Implications of DOL Fiduciary Rule Decisions and RESA Legislation

April 5, 2018

by Drew Carrington, Michael Doshier
of Franklin Templeton Investments

Some new developments in Washington and recent court rulings have implications for those saving and investing for retirement. Drew Carrington, head of Institutional Defined Contribution at Franklin Templeton Investments, along with Michael Doshier, head of retirement marketing, examine the status of the Retirement Enhancement and Savings Act (RESA) and what it might mean for both plan sponsors and participants. They also recap the latest court rulings impacting the Department of Labor's Fiduciary Rule.

Here are some highlights of the views of the speakers presented:

- The Department of Labor has a few options in regard to the latest court rulings on the Fiduciary Rule—namely, whether or not to appeal. However, the business changes that have happened—where organizations are focused on developing business models and approaches that adhere to the concept of acting in our customers' best interest—are likely to largely remain in place.
- Separately, the SEC has announced that it is close to completing a draft on a best-interest fiduciary standard of conduct for broker-dealers that would apply to both retirement and retail investors—a broader remit than what the DOL had proposed.
- We think RESA is positive legislation. It makes a number of proposed changes to the retirement system that are enhancements. There are many different pieces to RESA; it's a collection of improvements to the system.
- There is no real organized opposition to RESA. As there are no major revenue implications for the US government, the chances look good that some version of RESA may make it out of Washington with bi-partisan support.
- Thinking about retirement-plan coverage and the private-sector workforce, small employers often don't offer plans as frequently as large employers. RESA would make it easier for small employers to pool together to better mirror the economics of large plans.

A full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks.

Ahead on this episode: new developments with legislation in Washington that could have major effects on retirement plans. Speaking with Drew Carrington is Michael Doshier. Michael, take it away.

Michael: I'd be remiss to not start with the latest court activity regarding the Department of Labor's (DOL's) Fiduciary Rule, or otherwise known as the Conflict of Interest Rule. Can you walk us through the two recent rulings as well as any important differences in the cases? Recently, the Tenth Circuit [Court] upheld the Fiduciary Rule in a pretty narrow ruling regarding differences between fixed index annuities and fixed annuities. Basically, the Tenth Circuit said the DOL was well within their purview in distinguishing between those two types of products. A couple of days later, the Fifth Circuit came out in a much more broad ruling and said, in fact, the DOL exceeded their authority; you couldn't divide the rule up into parts, where maybe some parts were okay and some parts weren't. And so they said the entire rule had to be vacated, and in response to that, the DOL has said they're not going to enforce the rule while they're figuring out what they might do next.

Michael: So what do you think happens next? What are the options the DOL has in front of it?

Drew: So the DOL has a couple of specific options. They could appeal to the entire Fifth Circuit. That's called an En Banc Appeal. They can appeal it all the way to the Supreme Court. They could elect not to appeal it all together. If they elect not to appeal it by April 30, then the rule is vacated. So we may know something sooner, but if they elect to appeal then the process continues on. We continue to not have a final answer on that rule.

Michael: So they've got an appeals track, they've got a track to ultimately decide to abandon based on the ruling by the Fifth Circuit—the Fifth Circuit decision stands, so to speak. What do we think this all means for the providers who have already put so much effort, time and money into adjusting the way they do business to be in compliance with the rule?

Drew: I think it means a couple of things. The business implications of the rule—you're going to have a hard time finding anybody in the industry who says we'd rather not act in our customers' best interests. Many of the objections to the rule have to do with the way that the DOL elected to write the rule, and then, in particular, the Best Interest Contract, or BIC, exception provision which created this private right of action, and, in effect, sort of handing over the enforcement of the rule to private litigation. If the DOL elects not to appeal, the risk of private litigation for violating the rule obviously goes away. Not to say there are not other opportunities for private litigation, but those specific risks go away. But I think the business changes that have happened where organizations are really focused on developing business models and business approaches that adhere to that concept of acting in our customers' best interest—it's very unlikely that any of that goes away.

Michael: So the philosophical, core reason why the Fiduciary Rule came about—probably well-established and maybe for many firms, even before this even came down—but it's more about the enforcement and the administration, the burdens that the DOL Fiduciary Rule [creates] are where really the challenges lie.

Drew: I think that's fair. I think there's a lot of firms who will now wrestle with, "Well, so what other changes do we have to make? Do we go back to the old five-part test rule or does something else come into play?" But, I think with respect to what can firms look forward to on the litigation and enforcement front, obviously, if the rule is vacated, then the odds that they get sued for violating the rule go away.

Michael: Pretty clear—about the only thing in this situation that is crystal clear. Okay, Commissioner Clayton of the SEC [Securities and Exchange Commission] has already announced that not only are they addressing the Fiduciary Rule and Fiduciary Standard from the SEC perspective, but that the drafting has already begun and some even believe that they're close to completing the first draft. So we should see something relatively soon there.

Drew: Yeah. The DOL and the SEC have talked to one another about any new rule that might come out, and if the SEC issues guidance, then it will cover all accounts. The DOL rule only covered qualified plan and IRAs [individual retirement accounts]. And so you had the awkward situation of an individual might have some accounts that are covered by the Fiduciary Rule and some accounts that aren't. If the SEC offers guidance here, it would be more umbrella.

Michael: Alright. So let's move on to a new legislative activity: The Retirement Enhancement and Savings Act, aka, RESA. Before I ask what's going on right now about it, can you walk us through a little bit of the history and the journey behind this legislation?

Drew: I think RESA is very positive legislation. It makes a number of proposed changes to the retirement system that really are enhancements. This is a topic that goes back several years. RESA actually came out of the Senate Finance Committee in 2016 with a unanimous 26-0 vote, everybody was in favor of this. So this is the rare instance where we're talking about something substantive—retirement policy—but we have complete bipartisan, unanimity in approving it. As it turns out, the primary author of RESA, back in the day, is none other than Preston Rutledge. So Preston Rutledge, now the Assistant Secretary of the Department of Labor, the head of EBSA—Employee Benefits Security Administration—at the time, was the senior tax and benefits counsel for the Senate Finance Committee. He was the guy who was writing the very specific legislative language that's embedded in RESA today. So what happened though is it never made it to the Senate floor. It never made it to the house in 2016. It was refiled in and we're now in, in the midst of the, legislative process with respect to RESA.

Michael: A little background and color. Now, there are a lot of pieces to RESA. It's not a single thing. Let's start with one major area. Pooled employer plans, also now referred to as MEPs [multiple-employer plans]. What does the proposed bill due to fix some of the issues employers have historically had with the requirements?

Drew: So multiple-employer plans have been available. Employers could adopt multiple-employer plans prior to the passage of RESA, but there were a couple of risks involved with adopting a multiple-employer plan. The idea behind the multiple-employer plan, in our retirement system in the US, the plan is sponsored by a single employer. So an employer has a plan for their employees, and it's kind of a closed environment. The idea behind a multiple-employer plan is multiple employers get together and pool the assets and the buying power of more than one workforce to create some economies of scale. But there have been two hurdles—significant hurdles—in the past for employers to adopt a multiple or, or pooled employer arrangement. The first is referred to as the "Nexus Provision;" there has to be some connection between the employers. So we've typically seen these in the past in trade associations or other, you know, sort of business affiliations—so the American Medical Association, the American Bar Association, the National Association of Auto Dealers.

So you have some connection, some shared business interests, typically members of some sort of industry trade association. So that's the first. The second was actually much worse, and that's what's been referred to as the "One Bad Apple" rule. And under the "One Bad Apple" concept, let's just assume you have 10 employers who are participating in a multiple- employer plan for a number of years, and then it turns out that one of the employers has violated some aspect of the rules around offering a qualified plan or they don't make the contributions on a timely basis. There's no provision to fix that. There is no correction to that error.

In fact, the only fix is that the entire plan is disqualified, commonly referred to as the "nuclear option." All of the contributions ever made to that plan become taxable. The whole plan is considered in violation. So one plan, one employer, one bad actor can basically infect the entire plan.

So what RESA does specifically is repeals both the Nexus requirement and "One Bad Apple." It actually enables the treatment of that error, so that employer has to fix the error on their portion of the plan, but it doesn't have any sort of reverberating implications for all of the other participants in the plan.

Michael: Not a stretch to see how that could preclude employers at that size—smaller-size plans from forming. So to what extent do you think these changes will have an impact on small-business America really starting to cover participants more broadly?

Drew: We know the Nexus and "One Bad Apple" rules have been hurdles or hindrances for people adopting these kinds of plans. When you think about retirement-plan coverage and the private-sector workforce, the small employers are often the ones that don't offer coverage anywhere near the rates that we see for large employers. We know that states have tried to respond to that by offering state auto-IRA programs. This is a way now for small employers to get together, achieve those economies of scale that we see in large plans and many of the benefits that come with that—lower costs, better plan provisions—but actually deliver that in a vehicle that is similar to large plan 401(k)s.

So, you can have a match, you can have higher contribution limits, you can have auto enrollment and escalation all the features that we know work in the large plan space are now available to plan sponsors or employers who are smaller. And, I can't predict what the take-up rates on pooled employer plans will be, but I know it'll be greater than what we have now because of the limitations under the current law.

Michael: Seems like a fairly simple solution with a potential for fairly large impact on the coverage issue that I know we all struggle with.

Drew: That's one of the reasons why it passed out of committee 26-0.

Michael: Another big discussion area of RESA is around lifetime income. What does this proposal trying to do to move the needle on retirement income in DC plans?

Drew: So RESA picked up a couple of other legislative proposals that have been floating around regarding, sort of, thinking about Defined Contribution plans in a more retirement-income sort of framing. So there's a couple of different things that are in embedded in RESA that address the provision of retirement income from qualified plans. The first has to do with disclosure—helping people understand what their balance will produce in terms of income when they get to retirement. So, under RESA, there's a requirement that the benefit statement that you get converts your balance to some kind of income in retirement, and that you have to use certain assumptions to a sort of roll forward your balance today. So really, going further down the road to communicating to 401(k) plan participants—it's not just about a big pile of money, it's how much income can that money produce for me when I get to retirement.

Drew: And, you know, there's a lot of questions about—well, what assumptions do you use and how does the model work? So that's one of the pieces.

Michael: Yep.

Drew: The other two pieces have to do with very specific kinds of operational and fiduciary questions that plan sponsors have wrestled with when they think about these retirement income or lifetime income options. The first has specifically to do with the selection of a lifetime income provider**,**where plan sponsors and advisors and consultants have been really struggling in the past is the selection of an insurer with some sort of annuity-based product; some kind of product that may not start making payments until many years in the future and then has to make payments over the remaining life of not only the participant but maybe their surviving spouse. So very, very long- horizon instruments with a selection process that has felt, up to now, to be kind of risky.

Plan sponsors and consultants have felt like that they're just uncomfortable making that decision, that there's too much risk associated with that. What RESA does is provide a very clear legislative, safe harbor around the selection of lifetime income providers. If you do these things, then you cannot be sued. That has been, I think, to some extent, one of the hurdles for planned sponsors adopting lifetime income options. One of the other hurdles has to do with portability. So if I pick a lifetime income option as a plan sponsor, and then change my mind for whatever reason—something better comes along, I have concerns about the provider, I want to change record-keepers and my new record keeper is unable to administer the product that I had before—any of those things, there's the issue about portability. So can the participants maintain the lifetime income that they've already purchased up to now? So what RESA does is it creates a new, kind of a rollover opportunity. So if a plan sponsor makes a change like that, the plan participants can roll it over to an IRA without any tax consequences and maintain the income that they have acquired up to that point. And so again, clear legislative answer to a question that has kind of bedeviled the adoption of these products up to now.

Michael: Yeah, a couple of them that are very obvious around single-insurer risk and even that tail of the rest of a former employee's life and/or spousal—I mean, huge changes. So where do we stand now with RESA? Where do you think it's headed? What's next?

Drew: There was a chance that it might have gotten swept into the omnibus bill that just passed, but it didn't. So now we're back to regular order. So we've got two sponsors on the House side, bi-partisan, again, in this case. It goes to committee in the House. People can propose amendments. If it makes it out of committee—and it's hard to imagine that something with this kind of bi-partisan support doesn't make it out of committee—then it has to get on the calendar and get approved by the entire House. If the House makes amendments in committee to the bill, then it has to go back to the Senate for reconciliation. Then both have to approve it again, and then it can become law. But this is a bill that, again, there's really not any sort of natural opposition to. It doesn't have big scary, revenue implications for the government. There's no sort of organized opposition. I think the chances are good that some version of RESA may make it out of Washington with bi-partisan support.

Drew: It has a couple other, sort of, throw-ins, in the rest of the bill that are interesting. One of my favorites is, RESA actually repeals the little limitation that you can't make contributions to an IRA once you're past 70-1/2, when you reach the requirement and distribution age. So historically, once you reach 70-1/2, you can't put money in an IRA if you're working. Well, this repeals it, reflecting the ongoing reality that we see, you know, higher labor-force participation rates among the post-65 population and that sometimes, if you're working, maybe you don't need to withdraw, and you need to put money into your retirement accounts. So, it's a collection of improvements to the system, and we feel pretty good about it at this point.

Michael: Well, so it seems to align at many levels with a lot of the thought leadership that you and your team have been putting out around the retirement tier and broadening the view of how we take care of the older participants, as they're on their final stages of the old accumulation stage into distribution.

Drew: I think it aligns with a lot of our thinking here at Franklin Templeton. Anything we can do to make it easier for sponsors to act—to help participants get better prepared for retirement—we're fans of that. This addresses some of the communication questions—how do you talk to participants about being ready for retirement? It addresses some of the implementation questions, some of the gnarly sort of—what about portability, the fiduciary questions—it addresses those in a pretty head-on way. The multiple-employer plan opens the door to the benefits of scale to many more employers, and we know what the divide between the plans that have adopted kind of industry best practices versus those that haven't. We know what retirement readiness looks like between those two. So it's a chance to improve on those outcomes.

Important Legal Information

This material is general in nature, and is provided for informational and educational purposes only. It is not intended as investment, tax or legal advice, or as an investment recommendation within the meaning of federal, state or local laws or as a substitute for legal counsel. Laws and regulations are complex and subject to change; please consult with a qualified professional with respect to your specific circumstances and individual goals.

Financial decisions and investing involve risk, including risk of loss.