Locked Out of Retirement

The Threat to Small Business Retirement Savings

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Locked Out of Retirement:

The Threat to Small Business Retirement Savings

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SUMMARY

- Small business owners, through SEP and SIMPLE-type IRA plans, provide roughly <u>$472 billion in retirement savings</u> for over 9 million U.S. households.

- Ninety-nine percent of U.S. employers are small businesses, and they produce 63% of new private-sector jobs. These small business owners and employees need retirement plans at work.

- The DOL is proposing broad new regulations that would impose significant new compliance costs and legal liabilities on advisors to SEP and SIMPLE IRAs, costs that will be passed on to these small business plans and employees.

- Many small businesses cannot offer 401(k) or similar "traditional" retirement plans because of administrative complexity, costs, or eligibility requirements, and instead offer simplified, basic retirement plans built around IRAs.

- SEP IRAs and SIMPLE IRAs are popular choices that are easy and inexpensive to set up and operate. Studies estimate that more than 9 million households own IRAs as a result of these small employer-provided retirement plans.

Executive Summary

Stretching its current regulatory authority over employer-provided retirement plans, the U.S. Department of Labor (DOL) proposed in April a new regulatory package that would put DOL in charge of financial advice provided to all Individual Retirement Accounts (IRAs) as well as to all private-sector, employer-provided retirement plans. This regulatory expansion would change the rules governing how financial advice is provided to roughly $15 trillion in retirement savings, putting DOL in charge. Unsurprisingly, this kind of sweeping change would result in a lot of unintended consequences.

The DOL is expanding the definition of fiduciary investment advice under a federal law known as the Employee Retirement Income Security Act (ERISA). The result would be that many traditional forms of compensation, such as commissions that vary from one investment to another, for financial advisors could become illegal under special provisions in that law called "prohibited transactions." A number of aspects of the proposal appear unworkable in actual practice, and would negatively impact how advisors assist small businesses in providing retirement benefits for their employees. In particular, the change would impact two of the most popular retirement savings vehicles for small businesses: Simplified Employee Pension IRAs (SEP IRAs) and Savings Incentive Match Plan for Employees IRAs (SIMPLE IRAs).

The proposal would adopt a broad definition of fiduciary "investment advice" encompassing "sales" communications, certain educational materials, and other situations where no intention to provide individualized fiduciary advice traditionally has been expected. Under the DOL's new proposal, even providing a small business with marketing materials containing sample investment lineups for SEP IRAs or SIMPLE IRAs could constitute investment advice, as could providing an individual account holder with certain educational materials that reference the specific investment funds that are available to him or her. Consequently, small businesses may find it even harder to offer retirement plans than they do today.

Small businesses make up 99% of all U.S. employers, and account for 63% of new private-sector jobs, as well as almost half of all private-sector employment and output.[1] Like their large employer counterparts, small business entrepreneurs and the millions of workers they employ need retirement savings opportunities. But unlike large employers, many small businesses may not be able to offer a 401(k) or similar "traditional" retirement plan due to cost, administrative complexity, or eligibility rules. Instead, many of these small businesses rely on simplified retirement plans to cover their owners and employees.

Two of the most attractive and popular retirement savings solutions used by small businesses are SEP IRAs and SIMPLE IRAs. SEP IRAs and SIMPLE IRAs are easy and inexpensive to set up, and do not impose ongoing administrative or reporting requirements on employers, allowing

[1] *See* U.S. Small Business Administration, Office of Advocacy, "Frequently Asked Questions," March 2014, *available at* https://www.sba.gov/sites/default/files/FAQ_March_2014_0.pdf.

their focus to remain on growing their businesses. These special IRAs have been very successful in helping small business workers save for retirement—nearly 10% of all current IRAs come from SEP/SIMPLE-type plans.[2] As of the end of 2014, there were approximately $472 billion of retirement savings in these types of IRA plans.[3] Another study of IRA data concluded that more than 9 million U.S. households owned employer-sponsored IRAs like SEP and SIMPLE IRAs.[4]

More complex regulations mean more hurdles and compliance costs, and a greater likelihood of lawsuits. Main Street advisors will have to review how they do business, and likely will decrease services, increase costs, or both. Small business SEP IRA and SIMPLE IRA arrangements that currently depend on these advisors for affordable assistance are likely to disproportionately bear the costs of excessive regulation—their small scale means they are more expensive to serve. The U.S. Chamber believes that DOL's proposed regulations risk hurting the very small businesses and workers they are intended to protect.

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[2] "Individual Retirement Account Balances, Contributions, and Rollovers, 2013; With Longitudinal Results 2010–2013: The EBRI IRA Database," Craig Copeland, EBRI Issue Brief #414, May 2015.

[3] *See* Investment Company Institute, "The U.S. Retirement Market, Fourth Quarter 2014," March 2015, *available at* www.ici.org/info/ret_14_q4_data.xls.

[4] *See* Investment Company Institute, "How Many Households Own IRAs," based on year-end 2012 data, *available at* http://www.ici.org/faqs/faq/faqs_iras.

Introduction

This DOL regulatory expansion would change the rules governing how financial advice is provided to roughly $15 trillion in retirement savings. Unsurprisingly, this kind of sweeping change would result in significant unintended consequences. One such unintended consequence is that small businesses may find it even harder to offer retirement plans than they do today, and some may stop offering employer-sponsored IRA plans to employees. SEP and SIMPLE IRAs are basic retirement plans that allow small businesses to offer retirement savings opportunities to their employees, and are set up with the help of financial professionals that they trust. DOL, however, thinks these Main Street financial advisors need a new set of complex rules and regulations to prevent potential conflicts of interest.

The DOL proposal would adopt a broad definition of fiduciary "investment advice" encompassing "sales" communications, certain educational materials, and other situations where no intention to provide individualized fiduciary advice traditionally has been expected. Under the DOL's new proposal, even providing a small business with marketing materials containing sample investment lineups for SEP IRAs or SIMPLE IRAs could constitute investment advice, as could providing an individual account holder with certain educational materials that reference the specific investment funds that are available to him or her.

The proposed standards for defining what would or would not be fiduciary investment advice are highly subjective and would be difficult to observe in practice. Even well-meaning advisors who do not intend to provide specific, individualized investment advice may inadvertently "step in" to fiduciary status, triggering potential prohibited transactions and greater legal liability. To compensate for the significant liability they could face, these advisors, and the financial institutions they work for, would likely have to include an additional risk premium in the fees they charge to clients.

This expanded fiduciary definition can also make it hard for advisors to recommend SEP and SIMPLE IRA investments that use certain proprietary investment products. For example, an insurance agent advising a SEP or SIMPLE might not be able to discuss some of the investments offered by the insurance company for which the agent works, regardless of their performance or suitability for the individual.

In order to comply with the proposed regulatory package, many advisors and their related financial institutions would have to change how their products and services are structured, and how the retirement plans and IRA accounts are charged fees. If finalized in its current form, the proposed rule would very likely increase the costs associated with SEP IRAs and SIMPLE IRAs, and would make it more difficult for retirement savers to receive meaningful assistance, such as choosing appropriate asset allocations, within their accounts. Some Main Street advisors may choose to exit the SEP and SIMPLE IRA marketplace in light of the costs and risks of compliance with the new rule.

Benefits of SEP and SIMPLE IRAs

SEP and SIMPLE IRAs provide benefits for more than 9 million households because they are simpler for employers to offer than 401(k)s, but give employees more generous benefits than traditional IRAs not offered through employers. Though SEP and SIMPLE IRAs are built around IRAs, they are plans provided by the employer, and the tax laws permit more tax-preferred contributions than are allowed in a non-employer provided IRA, which limits contributions to $5,500 in 2015 ($6,500 for individuals 50 and older). SEP and SIMPLE IRAs are different from one another, however, and one may be better for a particular small business over another.

SEPs and SIMPLE IRAs are simplified plans presenting less administrative burden than 401(k) and other plans. For example, unlike many other plans, the assets and investments in SEP and SIMPLE IRAs are held within each participating employee's IRA account rather than in a common trust account. This reduces the record keeping at the plan level. Likewise, unlike other plans, there is no annual Form 5500 filing requirement for a SEP IRA or SIMPLE IRA, a significant cost savings in and of itself. Perhaps the most significant differences relate to investments. Under a traditional 401(k) or other defined contribution plan, the employer (or its plan committee, etc.) must evaluate, select, and monitor each of the core investment options offered to participants. There has been a significant uptick in lawsuits against 401(k) plan sponsors in recent years, often alleging excessive fees and expenses associated with selected investments.

For a SEP IRA or SIMPLE IRA, the investment funds offered are not individually selected by the employer—rather, they generally constitute a broad range of alternatives offered by the vendor through its IRA platform. The employer does not generally have involvement with monitoring the options or instructing the IRA vendor to add, replace, or discontinue the alternatives made available. Employers considering a SEP IRA or SIMPLE IRA that select the IRA vendor should review potential providers and make a prudent determination that the vendor selected offers a suitable product at a commercially reasonable price. Likewise, DOL guidance indicates that employers should periodically monitor the vendors (that is, the IRA trustees) to ensure they are doing their jobs and not charging unreasonable fees.[5] But, in comparison with a traditional qualified plan, the employer's fiduciary obligations as to a SEP IRA or SIMPLE IRA are very limited in scope. Not only does this limit the fiduciary liability of small business owners, but it also allows them to focus more of their time in managing and growing their business while increasing jobs.

Of course, the significant reductions in cost and administrative burdens also mean that SEP IRAs and SIMPLE IRAs are less flexible than traditional retirement plans. Employers have less ability to limit eligibility for participation, to vary contribution amounts for different employee groups,

[5] *See* DOL, SEP Retirement Plan for Small Businesses, "Monitoring the Trustee," *available at* http://www.dol.gov/ebsa/publications/SEPPlans.html; *and* SIMPLE IRA Plans for Small Businesses, "Monitoring the Trustee," *available at* http://www.dol.gov/ebsa/publications/simple.html.

and to offer certain other features than they would under a traditional qualified plan. However, this loss of flexibility is often a blessing in disguise for small businesses—with the flexibility of a traditional qualified plan comes complex nondiscrimination testing, numerous participant disclosures, government reporting, vendor oversight, and day-to-day administrative tasks.

SEP IRAs

SEP IRAs provide benefits similar to qualified profit sharing plans, in that contributions are funded by the employer. Contributions are limited to 25% of each eligible employee's compensation, and the same percentage must be applied for each eligible employee. Annual contributions are also capped at $53,000 (for 2015) and cannot be based on compensation exceeding $265,000 (also for 2015), which are the same limits that apply to qualified defined contribution plans. Employees are not allowed to contribute to a SEP IRA, but they benefit from the employer contributions, which are not taxed to the employee until the funds are withdrawn at retirement. As such, SEP IRAs are mostly utilized by sole practitioners or employers with a very small number of employees.

A SEP IRA can be established by executing Form 5305-SEP, issued by the Internal Revenue Service (IRS), or another prototype or individually designed plan document. All contributions are immediately 100% vested, and can generally be withdrawn or rolled over according to the same rules governing traditional IRAs.

Once a SEP IRA is established, the employer may, but is not required to, make contributions each year. Each eligible employee must be provided with certain information about the SEP IRA, and must have an IRA account established for his or her benefit. Eligible employees, subject to a few exceptions, generally include all employees who (i) receive $600 or more in compensation during the year (for 2015), (ii) are at least 21 years of age, and (iii) have worked for the employer during three of the previous five years. The employer can always be more generous in terms of eligibility, but cannot exclude employees who meet these eligibility criteria.

SIMPLE IRAs

SIMPLE IRAs are an option for employers that do not maintain other retirement plans, and have 100 or fewer employees. If the business grows, a two-year grace period is allowed in most cases after the 100-employee threshold is exceeded to transition to a 401(k) plan or some other retirement plan. SIMPLE IRAs are more similar to 401(k)s—eligible employees can make elective deferral contributions from their own pay, subject to a $12,500 annual limit (for 2015, plus up to $3,000 in catch-up deferrals for employees aged 50 and over), and employers make either (i) a dollar-for-dollar matching contribution on elective deferrals up to 3%, or (ii) a flat (nonmatching) contribution for all eligible employees equal to 2% of compensation. Again, contributions cannot be based on compensation exceeding $265,000.

A SIMPLE IRA can be established by executing IRS Form 5304-SIMPLE or 5305-SIMPLE (depending on whether each employee can select his or her own IRA institution, or if there is a designated financial institution for the entire arrangement), or another prototype or individually designed plan document. Again, all contributions are immediately 100% vested, and can generally be withdrawn or rolled over according to the same rules governing traditional IRAs. Once a SIMPLE IRA is established, each eligible employee must be provided with certain information about the SIMPLE IRA, and must have an IRA account established for his or her benefit. Eligible employees, subject to a few exceptions, generally include all employees who are expected to earn at least $5,000 in compensation during the year, and have earned $5,000 or more during any previous two years. Again, the employer can always be more generous in terms of eligibility, but cannot exclude employees who meet these eligibility criteria.

Small Businesses Are Most Harmed by the DOL Proposal

The DOL proposal expands the universe of financial advisors considered to be fiduciaries. The effect of being a fiduciary is that many traditional compensation arrangements, such as commissions that vary from investment to investment, utilized by advisors to SEP and SIMPLE IRAs would no longer be permitted. Unfortunately, the proposal puts small business retirement plans at a further disadvantage relative to large employer plans because they are not treated the same.

Small Business Advisors Unfairly Excluded From the Seller's Carve Out

The DOL proposal "carves out" large plan advisors from fiduciary status. If a plan has 100 or more participants, or $100 million or more in plan assets, the advisor to that large plan does not have to be a fiduciary, while an advisor to a small plan does. Because an advisor to a small plan is not carved out of the rule, the advisor who is trying to market retirement saving vehicles to a small plan is considered to be providing investment advice and must determine how to comply

Realizing the Impact

Consider Kathleen's Wedding Kakes, a hypothetical small business in Tucson, Arizona, that employs about eight people in its shop, bakery, and delivery service. Like most small business owners, the founder, Kathleen Carver, wanted to help her employees save for their retirements, but because her business was so small, she could not afford to offer a traditional 401(k).

Instead, she established SEP IRAs for each of her employees, and contributes matching funds each month. When these new rules go into effect, the cost of offering these plans could significantly increase. Her financial advisor says he may have to change his whole business model, and that he may not be able to afford to spend the time it takes to help her and her employees with their small account balances unless he charges higher, up-front fees. If this happens, Kathleen will have to reassess her ability to offer this important benefit to her employees.

with the rule. This advisor must either now provide advice for a level fee or, if the advisor has variable compensation, he or she must comply with the many conditions of an applicable prohibited transaction exemption (an exemption that may still limit fee variation). Advisors to large plans are not burdened with these additional hurdles under the carve out. Due to these additional burdens, advisors to small plans are likely to incur additional costs, which will be passed on to the plan. Further, some advisors to small plans may determine that the small-scale of such plans means the expense and risk of changing business models and fee structures is not justified, and may no longer offer their services to small plans.

It does not make sense that small business plans should have to absorb costs that large plans do not simply because of regulatory fiat. While DOL may intend this as “extra protection” for small plans, it really represents “extra cost.” SEP IRAs and SIMPLE IRAs are popular among small businesses because they are cheaper and easier to offer and operate than 401(k) plans; therefore, imposing additional costs would make SEP and SIMPLE IRAs less attractive to small business owners, making it harder to offer plans to their employees.

The Proposal Will Increase the Cost of Providing Services to Small Businesses

Because advisors to small businesses are not carved out of the fiduciary definition, they must change their fee arrangements, or qualify for a special rule called an “exemption” in order to provide services on the same terms as before. However, the new exemption proposed by the DOL may not apply to small business plans. It does apply to individual owners of IRAs, but it is not clear whether this exemption is available for SEP and SIMPLE IRAs while they are being offered by the employer. Further, even if it does apply, the new exemption—called the “Best Interest Contract Exemption”—would itself substantially increase costs for advisors due to its many conditions and requirements.

The reason the DOL regulatory package causes such significant change is that a fiduciary investment advisor under ERISA generally has engaged in a prohibited transaction if the advisor recommends investments that either pay the advisor a different amount than other investments, or that are offered by affiliates (for example, the advisor is connected with the insurance company that offers the investment). There are certain exceptions to these rules, called “prohibited transaction exemptions,” but as the DOL has proposed the new rules, the exemptions generally won’t help Main Street financial advisors who are working with small businesses to set up plans. Therefore, it may be illegal for those advisors to get commissions or to recommend certain investments.

For example, it may not be possible for a bank official to recommend that an IRA invest in the bank’s own certificates of deposit under some circumstances. Or if a financial institution provided SEP IRA or SIMPLE IRA marketing materials to a prospective small business client, and those materials described a sample allocation that included some of the institution’s own investment products, the marketing materials could be viewed as prohibited advice.

One way advisors might try to comply is by charging a flat fee for their SEP or SIMPLE IRA services. However, many IRA vendors prefer not to charge a direct fee to account holders, and many account holders prefer not to pay flat fees, especially in small accounts where a flat fee may be a significant portion of the assets. Logically, a vendor must generate a certain amount of revenue from servicing a SEP IRA or SIMPLE IRA account to generate some profit from it, or it will not provide the service. If advisors and vendors change to a flat fee model, they may actually charge more than before to account for the risk and expense associated with changing their method of doing business. This potential loss of low-cost investment assistance was one of the reasons why the DOL's previous proposal to redefine fiduciary investment advice several years ago—a proposal that was ultimately withdrawn—raised objections from many within Congress.[6] It is important to note, however, that some advisors may already be compensated in a manner consistent with the proposed DOL requirements, though this is less common in IRAs and small 401(k) plans.

How to Make a Difference

The public comment period for this proposal is open until July 20, 2015. After the comment period, there will also be public hearings at DOL. After all of the comments and hearings are concluded, DOL will have to review the comments and take them into account in writing a final rule. In all likelihood, this process will not be complete until sometime in 2016, and DOL proposed an eight-month transition period before the final rule would take effect.

To be most effective, the DOL proposal needs to strike a proper balance between protecting the interests of retirement investors and ensuring they have access to reasonably priced investment services. To accomplish this, advisors and financial institutions need to be provided with practical and clearly defined boundaries as to what is or is not fiduciary investment advice, as well as with commercially realistic and reliable standards.

Under the current proposal, Main Street advisors are very concerned that there may be no reasonable avenue to communicate meaningfully with individual and small plan investors (including SEP IRAs and SIMPLE IRAs) about matters related to investments without incurring potentially significant new costs and legal risks.

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[6] *See, e.g.* Letter from members of the Congressional Black Caucus serving on the House Financial Services Committee to then-Acting Labor Secretary Seth Harris dated March 15, 2013, warning that the "if the re-proposal reflects the Department's initial fiduciary proposal it could disparately impact retirement savers and investment representatives in the African American community…We are particularly concerned about the effects these regulations will have on savers in [IRAs]. If brokers who serve these accounts are subject to ERISA's strict prohibitions on third-party compensation, they may choose to exit the market…[i]f that occurs, it could cause IRA services to be unattainable by many retirement savers in the African American community."

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