

FIDUCIARY ISSUES IN THE SPOTLIGHT

PPA 2006 Provisions (Opportunities)

Current Fiduciary Cases (Threats)

November 16, 2006

R. Murray McBride, FSA, MAAA
Partner

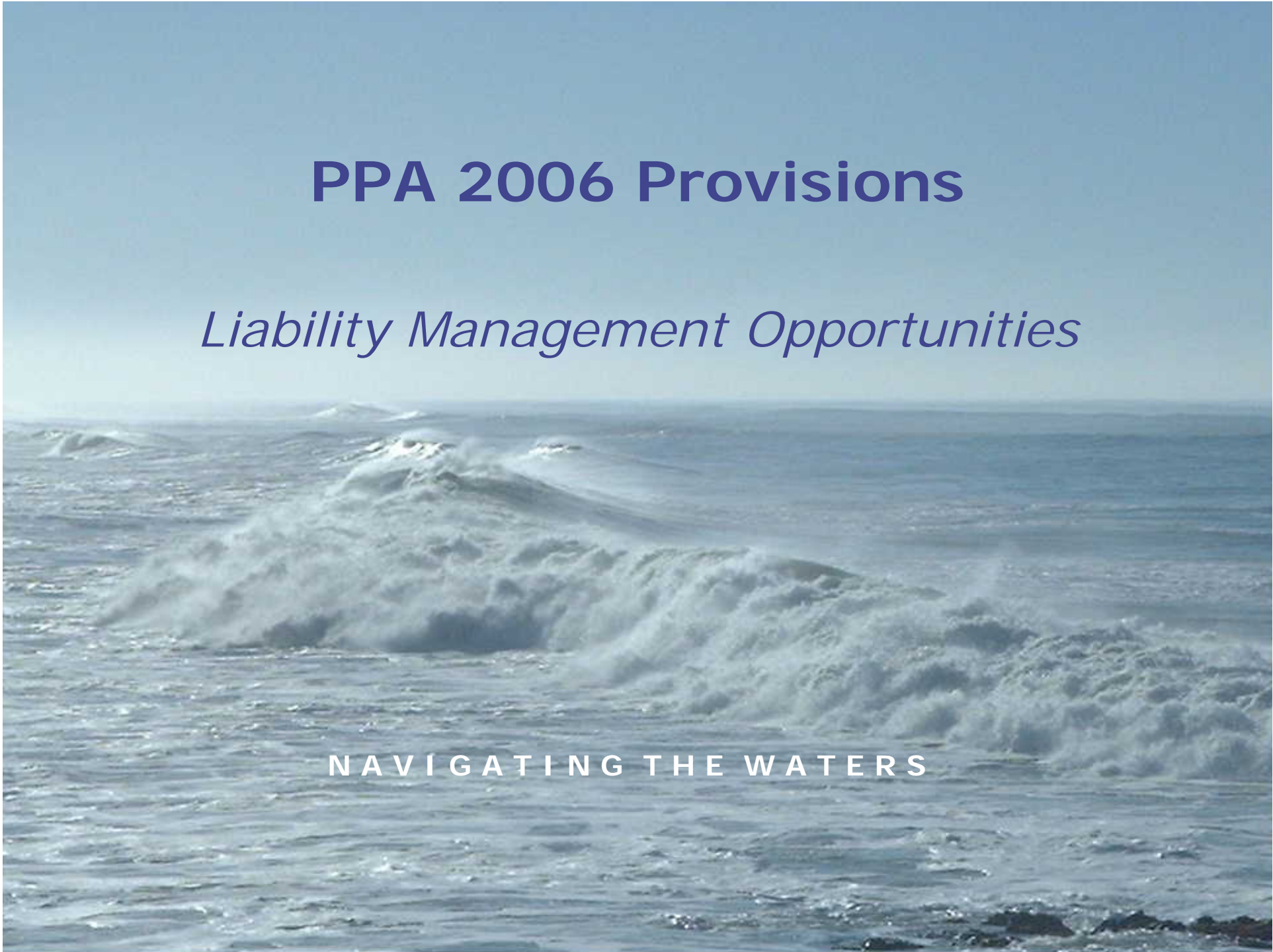
Stuart Hack, JD, CLU
Partner



PPA 2006 Provisions

Liability Management Opportunities

NAVIGATING THE WATERS



Default Investment Safe Harbor

- ◆ 404(c) type protection available where appropriate notice and appropriate default fund allocation are employed
- ◆ DOL required to provide regulations on:
 - the appropriateness of designating default investments
 - that include a mix of asset classes
 - consistent with capital preservation or long-term capital appreciation, or a blend of both
- ◆ PPA 2006 Provision - Effective for plan years beginning 2007



DOL Default Safe Harbor Proposed Rule

Default Investment Safe Harbor

- ◆ Effective 60 days after publication of final regulations
- ◆ Documented compliance is the prudent approach
- ◆ There are:
 - Six conditions for fiduciary relief
 - Five Qualified Default Investment requirements

Six Conditions for Fiduciary Relief

1. Default assets invested in a “qualified default investment alternative”
2. Participant had the opportunity to direct his or her account, *but did not*
3. Notice was furnished to Participant at least 30 days in advance of first investment, and least 30 days in advance of each subsequent plan year
 - Notice can be in the SPD, SMM, or as a separate notification

Six Conditions for Fiduciary Relief

4. Any material provided to the plan relating to qualified default investment alternative will be provided to the participant or beneficiary
 - Account statements, prospectuses, proxy voting material
5. Participants may transfer to any other investment alternative available under the plan without financial penalty
6. Participants have opportunity to invest in a “broad range of investment alternatives”
 - The “broad range of investment alternatives” standard of the section 404(c) regulation accomplishes this objective

Five Qualified Default Investment (QDI) Requirements

1. Subject to two exceptions, a QDI shall not hold or permit the acquisition of employer securities
2. A QDI may not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer, in whole or in part, from the QDI to any other investment alternative available under the plan.
3. A QDI must be either managed by:
 - an investment manager, as defined in section 3(38) of the Act, or
 - an investment company registered under the Investment Company Act of 1940.

Five QDI Requirements

4. A QDI must be diversified so as to minimize the risk of large losses
5. Three Qualified Default Alternatives
 - Life Cycle Funds for Age Groupings
 - Single Asset Allocation Based on Plan Demographics
 - Managed Portfolios Based on Either Each Participant's Age or a Target Retirement Date or Life Expectancy

It is clear that a money market or stable asset fund is not a Safe Harbor

Actions to Consider

- ◆ Evaluate whether the plan's default fund meets the requirements for safe harbor
- ◆ Advise on action needed to meet requirements
- ◆ Provide
 - Appropriate documentation
 - Communication to plan participants



Other 404(c) Type Provisions

Account Reallocations

- ◆ 404(c) type protection generally continues where:
 - Notice is provided, and
 - Participant's account is reallocated among the new investment options offered instead of the prior options, and
 - The characteristics of the new investment options, including risk and rate of return expectations, are, immediately after the change, reasonably similar to the characteristics of the investment options offered immediately before the change
- ◆ Generally effective 2008



Participant Investment Advice

Exemption Allowing Related Party Advice

Effective 2007

- ◆ If requirements under the provision are met, the prohibited transaction exemption applies to:
 - providing investment advice;
 - investment transactions (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and
 - direct or indirect receipt of fees or other compensation in connection with providing advice or an investment transaction pursuant to the advice

"Eligible Investment Arrangement "

◆ Must either:

- Produce compensation that does not vary depending on the basis of any investment option selected, or
- Use a computer model under an investment advice program

"Eligible Investment Arrangement "

- The computer model must
 - ◆ Apply *generally accepted investment theories* that take into account the historic returns of different asset classes over defined periods of time
 - ◆ Utilize *relevant information about the participant* (e.g., age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments)
 - ◆ Utilize prescribed *objective criteria* to make fund-specific asset allocation recommendations

"Eligible Investment Arrangement"

- ◆ Operate in a manner that is *not biased* in favor of investments offered by the adviser or an affiliate
- ◆ *Take into account all investment options* under the plan and is not inappropriately weighted with respect to any investment option
- ◆ *Be certified by 3rd-party expert*
 - An "eligible investment expert" (unaffiliated with the advisor) must annually certify that the computer model meets the foregoing requirements
- ◆ *Not offer other advice*
 - The only investment advice provided under the program may be the advice generated by the computer model, although the *participant* may solicit additional advice

“Eligible Investment Arrangement”

- ◆ Notice requirements - The adviser must provide to the participant a written notification, in advance, annually, updated on an ongoing basis and on request:
 - Role of any affiliated party in the development of the advice program and the selection of plan investment options
 - Past performance and historical rates of return of plan investment options
 - All fees relating to the advice that the adviser or any affiliate is to receive

"Eligible Investment Arrangement"

- Any affiliation of the adviser in the security or other property
- How information provided by the participant will be used or disclosed
- Types of services provided by the adviser in connection with advice
- That the adviser is acting as a fiduciary
- That a recipient of the advice may separately arrange for the provision of advice by another, unaffiliated (i.e., third-party) adviser
- That it is authorized by the plan sponsor
- That it is independently audited

Other Requirements

- ◆ Securities law disclosure

The adviser provides appropriate disclosure required by applicable securities laws.

- ◆ Recipient directs investment

Any investment "occurs solely at the direction of the recipient of the advice"

- ◆ Reasonable compensation/arm's length transaction

The compensation received by the adviser and its affiliates is reasonable, and the transaction is at least as favorable to the plan as an arm's length transaction

Other Requirements

- ◆ Preservation of records.

Records reflecting compliance with these requirements are maintained for a period of not less than 6 years

- ◆ Fiduciary responsibility of sponsor

Prudent selection of adviser and periodic review

And More Requirements

- ◆ The adviser must be a person who is a fiduciary of the plan by reason of providing investment advice
- ◆ In addition, the adviser must be either:
 - Registered as an investment adviser under federal or state law, or
 - A bank or similar financial institution (but only if the advice is provided through a trust department of the bank)

And More Requirements

- An insurance company
- A person registered as a broker or dealer under the Securities Exchange Act of 1934, or
- An affiliate or employee, agent, or registered representative of the foregoing

Investment Advice for IRA's

- ◆ By 12-31-2007 Secretary of Labor to determine whether computer models exist to appropriately provide investment advice
- ◆ If not, exemption to be granted for advice to IRA beneficiaries

Actions/Issues To Consider

- ◆ How do you envision this service being delivered?
- ◆ Plan sponsor considerations
 - Decide whether to offer investment advice
 - If so, establish initial and ongoing procedure for provider of selection and monitoring advice
- ◆ Service provider considerations
 - Decide whether to offer advice
 - If yes
 - ◆ Develop compliance program
 - ◆ Select third party for auditing

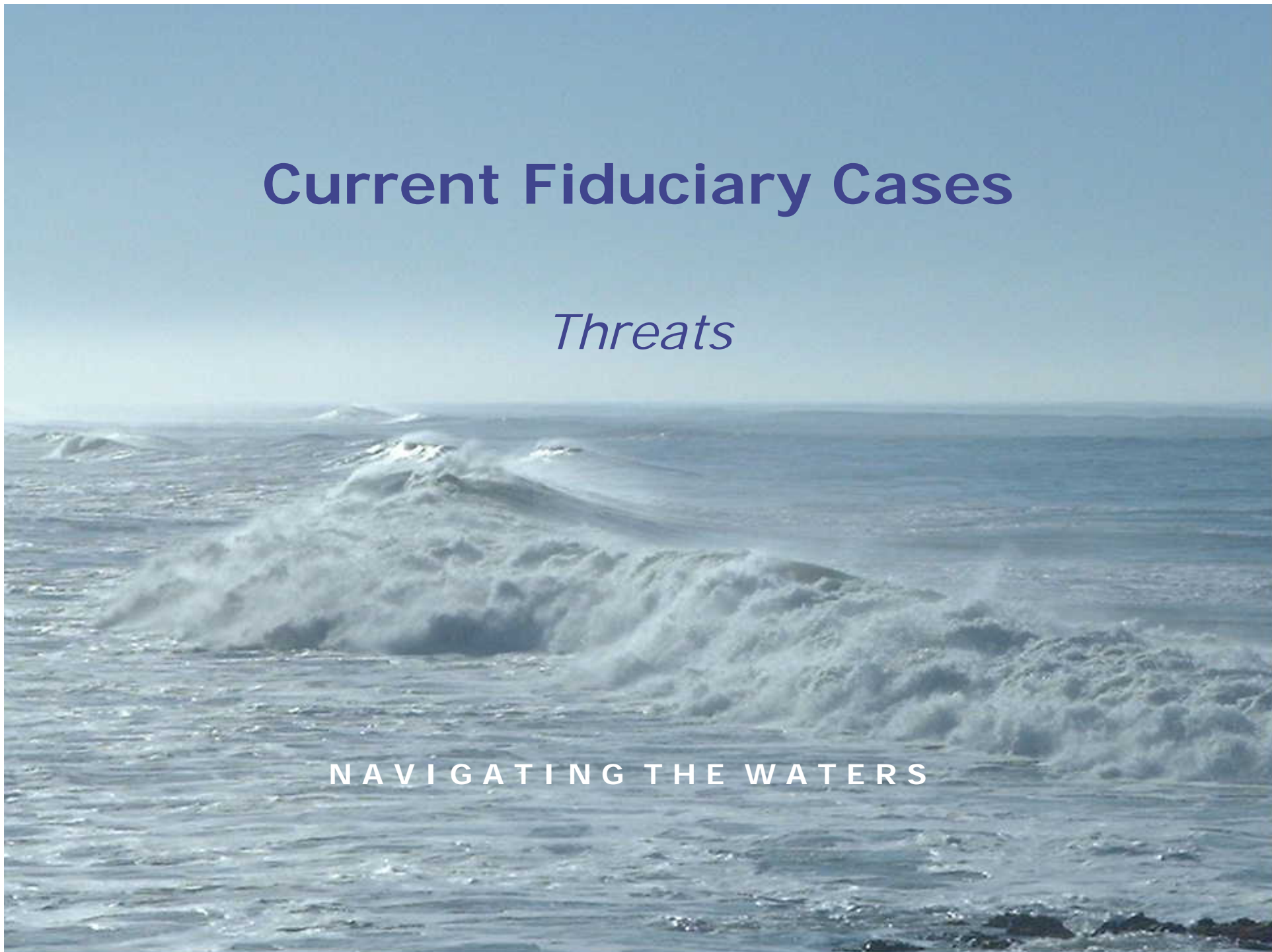
Actions/Issues To Consider

- ◆ Broker and RIA considerations
 - Impact on my compensation if I provide advice
 - Whether I need to offer advice to retain clients and attract new ones
 - Evaluation of products that include participant investment advice

Current Fiduciary Cases

Threats

NAVIGATING THE WATERS



Companies being sued

- ◆ Lockheed Martin
- ◆ Bechtel
- ◆ General Dynamics
- ◆ International Paper
- ◆ Exelon
- ◆ Caterpillar
- ◆ Northrop Grumman
- ◆ Boeing
- ◆ United technologies
- ◆ Kraft Foods

Parties Being Sued

- ◆ Plan Sponsor
- ◆ Administrative and investment committees and their individual members
- ◆ Compensation committees and board members on the committees, individually
- ◆ Members of the Board who appoint committee members

The Allegations

- ◆ Failure to disclose investment information
 - Undisclosed risks in investment funds vs. risks in benchmarks used to measure fund performance
 - Non-Disclosure of plan expenses charged to participant investment-directed accounts

The Allegations

- ◆ Unreasonable fees charged to participant accounts
 - Master Trust fees and expenses unreasonable and excessive, not incurred solely for the benefit of the Plans and their participants, and undisclosed to participants
 - Unreasonably high administrative fees charged against employer stock funds
 - Failure to exercise the care, skill, prudence, and diligence of a prudent person when acting in like capacity and familiar with such matters
 - Failure to inform themselves of, and understand, the various methods by which vendors in the 401(k), financial and retirement industries collect payments and other revenues from 401(k) plans

The Allegations

- ◆ ERISA 404(a) fiduciary responsibility failure
 - Forgone revenue sharing from expensive share classes of funds
 - Failure to monitor fees and expenses
 - Closet or Shadow Index funds that charge for active management – a fund which has a 95% or greater correlation to the index
 - Fiduciary conflict of interest in allocation of fees to each of multiple plans sponsored by same employer (master trust expenses & allocation)

Actions to Consider

- ◆ Documented initial and periodic reviews for:
 - Expense Identification
 - Expense Reasonableness
 - Adequacy of investment information disclosures to participants
 - Fiduciary Conflict