Flashpoint: DOL New Proposed ESG Regulations (And Other Updates)

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Without question, we heard from Third Party Administrators (TPAs), Certified Public Accountants (CPAs), and Institutional Pension Workers, that this year was one of the most challenging October 15th deadlines. The fallout from the 2020 census hokey-pokey, and ongoing personnel shortage with Plan Sponsors, added massive challenges to an already difficult process. While you were locked in your chair and not sleeping, lots of interesting proposed regulations and legislation were floated and it's time to start putting your thinking caps on to figure out how this all might impact our clients.

ESG Investments and Proxy Voting

A Notice of Proposed Rulemaking (NPRM) was issued by the U.S. Department of Labor (DOL) on October 13, 2021, regarding the final plan investment rules that were issued at the very end of 2020. Taking a quick trip down memory lane, in the last few months of the last Administration, the DOL issued two final rules: "Financial Factors to Selecting Plan Investments" and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights." Many commentors wrote to the DOL with concerns that these rules were half-baked and represented a significant departure from historical DOL guidance going back to 2008. Upon taking office, President Biden directed federal agencies to review regulations issued in the past four years that were "inconsistent with, or present obstacles to," the new Administration's goals of improving public health, protecting the environment, and help counteract the impact of climate change.

Environmental, social, and governmental (ESG) investments were singled out for additional scrutiny and documentation requirements by the 2020 rules. Historically, the DOL has used the standard of "all things being equal" as the test as to when ESG investments are permitted in Interpretive Bulletins (IBs) going back to 2008, although each Administration has added its own spin. The new NPRM recognizes that "climate change is already imposing significant economic consequences on a wide variety of businesses as more extreme weather damages physical assets, disrupts productivity and supply chains, and forces adjustments to operations." As a result, investment fiduciaries are permitted to consider any material factor that would impact the investment risk-return analysis and such factors may include ESG factors, including climate change.

The NPRM brings things back-to-basics. The fundamental bedrock principle under ERISA is a duty of loyalty. Therefore, a plan fiduciary always has to put the interests of the participants and beneficiaries in the plan first and foremost. Sacrificing investment return, increasing risk, paying higher fees, etc. just so the plan can invest in a special fund (including an ESG investment) has always been, and will continue to be, a potential breach of fiduciary duty. The NPRM doesn't swing the pendulum in the other direction and just reinforces these principles.

Continuing with the back-to-basics theme, the NPRM also dispenses with any special participant notifications for possible use of ESG investments in a plan fund menu, or as a default investment alternative (DIA). The current participant fee disclosure (i.e., the 404a-5 disclosure), perhaps with a minor modification, already provides the necessary information for participants to make educated decisions as to how to invest their retirement funds.

In a similar turn of opinion, the NPRM dispenses with the prior policy shift regarding managing and voting proxies. Under the December 2020 rule, plan fiduciaries were given a confusing bit of guidance, which the NPRM eliminates. "The fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." This statement had the concerning potential to be misread to suggest that a plan fiduciary could remain indifferent to voting proxies. The further obligations to take exceptional steps to document every vote and the reasoning behind each vote encouraged plan fiduciaries to remain passively on the sideline. However, abstaining from a vote can impact whether a particular proposal is approved or not.

Again, the DOL has reinforced that a prudent fiduciary should look at the costs involved with voting the proxy, the matter at issue, the requirements of the plan's investment policy, and monitoring obligations under the general prudence and loyalty duties under ERISA.

If anyone feels strongly enough about the NPRM, and would like to comment, the deadline is December 12, 2021.

NRPM for Form 5500

Here's where things start getting juicy and more of you may be directly affected. On September 14, 2021, the DOL released proposed rules relating to the impact of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) on the Form 5500 filing rules. This guidance came out right before my Fall Break trip with my son, and so I brought it with me on the airplane. I got very excited making notes in the margins, and using my highlighter, to the point that the man-child asked what I was reading. When I told him and explained that there were really exciting plot twists that I didn't see coming, he returned his air pods to his ears, positioned his body away from me, and declared, "You are such a nerd." True.

"Wisdom accepts that all things have two sides." – Carl Jung

This quote is exceptionally on point with this NPRM. Let's start with a simple piece – counting of participants in a defined contribution plan for purposes of determining the large plan status. Under the NPRM, instead of looking at the number of eligible participants, the DOL proposes to change the method to counting only participants with account balances at the beginning of the plan year. So, if a plan has 150 eligible participants, but only 20 have account balances, no independent audit would be needed if the NPRM gets finalized. The DOL estimates that this would result in nearly 20,000 plans currently paying for an audit to being audit-free.

When discussing this with TPAs, I received a rousing chorus of "huzzah!" and tales of unfortunate plan sponsors with historically low participation despite best efforts. When discussing this with CPAs, I've heard horror stories of plan sponsors being caught deliberately 'hiding' the plan from eligible employees and the many virtues of the audit process. Both camps make exceptional points, but rules can't be changed on a case-by-case basis.

Another two-sided gem from the NPRM that few saw coming is the DOL's determination not to adopt SECURE Act Section 101. This section gave the Secretary of Labor the ability to prescribe by regulation simplified reporting for multiple employer plans (MEPs) with fewer than 1,000 participants in total, provided each participating employer (PE) had fewer than 100 participants. When this initially came out, many people (the author included) had grave reservations. The idea of 999 participants in a plan with no independent adult supervision seemed like a recipe for disaster. The DOL agreed. While the DOL left the door open for persuasive comments as to why MEPs should be treated differently than single employer plans, this tone of anti-MEP isn't entirely new with the DOL (and it gets worse in this NPRM).

SECURE Act Section 202 created the occasionally misused term, "group of plans." This Section provided that, so long as a group of plans has the same trustee(s), fiduciary(ies), plan administrator(s), plan year, and same investments or investment options for participants and beneficiaries, it may file a single consolidated Form 5500. The NPRM, and members of the retirement community, saw this Section as primarily trying to address the 'open' MEP issue as the term was created in a 2012 DOL advisory opinion letter. The DOL has taken what should have been a simplifying measure and made things much, much more complicated for such plans.

A new Schedule DCG has been born for these arrangements. Additionally, the DOL has added other conditions not part of the original SECURE provision:
• These arrangements must be in a single trust;
• No employer securities can be held at any time;
• Assets must be invested 100% in certain secure, easy to value assets ("eligible plan assets");
• Unless exempt due to size, the plan must be subject to an independent audit; and
• Multiemployer, PEPs, and 'closed' MEPs (PEO, Association, or related employers) are not subject to DCG reporting.

The audit requirement doesn't just include separate audits for each PE within the group of plans, but also a separate audit for the trust itself, covering the entire group. For arrangements hoping to use this Section as a way to reduce costs and create pricing efficiencies for the group, there is tremendous disappointment, and the DOL explicitly stated this in the NPRM. DCG filers will need to file under a Form 5500 and will not be eligible to use the Form 5500-SF. Members of the group that are small employers may want to elect to file individual Forms 5500-SF, as permitted under the NPRM. Also, a separate Schedule DCG will need to be attached to all related filings and separate Form 5558 will need to be filed for each PE that needs an extension. This is all the opposite of efficiency.

For MEPs and PEPs, there will be a lovely Schedule MEP that will have a detailed listing of all PEs, their EINs, percentage of the total contributions for each PE, and the aggregate account balances. For PEPs, it will need to include the "ACK ID" for the Form PR submitted and details about the service providers involved. MEPs and PEPs can only file on a Form 5500.

The data on Schedules DCG and MEP, as well as the proposed modified Schedules H, R, MB, and SB are designed to help the agencies (DOL, Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corp. (PBGC)) gather intel on retirement plans to help determine where resources should be deployed for investigations and audits. Examples of IRS data include identifying which 401(k) plans are safe harbor versus ADP/ACP-tested and the opinion letter serial numbers to prove whether the plan is using a pre-approved document. The PBGC is looking to change former PDF attachments to actual Excel files to make data analysis easier. It is also focused on long-term projections as to the funding status to better identify possible future distress terminations. As I'm sure is no surprise to anyone, there will be more detailed fee reporting for the DOL to identify potential fiduciary breach issues. Will plaintiff's attorneys also use this data to possibly identify future targets? Certainly.

All this fun will kick in with the filings starting January 1, 2022. Anyone who wants to express themselves one way or another, and file comments, has until November 1, 2021, to do so.

The Build Better Back Act of 202?

Rattling around the halls of Congress as part of the messy budget debate is the Build Better Back Act. (Which is a terrible name and makes me think more about the Justin Timberlake song, "Sexyback," so that's what I've been calling it.) Hidden among the hundreds of pages of budget-related issues – such as a major increase in the IRS budget, which the IRS has already announced means more agents and more audits – are some proposed changes that will overturn people's apple carts. Of late, there have been numerous articles highlighting certain high-profile CEOs' personal retirement accounts. These so-called "mega-Roth" or "back-door Roth" accounts are like waving a red flag in front of a bull and Congress responded.

High-Income Taxpayers are being identified as single individuals with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $420,000 (as indexed). These individuals are being singled out so that, if the aggregate value of IRAs, Roth IRA, and defined contribution retirement accounts exceed $10 million, further contributions to the Roth or traditional IRA will be prohibited. There would also be further annual reporting required for defined contribution plans on aggregate account balances in excess of $2.5 million.

When the $10 million is exceeded, there will be a new minimum required distribution (MRD) for the following tax year. This new MRD is 50% of the amount by which the aggregate traditional IRA, Roth IRA, and defined contribution account balances exceed $10 million. For example, Thurston Howell III has a total of $15 million in his accounts at the end of the tax year. He will be required to take a distribution of $2.5 million to satisfy this MRD requirement.

The "back-door" Roth will be nailed shut for High-Income Taxpayers. Roth conversions for both IRAs and employer-sponsored plans would be prohibited, as would be all employee after-tax contribution conversions. Practically speaking, how a Plan Administrator is supposed to identify which of its employees are prohibited from making a conversion will need to be figured out, since a Plan Administrator won't necessarily know about outside income or other retirement accounts. Perhaps we'll be able to use a self-certification process? We'll have to see.

IRA compliance will also get tighter. To prevent self-dealing, the statute of limitations will be increased from three to six years, and the IRA owner will be strictly prohibited from investing IRA assets in a business in which he or she owns 10% (down from 50%) or acts as an officer. Lastly, the Internal Revenue Code will be amended to clarify that an IRA owner is always a Disqualified Person.

The Sexyback hasn't yet been finalized, so there is opportunity for the above to change, but it is important for service providers working with high-net worth individuals to keep a close eye on this.

So, No Napping for the Rest of 2021

There are so many moving pieces, and additional guidance expected on PEPs and required minimum distributions, that a close watch has to be kept for the remainder of the year. The SECURE Act has left us with numerous challenges that still need to be resolved. If SECURE Act 2.0 goes through during the early part of 2022, we all have lots of creative thinking and work to do. It's a great time to be in the retirement industry.

When the universe throws you challenges like these, remember – we are your ERISA solution!

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