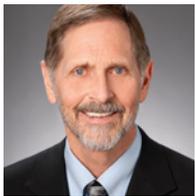


**Defined Contribution Plans**

This issue features an interview with **Fred Reish, Partner/Chair, Fiduciary Services ERISA Team**, at Drinker Biddle & Reath LLP.



Moderated by **Stacy L. Schaus, CFP®**  
PIMCO Executive Vice President and  
Defined Contribution Practice Leader

## A good sense of value.

In this *PIMCO DC Dialogue™*, we talk with ERISA attorney **Fred Reish** about the retirement plan issues on the agenda in Washington, D.C., and how they might be affected by the upcoming elections. Fred shares his views on how the need to balance the U.S. federal budget may lead to lower limits on the amount that high-income earners can contribute to defined contribution (DC) plans in the future. He also talks about how Washington supports income projections on statements and may back retirement income solutions and education to improve DC plans. Fred discusses the upcoming fee disclosure regulations at both the plan level and the participant level. He opines that plan-level disclosures are likely to have a significant impact on costs, including increasing the competitive pricing of DC services in the market. Yet he emphasizes that the move to “lower cost” does not mean giving up value; rather, that whether a plan sponsor is paying for recordkeeping or investment management, both the price and value should be assessed and deemed reasonable. What is important, given recent litigation, is that plan sponsors leverage their buying power when they shop for services and negotiate fees.

**DC Dialogue:** Can you talk about what is on the Washington agenda for retirement plans?

**Fred Reish:** I think there are two agendas in Washington: the political agenda, which is the White House and Congress, and the administrative agenda, which is primarily the Department of Labor and the Department of Treasury. In terms of the political agenda, I would be surprised, with one possible exception, if anything major made it through Congress this year.

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As part of the effort to balance the budget, there is some talk about reducing the limits on contributions to DC plans, so there's at least an outside chance for that. But realistically, I think we'll just have more discussions about it this year. After the election, there may be some actual legislative activity before this Congress goes home. Other than that, I don't think there will be anything particularly helpful or damaging that will come out of Congress this year.

Moving from the political arena over to administrative — the Department of Treasury and the Department of Labor (DOL)— there are a couple of initiatives that could prove to be significant. Both the DOL and the Treasury Department are focusing on retirement income as an issue; more specifically, how to make it easier for participants in a DC plan, particularly 401(k) plans, to build adequate retirement income.

**DCD:** What is the discussion around reducing the limits on DC contribution amounts? Do you see that as a real possibility?

**Reish:** Many groups are fighting proposals to reduce these contribution limits. The government view of DC contributions as a tax expenditure is misguided, because the tax-deductible money that goes into retirement plans ultimately comes out as future taxable income generated by retirees. While the government ultimately does receive these tax dollars, they tend to focus on the short term and what can be done to balance the budget.

Unfortunately, if a major bill gets some momentum later this year regarding cuts to military spending, maybe a reduction in Medicare and all other kinds of political issues, the retirement plans may be a very small attachment to these bills. So, if they're included in the bill, once that bill builds momentum, I think it would be almost impossible to stop. So there is a significant chance, I would say 50-50, that either this year or next year there could be a reduction in the amount that the more highly paid employees could defer into 401(k) plans.

A reduction in the DC tax-deductible contribution limit wouldn't directly affect the rank-and-file employees, because most of them don't contribute more than that to a plan, but it could make plans less attractive to businesses, because the owners and executives can't get a proportionate benefit out of them. That may create less incentive for them to contribute meaningful amounts for their employees. Also, some surveys say that it could more generally affect people deferring in the plans. But I don't think reducing the contribution limit for DC plans is a done deal by any means.

**DCD:** What are the DOL and Treasury Department concerns about retirement income?

**Reish:** There are two primary concerns: The first is that plan participants aren't accumulating enough money to retire adequately at age 65 or 67. As part of that, I believe that the Departments of Labor and Treasury would like to see income projections on DC statements so that plan participants can see the need to save more if their monthly or annual projections for income in retirement seem low, even including Social Security. Having this data should help make it obvious as to whether people need to be saving more while working, or whether they will need to work longer.

The second issue that both agencies are concerned about is whether there is sufficient legal support of both education and retirement income strategies to ease the transition from accumulation to distribution of invested funds, taking longevity into account. I believe planning for longevity is the biggest single issue. According to The Society of Actuaries a husband and wife aged 65 have around a 25% or 30% chance that one of them will still be alive at age 95. So there is a substantial possibility that that couple's money is going to have to last 30 years. Based on what I have read, it appears that most people think they're going to live for only 15 years in retirement, or maybe 20 at the most. Many may be underestimating how long they are going to live and how long their money is going to need to last.

The Departments of Labor and the Treasury are looking at ways to ease that burden — how to educate people about the need to withdraw retirement funds in a prudent fashion, taking into account the possibility of a long life expectancy. These agencies also are looking to increase support of the kinds of products and services that are necessary to achieve that goal.

**DCD:** What retirement income strategies are garnering attention in Washington?

**Reish:** There is a range of retirement income strategies, including immediate and deferred annuities as well as living-benefit features, such as guaranteed minimum-withdrawal benefits (such riders may be subject to additional fees and conditions; guarantees are based on the claims-paying ability of the issuing company). In addition, there are investment-based strategies, such as managed payout funds, systematic withdrawal programs, and managed accounts. And then there are combinations of the insurance and investment strategies, such as target-date strategies wrapped with a living benefit.

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There is concern in Washington that some of these solutions have barriers that hold plan sponsors back from offering them within plans. For example, there are questions about how the joint-survivor annuity rules apply to guaranteed minimum-withdrawal benefits. The Department of Treasury is trying to make it easier under the tax qualification rules for these products and services to be available to participants.

In addition, the Department of Labor is working on clarifying the guidance on plan sponsor selection of insurance company products, such as annuities. Current plan sponsors are concerned that, if they make a mistake, they may be liable for benefits 20, 30, 40 years from now. Therefore, they may be reluctant to offer insurance-related strategies, even though the law does not require a crystal ball to predict the future.

As mentioned, both Treasury and the DOL are working together on regulation that will require the projection of retirement income, which should allow participants to see the monthly income their accounts might generate for them in retirement. So we have a handful of things going on with retirement income, and we may get guidance on these areas this year. As a result, 2012 may be viewed as the "retirement income year."

**DCD:** What specific guidance do you believe plan sponsors need to move more rapidly toward selecting and offering in-plan, insurance-based retirement income strategies?

**Reish:** If the Department of Labor and the Department of Treasury really want participants to have access to more retirement income products that are reasonably priced and well explained, then they're going to have to make it easy for plan sponsors to offer them. I don't mean to lower the fiduciary standard, but to give clear guidance and tell plan sponsors that if they follow those guidelines, they won't be potentially liable.

I believe three things are needed: a clear definition of what's expected of plan sponsors in selecting the insurance companies, a DOL Interpretive Bulletin 96-1-type explanation of education about retirement income products, and a 404(c)-type safe harbor for plan sponsors who provide the required information to participants. If the DOL does that and the Department of Treasury makes some of the tax qualification rules easier to live with, I think they could dramatically accelerate the adoption of retirement income products and services for participants.

**DCD:** Can you comment specifically on the elections and how the outcome might affect retirement plans?

**Reish:** Balancing the budget is going to be the elephant in the room, and everything else is going to have to be secondary to that.

I believe that if the Republicans gain control of the White House and Congress, they will try to balance the budget faster, and therefore cutbacks may be more substantial and more abrupt. But even if the Democrats retain the White House and take control of the House as well as the Senate, they are going to have to cut back also. But right now they're just working around the fringes, talking about small issues like 401(k) deferrals.

You could shut down the Department of Education, the Department of Agriculture, all of the agencies in the government, but if you don't touch Medicare, Medicaid, Social Security, and the military, I believe there would still be a deficit. So what that tells us is that legislators are dealing with some of these relatively minor issues because, politically, they are easier to deal with. The real issue of balancing the budget is in those four areas.

Regardless of which party wins any given election, I think that the needs of workers and the needs of employers in the capacity as plan sponsors are so obvious in the retirement area that either party would have to respond to them. The responses may be a little different, but I don't think there is much choice except to respond.

**DCD:** Can you comment on Social Security and what changes we might see there?

**Reish:** As we know, Social Security was originally meant to be a support system for elderly people. But 65 is no longer elderly by many standards; heck, 70 may not be elderly. That alone tells you that you may have to raise the retirement age; otherwise, Social Security could become something it was never intended to be. I suspect that the retirement age eventually will be raised to age 70. The big political argument will be that minorities and blue-collar workers have harder lives and die at an earlier age, so it's not fair to delay benefits for everyone.

I don't think that, as a country, we should get into that argument, because then you can take it even further and say, well, women live longer than men, and therefore, women should have to retire at an older age. Or you can say that certain ethnic groups live longer and, therefore, they should get more or less.

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I don't think we should put an occupational, gender or ethnic face on America for this purpose. We just have to say that this is a program for everybody and we're going to raise the retirement age to 70. Then, in the future, we may have to move it up again, as life expectancy and medical advances keep increasing. While the perfect solution may be to tie it in to how long people are expected to live, I don't think the public is ready to go there yet.

**DCD:** How might changes in Social Security affect employer-sponsored retirement programs?

**Reish:** If you think about the likelihood that the Social Security retirement age will likely be raised to 70 and that Medicare benefits will likely be cut back, I believe there is going to be a need to enhance the opportunities in the private sector for people to save more for retirement and to have more access to health care in those latter years — say, ages 62 to 70 — before they have the benefits of Social Security and Medicare.

How can you cut back on the deduction limits and the availability of products and services to participants and at the same time move postretirement health care and Social Security income further away from them? That dilemma has to be solved in the coming years.

**DCD:** Let's come back to today and talk about the implementation of the new fee regulations. What impact are these new regulations likely to have on plans?

**Reish:** We need to consider both the plan-level and participant-level disclosure regulations. I treat them separately because the impact of each is going to be different. Stated succinctly, I think the plan-level disclosures will have a significant impact on the DC marketplace, but the participant-level disclosures will not.

The plan-level disclosures — 408(b)(2), as they are called — are going to provide plan sponsors with a significant amount of information about what their service providers are charging and about the revenue sharing they are receiving. Those service providers include recordkeepers, investment managers, broker-dealers, consultants, and so on. In many cases, it may be difficult for plan sponsors to figure out the disclosures because they will be spread out over multiple documents and may be reported in different formats, such as percentages or dollar amounts. It may take a significant effort for plan sponsors to go through and dig out all of this information. And even once they've dug it out, what are they going to do with it? How will they know what it means?

Consultants and advisers will assist plan sponsors in gathering this fee information, understanding and benchmarking the charges being imposed on the plans, and understanding the compensation being received by service providers. For the first time, even the consultants may have a full view of all sources of compensation to the service providers, including direct and indirect payments. Once plan sponsors get those benchmarking results, they are going to see that, in some cases, they are being charged too much. I believe these disclosures are going to make it a lot easier for providers to compete fairly in the marketplace.

Ultimately, I believe the effect of the plan-level disclosure regulations will be to drive down prices. That will be good because every dollar that doesn't come *out* of the plan stays *in* the plan for the participant.

**DCD:** Do you think the fee transparency will lead to a focus on fees without regard to the value of services?

**Reish:** Some people are worried that plan fiduciaries will become so focused on the dollars that they'll lose sight of the advantages of certain services; for example, services that help your participants get into and participate in the plan, services that help get the deferral rates up, and services that get participants well invested.

The money spent on those services may be well spent, and the concern is that plan sponsors would become blind to all those beneficial services because of their cost. I don't share that concern. I think some plan sponsors will focus only on the dollars and just want the cheapest possible plan, but I don't think that's going to be a common problem.

Most employers, the entrepreneur, the owner, the executives, the senior managers, plan committee members — most of those people have a good sense of value. They know when they are being well served. They know when their participants have a good experience, and they know that you have to pay for quality. Plan sponsors will use judgment to weigh cost and value; they'll handle it well. The fee disclosures will help the plan sponsors be better buyers of services, as they'll know what they're getting for what they're paying. They will determine whether the fees of all plan services are reasonable — whether they're overpaying for the value the plan is receiving.

So, I can see plans continuing to have the same or even better services but with costs being driven down, because with these disclosures, plan sponsors will be able to decide not only *if* the costs are too high, but also *where* the costs are too high — which particular investment or service needs to be reduced in cost. That approach doesn't necessarily result in the diminution of the value of the services.

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**DCD:** Can you talk more about investment management costs and how the fee disclosure regulations may affect manager selection? As you mentioned, plan sponsors should consider the value of the plan services, including investment management, and determine whether the fees are generally reasonable.

**Reish:** First of all, there is a range of reasonableness. It isn't a specific dollar amount or percentage. It's a range of what good providers in the marketplace charge for comparable products and services. Think of it as a scattergram, where what each provider charges is a little dot on the scattergram, and those who huddle together in the middle are, by definition, all reasonable prices.

So, to begin with, I suggest you think of reasonableness as a range. You shouldn't get too focused on a particular dollar amount or percentage. Second, there will always be the debate between passive investing with its low fees and active management with its higher fees. Laws don't take a position on passive versus active management. The law says that paying more for a service is fine, as long as you believe the price is reasonable for the value you receive. So the law itself is agnostic in the debate between active and passive management, notwithstanding the fact that some people in the investment community get very emotional about this issue.

Once the plan sponsor determines whether an active or passive approach makes sense for each investment category, they need to determine whether the investment fees are within that range of reasonableness for each particular category.

**DCD:** Do you anticipate that the fee disclosure regulations will drive greater movement toward non-revenue-sharing mutual fund share classes and other investment structures, such as collective investment trusts (CITs)?

**Reish:** Plan sponsors will need to use the buying power of their plan size to invest in the most advantageous investment structure. I believe the largest plans are more likely to increase the use of separately managed accounts, while mid-sized plans may use more CITs, institutionally priced mutual funds, or the lowest-priced share classes. Particularly in the midmarket and up, the new regulations should create a better understanding of fees in terms of the different options available, the costs, and the value of what is received.

I think that people are going to ask, "Is this the right price for the size of plan we have?" In the past, plan sponsors may not have taken their buying power into account. Now they likely will.

**DCD:** What is your view of plans offering two separate core investment tiers — one for passive and one for active?

**Reish:** Speaking just from a legal perspective, I don't believe there's any advantage or disadvantage to offering separate tiers for active and passive investment management. If you look at litigation and DOL enforcement activity, you'll find almost no litigation over active versus passive management. Plan sponsors should focus not so much on whether the investment options are actively or passively managed, but rather on whether the plan is spending the right amount, given its buying power. Is the plan sponsor picking the appropriate share class and vehicle for a plan of that size?

**DCD:** We've been talking about the plan-level fee disclosures. Let's turn to the participant-level disclosures. You mentioned that you believe the participant-level disclosures will be less significant.

**Reish:** Yes, I believe the participant-level disclosures will be less significant since most quality recordkeeping providers are already giving participants 90% of the information that is required by the new rules. The change in the "law" is significant, but that's only because the law didn't require very much before and, in fact, the private sector was delivering far more than was required by the law. So, in some ways, this is just the law catching up with common practices — certainly common practices by quality providers.

But there are a few changes that are of note. For one, enrollment and other plan materials will need to go out more often and to both active and eligible participants. For example, let's say that 70% of a plan's employees are actually participating and they are the ones now receiving plan information. After this new rule becomes effective on August 30, 2012, that plan information will need to go out not only to the 70% that are participating, but also to the 30% that haven't been deferring. I believe that the DOL hopes this will encourage the 30% to get into the plan.

So that's one change, but I can't really say that it's going to make a big difference. Another change is that money taken out of a participant's account to pay for expenses will show up on a participant's quarterly statement. Some providers have been doing that for years and some haven't. For those who haven't been, the next year or so may raise a lot of questions by participants who wonder why money is being taken out of their account for a provider or service they haven't heard of before, such as a consultant or accountant.

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You can anticipate some reaction from participants, but I think once the fees are explained, they will become a nonissue. Unfortunately, the DOL says that if somebody (for example, an investment manager or a broker-dealer) is paid out of the investment product’s expense ratio, that amount doesn’t have to appear on the quarterly statement. As a result, some of the largest expenses don’t show up as deductions from participants’ accounts. Participants will see the expense ratio, but they won’t know what it’s used for.

A third change worth mentioning is the requirement to have a website available to plan participants which provides more information about the investments and costs. My suspicion is that somewhere between 80% and 90% of participants will not take advantage of that additional website information, because it takes additional time and you need to have some understanding of investments to make sense of it.

**DCD:** Can you talk about the recent litigation in the DC market and what plan sponsors should make of it?

**Reish:** There are two broad lines of DC cases: the first consists of cases that generally say that plan fiduciaries are not required to “scour” the market for the lowest possible price, and the second that says you must understand and use your purchasing power to lower plan costs. In the first category, the leading case is [Hecker v. Deere](#) from the Seventh Circuit. Essentially, the court said that if you offer participants enough investments, you don’t have to worry about fees and expenses. In that case, there were a little over 20 core investment options and about 2,000 more via a mutual fund window.

The leading case in the second category is the Wal-Mart decision, where, essentially, the court said you have to take into account the purchasing power of the plan. A plan sponsor has to look at its ability to buy a share class or other investments appropriate for a plan of its size. [Tussey v. ABB](#) also fits into this second category. The case made it clear that, not only do you have to look at the expense ratio of the investment products and, where you can, buy the lower expense ratio investment products, but you also have to look at whether or not you are overpaying for the services you are getting. This includes understanding the expense ratio and revenue sharing, such as transfer agency fees and shareholder servicing fees.

For example, if you are overpaying your recordkeeper and it is getting too much revenue sharing from investment managers or too much in the way of credits from proprietary products, then that may be a separate fiduciary breach issue, even if the expense ratios are “reasonable.”

Going forward, I expect we'll see more cases in the second category. In the preamble to the 408(b)(2) regulations, the Department of Labor made it clear that fiduciaries have a duty to prudently evaluate the information that is disclosed to them. The 408(b)(2) regulation is really about getting the right information into the hands of plan sponsors so they can fulfill their fiduciary responsibility. So I see the fee, expense and revenue-sharing world changing on July 1, when it becomes clear that plan sponsors have to be more rigorous in their analyses.

**DCD:** Do you have any suggestions on how plan sponsors can fulfill their responsibility to evaluate fees?

**Reish:** I think the most obvious way to satisfy that fiduciary duty is to gather the disclosures from your service providers and then to work with your consultant. Use an adviser who is independent and will help you evaluate all of the fees and costs as objectively as possible. The adviser can help fulfill this obligation in two ways: the first is to benchmark the information with what similarly situated plans pay, because to some degree, the competitive marketplace establishes reasonableness. Alternatively, plan fiduciaries could take their plan out to the market in a request for proposal and review the competitive bids they get from service providers.

If the fiduciaries discover that their service providers or investments are making more off the plan than the benchmarking studies suggest a plan of that size should pay, or if an RFP discloses that the compensation level of some competitors is lower, then the fiduciaries have to act on that information. Fiduciaries in that case would have to be able to document that they believe the services they are currently receiving are better, or they would need to go back and negotiate lower pricing with their current provider, or they would need to switch to another provider.

**DCD:** It will be helpful to have greater transparency and clarity for plan sponsors. Thank you for your time, Fred.

**Reish:** My pleasure. Thank you.

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## About PIMCO and Our DC Practice

Based in Newport Beach, California, PIMCO is a global investment management firm with over 1,400 dedicated professionals focusing on a single mission: to manage risks and deliver returns for our clients. For four decades, we have managed the retirement and investment assets for a wide range of investors, including corporations, governments, not-for-profits, and other organizations, as well as for individuals around the globe.

As of March 31, 2012 our:

- Clients include more than two-thirds the Fortune 100
- Investment professionals on staff exceed 500
- Global presence includes offices in 12 locations
- Total assets under management exceed \$1.3 trillion
- DC assets under management over \$180 billion

Our PIMCO DC Practice is dedicated to promoting effective DC plan design and innovative retirement solutions. We are among the largest managers of assets in defined contribution plans, offering investment management for stable value, fixed-income, inflation protection, equity and asset allocation strategies such as target-date solutions. We also provide analytic modeling, plus can help plan sponsors identify DC consultant resources. Our team is pleased to support our clients and the broader retirement community by sharing ideas and developments for DC plans in the hopes of fostering a more secure financial future for workers. If you have any questions about the PIMCO DC Practice, please contact your PIMCO representative or email us at [pimcodcpractice@pimco.com](mailto:pimcodcpractice@pimco.com).

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