

Drinker Biddle



C. Frederick Reish

(310) 203-4047

Fred.Reish@dbr.com

www.drinkerbiddle.com/freish



Bruce L. Ashton

(310) 203-4048

Bruce.Ashton@dbr.com

www.drinkerbiddle.com/bashton

The Benefits of Mandatory Distributions

A WHITE PAPER BY

FRED REISH AND BRUCE ASHTON

Summary

Small 401(k) accounts of former employees increase plan costs, expand administrative obligations and extend fiduciary responsibilities. Plan sponsors should consider distributing these accounts under a well-defined process and regulatory safe harbors, and advisers can provide a valuable service to their clients by educating them on the benefits of mandatory distributions and helping them set up a routine process for sweeping out small accounts. By small accounts, we mean accounts of former employees with vested balances of \$5,000 or less. (In determining whether an account falls under the \$5,000 limit, amounts rolled over from a prior plan or IRA and earnings on those amounts are not considered. Thus, an account may have a larger total balance and still be considered a “small account” for purposes of this concepts discussed in this White Paper.)

This White Paper discusses the reasons for – and benefits of – making mandatory distributions on a regular basis and the regulatory guidance related to these distributions under the Internal Revenue Code (Code) and the Employee Retirement Income Security Act of 1974 (ERISA). We also address whether financial advisers may be compensated in connection with such distributions.

In the Discussion and Analysis section of this White Paper, we summarize the issues and rules and discuss services that can assist plan sponsors and advisers in handling mandatory distributions. In the three Appendices, we describe the regulatory guidance in greater detail – for those who want a deeper understanding of the legal underpinnings for our conclusions.

FEBRUARY 2013

TABLE OF CONTENTS

Summary	2
Discussion and Analysis	3
Introduction	3
Reasons for Mandatory Distributions	3
Internal Revenue Code Requirements	4
ERISA Safe Harbor	4
Compensation of Financial Advisers	5
A Possible Solution	7
Conclusion	7
Appendix A – Internal Revenue Code Authorities Regarding Mandatory Distributions	8
Appendix B – ERISA Authorities Regarding Fiduciary Issues	10
Appendix C – Legal Authorities Regarding Compensation to Financial Advisers	13

Summary of Conclusions

Benefits of Mandatory Distributions

- Help reduce plan expenses, such as per participant charges or charges based on average account balance, and audit fees.
- Reduce the administrative burden of keeping track of and providing disclosures to former employees.
- Reduce fiduciary responsibility by eliminating accounts of former employees.

Rollover Safe Harbor

- ERISA regulations provide a helpful safe harbor for fiduciaries in selecting IRA providers and investments for automatic rollovers.
- Providers that specialize in automatic rollovers have documents and procedures that facilitate compliance with the safe harbor.

Assistance by and Compensation of Advisers

- Advisers can provide valuable services to their clients by helping establish programs to make mandatory distributions a routine process.
- Both fiduciary and non-fiduciary advisers can be compensated by automatic rollover providers for referrals.

Discussion and Analysis

Introduction

When participants with small accounts -- \$5,000 or less¹ – terminate employment, they may not take distributions of their accounts. These small accounts can impose unknown costs, real burdens and unanticipated risks on plans and their fiduciaries.

Fortunately, there is a remedy for these burdens, and that is the making of mandatory distributions and using the automatic rollover rules of the Code and ERISA to facilitate the process. Such distributions, properly handled, will generally help to reduce plan costs, reduce administrative responsibilities and eliminate the fiduciary obligation for the balances in small accounts.

The remaining sections of this White Paper discuss these issues and the regulatory framework that facilitates it – as well as how service providers can help their clients by explaining this issue, and the solutions, to them. We also address the issue of whether advisers can be compensated for introducing an IRA rollover provider to plan sponsors.

Reasons for Mandatory Distributions

Many recordkeepers base their fees on the number of participant accounts or on the average account balance. In the latter case, small accounts obviously reduce the average account balance; and, in either case, retaining small accounts in a plan after participants have left employment increases the cost for all participants (or for the plan sponsor if it pays the recordkeeper's fees). To the extent the distribution of these small accounts can reduce the participant count to fewer than 100 participants, it will also eliminate the expense of auditing the plan.

These accounts also expand the administrative responsibilities for the plan and service providers in two significant ways. First, the participant disclosures under ERISA Regulation Section 2550.404a-5 (referred to as the “participant disclosure regulation”) must be made to all participants, which includes former employees so long as they have an account balance in the plan. This may mean mailing the annual and quarterly disclosures to these participants and retaining the ability of these participants to access and control their accounts

(even if they are unlikely to do so). Second, the plan sponsor and plan recordkeeper will need to keep track of these former employees and possibly engage in a search for missing participants. Both of these also add to the cost and burden of plan administration.

Finally, the plan committee retains fiduciary responsibility for the accounts of these former employees. While the liability exposure may be small in the case of small accounts, there is nevertheless exposure to act prudently and in the best interest of these participants just as much as for participants who remain employed by the plan sponsor.

Making use of the well-defined Code and ERISA safe harbor provisions – under which plan fiduciaries are protected from exposure to liability – for making mandatory distributions of small accounts to these former employees offers five benefits to the plan and the plan sponsor:

- Mandatory distributions help reduce plan expenses where the recordkeeper imposes per participant charges or charges based on average account balance, or where the plan otherwise incurs charges related to the former employees with account balances.
- In addition, by reducing the participant count to under 100, the cost of an audit of the plan's financial statements can be avoided.
- Since disclosures under the participant disclosure regulation have to be provided to all participants, force-out distributions will reduce the number of participants to whom the disclosures have to be made.
- Mandatory distributions eliminate the responsibility for tracking former employees and thus the possible need to do searches for missing participants.
- Such distributions reduce fiduciary responsibility for the accounts of former employees, and where the balances are rolled over to an IRA under the automatic rollover provisions of the Code, the fiduciaries have the benefit of a fiduciary safe harbor that protects them in implementing the rollover.

¹ The \$5,000 amount is the vested balance in the participant's account and does not include amounts rolled over from another qualified plan or IRA. See Internal Revenue Code §401(a)(31).

Internal Revenue Code Requirements

When a participant has a “distributable event” – .e.g., terminates employment, retires, suffers a disability or dies – the Code normally requires that the participant provide written consent before his account can be distributed.² This gives the participant the opportunity to decide whether to roll the money to another plan or an IRA, take a taxable distribution or leave the money in the plan. However, in the case of small accounts, under Code section 401(a)(31), plans may proceed with a distribution without participant consent, as explained below.

The fact that the plan may distribute a small account without participant consent does not eliminate sending out distribution election forms to former employees with small accounts. These participants have a right to elect how they want their account balances distributed. However, the election form must indicate that if the participant fails to provide an election, his account balance will be rolled over to an IRA; and if no election is made, the plan may distribute the money. (The issues related to the selection of that IRA are discussed in the next section.)

Section 401(a)(31) permits mandatory distributions on vested account balances of \$5,000 or less if the plan provides.³ (To the extent a plan does not provide for mandatory distributions up to \$5,000, it would need to be amended to take advantage of the opportunities discussed in this paper.) If the account balance is above \$1,000, absent other instructions from the participant, the plan must distribute the money in a rollover to an automatic rollover IRA. While automatic rollovers of accounts of \$1,000 or less are not required, the plan sponsor may elect to do so.⁴ In fact, it may be advisable to provide for automatic rollovers of all sizes of small accounts to avoid the issues that arise when distribution checks remain uncashed. (While beyond the scope of this White Paper, uncashed distribution checks are problematic for a variety of reasons, not the least of which is that the money represented by the check belongs to the participant and must be held in trust if the check is not cashed. And this means that the effort to eliminate the small account has been thwarted. An automatic rollover eliminates this issue.)

Not all providers that accept automatic rollover IRAs accept accounts below the \$1,000 level. Thus, if the

plan sponsor elects to rollover all small accounts, regardless of the amount, the sponsor and its adviser will need to identify a competent IRA rollover provider that will accept all accounts.

The summary plan description (SPD) for the plan needs to explain the mandatory distribution and automatic rollover provisions of the plan.⁵ This is both a requirement under ERISA and potentially advantageous to the plan sponsor, if properly handled. By properly handled, we mean that the SPD is distributed to all plan participants, including former employees. If all of the participants, including former employees, have already received an SPD that describes the mandatory distributions for account balances up to the \$5,000 limit and for automatic rollovers, no further action is required.

On the other hand, when the automatic rollover provisions were first adopted, some plan sponsors elected to amend the plan to limit mandatory distributions to account balances of \$1,000 or less. By doing so, the plan avoided having to make automatic rollovers. These plan sponsors might now decide to amend the plan to effect mandatory distributions up to the \$5,000 limit and use the automatic rollover provisions for all small accounts in order to take advantage of the benefits discussed earlier. In this case, the plan will need to send out an updated SPD or a summary of material modifications (SMM). Again, this will need to be provided to all current employees who are eligible for the plan and to all former employees with account balances. If the SPD comes back undeliverable, the plan sponsor should then do a search for the missing participant and deliver the SPD once that participant is found. Where such a search is undertaken in connection with distribution of the SPD, it will not be necessary to do another search later on when an election form is returned undeliverable in advance of a mandatory distribution.

The issues discussed in this section are analyzed in more detail in Appendix A.

The ERISA Fiduciary Safe Harbor

In order to make a mandatory distribution, the money in the participant’s account must be rolled over to an IRA if the vested balance exceeds \$1,000 but is less than \$5,000 (excluding rollover amounts); it may also be advantageous to roll over the funds for accounts of \$1,000 or less, for the reasons discussed earlier. Since the participant has, by definition, not given

² Internal Revenue Code §411(a)(11)(A).

³ As noted in footnote 1, this does not include amounts rolled into the participant’s account from another qualified plan or IRA.

⁴ See ERISA Regulation §2550.404a-2, at subsection (d).

⁵ *Id.* at subsection (c)(4).

instructions on how to distribute his money, it is up to the plan sponsor to select the IRA provider and the investment vehicle to be used. This is a fiduciary decision under ERISA. Fortunately, the Department of Labor (DOL) has addressed this issue through a regulation that establishes a fiduciary safe harbor for the selection of providers and investments.⁶ If fiduciaries follow the relatively modest requirements of the regulation, they are protected from subsequent complaints by former participants

In contrast, absent the safe harbor, selection of an IRA provider and the investment for the rollover would normally require plan fiduciaries to engage in a prudent process. In that case, the fiduciary would need to gather information about providers, including their services and fees, plus information about their investment options, assess all of that information on a comparative basis, using an “objective, thorough and analytical” process, and then making an informed and reasoned decision. It would also mean that the fiduciary would have to revisit the decision periodically and possibly make a change for future automatic rollovers. In addition, it would leave the fiduciary exposed to liability for these decisions.

The requirements for the safe harbor regulation protection are:

- The rollover amount cannot exceed the \$5,000 limit under Code section 401(a)(31).
- The account balance must be rolled over to an IRA offered by a bank, trust company or savings association, a credit union, an insurance company, a registered mutual fund or other entities authorized by the Internal Revenue Service to act as IRA custodians.
- The rolled-over money must be invested in a product that meets requirements for preservation of principal and providing a reasonable rate of return, consistent with liquidity, such as a savings account.
- The fees and expenses for the IRA, including investment expenses, must not exceed the fees and expenses charged by the IRA provider for comparable, non-automatic rollover IRAs.
- The participant must have the right to enforce the terms of the IRA.

If these conditions are satisfied, the fiduciaries are deemed to have satisfied their fiduciary responsibilities with respect to the selection of the

IRA and the investment. Further, the fiduciaries will not have any on-going duty to monitor the decision. This safe harbor is described in more detail in Appendix B.

The requirements of the safe harbor should not be difficult to meet because:

- Many financial institutions offer individual retirement accounts and many insurance companies offer individual retirement annuities. Complying with the type of provider requirement should not be difficult.
- The types of investments specified by the regulation are readily available from the institutions that offer IRAs, especially rollover IRAs.
- Providers that accept rollover IRAs are well aware of the fees and expenses requirement of the regulation and structure their products and fees to comply.
- Providers that specialize in rollover IRAs routinely include a provision in their IRA documents indicating that the participants will have the right to enforce the terms of the IRA.

If a plan sponsor or its adviser select a provider that specializes in automatic rollover IRAs, it should not have any trouble satisfying the safe harbor.

Compensation of Financial Advisers

As noted earlier, advisers and other service providers to 401(k) plans can provide a valuable service to their clients by educating them on the benefits of making mandatory distributions of small accounts and helping them to establish a process for making sure that these accounts are distributed on a periodic basis.

The items an adviser should consider addressing with the client include the following:

- Assisting in the review of the plan document and SPD to make sure they provide for mandatory distributions of accounts of less than \$5,000.

6 *Id.*

Comment: The plan’s recordkeeper or third party administrator should be able to readily identify this provision.

- Helping select the provider for an automatic rollover program.
- Reviewing the documentation of the rollover program provider to make sure it specifically addresses each of the items in the DOL safe harbor regulation.

Comment: Often, the provider’s agreement will track the language of the safe harbor regulation, so this review should be relatively straightforward.

- Assisting the plan sponsor in selecting the investment for the rollover accounts.

Comment: It is likely that the provider will have a list of options that meet the requirements of the safe harbor.

- Facilitating a dialogue between the plan sponsor and the recordkeeper regarding periodic reports and/or an action plan for effecting distributions of small accounts of former participants.

One of the roles the adviser may play is to recommend to the plan sponsor a provider that fulfills the requirements of the ERISA fiduciary safe harbor. Under those circumstances, would it be permissible for the adviser to accept compensation from the IRA provider for accounts that rolled over? Keep in mind that in this discussion, we are addressing the role of the adviser in making a recommendation to the plan sponsor and not to plan participants.

The short answer is that in most instances, acceptance of such a referral fee would be acceptable. This is especially true if the adviser is not otherwise a fiduciary to the plan (*i.e.*, a record keeper, third party administrator or broker that is not a fiduciary), but may also be the case even if the adviser is a fiduciary so long as the IRA provider is not affiliated with the adviser and the adviser does not have the discretion to or exercise the control to pick the investment option into which the plan assets are rolled. (We recognize that the issue regarding selection of the IRA investment is not a realistic concern.) The legal principals underlying these conclusions are discussed in detail in Appendix C, but the following summarizes the considerations.

The concern here is whether the receipt of the fee would be a prohibited transaction under ERISA and the Code. There are two prohibitions that might apply: the first is a prohibition against fiduciary self-dealing;⁷ the second is a prohibition involving both fiduciaries and non-fiduciaries against service arrangements that are unreasonable.⁸ The second prohibition can be avoided if the disclosures under the 408(b)(2) regulation are made and the compensation being received is reasonable.⁹

First, we examine the situation of an adviser who is not a fiduciary. This would include, for example, a broker who does not provide investment advice or possibly a third party administrator or recordkeeper. In this situation, the adviser is recommending to plan sponsors and fiduciaries the provider of a service to the plan. The recommendation of a service provider is generally not considered to be a fiduciary act (except for the recommendation of an investment manager), so the adviser in this instance would not fall under the fiduciary self-dealing prohibition. However, because the adviser is performing a service in making the recommendation, it would need to make the appropriate 408(b)(2) disclosures regarding the service it will provide and the referral fee that it may receive if the provider is selected and if mandatory distributions are made to that provider. (This is true even though the compensation would be paid after the assets have been rolled over to the IRA, because it is compensation that the adviser expects to receive in connection with a service being provided to the plan. This assumes that the amount is reasonable for the service being provided.)

The analysis is substantially the same if the adviser is a fiduciary to the plan. This would include, for example, a registered investment adviser that provides investment advice at the plan or participant level. For purposes of the 408(b)(2) disclosure issue, the compensation the adviser would be receiving for the referral of an IRA provider would be considered indirect compensation, such that the adviser would be “covered” by the regulation and would be required to make the disclosures.

In addition to the 408(b)(2) disclosure issue, there is a second set of prohibitions that apply in the case of a fiduciary. These include a prohibition against dealing with plan assets in the fiduciary’s own interest or for his own account, and the second prohibits the receipt by a fiduciary of compensation from a third party in connection with transactions

⁷ ERISA §406(b)(1) and (3).

⁸ ERISA §406(a)(1)(C).

⁹ ERISA Regulation §2550.408b-2.

involving plan assets. If the recommendation of an IRA provider is considered a fiduciary act, both of these prohibitions are implicated. That said, assuming the adviser does not have the discretion to select the IRA provider and does not recommend an affiliate as the provider, the analysis above should apply to the fiduciary adviser. That is, the recommendation is not a fiduciary act, so even though the adviser is a fiduciary for other purposes, it is not a fiduciary for purposes of the recommendation. Thus, neither of the fiduciary self-dealing prohibitions would apply.

At this point, some may question whether Advisory Opinion 2005-23A would require a change in these conclusions. It does not. In that Opinion, the DOL distinguished between fiduciary and non-fiduciary advisers in addressing whether providing assistance to participants about rollovers was permissible. In this situation, the adviser is providing a service to the plan sponsor, not to participants. Further, to the extent the adviser recommends an IRA investment, we presume its recommendation is designed to satisfy one of the categories of the safe harbor. This would not constitute fiduciary investment advice, since it is not individualized advice to a particular participant.

These issues are discussed in greater detail in Appendix C.

A Possible Solution

There are many IRA providers throughout the country, but only a few specialize in establishing and maintaining mandatory distribution automatic rollover IRAs. One such provider is Inspira, which focuses its business on IRA recordkeeping and administration. As described in information provided by Inspira, the firm provides assistance to employers at no cost to assist in the automatic rollover process. This includes notifying participants that they are eligible for automatic rollover, providing secure and easily implemented online account transfers, meeting the requirements of the ERISA fiduciary safe harbor and being willing to accept rollovers of even very small accounts. The funds are held by one of three trust companies that act as the IRA custodian. Each is an institution that meets the requirement for the type of entity required under the safe harbor. The accounts are invested in one of a number of safe harbor qualified investments,

including traditional money market funds, FDIC insured money market accounts and fixed return funds, with the ability to diversify the initial investment to encourage future savings.

With respect to the ERISA fiduciary safe harbor, the agreement that Inspira has negotiated with the trust companies serving as custodians, which the plan sponsor would enter into for establishing an automatic rollover program, contains terms that conform to the safe harbor requirements. In particular, the agreement provides that (1) the fees for a rollover IRA will not exceed those of any other comparable IRA offered by the trust company, (2) the assets being rolled over will be invested in a product designed to preserve capital and provide a reasonable rate of return, and (3) the participant whose account is rolled over will have the right to enforce the agreement.

Inspira also offers an IRA rollover program for qualified termination administrators (QTAs) under ERISA Regulation Section 2550.404a-3.

Conclusion

There are a number of reasons for plan sponsors to make mandatory distributions of small accounts – to reduce expenses, to reduce administrative burdens and to eliminate fiduciary responsibility. Under the Code, such distributions are mandated for accounts of between \$1,000 and \$5,000, so long as the plan document so provides. Given the benefits of making such distributions, if the plan does not provide for mandatory cash outs up to the \$5,000 limit, plan sponsors should consider amending the plan. They may also wish to consider providing for automatic rollovers of all accounts below \$5,000 in order to ensure that the accounts get distributed.

The process of effecting mandatory distributions through automatic rollovers is simplified under the ERISA fiduciary safe harbor for the selection of an IRA provider and the investment into which participant funds are rolled.

Financial advisers and other service providers can offer their clients a valuable service by educating them on the desirability of adopting a program for ensuring that mandatory distributions occur on a periodic basis. And they may be compensated (if they so choose) by the IRA provider for assisting in this process.

APPENDIX A

Internal Revenue Code Authorities Regarding Mandatory Distributions

General Requirements

Under the Code and ERISA, a plan generally may not distribute benefits to a participant who has experienced a distributable event – termination of employment, retirement, disability or death -- without his consent. Code section 411(a)(11)(A) provides as follows:

“If the present value of any nonforfeitable accrued benefit exceeds \$5,000 a plan meets the requirements of this paragraph only if such plan provides that such benefit may not be immediately distributed with the consent of the participant.”¹⁰

This section indicates, however, if two conditions are satisfied, distribution without the participant’s consent is permitted. The two conditions are: first, the participant’s vested account balance must be \$5,000 or less (not including funds rolled into the plan and their earnings); second, the plan must provide for “cash out distributions” up to the \$5,000.

The Code was amended in 2001 to add an automatic rollover feature to Code section 401(a)(31). Under subsection (B), if the account balance is not more than \$5,000 but exceeds \$1,000, the plan is required to roll the account over to an “individual retirement plan” (an individual retirement account or individual retirement annuity) absent directions from the participant.¹¹ The automatic rollover provision does not apply to account balances of \$1,000 or less. However, there is nothing in section 401(a)(31)(B) (or the comparable ERISA provision) that prohibits a plan from providing that all distributions of under \$5,000 (including those of \$1,000 or less) will be rolled over unless the participant otherwise directs. In addition, the DOL has indicated in its fiduciary safe harbor guidance, that such a rollover will qualify for the safe harbor.¹²

Notice Requirements

The plan administrator is required to notify the participant of both the automatic rollover and the participant’s right to make a distribution election to receive the distribution or have it rolled over to another plan or IRA. The notice is required to be sent no less than 30 days and no more than 180 days from the date of distribution or automatic rollover.¹³ IRS Notice 2005-5, Q&A3 provides that:

“In order to satisfy the automatic rollover requirement of § 401(a)(31)(B), a plan must provide that, when making a mandatory distribution that exceeds \$1,000 and that is an eligible rollover distribution, if, after receiving the notice described in §402(f), a participant fails to elect to receive a mandatory distribution directly or have it paid in a direct rollover to an eligible retirement plan, the distribution will be paid in a direct rollover to an individual retirement plan.”

The Notice does not address rollovers of accounts of \$1,000 or less, but there is nothing in either the Code or the Notice that would prevent such a rollover. In addition, as discussed in Appendix B, the DOL has provided that the fiduciary safe harbor applies to such accounts.

In notifying the participant, the IRS indicated in Notice 2005-5 that “plan administrator may use the participant’s most recent mailing address in the records of the employer and plan administrator.”¹⁴ It also explained the requirements if the notice was returned undeliverable:

“Further, for an eligible rollover distribution paid as an automatic direct rollover, a plan administrator will not be treated as failing to satisfy this notice requirement or section 402(f) with respect to an eligible rollover distribution merely because the notice is returned as undeliverable by the United States Postal Service after having been mailed to the participant using the participant’s most recent mailing address in the records of the employer and plan administrator.”¹⁵

¹⁰ Code §411(a)(11)(A); see also ERISA §§203(e)(1) and 205(g);

¹¹ Code §401(a)(31)(B). For a definition of “individual retirement plan,” see Code §7701(a)(37).

¹² See discussion in Appendix B.

¹³ See, Prop. Treas. Reg. §1.402(f)-1, Q&A-2.

¹⁴ Notice 2005-5, Q&A 10.

¹⁵ Notice 2005-5, Q&A 15.

In other words, the Plan Administrator is not required to search for the missing participant. This presupposes that the plan provides for the automatic rollover of accounts between \$1,000 and \$5,000, that the plan's summary plan description (SPD) describes the program and that the SPD has been distributed to the participants. As discussed in Appendix B, there is a requirement that the automatic rollover arrangement be described in the plan's summary plan description, so in the case of a plan that must be amended to add the automatic rollover feature, an updated SPD or summary of material modification (SMM) would need to be delivered to the participant in order for the relief described in Notice 2005-5 to apply. And in that case, the plan would need to have taken steps to find missing participants to ensure that he has received the SPD or SMM.

Practical Considerations

In our experience, when the automatic rollover provision was added to the Code, a number of employers elected to restrict cash out distributions to \$1,000 or less, thus avoiding the requirement of doing automatic rollovers to an IRA. Presumably, the perceived advantages were that the plan fiduciaries would not be required to select an IRA provider, the plan would not be required to go through the notice process required by the Code, and the plan recordkeeper would not have to go through the process of doing the rollover. Instead, the plan could issue a check to the participant, net of the required 20% withholding,¹⁶ and (at least theoretically) be relieved of any further obligation with respect to the participant's account.

This approach meant that if the participant failed to cash the check, the plan had to establish a procedure for getting the funds back into the plan trust. It also meant that small accounts of between \$1,000 and \$5,000 remained in the plan.

Even in plans that provided for the cash out at up to \$5,000 and for the automatic rollover, few provided for rollovers of accounts of \$1,000 or less.

In light of the ERISA fiduciary safe harbor for selecting the IRA provider and investment vehicle and the emergence of firms that will accept rollovers of all amounts, regardless of how small, the perceived impediments to adopting an automatic rollover arrangement would appear to have been eliminated. That said, before proceeding with such an arrangement, four steps are necessary: first, the plan document should be reviewed to ensure that it does not restrict cash out distributions to accounts of \$1,000 or less; second, the SPD should be reviewed or amended to describe the cash out and rollover program; third, the revised SPD or SMM should be distributed to all participants with account balances (including former employee who may be "missing"); and, fourth, a reputable IRA provider should be identified for this purpose.

Conclusion

A plan may distribute small accounts without participant consent so long as the document so provides. Unless a participant provides instructions to the contrary, account balances of less than \$5,000 and more than \$1,000 must be rolled over to an IRA. Balances of \$1,000 or less are not required to be rolled over, though a plan may provide for such rollovers. Prior to effecting a rollover, the plan must provide notice to the participant but is not required to search for missing participants if the plan's SPD described the automatic rollover process.

APPENDIX B

ERISA Authorities Regarding Fiduciary Issues

The Fiduciary Safe Harbor

Under ERISA, fiduciaries must act in the best interest of participants and for the exclusive purpose of providing them with benefits.¹⁷ In the context of mandatory distributions that are being rolled over to an IRA, this obligation imposes on the plan sponsor or plan committee the requirement that they act prudently in selecting the provider of the IRA and the investment vehicle into which the participant's account is rolled. It also requires the sponsor or committee to periodically monitor the provider to ensure that it continues to be a prudent choice for future rollovers (though it would not need to monitor the provider once the distribution has been made, since the assets rolled over would no longer be plan assets over which the fiduciaries have responsibility).

To facilitate this fiduciary process, the DOL has adopted a safe harbor that applies to the decisions that must be made in connection with mandatory distributions.¹⁸ The Regulation states:

"...this section provides a safe harbor under which a fiduciary of an employee pension benefit plan subject to Title I of [ERISA] will be deemed to have satisfied his or her fiduciary duties under section 404(a) of the Act in connection with an automatic rollover of a mandatory distribution described in section 401(a)(31)(B) of the Internal Revenue Code of 1986, as amended (the Code). This section also provides a safe harbor for certain other mandatory distributions not described in section 401(a)(31)(B) of the Code."

The regulation goes on to indicate the decisions that are covered by the safe harbor:

"A fiduciary that meets the conditions of paragraph (c) or paragraph (d) of this section is deemed to have satisfied his or her duties under section 404(a) of the Act with respect to both the selection of an individual retirement plan provider and the investment of funds in connection with the rollover of mandatory distributions described in those paragraphs to an individual retirement plan, within the meaning of section 7701(a)(37) of the Code."¹⁹

Thus, if fiduciaries comply with specified conditions, they are deemed to have fulfilled their fiduciary obligations with respect to the selection of the IRA provider and the investment into which participant moneys are rolled. The conditions, described below, are relatively easy to achieve, so that essentially all of the perceived risk of making mandatory distributions and automatic rollovers is eliminated.

The regulation establishes five conditions for the safe harbor to apply:

- The amount of the benefit being rolled over may not exceed the maximum provided under Code section 411(a)(11), that is, \$5,000;
- The distribution must be rolled over to an "individual retirement plan" that meets the definition set out in Code section 7701(a)(37), *i.e.*, an individual retirement account or an individual retirement annuity;
- The fiduciary must enter into a written agreement with the IRA provider. The agreement must address the following five requirements with respect to the rollover IRA:
 - The investment into which the account is rolled must be designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, consistent with liquidity;
 - The investment must "seek to maintain, over the term of the investment," the dollar value equal to the amount rolled over;
 - The investment must be provided by a bank or savings association, with FDIC insured deposits, a credit union, with accounts insured under the Federal Credit Union Act; an insurance company whose products are protected by state guaranty associations; or a registered mutual fund;

¹⁷ ERISA §404(a)(1)(A).

¹⁸ ERISA Regulation Section 2550.404a-2.

¹⁹ *Id.* at subsection (b).

- All fees and expenses of the IRA, including investment fees, must not exceed the amounts that the IRA trustee charges for comparable non-automatic rollover IRAs; and
- The participant must be able to enforce the terms of the IRA.
Comment: Examples of investments that meet these requirements would be bank savings accounts or certificates of deposit and guaranteed investment contracts. Note that investments that would satisfy the requirements for qualified default investment alternatives (QDIAs) would generally not satisfy these requirements.
- Participants must be furnished a summary plan description, or a summary of material modifications, that describes the plan's automatic rollover provisions. This must include:
 - an explanation that the mandatory distribution will be invested in an investment product designed to preserve principal and provide a reasonable rate of return and liquidity;
 - a statement indicating how fees and expenses will be allocated (i.e., the extent to which expenses will be borne by the account holder alone or shared with the distributing plan or plan sponsor), and
 - the name, address and phone number of a plan contact for further information concerning the plan's automatic rollover provisions.
- The selection of the IRA and investment of the rolled over money would not result in a prohibited transaction under section 406 of ERISA unless an exemption is available.

The DOL also addresses account balances that are \$1,000 or less and says that the fiduciary safe harbor can also be utilized even though the Code does not require an automatic rollover for those balances.²⁰ The regulation states:

A fiduciary shall qualify for the protection afforded by the safe harbor described in paragraph (b) of this section with respect to a mandatory distribution of one thousand dollars (\$1,000) or less described in section 411(a)(11) of the Code, provided there is no affirmative distribution election by the participant and the fiduciary makes a rollover distribution of such amount into an individual retirement plan on behalf of such participant in accordance with the conditions described in paragraph (c) of this section, without regard to the fact that such rollover is not described in section 401(a)(31)(B) of the Code.

Informally, the DOL stated its reasoning for including this provision in the safe harbor:

"Staff believes this extension should assist plan fiduciaries in avoiding the issue of uncashed checks, and also has been told that many plans were amended to remove cash outs below the \$1,000 amount."²¹

Thus, for a mandatory distribution under \$1,000, the account can be rolled over to an IRA subject to meeting the fiduciary safe harbor requirements.

Note that there is no on-going requirement for the fiduciary to monitor the selection once it has been made. Further, there is no duty to monitor the selection of the provider or the investment vehicle, though it may be prudent for a plan sponsor to review its selection every few years to ensure that the provider and investment continue to meet the requirements of the safe harbor.

It should also be recognized that in a terminating plan, all accounts, regardless of size, can be rolled over to IRAs if participant's fail to provide timely consent to the distribution.²²

Missing Participants

In some instances, the distribution package sent to a participant with a small account will be returned as undeliverable. If the automatic rollover process has been described in the SPD previously delivered to the participants, the plan sponsor will be relieved of the obligation of taking steps to locate the missing participant under the IRS Notice discussed in Appendix A.²³ However, if the plan had to be amended to permit mandatory distributions of up to \$5,000, it would be necessary to provide an amended SPD or a SMM to all participants. In this case, in order for a fiduciary to

²⁰ *Id.* at subsection (d).

²¹ Informal, nonbinding remarks, ABA Joint Committee on Employee Benefits, meeting with DOL staff, Q/A-6 (May 7, 2009).

²² ERISA Regulation §2550.404a-3.

²³ See IRS Notice 2005-5.

take advantage of the fiduciary safe harbor relief, steps would need to be taken to find missing participants who did not receive the amended SPD or SMM.

The DOL has not addressed the issue specifically in the context of delivery of an SPD or SMM, but it has provided guidance on the steps plan administrators should take to locate missing or unresponsive participants in the context of a terminated plan.²⁴ While this guidance applies to terminated plans, we believe that the process can be applied by analogy in this context. These search methods described by the DOL include:

- **Certified Mail.** Send out the SPD or SMM using certified mail. This may seem obvious, but if the package is returned as undeliverable, the plan administrator will know that it needs to take further steps to locate the participant.
- **Check Related Plan Records.** The plan administrator should look at the records of other plans (for example, the group health plan) for a more current address for the missing participant.
- **Check with Designated Plan Beneficiary.** The plan administrator may also attempt to identify and contact any individual that the missing participant has designated as a beneficiary (e.g., spouse, children, etc.) for updated information concerning the location of the missing participant.
- **Use A Letter-Forwarding Service.** Currently, only the Social Security Administration (SSA) offers a letter-forwarding service. The SSA will search its records for the most recent address of the missing participant and will forward a letter from the plan fiduciary/requestor to the missing participant if appropriate. The SSA charges \$25 per letter.

The DOL guidance also discusses other search options that plan fiduciaries should consider, including: internet searches, commercial locator services, and credit-reporting agencies. However, if the cost of these additional search options will be charged to participants' accounts, plan fiduciaries are required to consider the size of a participant's account in relation to the cost of the search when deciding whether the search option is appropriate.

Conclusion

The ERISA safe harbor materially reduces the process that fiduciaries must undertake to select an IRA provider and the investment vehicle into which small accounts are rolled. The safe harbor applies to account balances of more than \$1,000 and less than \$5,000, which are the amounts covered by the automatic rollover rules in the Code; it also applies to accounts of \$1,000 or less. The conditions for satisfying the safe harbor are straightforward and relatively easy to meet. They require only that the fiduciaries – with the help of their advisers – find a provider that is accustomed to handling automatic IRA rollovers and has the documentation and investment vehicles in place that already meet the safe harbor requirements.

The safe harbor does require the plan sponsor to have provided to participants a SPD or SMM that describes the rollover process. If the plan is amended to meet the Code requirements for automatic rollovers, such that an amended SPD or SMM must be provided, the plan sponsor will need to take steps to locate missing participants in an effort to ensure that they receive this document.

APPENDIX C

Legal Authorities Regarding Compensation to Financial Advisers

In General

Plan advisers need to assess the Code and ERISA rules before accepting compensation in connection with the referral of an IRA provider to a plan sponsor (in its role as the ERISA plan administrator). The concern arises under the prohibited transaction rules.²⁵ The prohibitions are divided into two broad categories:

- ERISA Section 406(a) prohibits certain acts between a plan and a “party in interest” – which includes plan service providers.²⁶ The section prohibits (i) furnishing services to a plan by the party-in-interest unless the arrangement and compensation are reasonable;²⁷ and (ii) the transfer to or use by a party-in-interest of any assets of the plan.²⁸ These rules apply to both fiduciary and non-fiduciary parties-in-interest.
- Section 406(b) prohibits certain acts of fiduciary self-dealing, including
 - (i) dealing with the assets of a plan in the fiduciary’s own interest,
 - (ii) acting on behalf of a party whose interests are adverse to those of the plan in a transaction involving plan assets, and
 - (iii) receiving compensation from a third party in a transaction involving plan assets. These prohibitions only apply to parties in interest who are fiduciaries.

In this context, the question is whether the receipt of a referral fee from an IRA provider would constitute a prohibited transaction or other violation of ERISA or the Code. The discussion that follows is divided into three sections:

- discussion of the prohibition against furnishing services unless the arrangement is reasonable and the compensation to be received by the service provider is reasonable;
- discussion of the rules as they apply to non-fiduciary advisers; and
- discussion of the rules as they apply to fiduciary advisers.

Furnishing of Services

This issue has received considerable attention in the last several years in light of the issuance by the DOL of ERISA Regulation 2550.408b-2. That regulation provides guidance on the exemption afforded by Section 408(b)(2) to the prohibited transaction restriction under Section 406(a)(1)(C). It requires disclosures by service providers in order for the service arrangement with a covered plan to be considered reasonable and thus entitled to exemption.

Where an adviser makes a referral or recommendation to the plan sponsor of an IRA provider for automatic rollovers, it is providing a service to the plan. As a result, it must make written disclosure of the service it is providing, the compensation it expects to receive and its status as a fiduciary and/or a registered investment adviser under the Investment Advisers Act of 1940 in advance of making the referral (though we presume that the status disclosure has previously been made in connection with its overall 408(b)(2) disclosures). If the adviser elects not to accept a referral fee, the disclosure would still be required if the adviser is already a service provider to the plan (and thus already subject to the 408(b)(2) disclosure obligation). The adviser would need to provide a written description related to the referral, including the service it will provide and a statement regarding the amount of the referral fee, the payer of the fee and the “arrangement” with the payer under which it will receive the fee.

²⁵ ERISA Section 406(a) and (b); Code section 4975(c). The provisions are nearly but not entirely identical in ERISA and the Code. In this paper, we will focus on the ERISA provisions.

²⁶ ERISA Section 3(14)(B); parties in interest are referred to as “disqualified persons” in the Code.

²⁷ ERISA Section 406(a)(1)(C) and 408(b)(2).

²⁸ ERISA Section 406(a)(1)(D).

It does not appear that this requirement would be especially onerous, but it is important to comply with the notification requirement in order to avoid engaging in a prohibited transaction.

Non-Fiduciary Advisers

Aside from the restriction related to providing services (under ERISA Section 406(a)(1)(C) and to which the 408(b)(2) exemption applies), the other prohibition that might apply to a non-fiduciary adviser is under 406(a)(1)(D), which prohibits the transfer of plan assets to or the use by or for the benefit of a party interest. However, since the 408(b)(2) exemption applies to all of the prohibitions under ERISA Section 406(a), this would not be an issue assuming the disclosures have been made and the compensation is reasonable.

There is a second issue for non-fiduciary advisers, however, and that is whether the making of the referral or recommendation itself constitutes a fiduciary act that would cause the 406(b) restrictions to apply. This is discussed in the next section.

Fiduciary Advisers

As a general proposition, a fiduciary cannot use its authority as a fiduciary to cause itself to receive additional compensation.²⁹ This would constitute a violation of the Section 406(b)(1) prohibition against dealing with plan assets for the benefit of the fiduciary. It is important to note that under ERISA, a party is a fiduciary only to the extent it engages in an act specified in ERISA Section 3(A)(21). This means, in the case of an adviser that is already a fiduciary to a plan, not all acts of the adviser are fiduciary acts; and the referral of a plan sponsor to an IRA provider would generally not be considered a fiduciary act.

Generally, the referral of another service provider to a plan is not considered a fiduciary act because it does not constitute the exercise of discretion or control over management of the plan or the assets of the plan, discretionary authority or responsibility over the administration of the plan and does not constitute investment advice.³⁰ Thus, a service provider who is a non-fiduciary adviser would not become a fiduciary for purposes of the 406(b) restrictions, and a fiduciary adviser would not be a fiduciary for purposes of making the recommendation or referral of the IRA provider. And, therefore, the 406(b) prohibitions would not apply.

In this regard, it is instructive to review DOL Advisory Opinion 2005-23A, in which the DOL discussed whether the solicitation of rollovers from participants, the recommendation of an IRA provider and providing assistance on the investment of the funds once rolled to the IRA was permissible. The DOL concluded that such acts did not constitute fiduciary investment advice. As a result, a non-fiduciary who engaged in these acts was not performing a fiduciary function, and his receipt of compensation for providing advice or assistance with respect to investment of the IRA account would not be a prohibited transaction under ERISA. On the other hand, the DOL said that these acts by a person who was already a fiduciary to the plan would be considered to be fiduciary acts (though not investment advice), stating that the fiduciary would be “exercising discretionary authority respecting management of the plan...”³¹ Presumably, the DOL’s position is based on the concept that the fiduciary is, in some way, exerting control over the participant and his plan assets.

When an adviser recommends an IRA provider, it is one or two steps further removed from the arrangement discussed by the DOL in the Advisory Opinion. That is, the only step taken by the adviser is to recommend a service provider to the plan sponsor. It is not providing any advice or assistance to participants, which is the subject of the advisory opinion. It is soliciting the rollover, and it will not be involved in the investment of the funds after the rollover takes place. To the extent the adviser has any role related to the IRA investment, presumably its recommendation relates to selection of a product that satisfies the safe harbor. In this sense, the recommendation is not fiduciary investment advice, since it is not individualized, based on the particular needs of an individual participant.

Non-fiduciary advisers can take some comfort from the Advisory Opinion conclusion that the referral of the IRA provider will not cause them to become fiduciaries such that the receipt of the referral fee would be prohibited.

²⁹ See ERISA Regulation Section 2550.408b-2(e).

³⁰ See ERISA §3(21)(A)(i), (ii) and (iii).

³¹ Advisory Opinion 2005-23A, Q&A2.

Fiduciary advisers can also take some comfort from the Opinion in that they are not engaging in the types of acts found by the DOL in that opinion to be fiduciary acts. As noted, they are not soliciting a rollover or seeking to advise the participant on the assets once they are rolled over. They are only recommending a provider to the plan sponsor.

Conclusion

Advisers that recommend an IRA provider will need to provide the 408(b)(2) disclosures in advance of the recommendation to avoid engaging in a prohibited transaction. However, the receipt of a referral fee for making the recommendation would not otherwise constitute a prohibited transaction because it would not constitute a use of plan assets by a non-fiduciary adviser. In the case of a fiduciary adviser, it would not invoke the fiduciary self-dealing prohibitions under ERISA Section 406(b) because the referral would not constitute a fiduciary act.

The law and Drinker Biddle's analysis contained in this White Paper are general in nature and do not constitute a legal opinion or legal advice that may be relied on by third parties. Readers should consult their own legal counsel for information on how these issues apply to their individual circumstances. Further, the law and analysis in this White Paper are current as of March 2013. Changes may have occurred in the law since this paper was drafted. As a result, readers may want to consult with their legal advisers to determine if there have been any relevant developments since then.

Drinker Biddle

www.drinkerbiddle.com

CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY | NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN

© 2013 Drinker Biddle & Reath LLP.
All rights reserved.

A Delaware limited liability partnership | One Logan Square, Ste. 2000 | Philadelphia, PA 19103-6996 | (215) 988-2700 | (215) 988-2757 fax
Jonathan I. Epstein and Andrew B. Joseph, partners in charge of the Princeton and Florham Park, N.J., offices, respectively.