect to the meaning of 'averaging" under the PPA provision.

The Committee report makes it clear that the Committee viewed the term "averaging" as equivalent to "smoothing":

> In general, smoothing refers to averaging of interest rates used to calculate plan liabilities as well as the averaging of plan assets. [report at 79, n. 19]
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> Under current law, interest rates used to calculate pension assets and liabilities are "smoothed," or averaged, over approximately five years for assets and four years for liabilities. [report at 60]

Also, the Committee report leaves no doubt that Treasury is intended to use its authority to permit smoothing as under current law, except that the smoothing period is reduced to three years and the 20% valuation flexibility is reduced to 10%:

> Asset smoothing is also reduced to a maximum of three years; however, the smoothed value of plan assets may not vary by more or less than 10 percent of the fair market value of such assets. [report at 60]

The House Ways and Means Committee issued its report on H.R. 2830 on December 6, 2005 (House Report 109-232 - Part 2). The legislative language with respect to asset smoothing was not changed from the E & W Bill. And the Committee report is completely consistent with the E & W Bill report:

> The Committee believes that . . . slightly reducing the smoothing periods under present law would improve accuracy while maintaining predictability. Thus, the Committee bill incorporates smoothing techniques in applying the modified yield curve and in determining asset values. However, the bill also generally reduces by one year the period over which smoothing is permitted . . . [A] valuation method may not provide for averaging of fair market values over more than the three most recent plan years (including the current year). [report at 71, 82].

The Senate-passed bill (S. 1783), which was a compromise between the Finance Committee bill and the HELP Committee bill, was similar to the House bill, with two exceptions. First, like the PPA provision, the Senate bill only permitted the use of fair market value or Treasury-approved averaging; the Senate bill did not permit flexibility to use any method approved by Treasury. Second, the Senate limited the averaging period to 12 months. But it is also clear that the Senate used the term "averaging" to mean smoothing. The September 28, 2005 Finance Committee summary of the Finance/HELP compromise states:[3]

> *Current Law:* For funding purposes, plans may measure assets either by using the market value of assets or by using an actuarial smoothing method that allows smoothing over 5 years as long as the ultimate value is between 80% and 120% of the market value.
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> *Finance Bill:* The Finance bill requires use of either the market value of assets or, pursuant to Treasury guidance, the market value averaged over the prior 3 months and one day.

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[3] Although the summary does not have the same force as a Committee report, it is the best available information regarding the Senate-passed bill and is clearly relevant legislative history under the applicable legal principles discussed at the end of this letter.

HELP Bill: The HELP bill allows use of either the market value or a smooth value. It restricts the smoothing to 3 years and a 90% to 110% range.

S. 1783: The compromise adopts that Finance structure but allows smoothing (unweighted) over 12 months.

The final version of the PPA followed the Senate structure in only permitting the use of fair market value or Treasury-approved averaging. The PPA compromised on the averaging period - - setting a maximum period of 24 months - - and adopted the House rule regarding the corridor around fair market value. The key point is that throughout the legislative process, Congress was consistent: the bill language referred to averaging, and the Committee reports and summaries made it very clear that the intent was to preserve present-law smoothing, as specifically modified.

The above legislative history also demonstrates an additional point. Congress viewed present-law smoothing as coextensive with the smoothing permitted under Revenue Procedure 2000-40. In other words, under current law, neither the statute nor the regulations limit the smoothing period to five years; the five-year limit is solely a product of the Revenue Procedure. Yet, by consistently referring to the five-year rule as present law, the legislative history is clear that the version of current-law smoothing that is intended to be retained is the version reflected in the Revenue Procedure, subject, of course, to the shortening of the smoothing period and the narrowing of the corridor around fair market value. Thus, Treasury has the authority to narrow the scope of the valuation techniques permitted under current law, but it is clear that Congress' intent was that that authority is to apply to valuation methods other than the smoothing method approved by Revenue Procedure 2000-40. Congress clearly intended that the Treasury regulations retain that smoothing method, subject to the two modifications described above.

Mechanics of Smoothing

The next question relates to the mechanics of asset smoothing under the PPA. The PPA eliminated the relevance of a plan's expected rate of return for other purposes. The question is whether this concept is retained for smoothing purposes. (As discussed above with respect to Revenue Procedure 2000-40, a plan's expected rate of return is a key concept with respect to present-law smoothing.) The answer is that a plan's expected rate of return is clearly an integral part of smoothing under the PPA, for three reasons:

1. As discussed at length above, the PPA legislative history indicates a clear intent to adopt current-law smoothing (as reflected in Revenue Procedure 2000-40), as specifically modified with respect to the smoothing period and the corridor around fair market value.

2. Any other approach would systematically understate or overstate the value of plan assets, which was clearly not the intent of Congress.
3. It is clear that the PPA was not intended to preclude all discretion in the operation of the funding rules. Thus, there is no argument that the use of a plan's expected rate of return introduces an element of prohibited discretion. Moreover, any concerns regarding actuarial discretion can be addressed without disturbing the fundamental concepts underlying smoothing.

As noted above, it is clear from the legislative history cited previously that the intent was to preserve current-law smoothing with the specified modifications. This means that smoothing is to be based on a comparison with a plan's expected rate of return.

Some might argue that a plan's expected rate of return is a concept that no longer exists for any other purpose and thus should not exist for this purpose. In our view, this argument does not logically follow. If Congress' intent was to preserve the use of a plan's expected rate of return for purposes of asset smoothing, and smoothing only works effectively based on this concept, it is not relevant that the concept is not used for other purposes.

The use of the 3-segment corporate bond yield curve for purposes of valuing liabilities - - in lieu of a plan's expected rate of return under the current-law non-DRC funding rules - - does not imply in any way that that same rate should be used for asset smoothing purposes. The use of a corporate bond yield curve is a movement in the direction of measuring liabilities on a termination basis; there is no suggestion at all that it is intended to be a proxy for a plan's expected rate of return. And asset smoothing only works in a rational manner if it is based on a plan's expected rate of return, as discussed below.

As noted, the next question is whether smoothing makes sense if it is not based on a plan's expected rate of return. We believe the answer is clearly no. Assume, for example, that a plan's expected rate of return is 8%. Assume further that smoothing is based on the plan's "effective interest rate" (i.e., the single rate of interest that creates the same plan liability as the 3-segment corporate bond yield curve), which is assumed here to be 5.5%. (As referred to above, in the absence of any statutory benchmark to use as the expected rate of return for asset smoothing, some have inquired as to whether the rate used for a different purpose - - i.e., the determination of liabilities - - should be used for asset smoothing.) In that case, smoothing would systematically understate the value of plan assets. Such systematic understatement of plan assets is inconsistent with the fundamental premise of smoothing, which is to "mitigate short-run changes in the fair market value of assets"[4], not to create a consistently lower valuation.[5]

[4] Treasury Regulation § 1.412(c)(2)-1(a)(4)(ii).

[5] Some plans may invest in the types of bonds that make up the yield curve and thus will have an expected rate of return generally equal to the effective interest rate. However, such plans will have little

Systematic undervaluation of assets would be contrary to the express regulatory provisions of current law, which prohibit a valuation method that "is designed to produce a result which will be consistently above or below [fair market value and average value]". Treasury Regulation § 1.412(c)(2)-1(b)(5). Under section 3.4.1 of the Proposed Actuarial Standard of Practice, "Selection and Use of Asset Valuation Methods for Pension Valuations" (fourth exposure draft, approved for exposure by the Actuarial Standards Board, August 2006), such a systematic undervaluation would also require that an actuary, when issuing an actuarial report, disclose that the asset valuation method has a "significant systematic bias" toward understatement of asset values.

The understatement of value would indeed be significant. Assume, for example, that a plan has $100 of assets and the plan has an expected rate of return of 8% based on an objective analysis of historical returns. Assume further that over a three-year period, the plan makes 8% per year. If smoothing is based on a 5.5% return, the smoothed value of assets would be almost 2.5% below market value (assuming no contributions or disbursements). <u>This would be the case despite the fact that the plan has earned exactly what it was projected to earn and thus there were no unexpected returns to smooth</u>. In effect, basing smoothing on the effective interest rate would not be smoothing in any economically sound sense. Such a system would produce a distorted value that is consistently and unjustifiably below market value. There is no evidence of any Congressional intent to require such a skewed and artificial version of smoothing.

Basing smoothing on a plan's expected rate of return requires actuarial discretion in determining that rate. This is not contrary in any way to the structure of the PPA, since it is clear that the PPA was not intended to eliminate all actuarial discretion with respect to the funding rules. For example, the funding target of plans that are not at-risk is based on certain critical assumptions that are subject to actuarial discretion, such as the future retirement rate and the forms of distribution projected to be elected. In addition, the test for at-risk status turns in part on this same calculation of a plan's funding target. And even for at-risk plans, there is an element of the retirement rate that is subject to actuarial discretion. Also, in the case of any plan with a subsidized qualified joint and survivor annuity, assumptions regarding marital status are needed. In short, any argument that the PPA was intended to eliminate all actuarial discretion is in direct conflict with the very clear provisions of the PPA.

In the absence of this argument, the questions become: (1) what did Congress intend with respect to asset smoothing, and (2) how should the asset smoothing rules be

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or no need for asset smoothing, thus making this segment of the plan population an inappropriate basis for creating smoothing rules. Plans that invest at least partially in equities - - with higher expected rate of returns and more uncertainty - - are the ones that need smoothing; for such plans, the expected rate of return is generally higher than the effective interest rate.

structured to work properly? Those issues are addressed in the preceding portions of this letter.

But there is a remaining issue. Since Treasury has regulatory authority over asset smoothing, is there a way to address any concerns regarding actuarial discretion without doing violence to the essential components of asset smoothing? The answer to this question is yes. For example, the regulations under Code section 401(a)(4) establish a "standard interest rate" that is used in converting account balances to annuity benefits generally payable at normal retirement age. This regulatory rule reflects a projection of an expected rate of return. If there is a desire to minimize actuarial discretion, Treasury could provide that a plan's expected rate of return for asset smoothing purposes must be based on reasonable historical data and may not exceed the highest standard interest rate permitted. This would establish a workable rule that strikes a reasonable balance between the fundamental concept underlying asset smoothing and a desire to control actuarial discretion. There are certainly other ways to control actuarial discretion (if that is desired), but it is critical that any applicable rule permit expected rates of return that are consistent with historical returns.

PPA Legislative History

Because of the unusual fashion in which the PPA was enacted, some have raised the question as to whether the Committee documents cited earlier constitute legislative history with respect to the PPA. The PPA was technically based on H.R. 4, which was introduced in the House on July 28, 2006 and passed by the House and Senate without any amendments. There were no Committee reports with respect to H.R. 4; this is the basis of the argument that there is technically no legislative history with respect to the PPA.

However, the law does not support the technical argument set forth above. H.R. 4 was drafted based on the conference negotiations with respect to H.R. 2830 and S.1783, the bills discussed above as containing relevant legislative history. And the law on this subject is quite clear. In interpreting a statute, legislative history clearly includes all relevant Congressional history, without regard to whether the history relates to the precise bill that was enacted. *See, e.g., United States v. States of La., Tex., Miss., Ala., and Fla.*, 363 U.S. 1, 18 n. 16 (1960) ("The legislative history of all the bills considered prior to enactment of the Submerged Lands Act in 1953 is directly relevant to the latter Act, since the purposes and phraseology of such bills, and the objections raised against them were substantially similar."); *Wilderness Society v. Morton*, 479 F.2d 842, 856 (D.C. Cir. 1973) (In describing the reasoning for looking at the legislative history of similar prior bills, the court stated the following: "The Mineral Leasing Act of 1920 . . . was not part of a single Congress. Other versions of the Act, substantially similar to the one finally adopted and containing provisions virtually identical with [the relevant section at issue], were introduced, reported out of Committee, and debated on the floor of Congress . . . . The legislative history of the bill that was finally enacted into law . . .

contains no discussion of the [relevant provision] in either the reports, the hearings, or the floor debates. The legislative history of similar bills in prior Congresses, however, is very revealing."). *See also United States v. Plesha*, 352 U.S. 202, 204-06 (1957) (The Supreme Court examined the history of the Soldiers' and Sailors' Civil Relief Act of 1918, specifically, the Committee hearings on the 1918 bill, to interpret the meaning of a provision in the Soldiers' and Sailors' Civil Relief Act of 1940, stating that "Article IV of the 1940 Act substantially reenacted the insurance provisions of the [1918 Act]" and that the 1940 Act had little independent legislative history, which "is of little, if any, help" and they, "therefore, must examine the history of the 1918 bill." In addition, in stating its affirmation of the Court of Appeals' decision, the Supreme Court broadly noted that its affirmation rested on the "language of the 1940 Act, *its legislative history* and its administrative interpretation," indicating that the Court considered the Committee hearings of the 1918 bill as also the legislative history of the 1940 Act.); *United States v. Laub*, 253 F. Supp. 433, 457 (E.D.N.Y. 1966) (stating that since the enactment of 8 U.S.C. § 1185 in 1952 has no independent legislative history and since the relevant section is cast in language almost identical to that of the Acts of May 22, 1918 and June 21, 1941, the intent of the Congress may be ascertained from the history of those earlier acts.)

Secondary sources are similarly quite clear on this point. Justice Frankfurter, in his discussion on the interpretation of statutes and the use of legislative history in his Columbia Law Review article, *Some Reflections on the Reading of Statutes*, stated that "[i]f the purpose of construction is the ascertainment of meaning, nothing that is logically relevant should be excluded."[6] "Legislative history" was described in another Columbia Law Review article as "a catch-all for extrinsic evidence of congressional intent."[7]

In addition, the book, *Legislative History, Research for the Interpretation of Laws*, specifically states that "[t]he legislative history of a predecessor act, or *of an earlier bill which failed of enactment*, is also sometimes used as an aid to construction of a later act.[8] *Legislative History, Research for the Interpretation of Laws* also describes certain situations in which research in legislative history is more complicated, including circumstances in which the history of prior bills, and bills on the same general subject considered during the same period, must be examined:

> Examination of the reports or debates may reveal that the bill in question was the same as, or a modification of, a bill which had been introduced in a former Congress, on which hearings were held, but which failed of enactment. In such a case it will be necessary to trace the history of both the prior

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[6] Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 541 (1947).

[7] Note, *A Re-Evaluation of the Use of Legislative History in the Federal Courts*, 52 Colum. L. Rev. 125, 128 (1952).

[8] Gwendolyn B. Folsom, LEGISLATIVE HISTORY, RESEARCH FOR THE INTERPRETATION OF LAWS 17 (The University Press of Virginia) (1972) (Emphasis added).

> and the later proposals, noting any statements as to the purpose of the original proposal and of any changes made at the various stages of both proposals. . . . Where reports or debates on a measure indicate it was one of a number of bills on the same general subject considered during the same period, the enactment of one in preference to another may be significant. In this situation, it may be necessary to . . . trace the history of the several bills, examining comparable provisions in each with care to note any reasons stated for selection of the provision finally enacted.[9]

Conclusion

In conclusion, the legislative history of the PPA is very clear that Congress intended to preserve current-law asset smoothing - - as reflected in Revenue Procedure 2000-40 - - subject to a reduction of the smoothing period and a contraction of the permissible corridor around fair market value. We respectfully request that the Treasury Department issue regulations in accordance with this legislative history.

Sincerely,

Lynn D Dudley

Lynn D. Dudley
Vice President, Retirement Policy

cc: William Bortz
Marjorie Hoffman
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[9] *Id.* at 61-62.