

2011 ERISA Advisory Council
Current Challenges and Best Practices for ERISA Compliance for 403(b) Plan Sponsors

Joint Statement of the Investment Company Institute and Fidelity Investments
August 30, 2011

The Investment Company Institute (ICI)¹ and Fidelity Investments appreciate the opportunity to appear before the ERISA Advisory Council to present our views on how the Department of Labor could address ERISA compliance issues currently facing 403(b) plan sponsors. ICI is the national association of U.S. investment companies, which includes mutual funds. According to ICI estimates, as of the end of 2010, mutual funds held \$2,469 billion of defined contribution plan assets, including 401(k), 403(b) and 457 plans. We estimate that assets in 403(b) plans totaled \$758 billion at the end of 2010. Twenty-six percent of this total (or \$197 billion) was held in mutual funds through variable annuity contracts and 22 percent (or \$168 billion) was held in mutual fund custodial accounts.² ICI members not only offer investments, but also provide services to 403(b) plans and participants.

This written statement is submitted in conjunction with the testimony before the Council on August 30, 2011 of Elena Barone Chism, Associate Counsel for Pension Regulation, and Weiyen Jonas, Vice President and Associate General Counsel of FMR LLC. FMR LLC is the parent company of the group of financial service companies known collectively as Fidelity Investments.³ Fidelity Investments provides various services to over 1,800 ERISA 403(b) plans covering over two million participants.⁴

Executive Summary

Section I describes various difficulties faced by employers with 403(b) arrangements intended to meet the Department's ERISA safe harbor exemption. Many of these employers are finding that their efforts to comply with tax regulation changes are inconsistent with new guidance from the

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders. ICI's mutual fund members manage about half of defined contribution plan and IRA assets combined and advocate policies to make retirement saving more effective and secure.

² Investment Company Institute. 2011. "The U.S. Retirement Market, First Quarter 2011" (June). http://www.ici.org/info/ret_11_q1_data.xls.

³ Fidelity Investments provides record keeping, investment management, brokerage, and trustee or custodial services to thousands of Internal Revenue Code Section 401(k), 403(b), 457(b) and other retirement plans covering millions of participants and their beneficiaries.

⁴ Figures based on 403(b) retirement plans recordkept by Fidelity Investments as of July 31, 2011.

Department on maintaining a non-ERISA 403(b) plan. We outline steps the Department should take to permit these employers to reform their arrangements and stay within the safe harbor.

In Section II, we recommend additional guidance for ERISA 403(b) plans, similar to the Department's transition relief for purposes of Form 5500 reporting, recognizing that certain 403(b) contracts and accounts logically are not part of the ERISA plan. This testimony describes two categories of 403(b) contracts and accounts that deserve this recognition. First, individual annuity contracts and individual custodial accounts held by former employees should not be considered plan assets. Second, contracts held by vendors discontinued as plan vendors prior to 2009 or vendors who established 403(b) contracts or accounts pursuant to IRS Revenue Ruling 90-24 should not be considered ERISA plan assets, even if contributions are being made on behalf of an individual (who is a current employee) to another vendor under the plan.

Finally, Section III discusses numerous issues arising for 403(b) plans subject to the Department's new disclosure rules under ERISA sections 408(b)(2) and 404(a). The Department should provide relief under both rules for discontinued vendor contracts (also addressed in Section II) and the mistaken belief that a plan or a particular contract is exempt from ERISA coverage. The participant disclosure rules under section 404(a) also require clarification for 403(b) plans of what constitutes a "designated investment alternative" (which triggers certain investment-related disclosures) and how to combine the investment-related disclosures from multiple vendors. We also explain why the Department should immediately provide interim guidance allowing greater use of electronic delivery methods for the participant disclosures.

I. Non-ERISA Safe Harbor

We recommend that the Department provide transition relief to nonprofit organizations maintaining 403(b) arrangements that are meant to be exempt from ERISA. The last few years have been a period of enormous upheaval for 403(b) plans, particularly for arrangements meant to fall within the safe harbor exemption from ERISA at 29 C.F.R. § 2510.3-2(f). The final 403(b) regulation published by the Internal Revenue Service in July, 2007 fundamentally restructured the manner in which 403(b) plans are administered. The Department has since issued two field assistance bulletins (FABs) – FAB 2007-02 and FAB 2010-01 – that illuminate the safe harbor regulation, providing important new guidance on the ongoing viability and scope of the regulation in light of the new tax rules.

As the dust has started to settle, it is apparent that some plans meant to be safe harbor plans exempt from ERISA may not be exempt. Some programs may have inadvertently crossed the line into ERISA coverage in attempting to comply with the tax regulation, for example, by entering into information sharing agreements that impose responsibility on the employer for authorizing

distributions. Others may have engaged a third-party administrator (TPA) to manage tax compliance, which FAB 2010-01 indicates is inconsistent with the safe harbor exemption. Others may find that the program they thought was compliant with the safe harbor has never been within the safe harbor, for example, because FAB 2010-01 concludes that, absent special circumstances, a single-vendor plan is outside the safe harbor unless it permitted 90-24 transfers in the past and, after publication of the tax regulation, allows exchanges.

The evolving law of 403(b) plans and the safe harbor exemption has taxed even the most compliance-minded employers and vendors. The interaction between the safe harbor exemption and the tax regulation has been particularly challenging simply because the two regulations point in opposite directions. The core concept underlying the safe harbor exemption is that a 403(b) plan is not “established or maintained by an employer” to the extent the employer has very limited involvement in plan design and operation. However, the fundamental notion underlying the 2007 tax regulation is that employers suddenly are responsible for the administration and operation of the plan, which is a complete reversal of over 30 years of tax policy.

The upheaval and confusion has had, and continues to have, significant adverse consequences for participants. As the nonprofit community has become sensitized to the possibility that their plans may in fact be subject to ERISA, some employers have become very wary of coordinating with the vendors for fear of losing the safe harbor exemption. These employers have refused to authorize distributions and have indicated that the vendors should be responsible for authorizing distributions. The vendors, however, may be reluctant to do so in the absence of either a contractual agreement to that effect or a means of obtaining necessary information relating to contracts with other vendors. The sad result is that some participants have not been able to access their retirement savings, even though they are otherwise entitled to receive their benefits. While the employee may ultimately be able to pressure the employer into authorizing the distribution, affected employees have suffered, and continue to suffer, significant delays in accessing their accounts.

Relief Requested

We believe the Department should provide relief to nonprofit employers from the severe consequences associated with inadvertently acting outside the safe harbor, even temporarily, which range from fiduciary liability to monetary penalties for failure to file Form 5500 annual returns.⁵

⁵ One particularly difficult issue relates to the application of the qualified joint and survivor annuity requirements of section 205 of ERISA. While a non-ERISA custodial account arrangement will ordinarily satisfy the minimum requirements of section 205, for example, by providing that the spouse must be the participant’s beneficiary absent consent to the contrary, there may be questions about whether a tax-sheltered annuity arrangement that was in fact subject to ERISA satisfied the requirements of section 205.

Private charitable and nonprofit organizations often have modest budgets and limited staff, a situation particularly common among those relying on the ERISA safe harbor regulation.⁶ Resources dedicated to plan administration are also resources that are diverted from charitable purposes so that charities are often forced to make difficult resource allocation choices. The last few years have been especially tough on nonprofit organizations as the steep decline in the stock markets in 2008 and continued economic uncertainty have generally diminished endowments and charitable giving. The Department's relief must address three particular issues.

First, 403(b) plans that are intended to fall within the safe harbor should not be treated as ERISA plans solely because the employer assumed some responsibility for authorizing distributions. The Department's evolving guidance on the safe harbor exemption draws a fine distinction between *sharing information* and *making discretionary determinations*. Thus, for example, under the existing guidance, an employer may communicate to a vendor that an employee does not have any outstanding plan loans but may not communicate that an employee is eligible for a plan loan. This distinction puts enormous pressure on the form in which the vendor and the employer agree to coordinate. As a practical matter, there is very little, if any, substantive difference between approving a distribution and providing the factual predicate for a distribution. Benefit payment provisions in 403(b) plans rarely require truly discretionary determinations, especially as most 403(b) plans are typically funded solely with salary reduction contributions. Continuing with the plan loan example, if a participant does not have other plan loans outstanding, the plan must provide a loan. There is generally no discretion to do otherwise.⁷

Many employers did not appreciate the significance of the distinction between information sharing and discretionary determinations when they entered into service agreements and information sharing agreements. Rather than draft the agreements to state that the employer provides the necessary information and the vendor then approves the transaction on a ministerial basis, the agreements provide that the employer is responsible for authorizing distributions. This distinction has become a trap for the unwary and is also particularly difficult to articulate and communicate to our members' front-line employees and plan sponsor clients. This distinction does not apply and the associated service model alterations are not required for either ERISA-covered plans or non-ERISA governmental

⁶ We note that the Department provided large ERISA 403(b) plans with much-needed transitional relief from Form 5500 reporting and audit requirements with respect to contracts and custodial accounts issued prior to January 1, 2009. In contrast, many of the employers relying on the safe harbor are small and thus have even more limited resources, so it would be a logical step for the Department to grant transition relief in this context.

⁷ Hardship withdrawals present similar issues. Most 403(b) plans use the safe harbor hardship standards in Treasury regulation § 1.401(k)-1(d)(3), which do not involve discretionary determinations.

plans. It is often viewed as nonsensical and unnecessarily bureaucratic by employers who just want to help their employees save for retirement.

Second, single-vendor 403(b) plans that do not fall within the four corners of FAB 2010-01 should also be provided transition relief. FAB 2010-01 describes for the first time what specific single-vendor situations would satisfy the reasonable choice requirement. Some employers reasonably interpreted the existing guidance to contemplate single-vendor arrangements if the vendor simply afforded employees a reasonable choice of investments, for example, through an open architecture custodial account.⁸ For example, Fidelity Investments offers over 150 different proprietary mutual funds in its standard 403(b) plan offering, including a series of institutional target date funds. ERISA-covered 401(k) plans offering far fewer investment options can comfortably meet Department's regulation under ERISA section 404(c), which requires that participants and beneficiaries have a reasonable opportunity to choose from at least three investment alternatives, each of which is diversified and has materially different risk and return characteristics, among other requirements.⁹ FAB 2010-01, however, indicates that a 403(b) plan will ordinarily fall outside of the safe harbor exemption if the program only remits contributions to a single vendor and exchanges – the contemporary equivalent to 90-24 transfers – are not permitted.¹⁰ As you may expect, the limits in this interpretation have cast doubt on whether many 403(b) programs are in fact exempt from ERISA coverage.

Third, employers that selected a TPA to manage tax compliance and other plan administration should be covered by transition relief. FAB 2010-01 indicates that an employer may not select a TPA to make discretionary decisions under the plan consistent with the safe harbor exemption. The notion is apparently that the selection of a TPA results in too much employer involvement. However, it was reasonable to read FAB 2007-02 to allow an employer to select a TPA. FAB 2007-02 specifically noted that the documents governing the arrangement could identify parties other than the employer as responsible for administrative functions. Moreover, the notion reflected in FAB 2010-01 is subtle. An employer may make a vendor available who takes on responsibility for making discretionary determinations but cannot select a TPA to perform the same function. It is not clear why a distinction in these two contexts is appropriate merely because the vendor is also providing investments. We also note that a TPA could be particularly useful to facilitate information sharing

⁸ The 1979 safe harbor regulation does not provide that a safe harbor plan must offer a choice of more than one 403(b) contractor. 29 C.F.R. § 2510.3-2(f). It can very reasonably be read to require only that a participant have access to a reasonable choice of investments, such as the choice typically found through a mutual fund custodial account. In fact, the preamble to the regulation explicitly holds out the notion that a single vendor may constitute a reasonable choice in some circumstances. 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979).

⁹ See 29 C.F.R. § 2550.404c-1(b)(3).

¹⁰ Alternatively, FAB 2010-01 provides that the employer may justify offering only one vendor by demonstrating that increased administrative burdens and costs to the employer in offering multiple vendors would cause the employer to stop making its payroll system available to collect and remit 403(b) salary deferrals.

across different vendors, and at the very least, the Department may want to reconsider allowing employers to engage a TPA for data aggregation and information coordination services without exceeding the safe harbor, as long as the TPA is not acting in a discretionary capacity on the employer's behalf.

Accordingly, we believe the Department should provide that it will not assert that a 403(b) plan is subject to ERISA solely because (i) the employer assumed responsibility for authorizing distributions after publication of the tax regulation, (ii) the program offers a single vendor that does not permit exchanges or transfers, but offers access to a reasonable choice of investments, or (iii) the employer selected a TPA to administer tax compliance or other administrative responsibilities after publication of the tax regulation, provided that the employer restructures its arrangement(s) to comply with the Department's new interpretation of each of the foregoing issues by the first day of the plan year beginning at least 12 months after the transition relief guidance is published. The relief should further provide that employer involvement in the restructuring of the arrangement, for example, terminating the TPA relationship and transitioning to a new administrative system, will not taint the safe harbor exemption.

The relief we propose is necessary because FAB 2010-01 was effectively new guidance, significantly altering the regulatory landscape, and it should therefore have been subject to the standard processes for issuing regulations, including a notice and comment period and a prospective effective date. The relief will allow employers and vendors to structure (or restructure) their 403(b) plan arrangements to meet definitely determinable legal requirements with a prospective effective date. It will also ensure that participants are not denied access to their plan benefits solely because of an employer's fear of falling outside of the safe harbor.

II. Definition of Plan Assets

The second fundamental issue that the Department must address is the extent to which ERISA applies to particular 403(b) contracts and accounts. As mentioned earlier, ERISA-covered 403(b) plans are sometimes funded through individual annuity contracts and individual custodial accounts, rather than group annuity contracts or group custodial accounts. The plan sponsor or plan administrator typically will have very limited rights over the contracts and the question arises whether the individual annuity contracts and custodial accounts should be considered part of the ERISA plan.¹¹ For the reasons described below, we believe that individual annuity contracts and individual custodial accounts

¹¹ For convenience, we assume that individual annuity contracts and individual custodial accounts do not reserve material rights for plan fiduciaries and, in contrast, that group contracts and accounts have retained rights. It is, however, not the form of the contract or account that is dispositive; it is the terms of the contract or account and, in fact, it is possible to issue individual certificates under a group contract that operate just like individual annuity contracts or to issue individual contracts that retain significant rights to the plan fiduciary.

held by former employees should not be considered plan assets. In addition, contracts held by vendors discontinued prior to 2009 should not be considered ERISA plan assets, even if contributions are being made on behalf of an individual (who is a current employee) to another vendor. Similarly, we believe that 403(b) individual annuity contracts and individual custodial accounts established pursuant to Revenue Ruling 90-24, while in effect, should not be considered plan assets.¹²

In FAB 2009-02 (clarified by FAB 2010-01), the Department provided transition relief with respect to certain existing 403(b) annuity contracts and custodial accounts, allowing exclusion of these contracts from the Form 5500.¹³ While this guidance was helpful for purposes of the expanded Form 5500 reporting requirements for 403(b) plans, it did not go far enough.¹⁴ We recommend a broader exclusion for these contracts so that they are not considered assets of a 403(b) plan for any purpose under ERISA.

To assist the Council in understanding this issue, Appendix A shows a graphical representation of the various types of 403(b) contracts which currently exist and the extent of the transition relief provided in FAB 2009-02.

The current challenges facing 403(b) plan sponsors and their providers caused by the regulations under ERISA section 408(b)(2) (the “service provider disclosure regulations”) and the participant-level disclosure regulations under ERISA section 404(a) (the “participant disclosure regulations”) are described in Section III, below. Many of the same issues that made it necessary to grant Form 5500 reporting relief have appeared in these other contexts. For that reason, we believe a

¹² The IRS obsoleted Revenue Ruling 90-24 as part of the final 403(b) regulations, generally effective on September 24, 2007. It was possible to create “transitional 90-24 contracts” for a brief period after that date, but those contracts are no longer relevant.

¹³ The conditions for exclusion are: (a) the contract or account was issued to a current or former employee before January 1, 2009; (b) the employer ceased to have any obligation to make contributions (including employee salary reduction contributions), and in fact ceased making contributions to the contract or account before January 1, 2009; (c) all of the rights and benefits under the contract or account are legally enforceable against the insurer or custodian by the individual owner of the contract or account without any involvement by the employer; and (d) the individual owner of the contract is fully vested in the contract or account.

¹⁴ We believe the Department’s transition relief for Form 5500 reporting, as clarified in FAB 2010-01, presents problems similar to the ERISA safe harbor guidance in FAB 2010-01. The FAB clarifies that providing information, such as an individual’s employment status, does not constitute employer involvement that would prevent a contract or account from being excluded from Form 5500 reporting. No reporting relief is available, however, if the employer must consent to decisions regarding enforcement of employee rights under the contract, if the employer must certify that the employee is eligible for a distribution, or has to approve hardship distributions or loans. As with the ERISA safe harbor guidance, the Department has drawn a fine distinction between sharing information and making discretionary determinations, which puts enormous pressure on the form in which the vendor and the employer agree to coordinate. Again, we see very little, if any, substantive difference between approving a distribution and providing the factual predicate for a distribution.

more comprehensive approach by the Department to contracts held by former employees and discontinued vendors is appropriate.

Contracts Held By Former Employees

The Department's regulations strongly suggest that many of these individual annuity and custodial accounts are not plan assets. In this regard, the relevant regulation (the "participant regulation")¹⁵ provides that:

An individual is not a participant covered under an employee pension plan or a beneficiary receiving benefits under an employee pension plan if –

(A) the entire benefit rights of the individual –

(1) are fully guaranteed by an insurance company, insurance service or insurance organization licensed to do business in a State, and are legally enforceable by the sole choice of the individual against the insurance company, insurance service or insurance organization; and

(2) a contract, policy or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual; or

(B) the individual has received from the plan a lump-sum distribution or a series of distributions of cash or other property which represents the balance of his or her credit under the plan.

Taken at face value, this regulation suggests that any individually owned annuity contract is not a plan asset.

The Department has clarified the scope of the participant regulation, however, by indicating that the "entire benefit rights" of an individual are not guaranteed or distributed for purposes of the regulation if an employee is continuing to accrue benefits.¹⁶ Instead, the regulation is "directed to situations where employment has been severed, where the employee is fully vested and changes to employment not covered by the plan, or where the employee has earned the maximum benefit he can earn under the plan."¹⁷ As a result, the mere fact that a retirement plan is funded through individual annuity contracts does not mean that the plan has no assets. It is only after contributions are discontinued that the individual assets are effectively treated as distributed from the plan.

¹⁵ 29 C.F.R. § 2510.3-3(d)(2)(ii).

¹⁶ See 44 Fed. Reg. 23527 (April 20, 1979) (preamble to 29 C.F.R. § 2510.3-2(f)); Advisory Opinion 77-10 (June 2, 1977).

¹⁷ Adv. Op. 77-10.

Taken as a whole, existing guidance provides that a former employee holding 403(b) contracts that are individual annuity contracts is not a “participant” in a pension plan for purposes of ERISA.¹⁸ As a result, an individual annuity contract held by a former employee is not a plan asset.

We believe that a similar analysis logically applies to individual custodial accounts held by former employees. The Department’s regulations provide two different grounds under which an individual ceases to be a participant: (i) participants are paid their entire benefit in the form of an annuity or (ii) participants are paid their entire benefit in cash or other property. Both grounds suggest that individual custodial accounts held by former employees are not plan assets.

Under the first prong, individual custodial accounts should be viewed as equivalent to annuities and should be covered by the participant regulation. Section 403(b)(7) of the Internal Revenue Code provides that amounts contributed to a custodial account shall be treated as amounts contributed to an annuity contract if the applicable 403(b) requirements are satisfied. Further, the final 403(b) regulations state that “[u]nder section 403(b)(7), a custodial account is treated as an annuity contract” for all purposes under the 403(b) regulations.¹⁹ We appreciate that this is a tax, not an ERISA, concept. However, we believe that it is highly relevant to whether an analogous approach should be taken in the context of ERISA, at least as it applies to 403(b) plans. Moreover, a custodial account has the same key characteristics as an annuity contract for this purpose, in particular, that all of the rights are vested in the participants and the employer does not have material retained rights. In this regard, the Department has treated a group annuity contract as distributed from a plan in cases where the employer does not have any material retained rights under the group contract.²⁰

The second prong of the participant regulation also offers a basis for concluding that individual custodial accounts in the hands of a former employee are not plan assets. A custodial account is a form of property. The mere fact that a custodial account is tax-deferred does not cause the account to be other than property. It should be possible, therefore, to conceptualize an individual custodial account as a distribution of property and, therefore, a distribution of the individual’s entire benefit rights. In such a case, the account should not be a plan asset.²¹

¹⁸ See, e.g., 44 Fed. Reg. 23527 (indicating that not all *employees* who take part in a 403(b) plan are participants).

¹⁹ Treas. Reg. § 1.403(b)-8(d)(1).

²⁰ See Advisory Opinion 81-60A (July 21, 1981).

²¹ See, e.g., FAB 2004-2 (Sept. 30, 2004) (“the distribution of the entire benefit to which a participant is entitled ends his or her status as a plan participant and the distributed assets cease to be plan assets under ERISA”).

*Discontinued Vendors*²²

A separate issue is whether an individual annuity contract or custodial account held by a vendor that is no longer authorized to receive contributions is a plan asset, even if the individual contract or account owner is a current employee eligible for ongoing contributions to another vendor as a plan participant. As mentioned earlier, guidance interpreting the “participant” regulation generally provides that the regulation applies if contributions are not being made. The question is whether the regulation applies to the extent that contributions are not being made to a discrete annuity contract or custodial account. The existing guidance does not address the situation unique to 403(b) plans where contributions may be made to multiple funding vehicles. It is perfectly logical, however, to conclude, for example, that an individually owned annuity contract remains a plan asset only as long as contributions are being made to the annuity contract. It is quite different to hold that an annuity contract that is not receiving contributions is a plan asset simply because contributions are being made on the individual owner’s behalf to another funding vehicle under the plan. Accordingly, we believe the Department could very reasonably construe its existing guidance to support the proposition that contracts held by discontinued vendors are not ERISA plan assets, even if contributions are being made on behalf of an individual to another vendor, and we recommend guidance to this effect.

More generally, the approach to plan assets that we suggest recognizes the absence of effective fiduciary control over individually-owned annuity contracts and custodial accounts. Except in situations that are not relevant to this discussion, the assets of an ERISA plan are to be identified on the basis of ordinary notions of property rights.²³ This requires an analysis of whether the plan has a beneficial interest in particular property.²⁴ It should be apparent that a 403(b) plan should not be considered the owner of individual annuity contracts and custodial accounts under ordinary notions of property rights in situations where the contracts and accounts do not reserve any material rights for the plan fiduciary.²⁵

For these reasons, we believe the guidance we suggest is technically sound. It would provide for a very clean and logical rule under which all contracts held for participants for whom contributions are

²² The term “discontinued vendor” includes all vendors currently holding 403(b) plan contracts or accounts, which they may have obtained as a prior vendor to the plan, or as a result of a transfer of assets initiated by the participant. In either case, these 403(b) contracts and accounts are generally not considered part of the 403(b) plan by the Internal Revenue Service. *See Appendix A.*

²³ *See, e.g.*, Advisory Opinions 2003-05A (Apr. 10, 2003), 99-08A (May 20, 1999) and 94-31A (Sept. 9, 1994).

²⁴ *Id.*

²⁵ The mere fact that an employer would continue to have ministerial responsibilities under the contract, for example, certifying to an employee’s severance from employment, should not affect the plan asset question. These responsibilities are generally required under the final 403(b) regulations and, more generally, do not constitute ongoing employer involvement sufficient to undermine the characterization we suggest.

being made to the contracts on or after January 1, 2009 are ERISA plan assets. This treatment would have little adverse effect on participants, as there would appear to be very little difference in the rights of a participant after a contract ceased to be part of the employer's plan, at least where the plan fiduciary has no control over the contract or its terms.²⁶

We are sensitive to concerns that the analysis we suggest could materially narrow the application of ERISA with respect to arrangements that are funded through individual contracts and accounts. However, the final 403(b) regulations issued by the IRS generally require that all contracts be held pursuant to an employer's written plan document, but allow significant exceptions for contracts issued to former employees and beneficiaries, contracts established pursuant to a transfer permitted under Revenue Ruling 90-24, and contracts held by discontinued vendors.²⁷ The IRS's plan document requirement necessitates significant integration between the employer's plan and the non-excepted individual custodial account and annuity contracts held under the plan. As a result, employers have since been requesting and obtaining significant rights under annuity contracts and custodial accounts in order to comply with the IRS's current requirements. These significant rights obtained by employers under contracts and accounts after implementation of the IRS regulations may be incompatible with the notion that these contracts have been distributed from the plan.²⁸ For this reason, we believe it would be reasonable to differentiate between contracts that ceased receiving contributions before January 1, 2009 (and are not required by the IRS to be considered part of the 403(b) plan) and those that ceased receiving contributions sometime after the final 403(b) regulations were effective (and must be considered part of the 403(b) plan under the current tax rules). As a result, the rule we suggest does not have to be a permanent rule but rather could operate in effect as a transition rule, and should be consistent with the IRS' approach to the exact same contracts.

Finally, there is an underlying policy issue of whether it is prudent and appropriate for an ERISA plan to be funded through individual annuity contracts and custodial accounts, at least where the plan fiduciary does not retain material rights over the contracts and accounts. It is important,

²⁶ It appears that the participant protection provisions of ERISA would continue to adhere to an individual contract that ceases to be a plan asset. Pursuant to state and federal law, the custodians of section 403(b)(7) custodial accounts and the issuers of section 403(b)(1) annuity contracts are obligated to honor the terms of the contracts (including terms relating to ERISA rights) regardless of whether the contracts remain subject to ERISA. In addition, regulations that interpret the spousal consent provisions of the Internal Revenue Code and ERISA state that spousal-rights provisions, to the extent otherwise applicable, apply to payments from a distributed annuity contract. Treas. Reg. § 1.401(a)-20, Q&A-2. Similarly, a contract could not be amended to eliminate any rights that would have been protected while the contract was part of an ERISA plan, because the applicable anti-cutback regulations state that the prohibitions against reductions of accrued benefits apply to distributed annuity contracts. Treas. Reg. § 1.411(d)-4, Q&A-2(a)(3)(ii).

²⁷ See 26 C.F.R. § 1.403(b)-11(g) and Rev. Proc. 2007-71.

²⁸ See Advisory Opinion 81-60A (employer's retained rights under a group contract may or may not be consistent with the participant regulation).

however, to recognize that, regardless of the Department’s view of this issue, there are numerous individual annuity contracts and custodial accounts held by ERISA plans. The reasons for this are myriad and it would be inappropriate to conclude or assume that these contracts are in plans as a result of fiduciary oversight. The use of individual contracts is part of the fabric of section 403(b) and, for many years, it would have been extraordinary to see a 403(b) arrangement funded through a group contract. The notion of section 403(b) arrangements as employer-maintained plans has also evolved slowly. Many plans originated as non-ERISA salary-reduction-only arrangements that satisfied the Department’s safe harbor in 29 C.F.R. § 2510.3-2(f) and migrated into ERISA plans, for example, with the addition of an employer contribution or a decision by the employer to exercise oversight of the program. Our point is simply that it is not possible to “unscramble the egg” and there is a need for a more systemic solution.

III. New DOL Disclosure Rules

Recordkeepers and service providers to ERISA-covered plans are currently preparing for the effective dates of the service provider disclosure regulations and the participant disclosure regulations. One of the biggest challenges faced by both ICI members and sponsors of ERISA-covered 403(b) plans is the determination of which contracts and accounts constitute assets of the 403(b) plan, with severe consequences for making the wrong decision. Plan administrators and service providers for 403(b) plans funded by multiple vendors (sometimes called “multivendor” or “multiple provider” plans) are also facing practical implementation challenges related to the participant disclosure regulations.

Service Provider Disclosure Regulations

The service provider disclosure regulation under ERISA section 408(b)(2) requires that providers disclose to the plan sponsor fiduciary information about the services to be performed and the fees and compensation to be received. The regulation generally requires vendors to provide disclosures to the plan fiduciaries of ERISA-covered 403(b) plans when the service provider disclosure regulation initially takes effect and prior to subsequent contracts with new clients, and provide a 60-day advance notice of any changes.²⁹

ERISA Status

In many cases, service providers must rely on the representations of plan sponsors regarding whether the 403(b) plan is subject to ERISA, thereby alerting the vendor to make the mandatory disclosures. Indeed, many of the conditions of the ERISA safe harbor exemption are based on the actions of the plan sponsor. However, as described in Section I above, plan sponsors may not be certain whether their 403(b) plans are subject to ERISA. In addition, even if the plan sponsor believes that the

²⁹ 29 C.F.R. § 2550.408b-2.

active portion of its 403(b) plan is subject to ERISA, it may be unsure whether the contracts held by former employees or discontinued vendors are part of the 403(b) plan, as described in Section II above. In other cases, the vendor may not know the identity of the employer associated with a 403(b) plan or account, or may not know whether the associated plan is covered by ERISA due to lack of employer responsiveness.

It is possible that a plan initially believed to meet the safe harbor exemption might subsequently be determined not to meet the exemption. The Department addressed analogous circumstances in the interim final 408(b)(2) regulation. Section (c)(1)(v)(1) of that regulation provides that if a non-plan asset investment is subsequently determined to hold plan assets, the required disclosures must be made as soon as practicable, but not later than 30 days from the date the covered service provider knows the investment holds plan assets. Similarly, section (c)(1)(vii) provides that service providers can correct reasonable errors or omissions as soon as practicable, but not later than 30 days after learning of the error or omission. We recommend that the Department expressly confirm that similar relief for service providers from the penalties for nondisclosure would be available if a 403(b) plan reasonably believed by a service provider not to be a “covered plan” under section (c)(1)(ii) is subsequently determined to be a covered plan, or if an individual annuity or custodial account reasonably believed by a service provider not to be part of a covered plan is subsequently determined to be part of an ERISA-covered plan.

The service provider disclosures are expensive to produce and deliver. Vendors have two choices: either err on the side of caution and provide the service provider disclosure to all ERISA and non-ERISA plans, potentially resulting in unnecessary costs (which are ultimately borne by the plan sponsor and participants) and confusion by non-ERISA plan sponsors, or follow their internal administrative practices and rely on employer-provided ERISA status information, potentially resulting in ERISA liability if the employer’s best guess was wrong.

Discontinued Vendors

The application of the Department’s 408(b)(2) service provider disclosure regulation to 403(b) contracts of discontinued vendors³⁰ may have the awkward result of a plan fiduciary receiving information about contracts and accounts over which it has no actual supervisory authority or control, and their resulting obligations will be unclear.

While some may argue that providing these disclosures would be beneficial even if the employer has no control over the assets invested in the contracts, or if the plan is not subject to ERISA, it is

³⁰ See note 23, *supra*, and accompanying text.

important to weigh any potential benefits against the compliance costs for both the plan sponsors and vendors. Regulations should be reasonable and not unduly burdensome on the regulated community. President Obama issued an Executive Order in 2011 directing agencies to ensure regulations “identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends [and] . . . take into account benefits and costs, both quantitative and qualitative.”

Participant Disclosure Regulations

The participant disclosure regulation requires that plan administrators ensure that eligible employees, participants and beneficiaries in ERISA-covered participant-directed individual account plans (which includes almost all ERISA 403(b) plans) receive certain plan- and investment-related information.³¹ These disclosures may be provided in whole or in part by vendors and recordkeepers which are in the best and usually only position to provide the required investment-specific information, as well as some of the other plan information that must be disclosed. Although the Department addressed some 403(b)-specific issues in the final regulation, more practical questions remain, as discussed below.

Although the Department has delayed the effective date of the participant disclosure rule,³² vendors literally are programming their systems and creating new software today and trying to forecast production and support requirements for 2012, based on the language of the final participant disclosure regulation and its preamble. Creating a completely new disclosure document that must be customized for each retirement plan and distributing it to millions of Americans is a large, costly and complex task, requiring coordination among investment providers as well as between vendors and their clients. Accordingly, ICI recommends that the Department address the following real concerns with specific answers as soon as possible.

ERISA Status

As with the service provider regulation, vendors rely on the representations of plan sponsors regarding whether the 403(b) plan is subject to ERISA so that they can prepare and deliver the mandatory disclosures (or arrange for delivery through the plan administrator or its agent). However, as described in Section I above, some plan sponsors are not certain whether their 403(b) plans are subject to ERISA. In addition, even if the plan sponsor believes that the active portion of its 403(b) plan is subject to ERISA, it may be unsure whether the contracts held by former employees or discontinued vendors are part of the 403(b) plan under ERISA, as described in Section II above. In other cases, the vendor may not know the identity of the employer associated with individual accounts,

³¹ 29 C.F.R. § 2550.404a-5.

³² 76 Fed. Reg. 42539 (July 19, 2011).

or may not know whether the associated plan is covered by ERISA due to lack of employer responsiveness.

Therefore, in the absence of definitive direction regarding ERISA coverage from a plan sponsor, some plan administrators will choose to not provide the participant disclosures because of the associated cost and complexity of the disclosure, which will vary among plans. We recommend that the Department provide relief, similar to the relief requested in the service provider disclosure context, from the participant disclosure penalties for plan administrators who reasonably believe that the individual accounts or annuities under the plan, or the plan as a whole, are not subject to ERISA or to the participant disclosure requirement.

Designated Investment Alternatives

The definition of the term “designated investment alternative” is another significant issue. The comparative chart and other parts of the participant disclosure regulation require participants to receive information on a plan’s “designated investment alternatives,” defined to mean any investment alternative designated by the plan into which participants may direct the investment of assets held in, or contributed to, their individual accounts.³³ The rule explicitly excludes from this definition brokerage windows and similar arrangements where participants can select investments beyond those designated by the plan. There is still uncertainty for 403(b) plans that include multiple vendors (each offering a different range of investment options) and other common 403(b) situations.

For example, it is unclear whether the brokerage window exception extends to mutual fund window arrangements and certain 403(b)(7) custodial accounts offering only mutual funds from an affiliated mutual fund family. Historically, some 403(b) custodial accounts have been offered through mutual fund-only accounts and not through brokerage accounts, which are technically held by a broker-dealer. Although these custodial accounts are the functional equivalent of a brokerage account or similar arrangement excluded from the definition of “designated investment alternative,” it is possible that all of the funds offered and made available by a vendor through a mutual fund-only custodial account must be considered designated investment alternatives (and therefore subject to disclosure requirements), even if the plan sponsor chooses to designate (in other written materials) only a subset of these mutual funds as the plan’s designated investment alternatives.

Whether discontinued vendors constitute designated investment alternatives and must be included in the comparative chart is another outstanding question. Plan sponsors need to know whether a custodial account or variable annuity contract to which no additional contributions can be

³³ 29 C.F.R. § 2550.404a-5(h)(4).

made, but within which investment allocations can be changed, constitutes a designated investment alternative.

Clarification by the Department of what constitutes a designated investment alternative in the context of these common 403(b) arrangements and situations would be helpful.

Combining Disclosures from Multiple Vendors

Multivendor plans have particular issues providing the required comparative chart, which must list the designated investment alternatives, and provide information on performance, fees and expenses, and certain additional information on annuities, in a format that facilitates comparison.³⁴ Trying to consolidate into one comparative chart the information from multiple vendors may be practically impossible. We understand that some vendors are using a reasonable interpretation of the final regulations to create their own disclosure materials, but because of the multitude of vendors, annuity products and insurers in the marketplace today, uniformity among vendors is unlikely.³⁵

For most multivendor plans, the current marketplace understanding is that the comparative chart information will be created separately by each vendor, and it will be the responsibility of the plan administrator (or its agent) to combine the documents somehow and distribute them to eligible employees, participants and beneficiaries. However, many of these non-profit employers will have limited capacity to handle this level of involvement in terms of mailing large bundles of documents and other administrative tasks related to assembling the disclosures. It is unclear whether merely stapling together or including in one envelope the distinct documents from each vendor will be sufficient, although it is the only option for most multivendor plan sponsors.³⁶ It will also become a costly exercise to create and deliver these documents to all new employees, who are typically eligible to participate in the 403(b) plan upon hiring. In cases where the vendor offers assistance, it may also have limitations, such as with respect to new hires for whom the provider has no electronic or U.S. mail delivery information.

³⁴ 29 C.F.R. § 2550.404a-5(d)(2).

³⁵ Many annuity products used to fund 403(b) plans do not “fit” the model charts provided by the Department, because fixed return annuities and variable return annuities used in the retirement plan context have both accumulation features (to be displayed on the fixed return chart or variable return chart, as appropriate) and distribution features (to be displayed on the fixed annuities chart or the variable annuities chart, as appropriate).

³⁶ The Preamble states that the final regulation does not preclude plan administrators from “combining multiple documents” to satisfy the comparative chart requirement. On the other hand, separate distribution of comparative charts reflecting the particular investment options of a given issuer would not suffice. 75 Fed. Reg. 64910, 64922 (October 20, 2010). It therefore is unclear whether the paper clip method, for example, would constitute the “combining” of multiple documents.

ICI urges the Department to recognize the reality of the multivendor 403(b) plan situation and recommends that the Department address these issues as quickly as possible, especially in light of the imminent deadlines for providing the disclosures.

Discontinued Vendors

Finally, whether the assets held by a discontinued vendor are plan assets also impacts the identification of participants in the plan to whom the participant disclosure may be required. Because many ERISA-covered 403(b) plans have been in existence for years and have multiple discontinued vendors, researching this information will require months to perform. Plan sponsors also will need to develop new relationships with the discontinued vendors, relationships which are not otherwise required for IRS compliance purposes or Form 5500 reporting purposes. These “newly discovered” participants, whose service with the plan sponsor may have terminated years ago, will most likely be very confused if they begin to receive communications from the plan sponsor under the participant disclosure rule. Conversely, providing participant disclosures about numerous discontinued vendors to newly eligible employees may also be confusing.

Electronic Delivery

Finally, ICI and its members have recommended that the Department revise its rules for electronic delivery of information to participants. While not an issue unique to 403(b) plans, the ability to make greater use of electronic delivery methods would help tremendously in the 403(b) community, where cost savings is especially important. The Department expressly reserved a section of the participant disclosure rule to address the manner of furnishing the required disclosures, in anticipation of developing updated rules for electronic delivery pursuant to its recent Request for Information. While we appreciate that the Department has a great deal of work ahead of it to fully consider the comments received in response to the RFI, we have urged the Department to provide immediate interim guidance permitting the use of electronic delivery for information required under the 404(a) rule, to the extent permitted in the Department’s FAB 2006-03 for quarterly benefit statements. The FAB allows greater flexibility to use electronic methods of delivery compared to the more restrictive, and outdated, safe harbor published by the Department in 2002. Guidance to this effect is urgently needed in order to meet upcoming deadlines for furnishing the participant disclosures beginning in the first half of 2012.

* * *

ICI and Fidelity Investments appreciate the opportunity to testify as this hearing. Please contact the undersigned if you need additional information about the foregoing. Thank you.

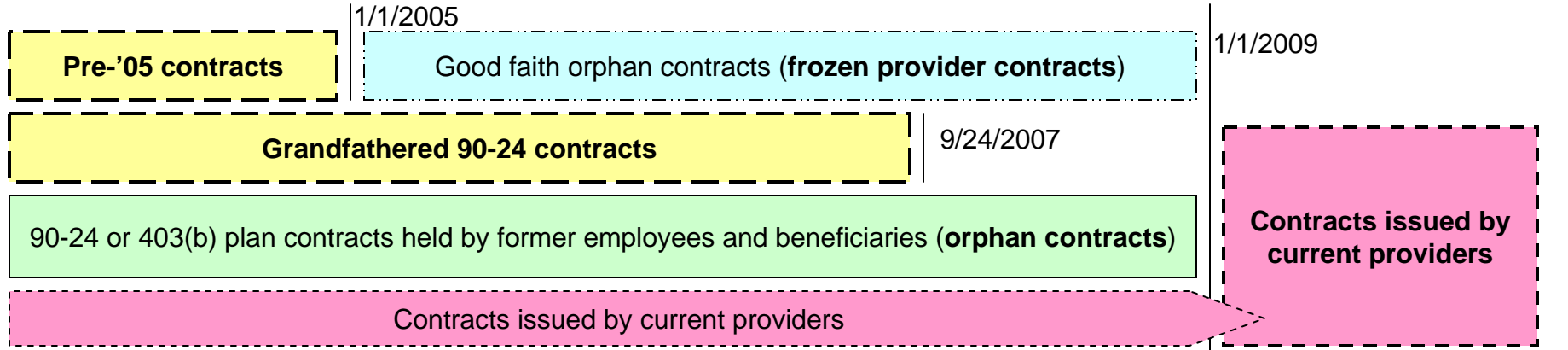
Respectfully,

Elena B. Chism

Weiyen M. Jonas

- For illustrative purposes only.
- This does not constitute legal advice of any kind.
- Subject to additional IRS and DOL guidance.

Appendix A: 403(b) Contract Type Overview



Grandfathered 90-24 and pre-2005 contracts:

- Not required to be included in plan for IRS compliance purposes
- Not subject to information sharing requirements prior to distributions or loans (issuers can generally rely on participant self-certification)

(Treas. Reg. Sec. 1.403(b)-11(g) for 90-24 contracts and implied in Rev. Proc. 2007-71, Sec. 8.01 for discontinued pre-2005 contracts)

Orphan contracts:

- Not required to be included in plan for IRS purposes
- Can rely on participant self-certification regarding terminated status as of 1/1/2009 unless unreasonable
- “Reasonable, good faith efforts” required to contact existing employer prior to making any loan

(Rev. Proc. 2007-71, Sec. 8.02)

Frozen provider contracts:

- Employer must make reasonable, good faith efforts to include in plan for IRS compliance purposes and share information with issuer regarding employer contact
- Or, issuer must make reasonable, good faith efforts to contact employer prior to making any distribution or loan

(Rev. Proc. 2007-71, Sec. 8.01)

Current provider contracts:

- Considered part of plan for IRS compliance purposes
- Need full information sharing between employer and issuer

(Code Sec. 403(b))

ERISA-covered grandfathered 90-24, pre-2005, frozen provider and orphan contracts: ERISA Form 5500 reporting and audit relief is generally available unless contributions and loan repayments are made to the contract after 2008, employer involvement is required to enforce contract rights or the contract is not fully vested. (FABs 2009-02 and 2010-01)

ERISA-covered current provider contracts:

- ERISA Form 5500 reporting and audit relief is generally not available

(FABs 2009-02 and 2010-01)