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DEFINED CONTRIBUTION PLAN ISSUES IN PENSION REFORM LEGISLATION: AUTOMATIC ENROLLMENT, DEFAULT INVESTMENTS, AND MAPPING

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The pending pension reform legislation contains critical reforms of the rules relating to defined benefit plan funding, hybrid plans, and defined contribution plans. In response to suggestions from the Hill, the business groups listed above have assembled the following list of issues with respect to the provisions of the bills regarding automatic enrollment, default investments, and mapping of investments. The list does not address fundamental policy issues. Instead, the list is intended to serve as a checklist of technical issues and other issues where input may be helpful.

Similar lists addressing other defined contribution plan issues will be sent shortly.

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 non-governmental 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 final default investment guidance.
d. The default investment rule should apply to non-ERISA non-governmental 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.
e. The default investment guidance should apply to beneficiaries in addition to participants. Also, the guidance should apply to any assets in an individual account, not just contributions to such an account. Such changes are needed, for example, with respect to existing participants or beneficiaries who did not make an investment election.
f. New section 404(c)(5)(B)(i)(II) of the House bill defines a "default investment arrangement" as one under which "the participant is treated as having elected to have the plan sponsor exercise control over the assets in the participant's account until the participant specifically elects to exercise such control". Since the flush language of new section 404(c)(5)(A) already refers to treating the participant as exercising control, the above quoted language is confusing and could suggest the existence of some employer liability. Subclause (II) should read as follow: "under which the assets in a participant's or beneficiary's account are invested, in the absence of an affirmative investment election by the participant or beneficiary, in accordance with regulations prescribed by the Secretary."

3. <u>Corrective distributions.</u>

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; automatic increases at the employee's anniversary date should also be permitted.
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).

g. The House bill requires that at least 70% of the eligible nonhighly compensated employees make elective deferrals during the current or preceding year. This provision will dissuade many employers with large numbers of low-paid employees (such as in the retail industry) from adopting the safe harbor. Yet those are exactly the employers that from a policy perspective, we most want to adopt automatic enrollment arrangements. For example, if a plan has a 30% participation rate and automatic enrollment could increase the rate to 50%, why shouldn't that be encouraged?

h. It would be helpful to clarify in the legislative history that a participant can elect out of the auto increase feature before it takes effect. For example, if a participant is defaulted into a 3% contribution and wants to stay at that level, a participant can make such an election. In other words, the participant need not wait until the 4% level takes effect and then make a subsequent election to return to 3%.

i. It would be helpful if the Secretary of the Treasury could be given broad regulatory authority to implement the safe harbor in a manner that is consistent with the intent of Congress and that promotes auto enrollment and auto increase and minimizes administrative burdens.

5. **Automatic enrollment generally.** It would be very helpful for the statutory language or conference report to include a statement that directs the IRS to issue a model automatic enrollment amendment for prototype users. This would enable thousands of smaller employers to adopt an automatic enrollment arrangement without concern that such adoption will adversely affect the pre-approved status of their plan documents while they wait for new IRS approval letters.

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. The replacement option should be permitted to be any option specified in the advance notice as the replacement 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. 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.
3. New ERISA section 404(c)(4)(B) of the House bill refers to "a change in the investment options offered to the participant or beneficiary under the terms of the plan". The phrase "under the terms of the plan" should be changed to "under the plan"; it is common for the plan document not to refer to specific investment options, but rather to authorize the plan fiduciary to set or modify the investment menu.
4. The mapping provision refers only to participants in certain provisions. All references should be to participants or beneficiaries, since the mapping rule is needed with respect to both.
5. You may wish to consider replacing references to investment "instructions" with references to investment "elections" to be consistent with other statutory provisions.

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.