COALITION TO PRESERVE
THE DEFINED BENEFIT SYSTEM

August 22, 2012

HYBRID PLAN REGULATIONS:
A DISCUSSION WITH TREASURY AND THE IRS

On August 15, representatives of the American Benefits Council, the Business Roundtable, the Coalition to Preserve the Defined Benefit System, and The ERISA Industry Committee had a meeting with Treasury and the IRS to discuss the proposed hybrid plan regulations. The topics addressed were suggested by Treasury and the IRS based on questions that had arisen in the context of their work on the regulations. We reiterated the importance of other issues that were not on their list, but were included in the joint trade association September 7, 2011 submission (attached). Treasury and the IRS were very clear that they continue to use that submission as a reference in their consideration of the regulatory issues.

Our discussion with the government is summarized below. (This summary was prepared by the Council and the Coalition.) Points on which we need to respond to the government are in bold and italics.

I. Effective Date/Transition Issues.

A. Effective date. We briefly reiterated our view that the final hybrid plan regulations should be effective no earlier than the first plan year beginning at least 12 months after the later of (1) the publication of the final regulations, or (2) the issuance of the associated anti-cutback relief (discussed below). Treasury and the IRS were very familiar with this issue and the reasons underlying our request, so we spent very little time on it.

B. Anti-cutback relief. If a hybrid plan has an above market interest crediting rate (and thus violates the law), the IRS has the regulatory authority (which it intends to use) to permit the plan's interest crediting rate to be reduced "to the extent necessary" to comply with the requirement that the crediting rate not be above market. Treasury

and the IRS asked what guidance would be helpful with respect to the application of the "to the extent necessary" standard.

1. Need for certainty. We stressed that plan sponsors very much need certainty and clarity so as to avoid potential liability and litigation. For example, assume that a plan provides an interest creating rate equal to the greater of (1) a specified bond rate that is not a permitted market rate, or (2) 5.5%.

Assume further that the proposed regulations are finalized in their current form. The assumed interest crediting rate would be above market. How would a plan sponsor reduce it only "to the extent necessary"? Should the plan sponsor change the specified bond rate to the third segment rate and the 5.5% to 4%? Or should the plan sponsor adopt a fixed 5% rate? Or should the plan sponsor pick a permissible bond rate other than the third segment rate? Without guidance, a plan sponsor making any of these choices could be subject to litigation and potential liability.

Accordingly, we asked for the guidance described on pages 23-24 of the September 7, 2011 joint submission. For example, we asked that the government create safe harbors under which a plan with an above market rate of return would be treated as only reducing the rate "to the extent necessary" if the above market rate was reduced to any of the following: (1) the third segment rate, (2) the highest permitted fixed rate of return (5% under the proposed regulations), or (3) any maximum rate specified in IRS Notice 96-8 (as long as the margins set forth in the Notice are increased and updated to reflect the fact that the margins are intended to increase the base rate to the equivalent of the third segment rate, rather than to the equivalent of the 30-year Treasury rate).

2. Form of anti-cutback relief. We also noted that, for two reasons, it is important that the anti-cutback relief be provided through regulations (starting with proposed regulations), rather in non-regulatory form such as an IRS notice. First, non-regulatory guidance does not have the force of law; it is only an articulation of the IRS' views. Thus, plan sponsors relying on non-regulatory guidance are susceptible to challenges in a participant lawsuit claiming that a plan's rate reduction was more than "necessary" and thus was illegal.

Second, regulatory guidance ensures a notice and comment period. The anti-cutback issues can be difficult and complex, and should not be addressed without a public dialogue.

3. Government questions. The government did not, of course, provide any answers, but did raise questions.

- ***Does the government have the authority under the statute to permit rate reductions that are more than "necessary" to comply with the law?*** In other words, we are asking for simple, clear, and flexible safe harbors with respect to

permissible rate reductions. In some cases, our proposed rules—because they are not fine-tuned to the details of any particular situation—may permit reductions that are more than "necessary". Is there statutory authority for this?

- One way to address the statutory authority issue, at least in part, is to reduce the flexibility of our proposed rule, so that instead of having numerous optional safe harbors, there is a single safe harbor for each situation. For example, if a bond-based rate is above market, changing the rate to the third segment rate could be the sole safe harbor. ***How would we feel about that approach?***

- Aside from the anti-cutback issues, how important is it that the margins associated with the rates listed in IRS Notice 96-8 be updated? (This issue is discussed on page 19 of the September 7, 2011 submission.) Updating these margins would require substantial government resources. ***Is there enough interest in using the updated margins to justify the current use of those resources?*** We indicated initial support for the notion and said that we would get back to them with more on the interest in using the updated margins. We also noted that the rules, such as the anti-cutback relief, will apply in a more coherent and workable manner if the different permissible rates are similarly "at market", rather than having some of them below market (which would be the case if the 96-8 margins are not updated).

C. Segment rates. The funding stabilization legislation has created several issues for hybrid plans, which we raised at the meeting:

- We asked that the market rate of return regulations permit plans to use, as their crediting rate, either a "stabilized" segment rate or a "non-stabilized" segment rate.

- For plans that currently use the third segment rate (or the first or second) as their interest crediting rate, what rate should they be crediting for periods starting with the 2012 plan year—the currently higher stabilized rate or the currently lower non-stabilized rate? We asked for guidance stating that in the absence of a plan amendment expressly changing to the stabilized rate, the plan should be treated as using the non-stabilized rate. The government asked whether that was a government issue or an issue of plan interpretation.

- We also asked that the government provide anti-cutback relief permitting one opportunity to change from a non-stabilized segment rate to a stabilized segment rate.

We emphasized the importance of the second of the three points listed above and that the government does indeed have a role to play here. ***The government asked***

whether one solution to that problem was guidance under which the stabilized rates would be treated as above market.

D. Pre-effective date of regulations. Very generally, the new hybrid plan statutory requirements enacted as part of the Pension Protection Act of 2006 (the "PPA") have been effective for a few years. For example, for existing plans, the market rate of return statutory provisions generally took effect for the first plan year beginning after December 31, 2007. The regulations, on the other hand, take effect much later—generally 2012 in the case of most of the rules and "to be determined but not earlier than 2013" in the case of the market rate of return rules. The issue is the standard for compliance between the statutory effective date and the regulatory effective date (the "Interim Period").

We have asked for an explicit statement in the regulations that for this Interim Period compliance with any reasonable interpretation of the statutory provisions will be treated as compliance with the law. For a fuller discussion of this issue, please see pages 25-26 of the September 7, 2011 submission.

The government very much understands the issues and the arguments. On the one hand, employers could not have timely complied with the proposed regulations and could not have anticipated the final regulations. On the other hand, issuing a regulation reflecting a reasonable interpretation standard for the Interim Period could affect participants' rights. The government is struggling with the scope of their authority to affect participants' rights, as well as with the principles that would guide the use of any such authority.

The government asked if it would suffice if the regulations stated that there is no inference regarding the law in effect for the Interim Period (a position already set forth in the regulatory preamble). We indicated that more than that is needed due to the length of the Interim Period, the enormous effects of in plan not being a full compliance during the Interim Period, and the complexity and difficulty of fixing any problem retroactively.

Another key question raised by the government is whether there is evidence that a reasonable interpretation standard makes a difference in litigation. If courts implicitly adopt a reasonable interpretation standard for all interim periods, setting it forth in regulations may not be necessary. If courts generally ignore a regulatory reasonable interpretation standard, again, it may not be necessary to include the standard in the regulations. We told the government that we would review the case law on this issue and get back to them. We also pointed out that a reasonable interpretation standard could have a material effect in discouraging unjustified litigation, a point that would not be reflected in the case law.

The government asked whether it would trouble us if this regulation included a reasonable interpretation standard, but other recent regulations (and/or future regulations) do not include such a standard for their own interim periods. We agreed that that type of inconsistency was not ideal and that we would like to see comprehensive use of the reasonable interpretation standard for interim periods. But even in the absence of such comprehensive use, we still support application of the reasonable interpretation standard in the context of the hybrid plan regulations—not just the market rate of return rules—because of the acuteness of the need in this context (as described above).

II. Critical Points Reiterated.

We briefly reiterated the following points from our September 7, 2011 submission:

- The 4% limit on minimum rates of return needs to be raised to at least 5%. (We are cautiously optimistic that the 4% limit will be increased to some extent.)

- The 5% limit on fixed rates of return needs to be raised to at least 6%. (We are cautiously optimistic that the 5% limit will be increased to some extent.)

- The list of market rates of return in the proposed regulations should be safe harbors, not the exclusive list. (We are not overly optimistic on this point.)

- Hybrid plans should be permitted to provide subsidies without losing protection from whipsaw. (We are cautiously optimistic that the proposed regulations will be significantly modified in this respect, albeit subject to conditions.)

- There should be no conditions on the statutory protection from whipsaw. (We are somewhat pessimistic on this point.)

There was not much discussion of these points because the government had read our submission and did not have questions. We did point out that Treasury had decided to begin offering new variable rate Treasury securities. This is exactly the type of new development that will occur in the future and that would not be taken into account under an exclusive list of market rates, further underscoring the point that an exclusive list is not the right answer. We also noted that today's abnormally low interest rates do not materially affect the historical analysis previously submitted with respect to 4% and 5% limits.

III. Pension Equity Plans ("PEPs").

We briefly raised a question about the unique PEP issues that do not arise under the PPA provisions. We stressed that guidance on these issues -- which we anticipate being issued first in proposed form -- needs to be prospective only. The government responded that that project was being worked on but was on a separate track and could be discussed at a subsequent meeting.

IV. Participant Choice.

The government was very interested in how important it is for the rules to facilitate participants' ability to choose their interest crediting rate among a menu of options. For example, a plan might offer a choice of crediting rates based on different mutual funds and specified bond-based crediting rates (such as the third segment rate). The government's message was that working through all of the rules necessary to facilitate participant choice—such as addressing the application of the anti-cutback rules where an offered menu choice is eliminated—would require significant government resources. ***In evaluating how best to use their resources in the short term, the government asked (1) how many plans currently permit participant choice, and (2) how much of a difference permitting participant choice would make in stimulating the defined benefit system.***

We responded by describing a significant level of interest among plan sponsors in exploring participant choice options. However, since there is perceived uncertainty in the absence of regulations, there has been very little follow-up on this interest, thus explaining the fact that participant choice plans are relatively uncommon.

The government also noted that if participant choice is important, why shouldn't an employer just enhance its defined contribution plan where the rules for participant choice are well established? We described some of the advantages of using a defined benefit plan instead of a defined contribution plan. In this regard, one of the issues we discussed was the annuitization advantages of defined benefit plans. ***The government asked for any available information on trends with respect to the percentage of participants receiving annuities as opposed to lump sums.***

Treasury also asked if the participant choice arrangements raised fiduciary issues.

We all recognized that if participant choice is not permitted (or is left in an uncomfortable limbo status), transition rules are needed either to grandfather existing plans offering choice or to permit their transition to a non-participant choice arrangement.

V. Target Date Funds/Managed Accounts.

The joint September 7, 2011 submission addresses the need for regulations to permit interest crediting rates based on target date funds and managed accounts. Briefly, it makes little sense to bless rates of return that do not take into account the different circumstances of different participants and not bless rates of return that do take such factors into account.

This issue is very much related to the participant choice issue discussed above. The government raised the following question. ***If participant choice is not permitted, would it be age discriminatory for a plan to require all participants to be placed in an age appropriate target date fund?*** The concern would be that younger participants would be invested in more aggressive portfolios with a higher expected rate of return and higher risk. If the test for age discrimination turns solely on the higher expected rate of return (or actual return in many years), the government was concerned that that could be considered age discrimination. We responded by noting that age discrimination involves treating older employees less favorably on account of their age. In this case, all employees are treated appropriately based on their circumstances, taking into account both risk and return.

The government asked how target date funds and managed accounts might be defined if a special rule is provided confirming that such arrangements—without participant choice—are not age discriminatory. We suggested using the DOL's QDIA definitions, but also said that we would get back to them with further thoughts on this.

We all recognized that a rule regarding such arrangements would require coordination with the EEOC (and would arise under the Code's general age discrimination provision (§411(b)(1)(H)), not under the PPA provision (§411(b)(5))).

The government also asked whether in the defined contribution plan context, any plans exist where participants who elect a target date fund are being required to invest in an age-appropriate fund.

Finally, we discussed whether the age discrimination issue could be addressed by (1) permitting a narrow set of participant choices among target date funds and managed accounts, or (2) permitting participants the effective ability to invest in non-age appropriate target date funds by basing participant placement in a target date fund on factors in addition to age, such as risk tolerance, other assets, other plan coverage, etc.

VI. Backloading.

Under the backloading rules, generally, current factors are held constant in projecting benefits to normal retirement age. In this regard, the proposed regulations

are premised on the notion that the interest crediting rate for the prior plan year is a factor that is held constant in projecting benefits to normal retirement age. The proposed regulations then go on to provide "relief" from this general rule. If the crediting rate for the prior plan year was below zero (such as could be the case where the crediting rate is based, for example, on a mutual fund return or the return on plan assets), the plan may assume a zero rate of return for projection purposes.

The proposed regulations create a significant problem for investment-based crediting rates that can be negative. Hybrid plans that vary pay credits based on age and service often need to project benefits using a positive rate of return in order to satisfy the backloading rules. The proposed regulations would effectively make it impossible for such plans to satisfy the backloading rules if they use investment-based crediting rates that can be negative.

Our position is that the rate of return that is held constant for projection purposes is not the return for the prior plan year (a position that does not appear in the statute or the current regulations), but the long-term expected rate of return based on the plan's crediting rate. This approach was used by the IRS in IRS Notice 96-8 and is clearly appropriate here. For projection purposes, it is hardly appropriate to make long-term projections based on the assumption that, for example, an S&P 500 index fund will never appreciate.

The government asked for other examples where the factor that is held constant for backloading purposes is based on a long-term average, rather than the preceding year. We cited Social Security covered compensation, which is a 35-year average.

VII. Topics Deferred.

The government had raised questions about the treatment of "zero-interest current lump-sum plans" and "fully subsidized deferred lump-sum plans". The meeting ended before we had a chance to discuss these issues (or to understand more fully the questions the government wanted to discuss). We did note that (1) we needed to better understand the questions, (2) the issues were complicated and could take a while to discuss, and (3) the issues could have implications for PEPs.