MEASURE: HB 3436
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SUBMITTED BY: John Mangan

Financial Security...for Life.

CALIFORNIA SB 1234 – STUDY OF A STATE-RUN RETIREMENT PLAN FOR PRIVATE SECTOR EMPLOYEES

As initially introduced California would have enacted a mandatory state run pension plan for private small businesses who do not offer such a plan. The bill was supported largely by public labor unions but was opposed by the insurance and financial industries, the state Chamber of Commerce, the Farm Bureau and a wide variety of private small business groups who would supposedly benefit from the plan. Opponents pointed out that employers and individuals already have a wide range of low cost retirement products available to them in the private marketplace. Studies by Milliman and recent DOL and private legal opinions confirmed that the plan described in SB 1234 would subject private employers to ERISA, triggering annual private employer compliance costs of more than $500 million per year.

The Governor's Department of Finance entered an *"Oppose"* position on SB 1234, citing large potential liabilities to the state.

Despite media reports to the contrary, California has not passed a state run retirement program for private workers. In fact, as finally approved, SB 1234 and its companion SB 937, represents an expensive and rather elaborate feasibility study of such a potential state run plan. The bill calls for the appointment of a board, the raising of up to $2 million for a feasibility study and board operations, the preparation of an RFP for the feasibility study, and the ultimate report on the feasibility of a state run plan. According to the author of the bill, the feasibility study will not be available until well into 2014.

As part of the feasibility study, the board must seek opinions from the DOL and the IRS regarding whether the potential state run plan will be subject to ERISA, and whether the IRAs called for in the program would receive favorable IRS tax treatment. If the opinions show that the plan fails either of these tests, then no program will proceed. Recent DOL opinions and private legal opinions indicate the plans described in SB 1234 will fail those tests unless Congress passes specific ERISA exemptions and tax provisions. The study must also show that any plan is self-sustaining and that there is no state liability and no need for taxpayer support or it will not proceed.

If a viable program is identified by the study, then the plan must still return to the Legislator for a full review and debate and cannot be implemented unless approved and signed by the Governor.

Implementation Update

SB 1234 and its companion bill SB 923 became effective on January 1, 2013. According to the author's summary of implementation activities, work began in December 2012 on organizational elements of the program. Names are circulating for appointments to the Board that will oversee fundraising, the feasibility study and the development of the potential program. The governor is seeking nominees for his two appointments to the board, and is said to be looking for private sector pension experts. The process of Board appointments is expected to last into the spring of 2013. Fundraising for the $2 million initial phase is under way.

At the same time, the State Treasurer is beginning to prepare an RFP for consultants to guide the feasibility research required by the legislation. Questions to be addressed by the feasibility study include whether there is a form of private insurance to cover the investment guarantees in the program, whether certain plans would be subject to ERISA and whether any IRAs included in the program would receive favorable IRS tax treatment.

John W. Mangan
Vice President, State Relations

March 13, 2013

TO: Representative Margaret Doherty, Chair
Members of the House Business and Labor Committee

RE: HB 3436 - Oregon's New State Mandated Retirement Plan

The goal of increasing retirement savings is laudable. Indeed, it is the core mission of the 300 companies who make up the ACLI. Our members write more than 90% of the individual annuities and retirement plans sold in Oregon and the United States. Banks, credit unions and other financial firms also offer these products. A large network of licensed agents, brokers and financial advisors ensure there is a vibrant private sector market for these products, with diverse, affordable options for employers of all sizes. We do not believe the state should be competing with the private sector in this market.

HB 3436 would create a new state benefits board and state managed retirement system for workers in the private sector, even as the state struggles to sustain its own public employee retirement system. Anyone under 70 with taxable income and a bank account can currently open an Individual Retirement Account (IRA), yet HB 3436 would impose costly new mandates on employers and create an expensive, and potentially risky, new government program at a time when the state faces a host of budget challenges.

HB 3436 appears to be modeled on a bill debated in California in 2012. That bill, SB 1234, created an elaborate and expensive study to be carried out by a board similar to the one created in HB 3436. The feasibility study alone will cost upwards of $2 million and will not be completed until 2014.

It would be a mistake to underestimate the cost to create and operate a new state mandated plan that must track workers from job to job and manage their accounts for years or decades. In addition, there are potential liabilities and shortfalls that could result if investment returns fall short of projections. The California Department of Finance said SB 1234, "could create a **multibillion**-dollar liability for the state if investment returns fail to cover the guaranteed rate of return and administrative overhead."

Thus, any plan to have the state create a new benefits board and offer private retirement plans should trigger Ways and Means review of state administrative costs.

Costs to employers would also be significant. Retirement plans for private sector employees are regulated by the federal Employee Retirement and Insurance Security Act (ERISA), which requires every employer participating in a private retirement program to file annual reports, track employee accounts and in some cases pay for actuarial valuations.

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Some have asserted that housing a private worker retirement plan within state government will provide the plan with a "government exemption" under ERISA. However, recent DOL rulings make clear that is not the case. The California bill provides that if the plan is subject to ERISA, it will not move forward.

According to a legal opinion by Davis & Harman, a Washington, D.C. firm specializing in retirement benefits and employment law, employers participating in such a program would not only be subject to ERISA compliance and reporting requirements, they could incur new fiduciary responsibilities. Based on recent U.S. Department of Labor Advisory Opinions, the firm concludes that, "each employer is deemed to have established and maintained a separate employee benefit plan for the benefit of its own employees" and "each employer sponsor of a plan that participates in the arrangement will be subject to ERISA's fiduciary provisions."

Under ERISA, the firm continues, "a fiduciary who breaches any of the responsibilities imposed by ERISA is *personally liable* to make good to the plan any losses resulting from the breach."

In addition, under ERISA, failure of one employer participating in state IRA plan could disqualify all the IRAs in the plan from favorable tax treatment under the Internal Revenue Code. Without favorable tax treatment, there is no incentive for private employers to participate in a state plan. As mentioned, qualified IRA products are widely available in today's marketplace.

Many Oregonians are unprepared for retirement, and it is commendable that legislators want to encourage more of us to save. We would like to be your constructive partner as you assess voluntary programs, education and other policy options that can put middle-income Oregonians on a path to retirement security. This is what we do.

But creating a new and potentially expensive state managed program and mandate on employers is the wrong approach at this time. We urge you not to adopt HB 3436.

Sincerely yours,

John W. Mangan

The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at www.acli.com.

MEMORANDUM

TO: Walter Welsh and James Szostek
AMERICAN COUNCIL OF LIFE INSURERS

FROM: Michael L. Hadley

DATE: March 15, 2013

RE: *Application of ERISA to State Mandatory Automatic Enrollment Retirement Plans*

You have asked for my views on the implications of recent advisory opinions issued by the U.S. Department of Labor ("DOL") on the status, under the Employee Retirement Income Security Act of 1974 ("ERISA"), of a number of state-run retirement arrangements under consideration. Although there is some variation, these proposals generally would create a state-run retirement arrangement open to private (non-governmental) employers, and for which employer participation is mandatory if the employer does not otherwise offer a retirement plan.

These arrangements are novel and have not been the subject of direct guidance from DOL or the courts on how the proposed arrangement would be treated under ERISA. As explained below, however, if DOL or a court were to apply the reasoning in recent analogous DOL advisory opinions, then these arrangements would:

(a) not meet the requirement to be a "governmental plan" exempt from ERISA;
(b) create *separate* ERISA-governed plans, each of which is separately subject to ERISA's reporting and disclosure requirements;
(c) impose ERISA's fiduciary provisions on the private employers that participate in the arrangement; and
(d) impose ERISA's prohibited transaction provisions with respect to any "party in interest" to the arrangement, including each employer and the state itself.

These conclusions would not change simply because the contributions under the arrangement are made to individual retirement accounts ("IRAs") rather than qualified trusts because the arrangements generally include an automatic enrollment feature that would prevent them from meeting DOL's safe harbor for payroll deduction IRAs.

In addition, some of these arrangements raise significant questions about whether they can meet the requirements to be an IRA because they appear to result in the transfer of assets between IRAs in violation of the "exclusive benefit" rule.

Per your request, the memorandum closes with a summary of the fiduciary and prohibited transaction rules that ERISA imposes on ERISA-governed plans and fiduciaries.

Background

A number of states are considering a state-wide retirement savings plan for private workers who do not participate in any other type of employer-sponsored retirement savings plan. These proposals have generally come in two types. One type of proposal is to offer a state-run tax-qualified plan that would be available on a voluntary basis for employers (or a subset of employers such as non-profits of a particular size).[1] In this case, the state operates much like a private retirement service provider, offering a plan that is intended to otherwise qualify for federal tax-favored treatment. Generally, we understand that proponents of these arrangements understand and agree that these arrangements must meet the federal tax code and ERISA requirements that apply to all private-sector retirement plans. This memorandum does not focus on these kinds of proposals, but portions of the analysis would apply. In addition, the sections of the memorandum that describe the fiduciary and prohibited transaction rules that ERISA imposes on ERISA-governed plans and fiduciaries would generally be applicable and may be helpful in understanding the implications of a state offering a voluntary retirement plan arrangement.

More recently, a second type of arrangement has been proposed. A number of states have proposed to create a plan that mandates participation by employers ("Mandatory Auto-Enroll Arrangement"). As of the memorandum, we are aware of Mandatory Auto-Enroll Arrangement proposals in California, Oregon, Illinois, Connecticut, and Maryland.[2] Generally under these plans, private employers that operate in the state and that do not offer a retirement plan would be required to automatically enroll their employees in the Mandatory Auto-Enroll Arrangement unless the employee opts out. The proposal sets a default contribution rate, such as 3% of pay, that employers must deduct from their employee's pay unless the employee selects a different rate. These proposals purport to utilize individual retirement accounts as the funding vehicle to receive contributions under the arrangement. Thus, for example, the contribution limits that apply to IRAs, which are lower than the limits for contributions to qualified plans, would apply.

In some cases, the proposals appear to operate like a defined benefit cash balance plan by creating "accounts" that receive stated interest credits added as declared over time. Unlike in a traditional defined contribution plan, the participant's account benefit is based on contributions and the stated declared rate of return and not the actual investment returns of the assets held with respect to the arrangement. Participants do not receive the actual return of the assets set aside in the trust and have no claim on any specific assets. Thus, the arrangement does not have the primary features of a defined contribution plan or an individual retirement account. These proposals create a segregated asset account which holds assets in order to support the stated rate of return. The segregated asset account receives "excess" earnings that are used in years when from investment earnings held outside the segregated asset account are insufficient to support the

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[1] *See, e.g.,* Massachusetts H.R. 3754 (2012).

[2] *See* Oregon H.B. 3436; Illinois S.B. 2400; California S.B. 1234; Maryland H.B. 1318. A short bill that would create a study has been introduced in the Connecticut General Assembly (S.B. 54), but we understand that this bill may be modified to create a Mandatory Auto-Enroll Arrangement.

promised interest rate. (As explained in more detail below, this results in a transfer of assets from one enrollee's IRA to another's.)

Other proposals – such as the Illinois proposal – do not have this feature but rather would offer a number of investment options from which enrollees can choose, designating a default investment that is used if an enrollee fails to select another alternative.

Background of ERISA Coverage

With certain exceptions, ERISA applies to any "employee pension benefit plan," which is defined to mean "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[3] ERISA does not apply to a "governmental plan,"[4] defined to mean "a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing."[5]

In broad terms retirement plans subject to ERISA must meet ERISA's rules regarding reporting and disclosure to participating employees and the Federal government, vesting and minimum participation, minimum funding, and fiduciary obligations.

Government Plan Definition

For a plan to be a "governmental plan" exempt from ERISA, it must be a plan established or maintained by a government entity for *its employees*. The Mandatory Auto-Enroll Arrangements contemplate a plan established and maintained by the state for non-governmental employees. Based solely on the plain language in ERISA, a Mandatory Auto-Enroll Arrangement would not be a governmental plan.

Over the years, DOL has issued a number of advisory opinions[6] to state and local governments, agencies, and municipalities on whether a particular retirement or health plan[7]

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[3] ERISA § 3(2)(A).

[4] ERISA § 4.

[5] ERISA § 3(32). Governmental plans are also exempt from the requirement to participate in, and pay premiums to, the Federal pension insurance program administered by the Pension Benefit Guaranty Corporation under Title IV of ERISA. ERISA § 4021(b)(2).

[6] An advisory opinion expresses the opinion of DOL regarding the application of ERISA to the facts described in the opinion. *See* ERISA Procedure 76-1, 41 Fed. Reg. 36,281 (Aug. 27, 1976).

[7] Broadly speaking, employer-based health plans are also subject to ERISA because they meet the definition of "employee welfare benefit plan." ERISA § 3(1). Like retirement plans, health plans that meet the definition of

qualifies as a governmental plan. Most recently, on April 27, 2012, DOL issued Advisory Opinion 2012-01A, which was addressed to Connecticut Governor Daniel Malloy. In this opinion, DOL examined a proposal by the state of Connecticut to make its group health plan established for state employees, retirees, and their families available for certain private nonprofit organizations that either have a service contract with Connecticut to provide health services to residents or who receive 50% or more of their gross annual revenue from public grants or funding.

The Advisory Opinion recites previous DOL guidance that private sector contractors, including nonprofit or tax-exempt organizations, are not governmental agencies or instrumentalities for purposes of ERISA merely because the contractors perform public service functions under governmental direction and control pursuant to contracts with governmental entities. DOL thus concludes that the private entities would not themselves be considered governmental entities.

The Advisory Opinion also addresses whether the arrangement might still be considered a governmental plan because only a *de minimis* number of non-governmental employees participate in the plan. Connecticut estimated that the total number of employees of private nonprofit employers that would ultimately enroll in the plan would be 175,000, and the number of State employees and retirees currently in the plan is approximately 100,000. Acknowledging that earlier DOL guidance states that *de minimis* participation of private employers does not affect a plan's status as a governmental plan, DOL concludes that the participation of this many private nonprofit employers in the plan is more than *de minimis*, and, therefore, such participation would adversely affect the plan's status as governmental under ERISA.

In broad terms, a Mandatory Auto-Enroll Arrangement would establish an arrangement that is similar to the effort described in Advisory Opinion 2012-01A to offer a state health plan to large numbers of employees of private employers. There is no apparent reason to believe that DOL (or a court) would not apply the same reasoning in Advisory Opinion 2012-01A to a Mandatory Auto-Enroll Arrangement and conclude that it is not a governmental plan.

The Department of Treasury and the Internal Revenue Service ("IRS") have an ongoing project to provide guidance on a similar definition of "governmental plan" that applies in the Internal Revenue Code ("Code").[8] Although the regulations have not been finalized, there is nothing in the first version of the proposal would undermine the reasoning behind Advisory Opinion 2012-01A.

"governmental plan" are exempt from ERISA's requirements. The same definition in ERISA for "governmental plan" is used with retirement and health plans.

[8] 76 Fed. Reg. 69172 (Nov. 8, 2011).

Separate ERISA Plans

Each "plan" under ERISA is separately subject to ERISA's rules. This includes, for example, a requirement to make an annual filing with DOL.[9]

In Advisory Opinion 2012-04A, issued on May 25, 2012, DOL addressed whether a retirement plan arrangement that provides for participation by numerous unrelated employers would be considered a single "plan" for purposes of ERISA, or, instead, an arrangement under which each participating employer establishes and maintains a separate employee benefit plan for the benefit of its own employees.

The arrangement described in Advisory Opinion 2012-04A is one offered by a single service provider and available to multiple employers who have no relationship with each other besides common participation in the arrangement. Under the arrangement, each employer adopts a "participation agreement" and delegates to the service provider full responsibility as plan administrator.

In the Advisory Opinion, DOL states that it has taken the view:

> [O]n the basis of the definitional provisions of ERISA as well as the overall statutory scheme, that, in the absence of the involvement of an employee organization, a single 'multiple employer' plan (i.e., a plan to which more than one employer contributes) may, nevertheless, exist where a cognizable group or association of employers, acting in the interest of its employer members, establishes a benefit program for the employees of member employers and exercises control of the amendment process, plan termination, and other similar functions on behalf of these members with respect to a trust established under the program. . . . It has been the Department's consistent view that where several unrelated employers merely execute identically worded trust agreements or similar documents as a means to fund or provide benefits, in the absence of any genuine organizational relationship between the employers, no employer group or association exists for purposes of ERISA.

In short, DOL's view is that where unrelated employers participate in an ERISA-governed retirement arrangement, each employer is deemed to have established and maintained a separate employee benefit plan for the benefit of its own employees. The Advisory Opinion describes DOL's views on the implications of this under ERISA's fiduciary rules:

> Importantly, we note that persons who operate the arrangement would be subject to the fiduciary provisions of Title I [of ERISA] to the extent they have control over plan assets or have discretionary control over the administration or management of the participating employers' separate plans. They would also be

[9] ERISA § 103.

> subject to the prohibited transaction provisions in ERISA section 406 to the extent they are "parties in interest" within the meaning of ERISA section 3(14) either as service providers to the separate employer plans or otherwise. ***Similarly, each employer sponsor of a plan that participates in the arrangement will be subject to ERISA's fiduciary provisions.*** See FAB 2002-03 (in selecting a service provider, plan fiduciaries must, consistent with the requirements of section 404(a), act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan). [Emphasis added]

The Mandatory Auto-Enroll Arrangement contemplates participation by employers that have nothing in common other than participation in the plan, being located in the relevant state, and not offering another retirement plan to employees. The Mandatory Auto-Enroll Arrangement is thus broadly analogous to the arrangement described in Advisory Opinion 2012-04A. If DOL (or a court) were to apply the reasoning in Advisory Opinion 2012-04A to a Mandatory Auto-Enroll Arrangement, each employer would have established a separate plan for ERISA purposes, and each employer sponsor of a plan that participates in the arrangement will be subject to ERISA's fiduciary provisions.

There is a least one difference between the arrangement described in Advisory Opinion 2012-04A and the one contemplated by the Mandatory Auto-Enroll Arrangement. The latter envisions *mandated* participation by employers that do not offer another retirement plan; in other words, employers are given a choice between using the state-run program or one offered by a private service provider. This is unprecedented. ERISA does not require an employer to offer retirement or welfare benefits but merely regulates those benefits once offered. It is unclear, therefore, whether the mandatory nature of the Mandatory Auto-Enroll Arrangement would affect the analysis.[10] For example, it may be that the fiduciary obligations imposed by ERISA would apply to the "choice" to use the state-run plan instead of one offered by a private service provider. Or it may be that the fiduciary obligations apply in other unexpected ways.

ERISA preempts any state law that "relates to" any employee benefit plan.[11] An analysis of ERISA preemption is beyond the scope of this memorandum, but it is worth mentioning that a number of courts have noted that the purpose of ERISA preemption is to prevent an employer from having to apply different benefit structures or administrative requirements with respect to their benefit program to employees located in different states.[12] A Mandatory Auto-Enroll Arrangement does exactly that – it requires an employer to have a retirement savings

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[10] Generally ERISA's fiduciary provision applies where an employer has bound itself to offer a retirement plan to union employees through collective bargaining. This might be viewed as analogous to an employer that binds itself to offer either a state-run retirement plan or one offered by a private service provider by deciding to do business in the state.

[11] ERISA § 514(a).

[12] *See, e.g., Rutledge v.* Seyfarth, Shaw Fairweather & Geraldson, 201 F.3d 1212 (9th Cir. 1999) (preemption applies to state laws that "mandate" benefit structures or that "bind employers or plan administrators to particular choices").

arrangement in place for employees located in the state unless it meets the state's minimum retirement plan requirements. To the extent the developed law under ERISA's preemption clause is relevant, this suggests that Mandatory Auto-Enroll Arrangements would be viewed by a court as encompassed by ERISA.

Implication of Using IRAs as Funding Vehicles

As stated earlier, a number of the Mandatory Auto-Enroll Arrangement proposals appear intended to utilize individual retirement accounts as the funding vehicle to receive contributions under the arrangement. A plan that otherwise meets the definition of a pension plan under ERISA does not fail to be governed by ERISA simply because the contributions are made to IRAs instead of a single qualified trust. Contributions under ERISA pension plans are funded in a variety of ways, including trusts, group insurance contracts, individual 403(b) contracts and custodial accounts, and IRAs.

DOL regulations provide a safe harbor for certain payroll deduction arrangements in connection with IRAs.[13] In order for a payroll deduction IRA to be exempt from ERISA coverage, the arrangement must satisfy the following:

- No contributions are made by the employer;
- Participation is completely voluntary for employees;
- The sole involvement of the employer is without endorsement to permit the sponsor to publicize the program to employees, to collect contributions through payroll deductions and to remit them to the sponsor; and
- The employer receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions.

If a payroll deduction IRA does not meet the safe harbor it will be considered an ERISA plan.

Although DOL has not addressed the issue directly, it is generally thought that the inclusion of an automatic enrollment feature results in employer involvement that exceeds that allowed under the safe harbor.[14] In fact, Congressional proposals for a federally-mandated

[13] 29 C.F.R. § 2510.3-2(d).

[14] A similar issue arises with respect to a safe harbor for 403(b) plans in the same DOL regulation. *See* Current Challenges and Best Practices for ERISA Compliance for 403(b) Plan Sponsors, Report of the 2011 Advisory Council on Employee Welfare and Pension Benefit Plans, available at http://www.dol.gov/ebsa/publications/2011ACreport1.html ("The Council also considered, but is not recommending, that DOL permit the inclusion of an automatic enrollment feature within the context of an ERISA safe harbor 403(b) plan. The majority of Council members concluded that automatic enrollment would require actions typically performed by a plan sponsor/fiduciary (e.g., designation of a default investment alternative), and consequently, an automatic enrollment option in the plan may not be viewed as voluntary even in light of the participant's right to opt out of the automatic contributions."); McKay Hochman, "On the Subject of Being a Non-ERISA 403(b)," Email Alert 2010-13 (Aug. 26, 2010), available at

automatic payroll deduction IRA have included a specific exception from ERISA because, otherwise, an automatic enrollment payroll deduction IRA, even one required by law, would be treated as an ERISA plan.[15] Congress can provide an exemption from ERISA for an automatic IRA mandate; a state cannot.

IRA Exclusive Benefit Requirements

As noted earlier, some of the state bills proposing a Mandatory Auto-Enroll Arrangement provide that each enrollee's account will be credited with a stated interest rate. This stated interest rate will be determined by the state's board overseeing the plan in accordance with an established investment policy. In addition, the state's board may establish a segregated account within the plan to fund a "reserve account." Specifically, the reserve account may be used to allocate interest to each account at the stated interest rate for years in which the state's board determines that the stated interest rate cannot be satisfied solely from investment earnings. In addition, the state's board may allocate excess earnings with respect to assets attributable to the plan to the reserve account. The amount allocated is generally determined based on an actuarial valuation each year. In determining whether to allocate excess earnings to the reserve account, the board will take into account certain factors, including: (1) whether or not the plan has excess earnings, (2) the sufficiency of the reserve account in light of the goal established for such account, (3) the amount required for the plan's administrative costs, and (4) the amount required for making allocations to individuals' accounts at the stated interest rate.

It appears that these state sponsored accounts are intended to qualify as IRAs under section 408 of the Code. If so, then under the Code, a number of provisions apply in order for an arrangement to be eligible for favorable tax treatment afforded to an IRA. Of particular relevance to the issues pertaining to the reserve account, Code section 408(a) requires that the IRA is a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries...." This is often referred to as the "exclusive benefit" rule. In addition, the arrangement must meet the requirement, *inter alia*, that the "assets of the trust will not be commingled with other property except in a common trust fund or common investment fund."[16]

The reserve account feature contained in these bills raises significant questions about whether the IRA will satisfy these Code requirements. In particular, it appears that the reserve account could violate the exclusive benefit rule. Generally, the purpose behind the exclusive benefit rule is to prevent the use or diversion of assets or funds for purposes other than to benefit

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http://www.mhco.com/Library/Articles/2010/A403b_062110.html. *See also* DOL Field Assistance Bulletin 2007-02 (July 24, 2007) (stating employer may enter into "salary reduction agreements" with employees consistent with 403(b) safe harbor, but not mentioning automatic enrollment); DOL Advisory Opinion 2012-02A (May 25, 2012) (contributions are not completely voluntary if employer makes matching contributions).

[15] *See* Automatic IRA Act of 2011, S. 1557, 112th Cong. (2011).

[16] Code § 408(a)(5). H.R. REP. NO. 93-1280, at 4604 (1974) (Conf. Rep.) (stating that the legislative language is intended to capture a group trust).

the individual.[17] Under these bills, it appears that the reserve account circumvents the exclusive benefit rule by allowing the board to allocate excess earnings with respect to the assets to the reserve account and then use such excess earnings to provide (or supplement) the stated interest rate credited to each individual's account. By doing so, the reserve account effectively pools together the earnings on each individual's contribution and then redistributes such earnings among the other individual accounts.

The guidance on the exclusive benefit rule as it relates to IRAs is sparse. However, courts have acknowledged that it is similar to the exclusive benefit rule applicable to qualified plans.[18] In that context, the IRS has held that an employer cannot transfer assets from one overfunded qualified plan to a separate underfunded qualified plan. The IRS interpreted the exclusive benefit requirement to mean that "there must be no diversion other than for the benefit of '*such* employees or their beneficiaries'...meaning the employees covered under the specific trust involved."[19]

Consistent with the requirement that any pooling occur only in a common trust fund or common investment fund, the IRS has allowed the creation of "group trusts" that hold the assets of multiple qualified plans and/or IRAs. Recent guidance from the IRS regarding the use of these group trusts confirms that assets cannot be used to benefit employees or individuals in other plans or accounts. In Revenue Ruling 2011-1,[20] the IRS stated that each group trust must expressly state in its governing document that it is impossible for any part of the corpus or income of the one plan (treating, for this purpose, each IRA as its own plan) to be used for, or diverted to, purposes other than for the exclusive benefit of the plan participants and their beneficiaries. For this purpose, plan assets are used for, or diverted to, purposes other than for the exclusive benefit of the plan participants and their beneficiaries if the assets of plan are used to provide benefits under another plan even if the plan participant or beneficiary receiving the benefits is a participant or beneficiary under both plans.

It appears that the effect of the reserve account is to transfer assets and income from one individual account to another individual account *via* the reserve account. Take a simple example. Assume a Mandatory Auto Enroll Arrangement has five enrollees. For three years, the

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[17] *See* Rodoni v. Comm'r, 105 T.C. 29, 33 (1995) (stating that the "essence of an IRA is that it is a retirement account created to provide retirement benefits to 'an individual'"); *see also* Bunney v. Comm'r, 114 T.C. 259 (2000).

[18] *See Rodoni*, 105 T.C. at 33 n.3 ("The requirement in sec. 408(a) that an IRA be for "the exclusive benefit of an individual or his beneficiaries" mirrors the requirement that a qualified profit sharing plan under sec. 401(a) be for the "exclusive benefit of * * * employees or their beneficiaries.").

[19] Rev. Rul. 73-534, 1973-2 C.B. 132 (emphasis in original). *Cf.* Rev. Rul. 68-242, 1968-1 C.B. 156 (holding that the transfer of the actuarial excess under an annuity contract to another annuity contract issued under a single qualified plan did not violate the exclusive benefit rule because such funds benefited employees under the same plan). Here, the reserve account is intended to satisfy the IRA rules, which require the trust to be for the benefit of the individual.

[20] 2011-2 I.R.B. 251.

stated interest rate is 3% but the assets consistently generate a 5% return. The extra 2% is placed into the reserve account as a cushion. After three years, one of the enrollees retires and is paid out. The next year, the stated interest rate is again 3%, but the investments generated only 1% return. Assets are moved from the reserve account to the remaining four enrollees' accounts to make up the difference. It appears, therefore, that the effect of the arrangement is to transfer assets from one IRA to another, in violation of the exclusive benefit rule.

The operation of the reserve account can be distinguished from annuity contracts, which are commonly used in connection with IRAs and qualified plans. In fact, if an annuity were purchased by a qualified plan or IRA, it might operate in a similar manner. Insurance companies place premium payments in their general account and use the assets in the general account to pay a guaranteed rate of interest. The insurance company generally uses the earnings on its investments for other purposes, including paying benefits to other policy holders. The Code and ERISA specifically recognize the use of contracts issued by licensed insurance companies to provide guaranteed benefits, and the assets held in the general account are not subject to the exclusive benefit rule.[21] That does not mean that *any group trust funding* arrangement is eligible for the special rules that apply to insurance companies.

While there is no guidance specifically on point, we think that this "reserve account" feature of a trust could raise serious questions about whether the arrangement would qualify as an IRA.

ERISA Fiduciary Obligations

You have asked me to describe, very briefly, the obligations that ERISA imposes on plan fiduciaries. This section is not a complete description of those obligations, which are frequently described as "the highest known to the law."[22] Under ERISA, a fiduciary who breaches any of the responsibilities imposed by ERISA is *personally liable* to make good to the plan any losses resulting from the breach.[23]

General fiduciary duties. ERISA's general fiduciary responsibilities include:

- Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them,
- Carrying out their duties prudently,

[21] Code section 408(b) authorizes the use of annuity contracts issued by insurance companies in connection with IRAs. Only a contract issued by an insurance company can be treated as an individual retirement annuity. *See also* Code § 401(f) (allowing annuity contracts issued by an insurance company to be a qualified trust for retirement plans). *See generally* ERISA § 401(b)(2) (providing that plan assets include only the "guaranteed benefit policy," *i.e.*, an insurance contract that provides for benefits guaranteed by the insurer, and generally will not include the assets of such insurer).

[22] Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996).

[23] ERISA § 409.

- Following the plan documents (unless inconsistent with ERISA),
- Diversifying plan investments, and
- Paying only reasonable plan expenses.[24]

It is important to note here whom ERISA defines as a fiduciary. A fiduciary is any person or entity that exercises any discretionary authority or discretionary control respecting management of a plan, exercises any authority or control respecting management or disposition of plan assets, or renders investment advice for a fee or other compensation.[25] There is no exception if the fiduciary happens to be a state or state official. Thus, not only would the employers that participate in the Mandatory Auto-Enroll Arrangement be ERISA fiduciaries (see discussion earlier) but *so would the state and state officials that operate the program and manage the assets held under the program.*

Trust requirement. ERISA generally requires that all assets of a plan be held in trust.[26]

Bonding requirement. ERISA generally requires that fiduciaries and others who handle plan funds or other plan property be covered by a fidelity bond.[27]

Detailed reporting and disclosure. ERISA imposes detailed reporting and disclosure requirements on retirement plans. DOL publishes a Reporting and Disclosure Guide for Employee Benefit Plans that takes eight pages to simply *summarize* these requirements.[28]

ERISA's Prohibited Transactions

In addition to the affirmative duties that fiduciaries must perform, fiduciaries must refrain from engaging in certain transactions with the plan and a wide range of persons associated with the plan considered to be "parties in interest." These transactions are most commonly referred to as ERISA's prohibited transactions. These prohibited transactions are set forth in ERISA section 406, with near-identical rules set forth in Code section 4975. ERISA labels those persons prohibited from engaging in transactions with the plan as "parties in interest," while the Code labels them "disqualified persons." A plan's parties in interest includes fiduciaries to the plan, service providers to a plan, the employer whose employees participate in the plan, its officers and employees, and various entities associated with all of these.[29]

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[24] ERISA § 404.

[25] ERISA § 3(21).

[26] ERISA § 403.

[27] ERISA § 412.

[28] *See* www.dol.gov/ebsa/pdf/rdguide.pdf.

[29] ERISA § 3(14).

The prohibited transaction rules apply to IRAs under Code section 4975 regardless of whether the IRA is used in a plan governed by ERISA. Thus, states that implement the Mandatory Auto-Enroll Arrangement must comply with these rules *even if the arrangement is ultimately determined not to be governed by ERISA*.

Under these rules, a fiduciary must not cause a plan to engage in a transaction if the fiduciary knows or should know that such transaction constitutes a direct or indirect transaction between the plan and a party in interest, including the sale or exchange, or leasing, of any property, the lending of money, or the furnishing of goods or services between the plan and a party in interest.[30] In addition, the fiduciary may not allow the transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan.[31]

The prohibition on the transfer to (or use by or for the benefit of) a party in interest of any plan assets does not require that the assets of a plan actually be transferred to a party in interest in order to come within the prohibition. Rather, it is sufficient if the assets are used so as to benefit a party in interest. Transactions that are prohibited between the plan and a party in interest are prohibited without regard to whether the transaction otherwise results in a benefit to the plan. In other words, the prohibited transaction rules are *per se* prohibitions.

In fact, plan sponsors and service providers that operate within the ERISA space accept that ERISA and the Code's prohibited transaction rules are so broad that virtually any transaction involving a plan could run afoul of the prohibited transaction rules. Thus, nearly every transaction involving a party in interest generally needs to be the subject of a statutory or administrative exemption. For example, any careful investment manager that manages ERISA plan assets will operate under the so-called "QPAM" exemption to avoid inadvertently creating a prohibited transaction by trading plan securities in the market.[32] Similarly, DOL needed to issue an exemption simply to allow a financial institution to offer a nominal incentive to a customer opening an IRA with the financial institution, such as a toaster.[33]

It is helpful to think about a straightforward example of a prohibition transaction that would apply to a Mandatory Auto-Enroll Arrangement. ERISA and the Code prohibit a plan fiduciary from causing the plan to engage a party in interest to provide services to the plan. Since service providers are themselves parties in interest, ERISA makes simply hiring a service provider a prohibited transaction. ERISA provides an exemption for certain service contracts, but imposes three requirements:

(1) the service must be *necessary* for the establishment or operation of the plan;
(2) the arrangement must be *reasonable*; and

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[30] ERISA § 406(a)(1).

[31] ERISA § 406(a)(1)(D); Code section 4975(c)(1)(D).

[32] *See* Prohibited Transaction Exemption 84-14.

[33] *See* Prohibited Transaction Exemption 93-1.

(3) no more than *reasonable compensation* may be paid.[34]

DOL has issued detailed regulations under this exemption that must be followed, including, effective in 2012, complex disclosures that must be provided with respect to certain plans and service providers before the arrangement is entered into.[35] In the context of the Mandatory Auto-Enroll Arrangement, this means that any service provider, including, presumably, the state itself, cannot impose fees without meeting the requirements of the exemption.

DOL's administrative exemptions impose even more exhaustive conditions when securities and investments of any complexity are involved. For example, DOL's exemption to allow plans to invest in real estate investment trusts (REITs) contains more than 50 subparagraphs in its "Conditions" section.[36] State retirement systems that meet the definition of "governmental plan" because they offer benefits solely to state and local employees do not have to contend with these complex rules and thus have no experience with them.

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The arrangement contemplated by the Mandatory Auto-Enroll Arrangements is novel and thus there is no direct precedent on how they would be treated under ERISA. If the DOL (or a court) were to apply the reasoning in the recent analogous advisory opinions described above, then a Mandatory Auto-Enroll Arrangement would (a) not meet the requirement to be a "governmental plan" exempt from ERISA; (b) create *separate* ERISA-governed plans, each of which is separately subject to ERISA's reporting and disclosure requirements; (c) impose ERISA's fiduciary provisions on the private employers that participate in the arrangement; and (d) impose ERISA's prohibited transaction provisions with respect to any "party in interest" to the arrangement, including each employer and the state itself. These conclusions would not change simply because the contributions under the arrangement are made to individual retirement accounts rather than a qualified trust.

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[34] ERISA § 408(b)(2).

[35] 29 C.F.R. § 2550.408b-2. These new disclosures do not apply to IRAs, but the other requirements of the regulation do apply.

[36] *See* Prohibited Transaction Exemption 2004-07.