Defined Contribution Legislative and Regulatory Update

For Government clients

June 2017

We are committed to providing you with the information and tools you need to help meet your fiduciary responsibilities as a plan sponsor and offer your employees an exceptional retirement plan. This newsletter is designed to inform you about the latest legislative and regulatory developments that may affect your plan.

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EMPOWER RETIREMENT™

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Tax reform and the 115th Congress: Potential impact on defined contribution retirement plans

Although efforts to lower the tax brackets for corporations and for very wealthy individuals do not directly impact governmental employers, it is important to keep an eye on how defined contribution (DC) plans might be impacted by tax reform. With both chambers of Congress and the White House under Republican control, GOP leaders, particularly in the House, are contemplating a comprehensive tax reform package. Kevin Brady (R-TX), the Chair of the House Ways and Means Committee, has repeatedly expressed his support for such an approach and, in the summer of 2016, published a blueprint for sweeping tax reform. Other members of Congress have shown less appetite for far-reaching tax reform and would rather focus solely on cutting current tax rates.

On April 26, 2017, Secretary of the Treasury Steve Mnuchin and Director of the National Economic Council Gary Kohn held a joint press conference to release President Trump's one-page tax proposal. Key elements of the Administration's proposal include lowering corporate tax rates to 15%, collapsing the current seven tax brackets to three (10%, 25% and 35%), and eliminating all itemized deductions except those for charitable giving and home mortgage interest. The Administration has promised a more detailed proposal by the end of June.

Even if GOP members of Congress can agree on a legislative proposal, the other hurdle tax reform faces is getting a bill to President Trump's desk, especially if Democrats are opposed to it. Under regular order, 60 votes are required in the Senate to end debate and bring a bill to the floor for a vote. Assuming that all 52 Senate Republicans support moving tax legislation forward, they would still need eight Democratic Senators to join them in ending a filibuster.

A more likely option is to utilize the budget reconciliation process, which allows for expedited consideration of certain revenue, spending or debt-limit legislation. Although certain limitations apply, it allows the Senate to move quickly and to pass a bill by a simple majority.

One limitation imposed by the budget reconciliation process is that legislation may not increase the deficit outside of the current 10-year budget window. Any cuts in tax revenues must be offset by (1) decreasing government spending or (2) raising revenues from another source. A major concern for employers and their service providers is that Congress may look to offset revenue lost by their proposed tax cuts by making changes to the tax advantages of employer-sponsored retirement plans. The tax incentives associated with retirement savings are the second-largest tax expenditure after healthcare, scoring at a 10-year cost of over $1.5 trillion by the Office of Management and Budget in 2016.

Recent surveys show that retirement savings rates reached record levels in the first quarter of 2017. Total US retirement assets were $25.3 trillion as of December 31, 2016, up 1.4% from the end of September and up 6.1% for the year. Retirement assets accounted for 34% of all household financial assets in the United States at the end of 2016. Assets in IRAs totaled $7.9 trillion at the end of the fourth quarter of 2016, an increase of 1.1% from the end of the third quarter. DC plan assets were $7.0 trillion in the fourth quarter, up 1.3% from a revised estimate of $6.9 trillion in the third quarter of 2016. Government defined benefit plans — including federal, state and local government plans — held $5.5 trillion in assets as of the end of December, a 2.4% increase from the end of September. Private-sector DB plans held $2.9 trillion in assets at the end of the fourth quarter of 2016, and annuity reserves outside of retirement accounts accounted for another $2.0 trillion.*

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As Congress prepares resolutions to begin the tax reform reconciliation process, we may see directions to all congressional committees to identify available sources of revenues and savings. This could definitely affect retirement plans. The House has already narrowly passed a bill to repeal and replace the Affordable Care Act, which in part would reduce the amount of money spent by government on healthcare to help pay for the proposed tax cuts. With respect to retirement savings, certain GOP proposals to change the tax advantages of DC plans have been floated in recent years. As recently as 2014, legislation was proposed that would have limited pretax contributions to 50% of the elective deferral limit, forcing the other 50% to be made as after-tax Roth contributions. Additional proposals included, among others, capping the elective deferral limit for 10 years ($18,000 in 2017 with an additional $6,000 in catch-up contributions), eliminating special catch-up contributions and subjecting 457(b) distributions to the 10% premature withdrawal penalty.

So what are the next steps and what might we expect in the months ahead? House leadership views sweeping tax reform as a once-in-a-generation opportunity and, in fact, the last truly comprehensive tax reform legislation occurred over 30 years ago with the Tax Reform Act of 1986 during the Reagan administration. House Ways and Means Committee Chairman Brady wants to move quickly in order to introduce legislation before the August recess and move it to the floor for a vote by year end. This is still a very fluid proposition.

Although no specific changes have yet been proposed that would impact governmental retirement plans, we at Empower Retirement are closely following the tax reform process and vigorously advocating for preserving the tax benefits of DC plans. We will keep you informed of any new developments.

* Sources: Investment Company Institute, Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, American Council of Life Insurers and Internal Revenue Service Statistics of Income Division

The continuing saga of the DOL fiduciary rule

The fiduciary rule became applicable on June 9, 2017, with some components of the Best Interest Contract (BIC) and other exemptions deferred until January 1, 2018. The 60-day delay from the original April 10 date resulted from a final rule issued by the DOL on April 4. The delay was in response to a presidential memorandum asking the DOL to conduct a revised legal and economic analysis of the rule and determine whether it may reduce access to financial advice, cause disruptions that may harm investors or cause an increase in litigation. While this analysis was not completed by June 9, the DOL has stated it will complete its analysis of whether the rule should be revised or rescinded after making it effective in its current form.

While some in the financial services industry had hoped that new Labor Secretary Alex Acosta would take steps to further delay the rule so it would not become effective until the DOL's analysis was complete, Secretary Acosta instead announced he did not believe there was time to conduct that review consistent with the Administrative Procedure Act, which requires a notice and public comment period for regulatory changes. While there was no delay of the June 9 date, in Field Assistance Bulletin 2017-02 the DOL did establish a "temporary non-enforcement policy" stating that it will not pursue claims against fiduciaries during the period June 9, 2017, to January 1, 2018, for noncompliance with the rule as long as the fiduciaries are working diligently and in good faith to comply. In Announcement 2017-04 the IRS offered companion relief, stating that it will not pursue prohibited transaction excise taxes for any transactions covered by the DOL's temporary non-enforcement policy. While this relief is somewhat helpful, it does not protect plan fiduciaries from private litigation, so it may not have had much of an impact on how those impacted by the rule have reacted to the June 9 compliance deadline.

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The delay rule did make substantive changes to what is required of those intending to rely on the BIC exemption during the transition period (June 9, 2017 – January 1, 2018). The original rule required more detailed compliance steps, including:

- Acknowledgement of fiduciary status
- Maintenance of records demonstrating compliance
- Appointment of a person responsible for ensuring transition period compliance
- A disclosure document containing a description of any conflicts of interest, specific disclosures related to proprietary products and third-party payments, and a description of the impartial conduct standards along with a statement that the advisor adhered to those standards

The delay rule only requires compliance with the "Impartial Conduct Standards" during the transition period. Those standards are acting in the best interest of the customer, receiving reasonable compensation and avoiding materially misleading statements.

The delay rule also deferred the deadline for complying with amendments to PTE 84-24, which covers the sale of annuity products, as well as the Principal Transaction Exemption until January 1, 2018, although anyone intending to rely on these exemptions must comply with the Impartial Conduct Standards during the transition period.

Impact on governmental plans

As we have previously indicated, the DOL's fiduciary rule with respect to investment advice applies only to employer-sponsored retirement plans subject to the Employee Retirement Income Security Act (ERISA) and individual retirement accounts (IRAs), not governmental plans. It could, however, impact conversations between an adviser and a governmental plan employee about available distribution options or rolling assets between a governmental plan and an ERISA plan or an IRA. While the transition period relief is welcome, the fact remains that, on June 9 many investment advice services and communications offered to ERISA plans and IRAs in a non-fiduciary capacity became fiduciary actions. This will impact not only the ways in which services and communications are offered, but also how advisors get paid and how they coordinate with other service providers. If you are a governmental plan sponsor, you will want to be sure you understand any changes that will occur in the services provided to you and your plan participants with respect to rollovers and distribution advice and how you pay for those services.

Service providers

If you are a service provider who will be changing from non-fiduciary to fiduciary status and relying on the BIC or another exemption requiring compliance with Impartial Conduct Standards, there are many outstanding questions, including:

- How will you demonstrate compliance with those standards? Should you have a checklist or some other documentation explaining why a recommendation is in the client's best interest?
- How do you know your compensation is reasonable, particularly in the IRA market where benchmarking services and other tools have not evolved as they have in the plan market?
- While disclosures are not required for the BIC during the transition period, is there information you want to provide in order to avoid making any materially misleading statements?

There are also issues that arise due to the continuing uncertainty surrounding the rule. For example, while there are no disclosures required under the BIC during the transition period, there is a requirement under the 408(b) (2) fee disclosure rules for service providers to notify their plan sponsor clients in the event of a change

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from non-fiduciary to fiduciary status. The updated disclosure must be provided within 60 days of when the fiduciary advice is provided. Absent specific relief from the 408(b)(2) disclosure requirement, it is possible that service providers will need to provide this notice even though they may subsequently determine they are not fiduciaries based on future changes to the rule.

The DOL addressed some questions surrounding the rule on May 22 in a set of Transition Period FAQs.

A couple of items of note are:

- **Request for information (RFI)** — The DOL intends to publish an RFI in the near future for comments on possible changes to the rule, including whether there should be a delay in the January 1, 2018, applicability date for full implementation of the BIC and other deferred exemption conditions.
- **Clean shares** — One product development arising from the rule is the potential availability of clean shares through which brokers, not a mutual fund, establish any commissions or sales charges, thus allowing firms to levelize broker compensation across all funds. The DOL clearly sees this as a positive development and suggested it may create a new streamlined exemption that is less burdensome than the BIC exemption based on using these types of funds. Clean shares are not yet broadly available, and one of the reasons cited for possibly deferring the January 1, 2018, date is to allow time for this or similar products to fully develop.
- **Clarifications on encouraging participants to save more** — The FAQ provides specific examples of communications encouraging participants to save more that would be considered education and not fiduciary advice.
- **Conflicts of interest during the transition period** — The DOL recognizes that compensation systems being developed to eliminate conflicts of interest may not have been fully operational by June 9, and advisors may have conflicts during the transition period that they won't have after January 1, 2018. The DOL clarified that these conflicts will not be violations of the Impartial Conduct Standards, and therefore will not preclude reliance on the BIC or other exemptions subject to those standards during the transition period as long as policies and procedures to reduce conflicts or increase monitoring of investment recommendations are adopted to safeguard compliance.

Most financial institutions, including Empower, are moving forward based on the assumptions that the January 1, 2018, date for full compliance will remain unchanged and the text of the rule will remain as is. We will be closely monitoring any further developments that might alter those assumptions and will be actively communicating with you in the event of any change.

Mandatory state-run retirement arrangements

The mandatory state-run IRA arrangements enacted by a number of states and municipalities apply only to private-sector employers, not governmental employers. Those of you in states considering these initiatives may, however, be interested in this summary of recent Senate activity with respect to these state-run plans. Thus far, seven states — California, Connecticut, Illinois, Maryland, New Jersey, Oregon and Washington — have passed legislation, and 30 others have introduced legislation to create state-sponsored retirement plans.

Summary of mandatory IRAs

During the Obama administration, a number of states and municipalities became concerned that some private-sector workers were not covered by an employer-sponsored retirement plan. Some have passed legislation requiring private employers to offer mandatory payroll-deduction IRAs to their employees.

Many of the state initiatives were designed to move forward only if they were deemed to be exempt from the rules under the Employee Retirement Income

Security Act (ERISA) that generally apply to private-sector retirement plans. In 2016, the DOL created a safe harbor exempting states, municipalities and private employers meeting certain requirements from fiduciary status with respect to the mandatory IRAs.

ERISA exemption

The DOL rules allowed states and their subdivisions to design and operate retirement savings programs covering private-sector employees with a safe harbor from liability under ERISA. Private employers covered by a state or local mandatory plan were exempted from ERISA's reporting and disclosure requirements that other private employers serving as retirement plan fiduciaries must abide by.

Concerns expressed about state-run plans

Private employers expressed a number of concerns about the mandatory arrangements, including administrative burdens and the possibility of a patchwork of differing state laws for employers with a multi-state workforce. Business groups expressed concerns about the lack of ERISA protections for employees automatically enrolled in any state- or city-run retirement program. Some argued there is the possibility of an uneven playing field since businesses mandated to provide IRAs are exempted from ERISA's disclosure, reporting and fiduciary rules while employers offering qualified plans must satisfy those requirements. Opponents to state-run retirement plans argue that these types of plans should be handled by the private sector rather than state governments. Many would prefer that the federal government soften DOL regulations to reduce the complexity and cost to employers and thus encourage more businesses to offer qualified retirement plans.

Senate repeals state-run IRA safe harbor

On May 3 by a vote of 50-49 the Senate passed H.J.Res. 66, which repealed the safe harbor issued by the DOL and signed into law by President Obama last year. President Trump signed the measure, just as he'd signed on April 13 a companion resolution, H.J. Res 67, which blocked a DOL rule to help cities and other political subdivisions create auto-IRAs. These repeals were taken under the Congressional Review Act (CRA), which creates a window in which the Senate may pass a joint resolution repealing regulations issued late in the prior administration's term. The current CRA window applied to any significant Obama-era rule that was either finalized or made effective after June 13, 2016. This included the DOL's state plan rule, which was finalized in August 2016 and became effective in October. Importantly, the CRA prohibits the DOL from issuing a new rule that is substantially similar to the repealed safe harbors unless specifically directed to do so by legislation.

State reactions

Although the DOL provided a clarification on how to proceed, elimination of the safe harbors does not bar state governments from moving forward with state-run plans. Each will have to decide how to deal with ERISA requirements if they choose to implement their plans. A number of state treasurers, including those in California, Illinois, Maryland and Oregon, have indicated that the Senate vote has not dissuaded them from continuing with their state-run plans.

Courts to decide?

Challenges to mandated state- and municipal-run plans may come from a number of corners, and whether these arrangements are subject to ERISA may be decided in the courts. It is unknown whether courts will find that state-run plans interfere with ERISA's goal of uniform national regulations for the administration of employee benefit plans. It is also possible that courts may be less inclined to allow these programs without ERISA protections in light of Congress specifically rejecting the DOL's safe harbors.

Empower Retirement will continue to monitor this activity at the state level.