RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 3B

LATE-BREAKING DEVELOPMENTS

Moderator: HAL S. TEPFER
Panelists: DENNIS T. BLAIR*
EDWARD E. BURROWS
Recorder: HAL S. TEPFER

- This session will cover legislative and regulatory developments which have occurred just prior to the meeting. The effect on the pension practitioner will be discussed.

MR. HAL S. TEPFER: I'm with The PENTAD Corporation in Massachusetts and Ed Burrows is the president of The PENTAD Corporation. Dennis Blair is the research director of The Alexander Consulting Group in Newburyport, Massachusetts.

When I was initially asked to moderate this panel, I thought it would be great, because by June we would have the 401(a)(4) regulations and the 401(k) regulations out. As we all know, we're not going to be talking about either of those today, because we're still at a point of being told that they're coming soon. So instead, Ed will focus on some relatively recent developments, including 404(c) and closing agreements. After that, Dennis is going to talk to us about the congressional outlook in 1991.

MR. EDWARD E. BURROWS: We have heard yesterday about the closing agreement program. I'd like to revisit it again now, for at least two reasons. First, I think it's a program that has not been well enough exposed to those of us in the profession.

And second, I think it's necessary that we approach the program a little bit differently from the way we heard it approached at an earlier session. I'd like to put a slightly different spin on it. And I believe that if you end up seeing things the way I see things, you're not going to be quite as happy about the program as the folks at the IRS have suggested we should be.

The disqualification is admittedly a Draconian penalty for what can often be innocent errors in the administration of a plan. And the closing agreement program has been brought to us as a demonstration that the Internal Revenue Service is merciful after all. I think you may end up agreeing with me that the kind of mercy the IRS is bringing to us with this program is strained indeed. As a matter of fact, I think the mercy may have been pushed through a piece of cheesecloth.

The pilot program was announced last December. It was to be utilized initially in the key districts of Brooklyn, Chicago, and Cincinnati. It's not just a small case program. As a matter of fact, it's part of the introductory memorandum that certain proposals should be referred to the national office. Those are closing agreement proposals involving either more than 500 participants or sanctions of more than $1 million.

* Mr. Blair, not a member of the sponsoring organizations, is Research Director of The Alexander Consulting Group in Newburyport, Massachusetts.

So, it's clear at the outset that we're talking about all sizes of cases. The process goes like this. First off, if you want to participate in the closing agreement program, if it's been proposed to you, you must correct whatever defect it was that could otherwise have led to a disqualification of the program, of your plan. You must make that correction both prospectively and retroactively. And you will, if you please, ignore any statutes of limitations that might otherwise have closed off past years. That is, you go back to the year one in making your corrections. If additional contributions are necessary to make these corrections, make the additional contributions. If you make additional contributions, you may or may not be able to deduct them, depending on current year's deduction limitations. There's nothing in the program that suggests that we will escape excise taxes on contributions that we have to make, which are not currently deductible.

Once you have made this correction and brought everyone to the position that they would have been in had we not committed these simple, nonegregious errors, then we talk about sanctions. And the first step in calculating a sanction is very easy. You determine what the taxes would have been had disqualification been the solution. That is, you determine the additional tax as a result of employer contributions not being deductible after all. You add to that the additional tax that would be incurred as a result of trust income not being exempt after all, because it would, at this point, have been a nonqualified trust. You add to that the additional tax that some participants would undoubtedly have incurred because they had additions being made under the plan to their benefit in a nonqualified plan. You add all of those up. Notice that we are at least as high as we would have been had we accepted disqualification. And that's the starting point for the sanction. I see nowhere in the discussion any suggestion that we subtract from that starting point what would have been tax-free disbursements later on, which would probably have been the case if we had accepted disqualification. Because certain participants, had they been taxed currently, would undoubtedly have been receiving disbursements later on, which were at least partially tax free. That's referred to in the kick-off memorandum as the maximum sanction.

And from that point, we negotiate a settlement. The settlement can be somewhere between zero and that maximum sanction. But here's what the memorandum has to say about where in that zero to the maximum we fall. The objective is to obtain agreement for 100% of the maximum payment figure. And there, ladies and gentlemen, is your quality of mercy. What do we have in terms of areas for which this can be utilized? Well, the initial proposal is that there will be four major areas. First, late amenders for TEFRA, DEFRA, and Retirement Equity Act (REA), that is, if the plan did not amend quite timely enough, may possibly make use of this closing agreement program. Second, integration problems. Now, I don't know why those problems should come about. The rules on integration are so simple and easy to understand today. Third, partial termination, which we didn't notice was a termination. Therefore, we failed to fully vest all the people involved in the partial termination. And fourth, operational top-heavy problems. Other areas are possible, but these are the big four that the program aimed at addressing. We have some areas where the program is not available: exclusive benefit violations, significant discrimination, and repeated or deliberate or flagrant violations.

Now, what is it that bothers me so much about the introduction to this program? After all, some practitioners have pointed out this is a purely voluntary program.

What's the harm in having one other possibility available to us? It's a possibility, these other practitioners have suggested, is one that we can turn our backs on if we see fit. Well, I'm not so sure that I see that analysis. All of us have had the experience, in dealing with simple, nonegregious errors, where there were not other complicating circumstances. All of us have had the experience of being told by the IRS examiner, "Fix it. Make everybody whole and let's move forward." That is, the examiner knew that the penalty that he would otherwise have to bring into play was too Draconian for the crime. Therefore, we have come to accept the proposition that in many, many cases, the examiner would simply tell us to fix it. We would do so. We would see to it that the problem did reoccur. And we'd go about our business.

Now the examiner is being told to propose this new alternative. What if we turn him down? Is the examiner going to have the same guilty feeling that he would have had if he had said, "All right. I now rule your plan disqualified." I don't think so. I think the examiner is going to say, "You accept this closing agreement proposal, or I'm going to disqualify your plan." So, I see this as a very troublesome entry into the arena of tax management and compliance management.

I think that before we leave that issue and go on to 404(c) issues, we should very quickly address the administration policy regarding sanctions. This is reflected in a memorandum that was published late in March. And it lists a number of extraordinarily innocent violations for which there will not be any sanction proposed. But there are six requirements that we have to touch base with, if we want to take advantage of this new policy. We heard all six yesterday morning, but I'm not sure that we paid quite the attention to them, or that we were invited to pay quite the attention to them that we perhaps should have. Requirement 1: The errors have to have been insignificant and isolated. Requirement 2: There has to be a history in the plan of compliance. And if your plan hasn't been around long enough to have that history -- say your plan has only been around for a couple of years -- then you have to demonstrate that whatever the error was, you corrected it before the examiner came on the scene. That's part of the memorandum. So anything that we can't point to as a plan that has a history of compliance, or we can point to as a plan where we corrected the error before the reviewer got on the scene, will not be eligible for this new administrative policy. Requirement 3: There must have been a procedure in place to avoid the error that happened. That is, there must have been a procedure so that what happened couldn't happen. Requirement 4: The procedure must have been followed. So we must have had a procedure so that what happened couldn't happen, and we must have followed the procedure so that what happened couldn't happen. Requirement 5: The error has to have involved insubstantial dollar amounts. Requirement 6: We must make immediate and complete correction. That is, we must bring the plan back to the status it had before the error was committed. So there's the other branch of mercy that has been brought to us by the IRS.

I will now outline 21 questions and answers beginning with those that involve some rules that I, as a practitioner, am quite unfamiliar with. They involve Section 16 of the 1934 Securities and Exchange Act. This is not a household word to employee benefit practitioners. These new rules impact to companies that have securities issues that have to be registered under the 1934 Act. And the objective of the new rules is to prevent insiders from making a killing on short-term buying and selling, where they're making use of inside information that's not available to the rest of us

outsiders. For this purpose, an insider is a director, a 10% owner of the company, or one of a short list covering certain officers. There are really two sets of rules. One covers reporting obligations and the other covers short-swing liability. Now, short-swing liability is the proposition that as an insider, if you make a profit on a round trip, that is either buying or selling at a higher price, or selling and buying back at a lower price, and if this round trip took place within a six month period, your liability is to disgorge to the corporation issuing the securities any profits you made. In the lingo of insider participation in a participant-directed qualified retirement plan, buying occurs when money is added to the employer stock account in the plan. Selling occurs when money is removed from the employer stock account in the plan. The enforcement scheme is very interesting. The enforcement scheme is that you must, as an insider, report all of your purchases and sales. Then, it's left up to the private sector to enforce the execution of the insider trader liability. So all of these purchases and sales are made public, they're put on the public record, and then, bless them, lawyers go look at the public record, pour over them, figure out who is a potential insider liability victim, go to the company and say, "Folks, we think you should go after this particular insider. And, of course, when you collect, we'd like, please, to have a piece of the action." And that's the enforcement scheme. It's a rather interesting one. It's a scheme that is foreign, I think, to those of us who, in the employee benefit field, are used to having the government regulators do all the enforcing.

Focusing on insider participants in a participant-directed fund, I don't think the insider is going to be able to escape the reporting requirements. This is a change. There are certain exemptions that did exist and continue to exist, as they apply to short-swing liability. It used to be the case that if you were eligible for one of those exemptions, you probably were eligible for exemption from the reporting requirement as well. This will no longer be the case. You will, as an insider, have to report your purchases and sales. Because you're dealing with transactions that are probably going to be exempt, you don't have to report them promptly, with each purchase and sale. You can make a blanket reporting, if you see fit, at the end of the year. The form, for anybody who's interested, is Form 5.

Now, you will, if you mind your p's and q's, be able to avoid insider trading liability. A transaction will always be exempt if it involves a six-month advanced notice of your decision to sell. And here, remember, that a decision to sell is a decision to either make a withdrawal or to make a transfer out of your company's stock account. It's also exempt if it involves an election or a transaction that is related to death, quitting, disability, retirement, or execution of the requirements of a qualified domestic relations order. In Massachusetts, those are qualified domestic relations orders (QDROs); I understand that in Washington they're QUIDROs.

Now, if you don't qualify for one of those blanket exemptions, then we have to get a little bit more explicit. And, of course, when we talk about not qualifying for one of those blanket exemptions, we're probably talking about in-service withdrawals, where you wouldn't have the incidence of death, disability, quitting, or retirement. And we're talking about transfers to or from your employer stock account, where the transferred money is going to one of your other investment options under the trust. To cover these two types of transactions, we have the following exemptions. First, the officer or director making a securities withdrawal is home free if he holds onto the security after he's withdrawn it from the plan for a period of at least six months.

Well, of course, that's not very helpful if his reason for making the withdrawal is that he had a hardship. So there's a second branch which is a little bit more useful. That same officer or director is home free if he refrains from further purchases, that means from having more money go into his employer stock account, for a period of six months after the withdrawal. An officer or director who opts to reduce the amount currently going into his employer stock account is going to find that he should be living with the reduction. He should not, again, increase that amount. He should be living with the reduced amount for a period of at least six months.

Now, the insider must not make an investment transfer into or out of his employer stock account, unless it's been at least six months since the last such transfer. And finally, the insider is permitted to elect such a transfer only if he elects it within a brief window period, which comes up once each quarter. It's a 10 day period. It begins on the third day and ends on the twelfth day, after quarterly financials have been published. So those are the SEC rules that, I think, we're going to become more familiar with. Notice that the plan itself, under these rules, does not appear to have any reporting obligations. There are certain circumstances where a plan itself could become an insider. But in the typical participant-directed plan, that's not going to happen. It's the insider participant who has the reporting obligation. But, of course, we're going to have to be talking intelligently to our clients about how we can run these plans so that these reporting obligations can be discharged, and so that insider short-swing liability can be avoided.

Now, with that background, let's take a look at our 21 questions and answers. First off, I think I would like to make the pitch to you that 404(c) is important to us. Now, many folks have questioned the importance of 404(c). They've pointed out that 404(c) does not exempt us from fiduciary responsibility for selecting the right investment options in the first place. And they've asked, as long as we have that responsibility anyway, why are we becoming concerned about jumping through the hoops? Why not just accept our responsibility, behave carefully, and let it be? Well, the answer is that we need protection from the inappropriate behavior of participants. I'll recite an instance where the participant could be making a very inappropriate decision. I suggest that we have a participant who, for many years, has been quite content to participate in the safe option under this particular plan. He's going to be retiring at the end of 1987. Around in September 1987, he sees that all those folks who have been using the equity option had been making out much better than he has, and so he says, "I'm just about to retire, here's my opportunity to make a quick killing. I'll move all of my money out of the safe fund, into an equity fund, and make a killing on the basis of appreciation which will occur for a short period of just a few months. I can't possibly be exposed to much risk. I'll be out before anybody knows what happens." He makes his move, and the rest is history. We all know, quite painfully, what happened in October 1987. Now, if we didn't have 404(c) to fall back on, it could very well be that although we have done our homework, we will end up sharing the blame for the inappropriate behavior of the participant. As we all know painfully well, you are your brother's keeper when it comes to fiduciary responsibility under ERISA. Some of us weren't sure that was the case, some of us thought it was a bit fishy back in 1974. But that's the way it works. So, I submit to you that we do, indeed need 404(c). Let's roam through our list of questions.

PANEL DISCUSSION

Question 1: New regulatory proposals. These replace 1987 proposals. The 1987 proposals required a basic battery of four funds. The new proposals call for only three. Which one was dropped? Well, that question betrays, I think, a lack of understanding of the basic change in fabric of the revised regulations. The initial set of regulations called for at least four funds, and they specified a requirement that has to be satisfied by each of the four. The new ones specified general requirements, and the real emphasis is on the relationship between the three funds. So, there was no one requirement that was dropped. Instead, we are focusing now on the requirements that these three funds, at least three, have to satisfy in terms of their relationship with each other.

Question 2: How should I select the fund types for the basic three? Well, the most important concept here is that we have to be looking at different risk characteristics for each of the three. And we have to structure the difference in risk characteristics in such a way that by making use of all three, the participant can, at least theoretically, come up with a lower overall risk than if he had used just one. Now that smacks an awful lot of what many of us have been referring to as modern portfolio theory. We asked the Department of Labor if that's what it had in mind. Did it have in mind modern portfolio theory? And it said, "What?" So, one combination that almost certainly would work would involve a well-selected equity fund, a well-selected managed bond fund, and what I'll refer to as a safe fund. Perhaps not an Executive Life GIC. I have a problem with that particular choice. My problem runs to the misunderstanding that many employees have regarding how bond funds work. The notion that values go down when interest rates go up is a very difficult notion to get across to the typical uneducated, unsophisticated plan participant. I'm personally a lot happier if we're talking about a safe fund, and perhaps two equity funds, with differing levels of risk taking – a very safe equity fund and a more aggressive equity fund.

Question 3: Is a GIC acceptable for the safe fund? Well, yes I think it is, if it's well selected. We have listed two things that you had better be careful about. First, you had better do a little underwriting of the insurance company so that you don't end up with next year's Executive Life. Second, it's important, if this GIC is to function as one of the basic three, that it permits the participant to move money into and out of the fund at least as frequently as he can move money into and out of any other option under the plan. This fund is going to be functioning as the most conservative option, and that frequency of being able to move in and out is a very important requirement.

Question 4: Do I need to offer a very aggressive fund? Well, on its face, that might seem like a silly question. Of course not. I don't think it's all that silly, though. The proposed regulations include this quote. "We must select our funds in such a way that we can accommodate risk and return characteristics, at any point, within the range normally appropriate for the participant." Now, let's ask this question. Suppose we had a younger, professional employee who has no short-term cash disbursement requirements. Suppose that younger, professional employee is not risk adverse. As a matter of fact, he is willing to accept risk in return for potential higher yield. Are we doing our job if the only options we offer that participant involve conservative investments? I think it can be argued that we are not. As a practical matter, however, we have not yet seen anyone go to jail for being too conservative in

the investment options he offers his participants. So probably, although theoretically we may have an obligation to offer a very aggressive fund, as a practical matter probably if we stick to our basic three -- a well-run equity fund, perhaps a bond fund, and the safe fund -- we're going to be all right.

Question 5: What about sector funds? Well, diversification is going to be our problem here. Diversification is one of the cornerstones of ERISA. And we aren't exempt from diversification just because we're told that we can restrict the choices to three funds. Because those three have to have look-through characteristics. They have to be look-through investments. We have to be able to look through the mutual fund share and see what's underlying that share. What portfolio securities underlie that mutual fund share? What happens when we look through a sector funds share? Well, the chances are we're going to see a lot of different companies, but how many industries are we going to see? Probably just one. So it's arguable that a sector fund, as useful as it might be for an investment option, should not be one of our big three.

Question 6: If I don't like mutual funds, can I construct my own portfolio and offer them as self-funds within the trust? We're not sure about the answer to this one, but we sure think the answer is, and should be, yes. I don't think we're going to have any difficulty if we take the approach that it's okay to construct our own options, as long as they're well constructed, and well diversified.

Question 7: Does use of an aggressive fund require offering changes more frequently than quarterly? Well, it very well could be, because we're going to be required, under the proposals, to offer changes with a frequency, and I'm quoting now, "which is appropriate in light of market volatility." And furthermore, our most conservative fund, our safe fund, perhaps our GIC, has to offer changes at least as frequently as the changes that we have concluded we must offer with our most aggressive fund. That's required under the difficult to question rationale; if you have the right to take your money out of an investment, you surely have the right to put your money back into something else. So, we must follow this rule that we have changes permissible as frequently as necessary in light of the volatility of the option. Now, a lot of practitioners are kind of unhappy with this rule. The reason why they're unhappy with it is that it's not a very definitive rule. Just how volatile is volatile? We're, I think, too used to the bright line tests that we're receiving from the Internal Revenue Service and from Treasury, where all the decisions are being made for us. All we have to do is follow the rules. Actually, I would suggest that this Department of Labor rule harks back to the kind of rules that we used to see coming from the Treasury and the Internal Revenue Service. That is, you must use your own judgment. If you make a mistake, things are going to happen. But you must use your judgment. We're not going to give you black and white rules. Now, that creates tension which I'm not sure is a really bad thing when it comes to effective administration of social policy. It's foreign to us. We're used to these bright line tests. But I think that this kind of tension may be a good thing and I think we're going to continue to see it coming out of the Department of Labor. Phyllis Borzi once told me that if the Department of Labor committees were responsible for writing all of the nondiscrimination requirements that we now see in the Internal Revenue Code, the section of the Code dealing with these requirements would be a much shorter

section. It would say, "Do the right thing. And if you don't, we'll sue you." It's a tension that I think may be effective administration.

Question 8: What if I incorporate a default option? This is not a problem, really, with salary reduction plans. It's possible to package things so that the employee can't elect to participate unless he also tells you which funds he wants to participate in. It's a bit more of a problem with nonelective contributions, where we give the employee investment discretion. The 1987 regulations gave us license to have a default option. The new regulations do not. I'm not terribly concerned about that. My response for most situations would be offer up your safe fund. Use that until we can get the employee to make up his mind. Again, nobody in our experience has come out on the short end of a lawsuit by offering too much conservatism.

Question 9: What happens when I lose confidence in one of the basic three? Well remember that you, as a plan fiduciary, had the responsibility for prudently selecting the basic three. And you have the responsibility to continue monitoring the basic three, or the basic whatever number it is, to make sure they continue to serve the plan's objectives. So if you decide that one of the basic three is turning sour, you have a responsibility for turning it off. What happens if you turn it off? Well, you'd better find a replacement if it's one of the basic three.

Question 10: What if a participant refuses to select a replacement fund that you have offered to him? Now, here's where the fact that we don't have a safe harbor for our default option gets a little bit stickier. There are a couple of possibilities. One possibility is that you see one of the basic three starting to deteriorate in such a way that it's not clear that it's really a bad option, you just don't have full faith in it anymore. If that happens, one really useful possibility is to close it off to future contributions, but to tell participants, "We think you should consider getting out. It's here if you want to stay with it. Use your own decision. In the meantime, we have this alternative. Please give it serious consideration." That's one possibility. Another possibility would be a more dramatic deterioration in the fund that you now think is no longer suitable. What if the chief executive officer of Executive Life, for example, shows up as the manager of one of the funds that you have been touting as your basic three? I think you will then want to get your employees out of that fund and get them out fairly promptly. Here, your basic option probably is either to automatically place your participants who do not elect a replacement, into the replacement that you've selected, or put them into one of the safe funds. I'm not real comfortable with either of those options.

Question 11: If I offer employer stock, are quarterly changes still okay? Well, here we get back to this problem of volatility. Even if your employer stock is a relatively stable stock, from the standpoint of market value changes, it is, after all, just one name, in contrast to your diversified basic three. So there is a good possibility that that single name is inherently more volatile and yes, you should indeed consider the possibility of offering changes more frequently than quarterly.

Question number 12: What if I comply fully except that I only offer changes every four months? Well, this is the question that often comes to us from the client who says, "You know, I think I'm going to be just about in compliance. That will be close enough, won't it?" I'm not sure it is close enough. That client reminds me of the

young woman who goes to the doctor and says, "I think I may be a little bit pregnant." Either you are pregnant or you are not pregnant; either you comply or you do not comply. Remember, we're not talking about protecting ourselves from the standpoint of fiduciary responsibility. We're talking about obtaining protection from the inappropriate decisions of the employee. I'd be a lot more comfortable if that client went all the way and said, "Changes are permitted quarterly."

Question 13: What if I comply fully, except that I don't offer pass-through voting rights on employer stock? The new proposals offer something that the 1987 proposals didn't offer. They offer us 404(c) protection for the employer stock option. But, in order to obtain that protection, it's going to be necessary for us to pass through shareholder voting rights to the participant. Now, that's a move that many employers are going to find objectionable. Those employers may want to structure things so that they don't feel uncomfortable if they intentionally fail to satisfy the 404(c) requirements, relative to their stock fund. For those employers, my advice is to make sure that we don't let any employee have too much of his total account invested in employer stock. If we follow that restriction, we probably are going to be home free, even though we have not satisfied 404(c) with respect to employer stock.

I'm going to skip question 14 – the discussion of independent fiduciaries. I'm going to skip question 15, will availability of participant loans cause me a problem? I'll just briefly say that when it comes to participant loans, although they are not included in the 404(c) regulations, the 404(c) protections appear to have enough protections of their own, as long as we follow the participant loan requirements we need not be too concerned.

That brings us to questions 16, 17, and 18, which we've already discussed a little bit.

Question 16: My insiders wishing to escape the bite of new SEC rules are restricted on investment transfers to or from my employer stock fund. In general, these transfers should not occur more often than once every six months. How do I reconcile this SEC rule and the 404(c) "at least quarterly" rule?

Question 17: These same insiders are also restricted to a short 10-day transfer election period each quarter. Will this restriction satisfy 404(c)?

Question 18: Actually, I have been told that there is no way to escape the bite of the new SEC rules. Is this true?

I think my major thesis here is that there are differences between the 404(c) requirements and the Section 16 requirements and we've already focused on some of those differences. In Section 16, a six-month period between changes becomes critical. With 404(c), we must offer changes at least quarterly if we're to obtain the protection of 404(c). I do not think that those requirements are incompatible. After all, 404(c) tells us what we must offer to participants. The rules under Section 16 tell the insider what he must do to avoid short-swing liability. There's no reason why the insider cannot turn his back on a privilege that 404(c) tells us we must give him. And I think that's exactly the way to solve that apparent incompatibility. So we'll be

telling the insider that he can make changes every quarter, but he better not do it unless he wants to end up sending some of his profits back to the company.

Question 19: Can I charge former employees for transfers without charging actives? Well, we think the answer is yes, as long as the charges are reasonable. Section 404(c) says that we can charge for transactions, as long as they're reasonable, and we see no restrictions that would preclude making the changes free to actives at the same time we charge a reasonable charge to former employees.

Question 20: What should I do if a participant requests an inappropriate transfer? This brings me back to my original horror story about the participant who made this change just at the wrong time in 1987. Well, if we have touched all the bases with 404(c), we don't really have to do a thing. We can stand back and watch that participant get himself into trouble.

Question 21: Do the new rules apply to cash balance plans? We think they do not.

So, that's the story, as we see it, on 404(c). We think it's a great improvement over the 1987 proposals. We think that it's a set of proposals that we can probably learn to live with.

MR. DENNIS T. BLAIR: Before getting to my prediction about what's going to pass or not pass this year, let me quickly review some of the basics of the legislative process, most of which we learned in high school. But we need to distinguish what we learned in high school from how the congressional budget process operates. You'll understand some of the basis of my predictions. First of all, what we learned in high school is very few free-standing bills pass Congress. And the reason for that is that it's a two-year legislative cycle. And during that two-year legislative cycle, it's an open process where the public is invited to comment on the legislation. A bill gets referred to a committee, the committee holds a hearing, it marks it up. It then goes to the floor. It's debated on the floor. It can be amended. And because the process is open and it takes two years, it's not surprising that not very many bills pass. In fact, the statistics show that only 15 out of 100 bills that are introduced survive the committee process. And of those 15, only four become enacted.

Now, in contrast, the budget bill has a six-month legislative cycle, generally from April 15 to October 15. And it's a secret process. Frequently the committees that are working on the budget bill, that is the labor committees and the tax committees, those are committees that we are interested in, do not hold hearings on those portions of the bill that they're going to include in the budget bill. In fact, we're not likely to know what's in the budget bill until the Budget Committee bundles all the pieces put together by the various committees with jurisdiction on the budget bill, and calls that package the Omnibus Budget Reconciliation Act. And when it comes out on the House and Senate floor, we find out what's in the budget bill. But part of that time, we generally do not know what's in it. And when it reaches the floor of Congress, there is a perfunctory debate because it's an all-or-nothing vote on the bill. So most of the legislation is written in stone in the committees.

Now, many of you said the benefit legislation frenzy will continue. What I hope to do today is persuade you that I think the benefit legislation frenzy indeed has stopped.

The first point is that there will not be a budget bill this year. In last year's budget bill, Congress changed the rules of game. For the last 10 years, when Congress has been working on the budget bill, an integral part of that has been the objective of reducing the federal deficit. That meant that the tax committees had to raise revenues. Last year, the Congress decided that it doesn't have the political will to reduce the deficit. So what it decided to do is not let the deficit grow any larger, at least by its actions. So we have a pay-as-you-go rule. There will not be any legislation this year dealing with entitlement programs like Social Security, Medicare, nor will there be any tax legislation unless the legislation is revenue neutral. That is, if someone wants to expand an entitlement program, they have to find the tax revenues to support it. Similarly, if somebody wants to have a tax decrease, they're going to have to cut an entitlement program, or find somebody else's taxes to increase. And this is the rule that Congress is operating under. They're reducing the deficit under this pay-as-you-go rule so that as the economy grows, the size of the deficit will shrink in proportion to GNP. Now, it remains to be seen whether or not this theory will hold water. But that's what we're operating under now. And for that reason, there will not be a budget bill this year.

The other way that Congress gets legislation is through free-standing bills. And by free-standing bills in Washington, that means any bill outside the budget bill. I don't anticipate that there will be any free-standing bills affecting employee benefits this year, except those that affect military personnel. However next year, in 1992, I expect we'll have legislation on tax simplification, PBGC reform, and ERISA enforcement.

Now, what I'm going to do next is review a little history with you.

Benefit Legislation -- Before ERISA

1964	Civil Rights Act
1967	Age Discrimination in Employment Act (ADEA)
1972	Social Security Amendments
1973	HMO Act

Benefit Legislation -- After ERISA

1974	ERISA
1976	Tax Reform Act (TRA)
1978	Revenue Act
	ADEA Amendments
	Pregnancy Discrimination Act
1980	Multiemployer Pension Plan Amendments Act

There was legislation every two years after ERISA. And you will note those are even-numbered years. And that's not an accident. That's the second year of Congress' two year legislative cycle. And I'm not going to obviously cover what was in each one of those bills, but as you can see, life was not too tough immediately after ERISA because we had two years to master each piece of legislation. So I feel reasonably comfortable about my pension law knowledge up until 1980.

Benefit Legislation – After Deficits

Year	Legislation
1981	Economic Recovery Tax Act (ERTA)
1982	TEFRA
1983	Social Security Act Amendments
1984	DEFRA
	Retirement Equity Act (REA)
1985	COBRA
1986	Omnibus Budget Reconciliation Act (OBRA)
	ADEA Amendments
	TRA
1987	OBRA
1988	Technical and Miscellaneous Revenue Act (TAMRA)
	HMO Amendment
	Retiree Bankruptcy Protection Act
	Medicare Catastrophic Coverage Act
	Family Support Act
	Worker Adjustment and Retraining Notification Act (WARN)
	Drug-Free Work Place Act
	Employee Polygraph Protection Act

The lights went out for me in 1982. I survived 1981. Again, notice that we have legislation in the even-numbered years again. But we also start having legislation in the odd-numbered years. And the explanation for these odd-numbered years of legislation is in 1981, Ronald Reagan's first year in office, he had promised the taxpayers a tax cut, and they got it. In 1983, we had a Social Security crisis. And essentially early in 1983, they worked on a bipartisan commissions report that was produced in the prior legislative session. In 1984 we got DEFRA and REA. In 1985, we got COBRA. And one of the mysteries for people who study benefits legislation is why all the other bills are called Omnibus Budget Reconciliation Act (OBRA), and in 1985 it was called COBRA? I'm not sure I have found the correct answer, but my speculation is in 1984, there wasn't a budget bill. In 1985, there essentially were two budget bills, the 1985 budget bill went back and retroactively applied to 1984, hence the word consolidated. In 1986, there was another budget bill, and two pieces of benefit legislation. In 1987 there was OBRA. This is when I stopped helping the actuaries. As you know, that piece of legislation gave us another set of minimum funding rules. And I still haven't sorted those out. In 1987, as Ed mentioned, there was a stock market crash, and Congress decided to get serious about the budget deficit. So what it did was put together a two year rule, along this one that was prospective. And so the budget agreement in 1987 also applied in 1988. But apparently Congress used the time that was available and freed up from the budget bill to work on these miscellaneous amendments for the benefit community. So we have nine pieces of legislation that certainly affected your clients. And so 1988 was my favorite year.

Nineteen eighty-nine started out to be a good year. Section 89 was repealed, Medicare catastrophic coverages was also repealed, and that was a mixed blessing, at least for employers with retiree health plans, and then with OBRA 89, there was the usual schedule of benefit changes. And I'm not going to review those in detail.

Benefit Legislation – After Deficits

1989 §89 repeal
Medicare catastrophic repeal
OBRA 89
- COBRA changes
- Medicare as secondary payor
- Medicare payment reform
- Retiree health deductions
- Group legal services/educational assistance
- Self-employed medical deductions
- Dependent care
- Employee stock ownership plans (ESOPs)
- Voluntary employees' beneficiary association (VEBA)/ Term life limit

1990 Americans with disabilities
ADEA amendments
Taft-Hartley housing plans
OBRA 90
- Defined benefit plans
- Payroll taxes
- COBRA/Medicaid "buy-in"
- Employee taxation
- Child care
- Medicare

In 1990, there were three free-standing bills. The Americans with Disability Act has a two-year fuse on it, and as far as I know, no one's paying attention to it yet. There were ADEA amendments, Taft-Hartley housing plans and again, there was another budget bill and more benefit changes.

Under 1991, as I said earlier, the only legislation I think we're going to see in the benefits area is going to affect military personnel. Already this year, we've seen a veterans bill. Also early in the year, Dan Rostenkowski pushed through a bill to give the gulf veterans time to file a tax return, very generous of him. Shortly after the war ended, there was a GI bill for gulf veterans. Now, those three pieces of legislation did not directly affect employers. However Soldiers and Sailors Civil Relief Act of 1991 did, which was enacted in March. The most significant change in there for employers is they no longer can have preexisting conditions or waiting periods for returning veterans, nor their dependents.

I believe the next piece of legislation affecting benefits that you will see is the Uniform Services Employment and Reemployment Rights Act of 1991. That's HR-1578 and S-1095. And I'll describe that in more detail in a while. There is another legislative package in the tax committees. During the war and prior to the war, many of the Congressmen introduced legislation to provide tax benefits for those in the military. The tax committees got those bundled up and the problem with those proposals is they would violate the pay-as-you-go rule. In other words, if Congress is going to provide those tax benefits, they've got to find a source of revenue. And the tax

committees can't figure out whether or not they want to take the political risk of increasing somebody else's taxes or taking a cut out of one of the entitlement programs. So they're holding onto those. And perhaps the other five pieces of legislation I've described will be enough to demonstrate that the Congress appreciated the service of the military in the gulf.

Back to the Uniform Services Employment and Reemployment Rights Act of 1991. The most significant change for you deals with the distinction between defined benefit and defined contribution plans. Under current law, only defined benefit plans have to give credit for military service for both vesting and accrual purposes. Defined contribution plans only recognize military service for vesting purposes, not accrual. This legislation I just described will require defined contribution plans to provide accruals for military service. How? Ed was talking about the benefits of having labor lawyers draft benefits legislation. One of the disadvantages of having labor lawyers draft benefit legislation is they don't give you the details. So we'll consult with Phyllis Borzi, and she'll probably tell us to do the right thing. One of the questions I was asked immediately is, in calculating someone's allocation, are we going to use the salary when they went into the service, or are we going to put a salary assumption on the pay while they were in the service, or a combination of the above? Ed asked if the legislation of the legislative history addresses contributor plans. I said it did. And, at first, I thought if you had a contributory profit sharing plan or a 401(k) plan, and if someone didn't make the contribution, then you wouldn't have to give them the employer's piece. That's not what the legislative history says on second reading. What it merely says is if the employer doesn't buy back his employee accrual, the employer still has to provide the employer-provided piece. Ed also asked if it addresses funding? Indeed it does. This is what it says about funding. "An employer reemploying a person under this chapter shall be liable to the employee benefit pension plan for funding any obligation of the plan to provide the benefits described in this section." Those are your funding instructions.

This Uniform Services Act also improves military personnel benefits in the health area. Employers will be required to provide continuation coverage at the employer's expense for military service less than 31 days. For those going into the military longer than 31 days, the employer will have to offer a corporate-type continuation coverage for 18 months. And we also retain the prohibition against pre-existing conditions and waiting periods. Essentially, what this piece of legislation I've just been describing does is rewrite the Veterans Reemployment Rights Act to clarify it. And indeed, I think it does clarify it because I've never been able to figure out the difference between active duty, active duty for training, inactive duty for training, and initial inactive duty for training. And under the old law, you had to figure out those differences, in order to figure out what the employer's obligation was under that law. This legislation eliminates all those distinctions and simply says, if there are going to be distinctions in the way that you treat military personnel, it will be based on their length of service, not the type of service. So that might help some employers.

President Reagan vetoed the Civil Rights bill last year and the family leave bill. Incidentally, the President is 13 and 0 on his vetoes. So the Congress has to take his veto threat seriously and the question is whether or not the President and the Congress will work out compromises on civil rights, striker replacement, and family leave. Based on its performance on the Civil Rights bill, it does not look hopeful. The

LATE-BREAKING DEVELOPMENTS

Civil Rights bill is in the news, and has been in the news, for the last three days. If you turn on a television when you get back to your room, you will find more coverage on this legislation. It initially started to be sort of a technical corrections bill to overturn six U.S. Supreme Court decisions in 1989. The most controversial one was *Ward* vs. *Colofth Packing*, which dealt with disparate impact discrimination cases. This exploded into a political issue when the Supreme Court in that case said that employees and applicants could no longer win by simply coming in, and demonstrating that the employer's statistics were out of balance with the surrounding work force. Under the old rules, when an employee group came in and did that, it was the employer's obligation to justify facially neutral employment practices as being justified by business necessity. And what Congress has proposed is to reinstate the old law prior to the Supreme Court's decision and require employers to justify their employment practices as having a "significant and manifest relationship to effective job performance." And what the President is arguing, although you don't hear it when he's talking to the press, is that confronted with that test, most employers are simply going to hire by the numbers, rather than try to demonstrate that their employment practices can meet this significant manifest relationship test. And the reason this has become such a political issue is because we've just went through a recession, people are worried about losing their jobs, and this also comes into reverse discrimination. So the President and Republicans are scoring lots of points on the debate on this civil rights bill.

The next item is the striker replacement. What this legislation would also do is overturn a 1938 Supreme Court decision, *National Labor Relations Board (NLRB)* vs. *McKay*. Essentially what the Supreme Court said in this case was an employer could hire permanent replacements for strikers. And it hadn't been a problem for the American Federation of Labor-Congress of Industrial Organizations (AFL-CIO) until recently, when employers started resorting to lock-outs. And with the combination of the lock-outs and the permanent replacements, employers had been successful in breaking unions. And so the AFL-CIO wants to take away the employer's opportunity to use permanent replacements. This piece of legislation would also have a rule barring preferential treatment for strikers who cross the picket line and come back to work. In 1989, the Supreme Court upheld preferential treatment for these strikers in a TWA case.

Family leave legislation would provide 12 weeks of unpaid leave for employees to deal with family illnesses and adoptions. It would also provide health continuation rights and reemployment rights. To some extent, it's similar to the veterans reemployment law that I was talking about. Although this doesn't directly impact most people here, it's something that your clients are going to be considering this year because there's going to be a lot of coverage of these issues in the general press.

Benefits issues are only going to get coverage in the trade journals. Congressman Dan Rostenkowski, Chairman of the House Ways & Means Committee, has made tax simplification his number one priority. And in the benefits area, his principal change would be to simplify the tax treatment of retirement plan distributions. Meanwhile, on the Senate side, Senator Pryor introduced last year, and intends to reintroduce this year, his benefits simplification bill. That would provide 401(k)s for tax-exempt organizations, simplify 401(k) discrimination testing. And it also has some portability provisions dealing with trustee-to-trustee transfers. So instead of the money going

from the retirement program to the employee, and then having the employee decide whether or not to put it in an IRA, the tax rules would be restructured to encourage the transfers to go directly from your client's plan to an IRA or to another employer's plan.

Following that, we have the Pension Opportunities for Workers Expanded Retirement (POWER) proposal that got a lot of publicity several weeks ago. What's interesting about this proposal is it doesn't have any legislative language. And the other observation I have about it is that somebody at the Department of Labor, probably Labor Secretary Martin, looked at the current simplification proposal, both on the House and Senate side, and decided to steal the best pieces from each and claim it as her own. The only new element in the POWER proposal that has not already been introduced in the other simplification proposals is this new simplified employee pension (SEP) program for small employers with less than 100 employees.

On the last day of the last legislative session, the Department of Labor introduced an ERISA enforcement bill that would require, among other things, that the plan auditors hunt for prohibited transaction violations. Also it would encourage private sector attorneys to bring lawsuits by increasing availability of attorney fees, and also change the rules on proxy voting. Also PBGC reform will probably be introduced later this year. The principal change that will affect you is the interest rate. The PBGC is very upset that the employers have an interest rate corridor that is provided to them by the IRS. They have noticed a strong correlation between the financial health of the client and the high rates of interest within the corridor. So what the PBGC would like to do is pick a much lower interest rate within that corridor. And the PBGC would control the interest rate, not the IRS. The other thing that the PBGC wants is higher priority in bankruptcy proceedings. It has taken a beating in the bankruptcy courts and wants legislative relief. It is also taking a look at plant shutdown benefits to see whether or not they ought to be guaranteed.

Let me make a comment on the legislation I've just gone through. Some of it's been introduced: the POWER and the ERISA enforcement. The PBGC has not yet even been introduced. Therefore, it's not likely to be enacted this year. It probably will be reintroduced late this year, and will be acted upon next year.

Pass-through deposit insurance, I think, may be acted upon this year. That is, there is a banking bill going through Congress and part of that banking bill deals with pass-through deposit insurance. There are two conflicts that your clients might be interested in. One is the distinction between defined benefit and defined contribution plans. Under the legislation, the $100,000 deposit insurance would only apply on a plan level basis for the defined benefit plans. Whereas for defined contribution plans, each participant's account would be protected up to $100,000. The other distinction is between GICs and bank investment contracts (BICs). The life insurance industry is lobbying hard to eliminate pass-through deposit insurance for BICs. And it remains to be seen whether or not the banking industry is going to fight off the insurance industry. It's going to be an interest lobbying war.

Finally, there is small employer health insurance reform. This was the only recommendation from the Pepper Commission report that received universal approval. What this proposal would do is preempt state laws mandating certain types of coverages,

eliminate preexisting condition clauses and waiting periods, and provide new underwriting and pricing rules. The reason why all of this legislation has a reasonable shot of passing next year is it doesn't violate the pay-as-you-go rule. In other words, it's not going to cost the government any money, particularly the small employer health insurance reform.

Let me go back and talk about the POWER bill for a moment on the pay-as-you-go implications. The reason why the Department of Labor has added to the simplification this new subconcept that would provide additional taxation for certain small employers is it believes that there will be tax savings from eliminating lump sum tax treatment. The Joint Committee on Taxation, however, has not verified whether or not eliminating lump sum tax treatment will indeed produce the tax savings. And that's going to be a key element in determining whether or not the POWER proposal's new subconcept will survive.

These legislative proposals (full-funding limit, Social Security tax cut, super IRA, Prescribed Right to Income and Maximum Equity (PRIME), and expiring benefits) receive a lot of ink in the trade journals. But, in my opinion, they are going nowhere because they violate the pay-as-you-go rule. That is, they're going to cost the government money, and as long as that pay-as-you-go rule is in effect, you're not going to see these changes. Now, there's been an intense lobbying effort for changing the full-funding limit for employers with young work forces. I believe society can make a strong case that employers with young workforces ought to have higher limits to provide benefit security as the population matures. Because that proposal would cost money, it's not likely to pass; the same thing with the Social Security tax cut. Earlier this year, there was a procedural battle on the budget bill that Senator Moynihan lost. It generally requires a 60-vote super majority in the Senate to ignore or waive the pay-as-you-go rule. He lost on a procedural battle, and Senator Moynihan does not have the 60 votes in order to get his Social Security tax cut through later on this year.

The super IRA by Bentsen and the PRIME proposal by Packwood, both in the Senate, would provide additional tax-favored retirement savings. They are going nowhere until those two Senators find out where they're going to get the revenues to support these additional tax benefits.

Which gets to my last item, expiring benefits, group legal and educational assistance. They've had sunset provisions, which meant they were supposed to disappear in the mid-1980s. But each year Congress extends them for a year or two, sometimes retroactively. My prediction is this year they finally died, unless somebody comes forward and identifies the revenues, needed to support extending these tax benefits. Representative Dan Rostenkowski has said he will not do it, and has challenged anybody else to come forward.

Congress is looking for a proposal to expand coverage to those who currently do not have health insurance coverage, and it wants to control cost and enhance quality, all at the same time. The question is: can it find a politically acceptable solution to achieve all three objectives simultaneously? Congress and its committees have been holding various hearings on it, from the tax committees to some of the Senate aging committees. There has not been a shortage of proposals from interested parties:

"play or pay," MediPlan, foreign models, tax cap, state initiatives, trade group proposals, AFL-CIO, MedAccess, and rationing. I don't think you're going to see any progress on retiree health in terms of additional tax incentives for funding, either for retiree health or long-term care, until Congress addresses the national health care issue.

I do not have a lot to say about regulation accounting standards. My last prediction is that the next regulation that we will see out of the Treasury will not have anything to do with 401(a)4 or 401(k). My prediction is the next regulation will be Federal Insurance Contributions Act (FICA) tax treatment for nonqualified deferred compensation. For those of you who forgot about this topic, back in 1983 when we had the Social Security Act amendments, Congress changed the FICA tax treatment for nonqualified deferred compensation. And while most people understand how the rules applied to defined contribution plans or to good, old-fashioned deferred compensation arrangements, nobody has yet figured out how they apply to nonqualified defined benefit plans. Most employers have been interpreting the law in their favor. I suspect when the legislation comes out, more executives will be paying FICA taxes than they ever dreamed of. But I think that's going to be the next regulation out of Washington.

MR. WALTER C. CROW: Ed, will 404(c) apply to 403(b)?

MR. BURROWS: I think it's arguable that it can, if there is the same relationship between the sponsor and the plan that we would normally expect to have in a qualified plan. That is, there are some employers who have elected to use 403(b) as their device for participant-directed accounts. And they have elected to set themselves up as plan sponsors of the 403(b) arrangement. I believe in that situation that one could argue that 404(c) applies. Dennis, what do you think?

MR. BLAIR: What's interesting about the question is that many of the plan sponsors with 403(b) programs are not subject to ERISA; for example, governmental plans.

MR. CROW: I'm referring to the private sector, nongovernmental.

MR. BLAIR: Well in that case, then it clearly would.

MR. CHARLES L. WALLS: Dennis, does the prohibition of any increases in taxes trading off for benefit changes go the other way, too? Can Congress or the IRS or anybody propose things that would enhance revenue, and have to find something to give in return for that?

MR. BLAIR: That's consistent with the pay-as-you-go rule.

MR. WILLIAM W. KEFFER: Could you tell me what the current status is of FICA taxes on distributions of nonqualified money? Maybe I didn't understand your point there.

MR. BLAIR: I may need some help on this, because I haven't looked at it in a long time. But the basic problem, as I see it, is that when that legislation went through, the basic rule said that executives would pay taxes on the nonqualified deferred

compensation at the later of when they earned it, or when it was no longer subject to a substantial risk of forfeiture. Now, the substantial risk of forfeiture provision was put in at the lobbying efforts of the ERISA Industry Committee (ERIC) and other large employer groups. And at first I thought it made sense, because what they were trying to do was have the nonqualified deferred compensation included in the executive's wage base, when that executive was over the wage base, rather than later on when he retired. In which case, they might be off the wage base, particularly if it's $125,000. The problem is that under most nonqualified deferred compensation, there is a substantial risk of forfeiture until the benefit is paid. This would suggest that the executives would pay taxes as they would receive the benefit payments, rather than when they earned it. Notwithstanding that analysis, I think most employers are treating the nonqualified deferred compensation as being taxable for FICA when earned, not when the executive is receiving it. And I think when the regs come out, they're going to flip that around.

MR. BURROWS: Is this about how things worked before ERISA, Dennis?

MR. BLAIR: That's my second question. I have a two-part question. Do you believe it's in the best interest of the employer and plan participants for the plan participants to move out of GICs into equity funds? And if so, what obligation does an employer have to communicate investment management information, or education, to the participants so that they could construct an asset mix that's appropriate for them?

MR. BURROWS: It seems to me like a lot more should be done in terms of communication regarding effective exercise of the rights which my employer has given me to choose between funds. It seems to me like that communication should be based almost entirely on an analysis of how soon I, as an employee, plan to need my money. And how much risk I, as an employee, am prepared to take in exchange for possibly enhanced reward. I have seen many employees who, at first blush, have said, "Well, the safe fund is what I want." However, when it was pointed out to them that they probably weren't going to need a whole lot of their accounts for many years to come, they gave some second thoughts to whether perhaps an equity investment was a better investment for them. In many cases, I think the right answer for the younger employee is to have a small stake in a safe fund, and to put a fairly substantial amount in an equity fund. I think our obligation should be viewed more as a discussion of the purposes for which you're going to be needing the money, and less as a question of buying low and selling high. The first thing I tell participants when I'm talking to them about their investment options is that there's a special name for people who try to buy low and sell high, and it's poor. That's the name for those people. So I think that we should be doing more. I do think, though, that it's just a fact of life that many, especially lower paid rank and file people, want the security that comes with a "safe" fund. And I really am not too optimistic that we're going to be able to convince them that they should be thinking about treating that security for improved long-term performance.

MR. WILLIAM C. HUFF: I had a question for Ed. On the quarterly transfer provisions, you have to make a transfer once per quarter. Is that one day per quarter chosen by the plan, or by the participant?

MR. BURROWS: It's our understanding that it's quite acceptable to have a single day per quarter chosen by the plan. We don't have to give the participant the option of deciding which day in the quarter he will make the transfer.

MR. BLAIR: How does an employer shut down a fund without giving the appearance that it has imprudently selected or monitored the fund in the past?

MR. BURROWS: I think there it's just a matter of clear and complete communication. Getting across the concept that things change, and that a fund which was a perfectly satisfactory fund three or four years ago is perhaps not the right answer today. Very frequently, the reason for becoming concerned about a fund is a change in investment management in that fund. And I think that we should be up front with our employees about the reasons why we're thinking about the change.