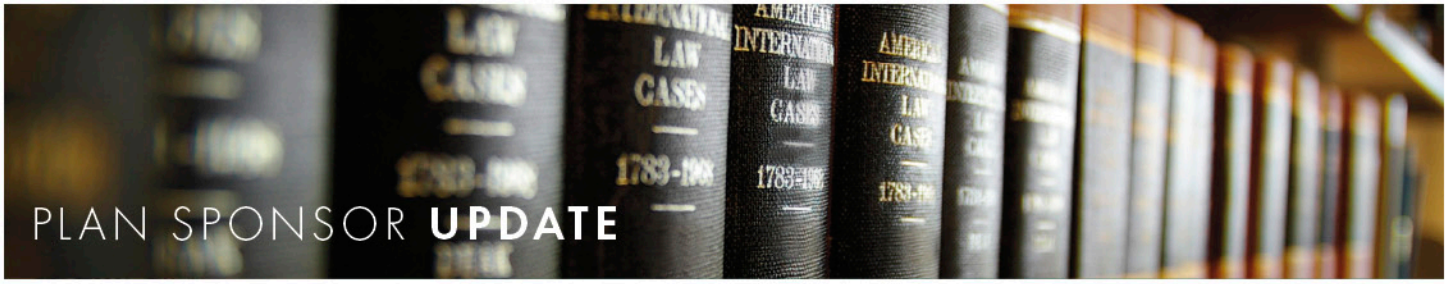

AN ANALYSIS OF LEGISLATIVE AND REGULATORY ISSUES AFFECTING PENSIONS

August 2016

CURRENT RETIREMENT SAVINGS POLICY OUTLOOK

Northern Trust is dedicated to helping you succeed in today's fast-changing environment. We are pleased to offer you access to this publication by Plan Advisory Services, to share regulatory developments that may be of interest.

Summary of the Situation

In this current outlook we discuss the recent decision by the Second Circuit in the *Lehman* stock drop case, the proposed revisions to Form 5500 and IRS's closure of the determination letter program for individually designed plans.

Who is most impacted by this?

Sponsors of DB and DC plans.

Key takeaways for clients

- *Decision in* Lehman *stock drop case*: The United States Court of Appeals for the Second Circuit has published its most recent decision in the *Lehman Brothers* stock drop case, in which plaintiffs (in their amended complaint) claimed, among other things, that sponsor fiduciaries "breached their duty of prudence under [ERISA], by continuing to permit investment in Lehman stock in the face of circumstances arguably foreshadowing its eventual demise" and that "Lehman's former directors, including Lehman's former chairman and chief executive officer … violated ERISA by failing to keep the Plan Committee Defendants apprised of material, nonpublic information that could have affected their evaluation of the prudence of investing in Lehman stock." The case involves several issues that, after the Supreme Court's 2014 decision in *Fifth Third Bancorp v. Dudenhoeffer*, are likely to be an element of future stock drop claims and to be litigated further:
    - *"Market price" vs. "too risky."* Some (including plaintiffs in this case) have argued that there may be situations in which an investment is, under ERISA's prudence standard, "too risky" for a retirement plan. The Second Circuit rejected this argument, finding that the Supreme Court's market-price analysis in *Fifth Third* was applicable "regardless of whether the allegations are framed in terms of market value or excessive risk …."

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Key takeaways for clients (cont'd)

- *"Special circumstances."* Plaintiffs in this case claimed that "special circumstances" made the market price of Lehman stock unreliable, a possibility that the Supreme Court acknowledged in *Fifth Third*. In this regard, the Lehman plaintiffs "point[ed] to orders issued by the [SEC] in July 2008 prohibiting the short-selling of securities of certain financial services firms, including Lehman." That sounds like an interesting argument, but the Second Circuit dismissed plaintiffs' claim as inadequately pleaded. What constitutes "special circumstances" is one of the big questions coming out of *Fifth Third*, and it will be interesting to see how other courts handle this issue.

- *Committee's "duty to investigate."* Stock drop claims based on inside information seem to be getting more traction with courts than claims based on public information. One issue in this regard is plan fiduciaries' duty to investigate. The *Lehman* plaintiffs argued that plan fiduciaries "breached their fiduciary duties by failing to investigate nonpublic information regarding the risks of Lehman." The Second Circuit found this claim (again) inadequately pleaded. Whether there is an obligation to investigate, in what circumstances and to what extent remain key questions for plan fiduciaries.

- *Appointing fiduciary's "duty to inform."* Finally, the *Lehman* plaintiffs argued that Lehman's CEO "inadequately monitored the Plan Committee Defendants and breached his fiduciary duty by failing to share with those Defendants nonpublic information he possessed regarding the risks facing Lehman." Given the importance of inside information claims in stock drop suits post-*Fifth Third*, whether other plan fiduciaries have a duty to inform members of the committee making the buy-sell-hold decision about inside information is a good question. On this issue, the Second Circuit held "Plaintiffs cannot maintain a claim for breach of the duty to monitor . . . absent an underlying breach of the duties imposed under ERISA … by the Plan Committee Defendants." And (quoting the lower court) "ERISA does not impose a duty on appointing fiduciaries to keep their appointees apprised of nonpublic information." Again, whether other Courts of Appeal will follow the Second Circuit approach on this issue remains to be seen.

- *Bottom line:* the Second Circuit in Lehman decided a number of key issues in favor of plan fiduciaries, but we can expect more litigation on these issues in other circuits and (conceivably) in the Supreme Court.

- *Proposed revised Form 5500*: The Department of Labor, IRS and the PBGC have issued a Proposed Revision of Annual Information Return/Reports – significantly revising the Form 5500 annual report requirements. According to the fact sheet published with the proposal the "target for implementing the proposed forms" is the 2019 plan year – so, the agencies are anticipating a fairly long lead-time for implementation of these changes.

- *Highlights*: The changes are both detailed and extensive and it will take some time to identify all the issues they present. The following are highlights, based on the description of changes provided by DOL:

  - *"Modernized" financial reporting*. "Plans invested in derivatives, limited partnerships, hedge funds, private equity, real estate, and other alternative investments would be required under the proposal to identify such investments specifically."

- *Modification of the limited scope audit exemption*. The limited scope audit exemption provides that "the examination and report of an independent qualified public accountant [required by Form 5500] need not extend to any statement or information prepared and certified by a bank or similar institution or insurance carrier." The new proposal would require, among other things, that the bank or insurance carrier certification: State whether the bank or insurance company is providing current value information regarding the assets covered by the certification, and if so, state that the assets for which current value is being certified are separately identified in the list of assets covered by the certification.

    - If current value is not being certified for all of the assets covered by the certification, include a caution that the certification is not certifying current value information and the asset values provided by the bank or insurance company may not be suitable for use in satisfying the plan's obligation to report current value information on the Form 5500 Annual Return/Report.

- *Identification of investments in DC plans*. In addition, with respect to, e.g., 401(k) plans, the proposal would require detailed information about "each designated investment alternative in the plan, information on qualified default investment alternatives, and information on whether the investment alternatives are actively managed or passively managed index funds."

- *"Improved" Service Provider Fee Information*. The proposal would "require filers to report all types of compensation for ERISA section 408b-2 'covered' service providers" – that is, more or less, it would require that all fees (direct and indirect) paid to providers be reported on the plan's Form 5500.

- *Enhanced Compliance with ERISA and the Code*. The proposal "would add selected new questions regarding plan operations, service provider relationships, and financial management of plans. These questions are intended to compel fiduciaries to evaluate plan compliance with important requirements under ERISA and the Code and to provide the Agencies with improved tools to focus oversight and enforcement resources."

- *Enhanced Data Mineability*. "The proposal would convert more elements of the Form 5500 into data or information that is organized in a structured manner to make them computer-processable and identifiable for data-mining and analytic purposes." Whatever its merits, when combined with the proposed new requirements discussed above – reporting each investment in a DC plan, detailed direct and indirect fee information and information "regarding plan operations, service provider relationships, and financial management of plans" – this enhanced "data mineability" will provide plaintiffs' attorneys with a goldmine of information that may form the basis of future lawsuits over, e.g., 401(k) plan fees.

- These changes are pretty significant and may pose significant issues for sponsors and, e.g., trust/custody banks.

- *IRS closes determination letter program for individually designed plans*: IRS has published Revenue Procedure 2016-37, "eliminat[ing], as of January 1, 2017, the five-year remedial amendment cycle system for individually designed plans …." Under the new procedure:

  - Effective January 1, 2017, the five-year remedial amendment cycle system for individually designed plans is eliminated.

  - After that date, determination letters for individually designed plans will be limited to (i) initial plan qualification, (ii) qualification upon termination, and (iii) certain other circumstances.

  - IRS says it will annually issue a "Required Amendments List;" the deadline for identified "required amendments" will be the end of the second calendar year following the year in which the list is issued.

  - Plans must be operated in compliance with changes in qualification requirements from their effective date. IRS says it will annually issue an "Operational Compliance List" identifying changes in qualification requirements.

  - For amendments to existing plans, the remedial amendment period is the end of the second calendar year following the calendar year in which the amendment is adopted or effective, whichever is later.

  - A transition rule extends the remedial amendment period for certain disqualifying provisions to December 31, 2017.

  - Generally, determination letters issued to individually designed plans will no longer contain expiration dates, and expiration dates included in prior determination letters are no longer operative. Sponsors with favorable determination letters may continue rely on those letters except with respect to a plan provision that is subsequently amended or that is subsequently affected by a change in law.

- Sponsors will want to consult with counsel concerning plan compliance with Tax Code qualification requirements in the future.

What's next?

We will continue to follow these issues.