OK Federal Legislative and Regulatory Summary Report, July 2005

A quick-read version of this month’s report. The full version begins on page 3.

I. Washington Update

The full article can be found on page 3.

Prior to the July 4th recess, several legislators introduced proposals pertaining to Social Security reform, reforming and strengthening the private sector defined benefit system and various provisions affecting defined contribution plans (including automatic enrollment). However, delays in this Congressional agenda could occur as a result of the confirmation hearings that will likely take place now that the President has nominated John G. Roberts Jr. to the Supreme Court seat vacated by the retiring Justice Sandra Day O’Connor.

Senator Grassley, Chair of the Senate Finance Committee and Representative Thomas, Chair of the House Ways and Means Committee, have been working on comprehensive legislative packages that may include both Social Security and other retirement related proposals. There have been many bills that have already been introduced this year that address these issues. This month’s report provides a brief overview of the more recent proposals for both Social Security reform and pension/retirement plan issues.

II. Domestic Partners and Employee Benefit Plans

The full article can be found on page 5.

Two IRS Private Letter rulings were recently issued to a governmental employer and illustrate the potential effect on the sponsor’s two eligible 457 plans when state domestic partnership laws are applied to the operation of these plans. Although private letter rulings apply only to the employer requesting them, plan sponsors may find them to be helpful guides to evaluate compliance with federal laws in the operation of retirement and welfare benefit plans.

In both letters the IRS concluded that the employer’s 457 plans would not be in compliance with IRC 457(b) if the plans were not, after the date of the ruling, operated using the definition of spouse contained within the Defense of Marriage Act when administering the plans’ spousal provisions. Spouses, former spouses and surviving spouses have distribution rights under these plans that do not extend to non-spouses, non-spousal alternate payees or non-spouse beneficiaries.
III. Joint DoL and SEC Fiduciary Guidance

The full article can be found on page 7.

Last month the Department of Labor (DoL) and the Securities and Exchange Commission (SEC) released guidance for plan fiduciaries to use in selecting and monitoring pension consultants. This guidance should be helpful for all plan fiduciaries.

To encourage the disclosure and review of more and better information about potential conflicts of interest, the Department of Labor and the SEC identified specific questions that plan fiduciaries can use to help them evaluate the objectivity of the pension consultant’s recommendations.
I. Washington Update

On July 19, 2005, President Bush nominated John G. Roberts Jr. to the Supreme Court seat vacated by the retiring Justice Sandra Day O'Connor. The confirmation process for a new Justice may delay several Congressional agenda items including Social Security and pension reform.

Prior to the July 4th recess, several legislators introduced Social Security solvency and personal account proposals, proposals to facilitate automatic enrollment and proposals to reform and strengthen the private sector defined benefit system.

Later this month, Chairman Charles Grassley and the Senate Finance Committee may submit a draft of their Social Security reform bill that could include proposals for progressive indexing of social security benefits for higher income workers, a phase in of a moderate increase in the Social Security normal retirement age, and cap on benefits payable to individuals with incomes of $90,000 and above.

The Committee is considering carve-out, add-on personal accounts or using Social Security surpluses to fund Social Security personal accounts. In the meantime, Chairman Bill Thomas and the House Ways and Means Committee continue to work on their version of the omnibus bill that is expected to include both Social Security and pension reform.

The following summarizes several proposals being considered in Congress.

Social Security Reform Bills

Senator Jim DeMint (R-S.C.) introduced the Stop the Raid on Social Security Act. The bill would use Social Security surpluses:

1. Only for Social Security, and not to finance other government programs
2. To finance personal retirement accounts (PRAs) that are legally owned by workers

If passed, workers under the age of 55 would have PRAs, or can choose to opt out. PRAs will initially be invested in marketable Treasury bonds which would later be expanded to include other investments. A copy of this bill is available at: http://thomas.loc.gov. Select # S. 1302.

Four members of the House Ways & Means Committee who have been actively involved in promoting Social Security personal account legislation – Jim McCrery (R-LA), Clay Shaw (R-FL), Sam Johnson (R-TX) and Paul Ryan (R-WI), introduced a similar proposal. The proposal – the Growing Real Ownership for Workers (GROW) Account Act – would also dedicate Social Security trust fund surpluses to personal accounts for workers under 55 and invest the accounts in Treasury securities.

Representative Thomas (R-CA), chairman of the Ways & Means Committee, offered positive comments about the proposal and indicated it will likely form the basis for one of the components of the broader Social Security/retirement security legislation the Chairman is preparing.

Senator Bob Bennett (R-UT) is expected to introduce two Social Security reform bills based on the Administration’s latest proposals. The first bill will deal exclusively with Social Security solvency and will include proposals for:

- Progressive indexing based on price indexing instead of wage indexing to determine initial retiree benefits beginning in 2012: Low wage workers would continue to have their benefits calculated using wage index, meaning that future benefit levels for higher wage earners will not
rise as rapidly as benefit levels for lower wage earners since prices have historically risen more slowly than wages.

- Longevity indexing and acceleration of normal retirement ages: Under present law, the retirement age is scheduled to increase incrementally beginning in 2022 until it reaches age 67 in 2027. The Bennett proposal would accelerate the move to age 67 beginning in 2012 until the Social Security normal retirement age of 67 is reached in 2017. After 2017, initial benefits for future retirees will be adjusted to account for changes in life expectancies.

The second Bennett bill would introduce the concept of “carve-in” personal accounts. Beginning four years after enactment, workers would have the option to create voluntary “carve-in” personal accounts. Workers who elected to contribute an additional 2% or their wages into an account modeled after the Thrift Saving Plan for federal workers would be allowed to move an additional 2% of their Social Security contributions into their “carve-in” personal account. Future retirement benefits from the core Social Security program for workers choosing “carve-in” personal accounts would be adjusted to reflect a lower level of tax contributions to the core security retirement fund.

A summary of these bills is available at: http://bennett.senate.gov/press/documents/062205bennett_sossummary.pdf

Retirement Related Proposals

Senators Gordon Smith (R-OR) and Kent Conrad (D-ND) unveiled their bi-partisan Retirement Savings and Security Act of 2005 which:

- Promotes automatic enrollment as a means to increase participation in 401(k) and other deferral plans.
- Expands and extends the Savers Credit through 2010 to benefit more Americans.
- Allows employees to transfer up to $500 per year in unused Flexible Spending Account balances to a defined contribution plan or IRA.
- Permits taxpayers to electronically direct some or all of their federal tax refunds to their IRAs.
- Provides tax incentives to retirees who purchase life annuities by making a portion of the annuity payments free from taxation. The bill also clarifies the fiduciary standards that apply to defined contribution plan sponsors that offer annuities to their departing employees.
- Extends deadline for correcting distributions from defined contribution plans from 2½ months to 6 months after the end of the plan year, simplifies the rules for calculating the distributions, and taxes corrective distributions in the year they are distributed from the plan.
- Clarifies fiduciary rules when plan sponsors need to change investment option because it is no longer prudent to keep them or when sponsors change service providers. Employers would be protected from fiduciary liability when funds are transferred (mapped) to funds that are the most comparable to the employee’s former investments.


On June 16th, Representative Earl Pomeroy (D-ND) introduced the “Lifetime Pension Annuity for You (PAY) Act of 2005” (HR 2951). This bill offers incentives to Americans to establish lifetime annuities from assets accumulated in qualified and non-qualified plans.
II. Domestic Partners and Employee Benefit Plans

The debate over the definition of marriage and the extension of marital rights to non-traditional relationships and unions continues to be a national hot topic. Massachusetts is currently the only state that permits same sex marriages. Vermont and Connecticut extend civil unions (similar to common law marriages) to same sex couples and California grants many marital rights applicable to spouses to registered domestic partners.

Pension and welfare benefit plan sponsors need to consider the implications of applying state domestic partnership and civil union laws to their employee benefit plans which are, for the most part, subject to federal law. Although public sector plans are not subject ERISA, they are subject to other federal laws including the Defense of Marriage Act (DOMA) which:

- Defines marriage as “only a legal union between one man and one woman as husband and wife.”
- Clarifies that the term spouse “refers only to a person of the opposite sex who is a husband or wife.”
- Requires that the DOMA definition of marriage, instead of a state law definition of marriage, be used to determine the meaning of any Act of Congress or any ruling, regulation or interpretation of various administrative bureaus or agencies of the United States.

Two IRS Private Letter rulings recently issued to a governmental employer illustrate the potential effect on the sponsor’s two eligible 457 plans when state domestic partnership laws are applied to the operation of these plans. In both letters the IRS concluded that the employer’s 457 plans would not be in compliance with IRC 457(b) if the plans were not, after the date of the ruling, operated using the DOMA definition of spouse when administering the plans’ spousal provisions. Spouses, former spouses and surviving spouses have distribution rights under these plans that do not extend to non-spouses, non-spousal alternate payees or non-spouse beneficiaries.

Background

The County government that requested the IRS Private Letter Rulings sponsors two eligible 457 plans, a collectively bargained voluntary contributory 457 plan and a FICA replacement plan. Under the laws of the State where the County is located, registered domestic partners, formerly registered domestic partners and surviving domestic partners have the same rights, protections, benefits, responsibilities and duties under law as granted to or imposed on spouses, former spouses or surviving spouses. Under this State’s laws, registered domestic partners will be treated as if federal law recognized domestic partners in the same way the state law does. However, state law expressly provides that it does not amend or modify federal law, or the benefit protections and responsibilities provided by federal law.

Although neither 457 plan defines the term spouse, both plans have spousal provisions that would apply to a participant’s spouse, former spouse or surviving spouse that would affect the:

- Application of the required minimum distribution rules including the determination of the required beginning date for making distributions, the use appropriate life expectancy tables for calculating these distributions and the applicable distribution period.
Right of a surviving spouse to roll over distributions from the deceased participant spouse’s plan to the surviving spouse’s own IRA, or retirement plan.

Early distributions to a spousal or former spouse alternate payee under a qualified domestic relations order and that alternate payee’s right to roll these amounts to the alternate payee’s retirement plan or IRA.

Basis for making unforeseen emergency distributions because of an illness or accident that causes severe financial hardship to the participant’s spouse. Income and assets of a spouse are also taken into account for determining if the participant is eligible for an unforeseen emergency distribution.

Conclusion

The IRS private letter rulings concluded that:

- Both plans were eligible 457 plans and that the one plan was a FICA replacement plan.
- Both plans would not be in compliance with IRC 457(b), unless the plan’s spousal provisions are interpreted and applied in a manner that is consistent with DOMA.
- A registered domestic partner, a former registered domestic partner or a surviving domestic partner as defined under the state law is not a spouse, former spouse, or surviving spouse for purposes of 457.
- These rulings will apply to deferrals made after this date of the rulings. The letters further note that if the plan is significantly modified, these rulings may not remain applicable.

Although both letter rulings apply only to the employer requesting them, and do not address potential tax implications if the plans do not apply the DOMA definition of spouse, employers may find them to be helpful guides to compliant operation of their retirement and welfare benefit plans.

These IRS private letter rulings are available at:
III. Joint DoL and SEC Fiduciary Guidance

Last month the Department of Labor (DoL) and the Securities and Exchange Commission (SEC) released guidance for plan fiduciaries to use in selecting and monitoring pension consultants. Since both ERISA and non-ERISA plan fiduciaries often rely heavily on pension consultants and other professionals to help them in carrying out their fiduciary duties, this guidance should be helpful for all plan fiduciaries.

According to a recent SEC staff report there are approximately 1,742 SEC-registered investment advisers who also provide pension-consulting services. The report found that some pension consultants offer only pension-consulting services, while other firms have additional business operations such as brokerage and money management that are often affiliates of the pension consultant. Broker-dealers and other types of firms have also started to provide pension consulting in addition to their other lines of business. The SEC report examined a cross section of the pension consultant community to determine if pension consultants fully disclose potential conflicts of interest that may affect the objectivity of the advice they provide to their pension plan clients.

Under the Investment Advisers Act of 1940 (Advisers Act), an investment adviser providing consulting services has a fiduciary duty to provide disinterested advice and disclose any material facts, including material conflicts of interest, to their clients. In this context, SEC examined the practices of advisers that provide pension-consulting services to plan sponsors and trustees and found that consulting services include:

- Assisting in determining the plan’s investment objectives and restrictions
- Allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers

Many of the consultants also offered, directly or through an affiliate or subsidiary, products and services to money managers. Many consultants also offered, directly or through an affiliate or subsidiary, brokerage and money management services, which are often marketed to plans as a package of “bundled” services. The SEC report concluded that the business alliances among pension consultants and money managers could give rise to serious potential conflicts of interest under the Advisers Act that need to be monitored and disclosed to plan fiduciaries.

To encourage the disclosure and review of more and better information about potential conflicts of interest, the Department of Labor and the SEC have developed the following set of questions and explanations plan fiduciaries can use to help them evaluate the objectivity of the pension consultant’s recommendations.

1. Are you registered with the SEC or a state securities regulator as an investment adviser? If so, have you provided me with all the disclosures required under those laws (including Part II of Form ADV)?

   You can check yourself – and view the firm’s Form ADV – by searching the SEC's Investment Adviser Public Disclosure Web site. At present, the IAPD database contains Forms ADV only for investment adviser firms that register electronically using the Investment Adviser Registration Depository. In the future, the database will expand to encompass all
registered investment advisers—individuals as well as firms—in every state. If you can’t locate an investment adviser in IAPD, be sure to contact your state securities regulator or the SEC’s Public Reference Branch.

2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan? If so, describe those relationships.

When pension consultants have alliances or financial or other relationships with money managers or other service providers, the potential for material conflicts of interest increases, depending on the extent of the relationships. Knowing what relationships, if any, your pension consultant has with money managers may help you assess the objectivity of the advice the consultant provides.

3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your other income (revenue)?

Payments from money managers to pension consultants could create material conflicts of interests. You may wish to assess the extent of potential conflicts.

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being a factor when you provide advice to your clients?

Probing how the consultant addresses these potential conflicts may help you determine whether the consultant is right for your plan.

5. If you allow plans to pay your consulting fees using the plan’s brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not over-pay its consulting fees?

You may wish to avoid any payment arrangements that could cause the plan to pay more than it should in pension consultant fees.

6. If you allow plans to pay your consulting fees using the plan’s brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?

Where and how brokerage orders are executed can impact the overall costs of the transaction, including the price the plan pays for the securities it purchases.

7. Do you have any arrangements with broker-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?

As noted above, you may wish to explore the consultant’s relationships with other service providers to weigh the extent of any potential conflicts of interest.

8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment adviser to the plan while providing the consulting services we are seeking?
All investment advisers (whether registered with the SEC or not) owe their advisory clients a fiduciary duty. Among other things, this means that advisers must disclose to their clients information about material conflicts of interest.

9. **Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?**

If the consultant is a fiduciary under ERISA and receives fees from third parties as a result of their recommendations, a prohibited transaction under ERISA occurs unless the fees are used for the benefit of the plan (e.g., offset against the consulting fees charged the plan) or there is a relevant exemption.

10. **What percentage of your plan clients uses money managers, investment funds, brokerage services or other service providers from whom you receive fees?**

The answer may help in evaluating the objectivity of the recommendations or the fiduciary status of the consultant under ERISA.

**NRS Comment:** Plan fiduciaries now know what kinds of questions to ask. It will be up to them to get this information and use it in selecting and monitoring pension consultants. Many consultants have already responded to these questions or posted relevant information on their websites.


The 10 Tips are available at: [http://www.dol.gov/ebsa/newsroom/fs053105.html](http://www.dol.gov/ebsa/newsroom/fs053105.html)

**IV. Keeping watch**

Nationwide continues to monitor investigations into mutual-fund trading practices and related issues. You can find the most recent information on these issues on the Employer page of your plan Web site. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through these publications:

- *Federal Legislative and Regulatory Report* – distributed monthly
- *Plan Sponsor Alerts* – distributed as needed to announce breaking news

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Tip: Click on underlined words to go to the topic being discussed.