VOLUNTARY EMPLOYEE ACCOUNTS PROGRAM STUDY

SUMMARY

Page 63 of the 2007 Joint Chairmen's Report requests the Maryland Supplemental Retirement Plans (MSRP) to conduct a study of the feasibility of the State sponsoring a voluntary employee accounts program (VEAP) for private sector employers and employees. That request is an outgrowth of H.B. 823, which was introduced during the 2007 General Assembly Session. The study directs MSRP to examine several factors relating to this program, including cost efficiencies, potential for State liability, and organization and administration requirements.

The perception that prompts the study—that small businesses with few employees find it difficult or expensive to establish retirement saving plans—is generally borne out by numerous studies that track overall workforce participation in private pensions plans. A system of State-sponsored and administered employee retirement accounts is a potentially worthwhile idea, but would be difficult to implement in the current environment.

A number of long-term administrative efficiencies could be created by the program. There are no short-term efficiencies, however, chiefly because the program involves collecting small amounts of data and dollars from a large number of sources. MSRP estimates that it will take several years before the program becomes self-sufficient; in the interim it will require a subsidy of between $300,000 and $500,000 a year for at least 5 to 7 years.

It is not legally possible to eliminate the risk of State liability which could occur because of administrative and fiduciary mistakes. However, the risk could be reduced through prudent practices and certain elements of program design. As stated above, it

will require significant State expenditures to design and maintain a quality program. A failure to expend funds under the theory that interested private financial entities can "take care of everything" would only serve to substantially increase the risk of liability to the State.

Under current law the program would also require a number of innovative rulings from federal agencies. These rulings would be designed to allow the State a limited but defined role in pension administration for practice areas normally governed by employer decision. The State would, in effect, become a joint (but limited) plan sponsor and administrator of the separate saving plans that adopted the program.

Prospects for an assistance program of this type would be enormously enhanced by changes in federal law. For example, one proposal pending in Congress would require most employers to offer some type of payroll deduction retirement I.R.A. or other retirement savings account. In similar terms, amendments to federal pension law could specifically authorize a State to sponsor this type of program. This type of legal authority, similar to what now exists for Section 529 college saving plans, would greatly increase program potential, because it would increase employer confidence in a State sponsored arrangement. It is possible to create a program without these changes to federal law, but employers may decline to participate because of its uncertain status.

A COMPARISON OF VOLUNTARY ACCOUNTS TO OTHER STATE FINANCIAL PROGRAMS

H.B. 823 envisioned a State run program of pension administration for plans established by private employers.[1] The Joint Chairmen's Report requests a study on the efficiencies, organization and liabilities associated with this type of endeavor. In examining these factors, a brief comparison to other State financial programs is beneficial.

<u>Injured Workers Insurance Fund</u>

One similar program is the Injured Workers Insurance Fund (IWIF). IWIF is an example of a successful State sponsored financial program. IWIF writes workers compensation insurance for Maryland employers. IWIF was originally established as a fall-back insurer of last resort for businesses unable to obtain affordable coverage in the private marketplace. IWIF now insures about 25% of Maryland businesses and 33% of covered Maryland workers. Its general stability has given it a well accepted place in government and business affairs. While various protective devices exist, IWIF does have a general potential to create State liability if its financial transactions are mismanaged.[2]

<u>Maryland Automobile Insurance Fund</u>

The Maryland Automobile Insurance Fund (MAIF) is similar to IWIF. MAIF is intended as an insurer of last resort for drivers required to purchase liability insurance but otherwise shut out of the private marketplace. MAIF is not as large a presence in the public market as IWIF, chiefly due to restrictions on persons eligible to purchase its policies. Like IWIF it has the potential to produce State liability if its financial transactions are mismanaged.[3]

College Savings Plans of Maryland

The College Savings Plans of Maryland are financial and tax devices authorized by federal and State statutes. The purpose of the program is to encourage and assist advance saving for college expenses. The plans offer either prepayment contracts or investment accounts that allow savings to accumulate on a tax deferred basis. Originally generated from creative use of tax and securities exemptions granted to several states through specific rulings, the basic legal structure for these plans is now well established. The Maryland Program has an annual State administration budget of $1.5 million that is used to sell and service 111,000 accounts with over $2 billion invested. The program is generally viewed as popular, efficient, and self-sustaining. The program can create State liability in two ways. One is if the reserves established for the pre-paid tuition contracts prove inadequate to pay the liabilities for those contracts. Another liability might be created through financial mismanagement or misrepresentation with respect to the investment accounts.[4]

Maryland Savings Share Insurance Corporation

The Maryland Savings Share Insurance Corporation (MSSIC) was not a State entity but instead an unusual quasi-public, quasi-private entity created by State statute. The purpose of the corporation was to offer non-federal deposit insurance on accounts in State chartered savings & loans. Public perception of MSSIC as a State entity with State backing was widespread. This was not entirely misplaced because the State did regulate the State chartered savings & loans that generated the MSSIC reserves and MSSIC assumed liability for deposits held in those entities. MSSIC became insolvent as part of the savings & loan crisis of 1986 and this lead to a State financial bail-out that cost the State several hundred million dollars to resolve the affairs of the banks and pay off the depositors.

These entities offer several useful lessons. IWIF and MAIF are reasonably successful and stable State sponsored entities. Their long-term success has been greatly assisted by statutes that require businesses and individuals to purchase the insurance that they sell. The experience of IWIF and MAIF demonstrates that it would need to be determined whether a voluntary employee accounts program would be available to all businesses, or only a specific defined category, such as small business.

The College Savings Plans have a substantial similarity to the voluntary accounts program: a personal financial product that is helpful but not required. The Plans have been reasonably successful in attracting investors, but this success has been assisted by two advantages that would **not** be available to a system of State sponsored voluntary accounts.

- The first advantage is that the College Savings Plans, at their inception, were able to rely on a well developed body of federal statutes and tax and securities rulings that outlined how such plans work, and their place in the regulatory framework.5 No such well developed body of law or practice exists for State sponsored voluntary retirement accounts. This deficiency would likely have a significant negative impact on employer interest in a voluntary accounts program.

- The second advantage for the College Savings Plans is that the Plans offer distinctive tax (and prepayment guaranty) advantages not available to most individuals in the private marketplace. This distinction will not exist for a State sponsored retirement plan, i.e., there will be no additional employee tax benefit for the State arrangement, as compared to a purely private arrangement. This means that a State sponsored program will have to compete on an equal footing with plans available in the private marketplace and will be subject to the same difficulties and inefficiencies as purely private programs.

MSSIC was not, in technical terms, a State agency, but the history of MSSIC is relevant for the policy considerations inherent in a system of State pension administration. In theory there was no State liability for MSSIC; it was a separate "corporation" that did not have sovereign status. In the end this deliberate exclusion from State liability proved impossible to enforce because of public expectations. State liability also increased because the bank losses that produced it were encouraged by a complicated legal structure that made it difficult to impose State standards on the private entities that generated the liability. It was a classic example of public/private partnership gone bad.

This history shows that public-private "partnerships" of the type envisioned by H.B. 823 can succeed, but they take substantial time, effort and resources on the part of the State, in addition to legally mandated requirements, to develop as self-sustaining entities. Furthermore, the potential for liability from these programs is real, and must be closely managed if liability risk is to be contained within reasonable limits.

STATE LIABILITY UNDER A PROGRAM OF VOLUNTARY ACCOUNTS

The experience of State involvement in financial entities demonstrates that it is necessary to plan for possible liability caused by these entities. In doing so policymakers must take into account the following factors:

- actions or conduct that causes loss;
- the various entities (public and private) that might be charged with the loss;
- the legal standards that determine liability; and
- the interaction of these factors with the structure of the program.

A program of voluntary accounts would be a complicated, multi-party endeavor with potential for a significant number of administrative mistakes, each one of which could cause a financial loss.[6] Most of the losses would likely be small, but all of them need to be taken into account in program design. While loss from many of these mistakes will fall on a direct administrator, the lesson of MSSIC is that devices and expectations for loss coverage cannot be assumed into existence; State liability that is "covered" by a right to claim indemnity from a contractor still creates litigation expense, and is a hollow right if the entity is insolvent.

Types of Liabilities

There are four types of liabilities associated with pension plans.

1. The first is liability for loss of expected tax benefits—a deduction is promised but does not occur, because the business or employee is not legally eligible for the type of plan or account that is established. The State could incur liability if it failed to adequately supervise eligibility standards and sales practices, and large numbers of ineligible transactions occurred.

2. The second type of liability is government penalties. Both the IRS and Department of Labor impose penalties when forms are not filed timely or if transactions are not conducted under the standards of the statute. Similar to the first example, a failure to adequately supervise sale or administration activities could lead to significant penalty expense.

3. The third type of liability is the expense or loss created by accounting mistakes. This would occur if transactions are not properly recorded, or some other record keeping failure occurs. This is probably the most underrated potential liability for a program of this type. It is not catastrophic, but a large volume of sloppy practice—particularly payroll practice—could lead to significant repair expense. For a variety of reasons it might prove difficult to pass this expense on to private entities or the account holders.[7]

4. The fourth category of liability is for general breach of fiduciary duty. Federal law requires that persons and entities controlling or administering private employer pension plans follow specific rules of fiduciary conduct. Failure to follow those rules can make a trustee, custodian or plan sponsor liable for losses that occur. These would typically be investment losses, although liability for account or penalty expense also comes under this standard. Under these rules the controlling parties owe a duty of loyalty and prudence to plan participants. This liability would typically occur because an individual was sold an improper investment unsuitable for his needs, or received misleading communications about investments.[8]

Reduction of Liability

State liability for the latter type of loss is probably remote but cannot be eliminated. The reason it is remote is that the legal rules recognize that the employee bears the risk of loss on the investment, and that a Trustee does not guarantee an investment return. A variety of provisions of federal pension law make it impossible to completely eliminate the risk of State liability. For example federal pension law pre-empts State law, and prevents the State from imposing its own limits on liability. Second, it cannot be assumed that liability can be avoided through designation of private trustees, custodians, or sponsor. Federal law recognizes that liability for these responsibilities depends on actual, not titular, control.[9]

However, potential liability can be reduced through adherence to the following elements of program design:

(a) Insist on indemnification from all vendors associated with the program.
(b) Severely limit investment options to reduce the possibility of unsuitable choice, or miscommunication.
(c) Restrict sales practices so that vendors may not sell other investment products to plan participants.
(d) Provide a well funded professional staff to supervise program details.
(e) Provide a simple program structure that reduces the likelihood of accounting mistakes.
(f) Retain specific control (through the organizing documents) of program investment options and administrative structure, to ensure that faulty practices can be eliminated.

If these steps were followed liability potential would be greatly reduced, and scaleable to the size of the program. It would also be in line with the potential for liability that exists in numerous other State entities.

POTENTIAL EFFICIENCES FOR STATE SPONSORED ACCOUNTS

A State sponsored VEAP has the potential for significant long-range efficiency. It does not offer any efficiency in the short run, however, because of four factors:

- ♦ difficulties from multiple payroll and data sources for contributions;
- ♦ securities and pension law that does not allow comingling/participation of unrelated private plans with larger State run investment pools;
- ♦ a regulatory environment that requires several specialized rulings before the program can proceed; and
- ♦ the significant time (5 to 7 years) it will take before the program becomes self-sustaining through growth of assets.

The primary efficiency from a State sponsored program occurs through centralized management of employee and account data, combined with use of existing State resources for communication, transactions, and education. For example, a State program might allow the following distinctive features:

(a) Employer ability to adopt the program when a business is created through registration with the Comptroller or the Department of Assessments & Taxation;
(b) Communication about the program at those business “entry” points;
(c) Use of multiple State resources for communication and investor education; community colleges, the State website, multi-purpose centers or high schools, tax returns, or drivers license records;
(d) Ability to access long-term participant data with these resources from anywhere in the State;
(e) Ability of participating employees to easily contact the program through any of the above reference points;

(f) Centralized analysis about participant behavior that encourages special program enhancements.

LIKELY INEFFICIENCIES FOR STATE SPONSORED ACCOUNTS

The primary difficulty for the program is caused by the difference between a large business and a collection of small businesses. The vision of a State sponsored VEAP is to bring the benefits of large, well run State programs to a small business with 2 to 50 employees. The difficulty of this concept is that large businesses (government or others) already have their operating efficiencies built in: a single payroll center, a single data center, and recognized methods for contacting employees.

None of these characteristics exist in a collection of otherwise unconnected, widely dispersed businesses, each with their own payroll system. Each of these businesses will have to routinely and regularly sign and return documents to a central administrator; provide annual reconciliation of contribution history; and follow instructions on distribution and collection of miscellaneous employee communication material. In practical terms it is unlikely that many small businesses who sign up for the program will consistently follow all these instructions.[10]

A variety of pension and securities rules restrict the ability of small businesses to simply piggy-back on existing State plans to achieve economies of scale. For example, the State could not operate a group trust for the plan assets, because current practice largely restricts these group trusts to related entities of a single employer.[11] In addition the State could not become a distributor of financial products without acquiring the relevant securities licenses. Records must be kept on a per employer basis, e.g., the individual participation record needs to match up with records of employer participation. Finally, each time a business terminates, its State sponsored plan has to terminate. As part of this process appropriate documents must be executed and required materials distributed to employees.

LIKELY PLAN TYPES FOR STATE ACCOUNTS

There are several types of plans that might be offered under a VEAP. All such arrangements (regardless of plan type) share most of the characteristics described below. These details have a significant effect on State liability, responsibility, efficiency, and oversight and mostly exist independent of plan type. The necessary elements are:

(a) Affirmative adoption of a plan structure by an employer;
(b) Employee participation through payroll deduction of salary;
(c) Employer control and responsibility over key elements of the arrangement, such as the right to appoint Trustees, select investment options, and to choose among alternative administrative methods;

(d) Fiduciary responsibility resting in specific persons or entities for key elements of the plan, e.g., accurate accounting; submission of accurate and timely reports to government agencies; accurate and timely communication to employees; selection of appropriate (and only appropriate) investment options.

Service providers and financial entities typically perform these tasks, or assist the employer in these tasks. A State program will affect these relationships in both positive and negative ways. Adding an additional layer of supervision might improve the overall quality of plan administration, but it will also increase expense. In other cases it might decrease plan efficiency, and create uncertainty over which entity has responsibility for which administrative task.

Two recent reports offer significant evidence on this aspect of plan administration.

- The first is a recent IRS Report on pre-approved plans and their relationship to compliance and administration. After extensive examination, the authors of the report found a widespread, but erroneous, assumption that the sponsor of a pre-approved plan was responsible for matters not under the control of the sponsor. The committee concluded that this often led to non-compliance.[12] The IRS conclusion—that competent administration requires more than distribution of a form document—supports the MSRP conclusion that a program of State sponsored accounts will require staff and increased State expenditures.
- The second report is a recent AARP report on Automatic IRAs. This report examines the potential costs and difficulties stemming from federal legislation that would require all employers to offer payroll deduction IRAs. The report describes in particular detail the practical difficulty of such a program because of the great diversity of record-keeping practices among small employers. It concludes that simplicity and centralization would be the key in making the proposal work. These points are crucial in the design of any VEAP. It would be imperative that the State centralize program detail and offer actual assistance in plan administration. The State program would not function well if it was merely a "brand", or a recommended adoption of a particular plan document. Finally, the number of interrelated activities and entities involved in the arrangement will require that State assistance focus on limiting employer and employee choice and use of simple and straight forward plan design.[13]

The 401(k) plan is the basic plan used by most private employers. The creation of a 401(k) plan requires the following actions by the employer.

(a) Sign appropriate corporate resolutions that adopt the plan document;
(b) Distribute employee notices about the plan and its investment offerings;
(c) File annual reports with the Department of Labor that list plan assets, identity of trustees, and certain other detail;
(d) Fulfill the audit requirements of the Department of Labor;
(e) Decide who will be the Trustee and/or the administrative committee that are responsible for basic plan activity;

(f) Select and periodically review the performance of the plan investment options;

(g) File appropriate reports on major business events and conduct wind-up activity to terminate the plan if the business closes.[14]

This list leads to three conclusions: State involvement does not necessarily assist performance of these activities. Administration and paperwork will be the primary plan expense, with investment expense a secondary factor. To achieve efficiency, any State sponsored VEAP must focus on eliminating or reducing as many administrative steps as possible. The question is whether any particular type of arrangement offers any particular advantage for the logistical barriers noted above.

MSRP examined a number of different plan types and assessed the viability of each plan type.

<u>Multiple Employer Plan Model</u>

The multiple employer plan is a collection or group of separate employers that combine to offer a single pension plan. This type of pooling arrangement is conceptually available for a group of small businesses.

It is similar to collectively bargained (Taft-Hartley) plans, but is not widely used. There is no body of experience, practice, rulings or regulations that could serve as a guide for using this as a model for a State sponsored arrangement. Use of this model would still require many of the individual employer actions that are necessary when an employer adopts its own separate plan. This includes plan entry and exit documents, record-keeping fields that track separate employer contributions, and management of payroll data from widely dispersed sources.[15]

<u>SIMPLE 401(k) Plan Model</u>

The SIMPLE (Savings Incentive Match Plan for Employees) 401(k) plan is a variation on the standard 401(k) plan. As its name implies its purpose is to simplify adoption and administration by stripping many of the features and requirements from the standard 401(k) plan. Thus, a SIMPLE 401(k) plan allows use of short form pre-approved plan documents and does require the employer to file a form 5500 annually with the Department of Labor but it does not require mathematical discrimination testing that compares employee contribution rates across salary ranges. This combination of factors would greatly assist administration efficiency.[16]

Employee contributions are limited to $10,500 in 2008, with additional catch-up contributions up to $2,500 by employees over 50 years old. These amounts are subject to cost-of-living adjustments.

SIMPLE 401(k) plans have certain requirements that may limit their appeal among some employers. For example, there must be an actual employer contribution. Moreover, a State-sponsored arrangement would still require many of the activities described above—adoption agreements, participation agreements, communication responsibilities, payroll processing, plan distribution responsibilities, and responsibility to properly account for the close-out of a plan when the business terminates.

SIMPLE IRA Plan Model

Another possible arrangement is the SIMPLE IRA. This is a more limited variation on the SIMPLE 401(k). There is a standard, pre-approved adoption agreement; no Department of Labor reporting or bonding requirements; no discrimination testing; and more limited employer communication responsibility. Like the 401(k), the SIMPLE IRA requires an employer contribution. Under the SIMPLE IRA the employer serves as a conduit for pre-tax salary reduction contributions to IRA accounts at qualifying financial entities. The accounts are titled in the name of the employee. The employee then has (unlike a 401(k) plan) a right to transfer the account to another investment/IRA maintained by a different financial institution. The employer has no duty to monitor the financial health of the IRA. Of greater importance, the employer has no active responsibility for the investment when the employee is no longer in their employ. This has a significant effect on possible overall efficiency of the arrangement. Employee contribution limits are the same as for the SIMPLE 401(k).[17]

Association Plan Model

MSRP staff also examined the "Association Plan" model. An Association Plan is not a formally recognized entity under tax, pension or securities law. It is an ad hoc arrangement that involves some sort of agreement between a "quasi-sponsor" and a financial entity or service provider. The financial entity in effect offers a pre-arranged standard package of administrative services, documents, and investments to employers that are members of an association. Depending on the nature of the quasi-sponsor, there may be advantages in communication or overall approach that assist in the marketing of the arrangement. In addition, a financial entity may be willing to offer additional benefits and/or discount pricing because of perceived marketing benefits.

There are significant difficulties in using the association concept as a device for State sponsored arrangements. The chief difficulty is that, under most of these arrangements, control ultimately resides with the financial entity that administers the plan and maintains the investments. The lack of control by the association would limit the ability of the State to enforce standards or restrictions on service providers. Any such program being considered by the State should be structured so that the State retains significant and specific control. Without such control there is a significant increase in risk for State liability and for administrative fiduciary mistakes.

ORGANIZATION AND ADMINISTRATION

If the State proceeds with the implementation of a State operated VEAP, it is strongly recommended that it be limited to the SIMPLE IRA or the SIMPLE 401(k) plan. Additional benefits (in terms of reduced liability potential) exist for the SIMPLE IRA plan, because the employee is able to transfer the account to another IRA investment of his or her own choice. This “safety valve” would likely reduce potential State liability for investment loss.

The primary administrative difficulty for the program is the uncertain status of the State over the accounts. Federal pension law contemplates that a plan will have a controlling sponsor, with authority to settle administrative detail through its power to amend or terminate the plan[18]. Federal law does not contemplate an outside entity controlling the plan unless it is directly appointed (by the employer sponsor) as Trustee, Custodian or Administrator. It is critical that this issue be addressed—before any VEAP is implemented. Thus, rulings from the IRS and the Department of Labor must be integrated into the organizational plan. A plan to implement the program would therefore have the following steps:

(a) As noted above, the number of investment vehicles should be limited to assist efficiency and limit State liability. The most probable choice is a series of life-cycle funds, with a savings account, money market fund or stable value fund as an alternative.[19]

(b) The IRS has published model plan documents for both a SIMPLE IRA and a SIMPLE 401(k) Plan. Neither of these model plans contemplate that a State will assume partial control of investment or administration. A model plan submitted for ruling would give the State this type of control (the right to select and replace investments; the right to select, compensate and replace administrative service firms; the right to direct re-imbursement of State administration expense). It would reserve for the employer/sponsor the right to terminate the relationship, and specify notice periods, responsibilities and transfer rights. Finally, it would specify in some detail the type of administrative oversight the State would exercise. This model plan would then have to be submitted to the IRS and the Department of Labor for rulings that the plan and contemplated State activity met all ERISA requirements.

(c) If favorable rulings were obtained the agency would seek bids from financial service/administrative service firms. It would then decide which potential combination of firms offered the most appropriate/attractive arrangement. This would include a detailed marketing program with cooperation of relevant departments, such as: the Comptroller; State Archives; Department of Assessments & Taxation; Department of Business & Economic Development; and Department of Labor, Licensing and Regulation. It would most likely include a requirement that participating employers use certain payroll, reporting and contribution transfer practices.
(d) Sign contracts with winning vendors;
(e) Design communication materials and program.

It is estimated that to design and implement a State operated VEAP program, MSRP would incur the following start-up and long range costs:

(a) Design and draft special plan documents that describe the structure of the accounts, the specific control mechanisms, the type of investment offerings, the processes for document flow, employee education, and specific employer responsibilities. Draft RFP for service providers and investment entities. Cost: $200,000 split between outside ERISA counsel and additional MSRP staff. Time: 12 to 18 months.

(b) Draft, submit and obtain rulings from the IRS and Department of Labor that approve plan documents; define the State's status under the arrangements, and authorize various control mechanisms. Cost: $150,000 – $200,000, split between outside ERISA counsel and MSRP staff. Time: 12 to 18 months.

(c) Draft special communication material; design web site; finalize coordination details among State agencies, hire new employees as retirement educators; begin sales. Cost: $200,000 – $300,000, largely for MSRP staff, with some allocation to communication specialists. Time: 12 to 18 months.

(d) Maintain MSRP staff and adjust-up or -down consistent with growth of program. If reception is poor, cost will adjust down to $100,000 – $50,000. If reception is excellent cost will adjust upward to $300,000 – $400,000 depending on the number of personnel assigned to employee education. There is a recurring annual cost of $20,000 – $40,000 for maintaining plan compliance through amendments, rulings and other ongoing technical analysis. Time: 3 to 4 years.

(e) Assuming that the VEAP has had a successful introduction and has reached its goal of 20,000 employee accounts from 1,500 businesses, and program assets have stabilized at $40,000,000 – $80,000,000. Ongoing annual cost is estimated at $400,000. About 75% of this cost is direct staff, and 25% is for outside contractors. Assuming a $40,000,000 base, State cost per employee account would be $20 a year or 1% of assets. These amounts are in addition to standard service provider fees of between 0.07% and 1%, with possible per/account fees of $10 – $25. At this point the program could begin gradual phase out of State subsidies, and force participants to pay these costs.

In evaluating these cost estimates the following points should be noted. First, the initial cost estimates (years 1 – 3) are relatively firm. They are also consistent with benchmarks such as ongoing legal costs for State retirement programs, start up costs for the College Savings Plan, and a recent $400,000 appropriation by the State of Washington for exploration and development of a similar program Second, it is conceivable that one or more private entities might be willing to assume some of those costs as a business development expense. Adoption of such a partnership, however, is strongly discouraged because it effectively cedes control of program structure to the funding entity. It also makes State liability more likely.

CONCLUSION

A State sponsored voluntary accounts program is potentially viable but will require significant long-term State expense. The program may also be difficult to establish or market in the absence of federal legislative changes, such as a requirement that all employers have a pension plan, or offer a payroll deduction IRA account. Finally, staff recommends that the program only proceed if the State retained direct control over investments and administrative arrangements, and received specific regulatory approval of that authority.

N.B.— The principle authors of the Report are Michael T. Halpin, Executive Director of MSRP, and John K. Barry, Assistant Attorney General and Counsel to the Board of Trustees for the Maryland Supplemental Retirement Plans. Mr. Barry cautions that the policy and legal views expressed in the report are not (and should not be represented as) the views or opinions of the Maryland Attorney General.

Technical Notes

[1] A conceptual framework for State efforts to assist or sponsor private retirement accounts is outlined in Iwry, *Growing Private Pensions: A Supporting Role for the States,* 34 Tax Management Compensation Journal No. 12, 12/01/06.

[2] Maryland Code Annotated, Labor & Employment Article, Title 10 provides the statutory framework for IWIF. It has many of the hallmarks and requirements of an insurance company. *See* Labor & Employment §10-123 (policy dividends); §10-122 (investment of surplus regulated under Insurance Article); §10-125 (solvency examination and enforcement by Insurance Commissioner). Notwithstanding these characteristics IWIF is not chartered as a limited liability corporation but is instead an instrumentality of the State. *Central Collection v. DLD,* 112 Maryland App. 502 (1996).

[3] Maryland Code Annotated, Insurance Article, Title 20, Subtitle 2 provides the statutory framework for MAIF. Provisions to limit State liability are more explicit than for IWIF. *See* §20-201 (membership in Property & Casualty Insurance Guaranty Corporation); §20-302 (Fund is a special account and shall not receive a general fund appropriation). As with IWIF and the College Savings Plan comments in this study on State liability are general in nature, and not intended as legal opinions of the Maryland Attorney General, or specific legal predictions on what should or will occur in the event of entity insolvency.

[4] The College Savings Plans are authorized by Education Article Title 18, Subtitles 19 and 19A. Subtitle 19 establishes a board (§18-1905) that issues contracts for pre-paid tuition (§18-1909) and holds the reserves for these contracts in trust. §18-1907. A contingent liability assumption is authorized by §18-1906.1. Subtitle 19A governs the College Investment Plan; this Plan holds tax-advantaged college investment accounts authorized by I.R.C. §529. Unlike the prepaid tuition plan there is an express disavowal of State liability for these investment accounts. §18-19A 05. The funds may not be commingled with the Prepaid College Trust that holds the reserves against liabilities for the tuition contracts.

[5] College Savings Plans generally rely on the exemption from registration for municipal securities. 1933 Securities Act, §3(a) (2); 201 WL 3408572 (SEC No-Action Letter). It is not certain that a similar letter would be issued for funds held as a separate investment pool for voluntary accounts, because: (a) it is difficult to characterize the status of the investment pool as an instrumentality of the State; (b) states generally do not run open-ended investment pools for distribution to the public; (c) unlike college savings plans, there is no explicit federal authorization for the program. With respect to pension plans, the basic rule is that the interest of a participant in a plan of his employer is not a security. *International Brotherhood of Teamsters v. Daniels*, 439 U.S. 551 (1979); SEC Act Rel. 6188, 29 SEC Dock. 4651 (1980). This is distinct from a separate principle of the securities laws, which is the broad definition of an "investment contract" as a security. *S.E.C. v. W. J. Howey & Co.,* 328 U.S. 293 (1946). Under this principle, participation in a security or pool of securities is itself a security separate from the

underlying security, and is subject to the registration requirements of the 1940 Investment Company Act. Rosenblum, *Investment Company Determinations Under the 1940 Act – Exemptions and Exceptions*, ABA Publications, 2003, p. 57. There is a recognized exception from this rule for group trusts used for pension plans, but this is limited to group trusts for plans of a single employer, or closely related employers. If not so limited, the pool is subject to its own registration requirements. *Id* at 542. The SEC might modify this rule, but such an effort would be a time consuming and possibly expensive effort.

[6] The Internal Revenue Service web site maintains an extensive and helpful guide "401(k) Plan Potential Mistakes", found at:

www.**irs.gov**/pub/irs-tege/401k_**mistakes**.pdf.

The guide is instructive on the type of errors that might tend to crop up in a system of State sponsored accounts for a large group of small businesses with a broad range of record-keeping practices. Typical mistakes would likely include: failure to update plan documents; failure to make timely match contributions; errors in application of inclusionary or exclusionary eligibility rules; excess deferrals; failure to distribute communication materials (such as the Summary Annual Report, or Summary Plan Description) to employees; failure to make timely deposit of deferrals. Compliance on many of these items might actually be improved by State involvement and sponsorship and the threat of penalty or total plan disqualification is, in general, overrated; but the program will need compliance mechanisms for all these items, and it is these mechanisms—the consistent follow-up across a broad range of businesses—that create the administrative expense.

[7] The State is normally immune from suit and resulting liability under the doctrine of sovereign immunity. Immunity can be waived by statute and two generally applicable waivers exist for torts (State Government Article, Title 12, Subtitle 1) and contracts (State Government Article, Title 12, Subtitle 2). Both systems of limited liability would be largely pre-empted by ERISA. 29 U.S.C.A. §1144; *Retail Industry Leaders Assoc. v Fielder*, 475F3d180 (4th Cir. 2007). This pre-emption substitutes federal law for State law in liability actions relating to the program and would have both positive and negative effects on State liability risk. On the one hand, it eliminates liability under State statutes and substitutes a liability under federal statutes that is generally more restrictive in the allowance of claims. On the other hand it also eliminates the legislature's ability to tailor or channel that liability, such as the damages limitation under the Maryland Tort Claims Act. Some potential contractual liabilities between the State and vendors hired to perform plan services will exist, and be covered by State law notwithstanding ERISA preemption. In theory State liability could also be limited by a system of State "pseudo – sponsorship" for the pension plans established under the program. This would eliminate all superficial State fiduciary or administrative activity, and thus eliminate any ERISA liability. The State could then contend in litigation that ERISA pre-emption does not apply, and State-law provisions limits liability. The difficulty with this approach is that it inherently conflicts with the overall message of the program which is encouragement by the State to sign-up for a specific State created plan. The inconsistency of these two

messages ("We created the plan and solicited the money but otherwise don't know anything about it.") are obvious.

[8] ERISA adopts the prudent person (often called the "prudent expert") standard and the corresponding rules of fiduciary responsibility. 29 U.S.C.A. §1104. These rules require the Plan Trustees to act solely in the interest of participants and for the exclusive purpose of providing benefits and defraying reasonable administration expense. The basic duties are that of competency and loyalty. For an individual account plan ERISA provides that Trustees are immune from liability for investment losses that result from participant decision—that is, the decision to invest in a particular product, as opposed to another product—if certain conditions are met. 29 U.S.C.A. §1104(c). ERISA also allows allocation of duties among Trustees. 29 U.S.C.A. §1105. Additional protection against Trustee liability exists independent of §1104(c). For example, the common law rules generally do not make a Trustee a guarantor of a particular investment result; it is part of the conceptual framework of trusts, including pension trusts, that an individual account will vary in value according to the profit and loss of the investment, and so long as the choices are reasonable the Trustees should not be liable if investment results are not as good as expected. The unusual nature of a State sponsored arrangement, however, and the many control elements involved, require either a federal statute or federal rulings that authorize State control and the various expense arrangements of the parties. One additional important element would be the permissible and non-permissible uses of data and program resources, so that non-plan State policy objectives (such as collecting taxes or child support) did not violate the duty of loyalty imposed by §1104(a)(1)(a). Another example of uncertainty relates to IRA accounts. These accounts are generally exempt from ERISA requirements. 29 C.F.R. §2510.3-2(d). That exemption can be forfeited if a party has influence on investments or negotiates special terms. 29 C.F.R. §2509. 99-1(c)-(e). Influence, control and special terms are the precise goals of State sponsored accounts, and these rules affect the ability to adopt a State sponsored I.R.A. program. *See* generally DOL Interpretative Bulletin 99-1 (Employer payroll deduction IRA not a formal ERISA plan if certain conditions are met, including employee choice for recipient IRA investment).

[9] *See* for example the discussion in *Haddock v. Nationwide Financial Services, Inc.*, 419F. Supp. 2d 156 (D. Conn. 2006) (Defendant's summary judgment motion denied on plaintiff's claim that investment provider is a plan fiduciary).

[10] The Employee Benefit Research Institute has published an extensive study on the practical difficulties of a national defined contribution plan as a replacement for social security benefits. EBRI Issue Brief Number 236, Special Report 40, September, 2001. The report contains a detailed discussion of the enormous variety of payroll methods and practices used by small businesses, and the large percentage of the workforce that is subject to these practices. It is precisely this variety of practice that creates the possibility of mistake, and the expense of fixing that mistake.

[11] The basic rule is that investment interests need to be registered with the Securities and Exchange Commission before being offered for sale to the public. If the State pools

funds for a group investment, and then allows new (but unrelated) entities into the investment pool, it has arguably created a new security and/or investment company, which then must be registered with the SEC. As noted supra (no. 5) the municipal securities exemption would likely be unavailable. The registered or exempt status of the securities is largely irrelevant at program inception however, because there is little question that registered vehicles would need to be used for several years, until the accumulation of a significant asset base that produced real benefits for a pooling arrangement.

[12] Recommendations of the Advisory Committee on Tax Exempt and Government Entities, 6/13/07, *Improving Compliance for Adopters of Pre-Approved Plans. See* Rev. Proc. 2005-16 for the requirements for submitting a master or prototype plan. Under existing rules it is not absolutely clear that the State is eligible to submit a Master or Prototype document, but a number of different technical devices could be used to solve this problem.

[13] *See* Schmitt and Xanthopolis, *Automatic IRAs: Are They Administratively Feasible, What Are The Cost To Employers and The Federal Government, And Will They Increase Retirement Savings? A Preliminary Report Prepared for AARP*, 3/8/2007.

[14] ERISA requires formal adoption of a written plan and trust. 29 U.S.C.A. §1102; 1103. These documents must be made available to participants on request. 29 C.F.R. §2520.104(b)-1(b). The plan administrator must also provide a summary annual report (29 C.F.R. 2520.104(b) – 10) a summary plan description (29 C.F.R. 2520.102) and a specific range of investment disclosures if ERISA 404(c) immunity is relied on. 29 C.F.R. §2550.404 c-1. Additional notices pertaining to rollover rights, tax withholding, minimum distribution rules and investment advice must also be distributed. All these items are part of the normal course of pension administration and would likely fall on hired services firms; but if the State wished to avoid liability for transactions not properly conducted it would have to make efforts to establish and supervise appropriate administrative procedure.

[15] I.R.C. §413(c).

[16] I.R.C. §401(k) (11).

[17] I.R.C. § 408 (p); Notice 98-4, 1998-1 CB 269.

[18] A plan sponsor is typically the employer, but can also be an employee organization in the case of a plan established by the organization. 29 U.S.C.A. §1002 (16) (B). The sponsor "adopts" the plan and retains the power to amend it. The "Administrator" is also a defined term for ERISA plans. 29 U.S.C.A. §1002 (16) (A) (ii). A sponsor is not typically a fiduciary; these duties instead are reserved for specifically named individuals or entities designated as Trustees by the Sponsor. Under a voluntary accounts program the State would be assuming some sponsor-like responsibility, some administrator

responsibilities and some fiduciary responsibility; the legality and effect of those assumptions would be the subject of the ruling requests noted supra.

[19] A Life Cycle Fund is a mutual find whose investment allocation is geared to a particular target retirement date, such as the year 2030. The fund's investment plan changes the fund investment allocation as the date approaches, under refinements that adopt the generally accepted investment principle that long term investors should accumulate equities when young, and debt as they enter retirement. The funds are offered in a series (2010, 2015, 2020, etc.) and the investor typically selects the fund that corresponds to his or her expected retirement date. Life Cycle Funds are typically used in automatic enrollment programs because they are deemed more likely to be suitable as an investment when the employee has not affirmatively recorded a choice. Numerous provisions of the 2006 Pension Protection Act and subsequent ERISA regulations encourage the use of this type of fund within a plan. Both MSRP and the State Retirement Trustees acting for the Optional Retirement Plan have recently made Life Cycle Funds available as program options.