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From the Editor

Let Them Eat Cake

States Want to Help Small Business Workers Save—Washington Doesn't

Half of all US employees today are not covered by any retirement plan—a level of participation that hasn't budged since the advent of the Employee Retirement Income Security Act of 1974 (ERISA) more than four decades ago. The numbers are shockingly lower at small businesses, where more than 80 percent are not covered. Worse still, most employees without access to any company-sponsored retirement plan do not choose to save on their own through an individual retirement account (IRA) or otherwise.

Congress's few attempts to date to expand the level of coverage through rules intended to reduce discrimination in favor of the high-paid and simplified employer plans have been ineffective. Absent a national savings policy, states are trying their own solutions. Currently, five states are actively pursuing—and many other states and cities are considering—"auto-IRAs" that are designed to spur employees to voluntarily save for their own retirement. (Full disclosure: My firm represents a number of these states and cities.)

Yet as the first programs prepare to launch, auto-IRAs are being increasingly and incorrectly attacked as an unholy combination of leftist overregulation, a disguised tax on workers to fund state pensions, and socialism (although the concept and the reasoning behind auto-IRAs actually originated with a conservative think tank). In fact, both sides of the aisle should be embracing auto-IRAs as a workable and simple tool to address the savings shortfall. Let's look at the facts, which directly contradict critics' unvetted reasoning.

WHAT IS AN AUTO-IRA?

Auto-IRAs are similar to the highly successful college savings 529 programs: that is, a state-organized initiative to help private sector workers voluntarily save for a future need. Auto-IRA programs are created by the state legislature and supervised by a state-appointed board empowered to hire recordkeepers and money managers, as well as set investment policy and operating rules. Crucially, an auto-IRA would automatically enroll employees at a set level of saving. Automatic payroll withholding, with an opt-out, has been time-tested in 401(k) plans as a simple and extremely successful method to nudge folks to save for retirement.

Employee contributions would default into a Roth IRA (more advantageous to lower-paid workers). However, workers could opt instead for a traditional IRA, choose a different contribution rate, or opt-out entirely *via* the Web, a toll-free number, or a paper form. All funds would be held by an independent financial institution as trustee or custodian. Although there will be differences in investment style, typically participants would choose among low-cost index and index-based target date funds, or a low-risk "stable fixed income" product. Once up and running, these programs are expected to pay for themselves through account fees—which, importantly, also are likely to be lower than for most existing IRAs. Best of all, there would be a modest administrative burden and little to no expense to employers. They would connect their payrolls to the state program, provide some basic census information, and process and deliver payroll withholdings to the program trustee—basically, the same tasks employers already perform for unemployment and workers' compensation insurance.

Every currently proposed auto-IRA—from California to Connecticut—requires that employers above a certain size that don't offer any other employee retirement plan must make this new program available to their workers. These states determined that without such a mandate, too many businesses would continue to do nothing to help their workers save. However, as discussed in more detail later, a state could take a more laissez-faire approach and choose not to impose a mandate.

DOES ERISA APPLY?

This question is critical. If applicable, ERISA's reporting and disclosure rules would increase the administrative costs of an auto-IRA, without any commensurate benefit to participants. The stakes are much higher for states with an employer mandate, given strong arguments that ERISA would preempt the mandate *if* the auto-IRA was an ERISA plan. Fortunately, under a 40-year-old safe harbor, payroll withholding programs are exempt from ERISA, providing the employer does not encourage employees to contribute, has little control or decision-making, and does not profit from offering the program.

Despite the well-established law, some states sought additional assurance from the US Department of Labor (DOL). Final DOL regulations issued in 2016 provided an additional ERISA safe harbor for all state and certain city/county programs that satisfied an 11-step test. These steps built on existing law (*e.g.*, limited involvement or control by the employer), but added a new wrinkle: To auto-enroll employees, the state *must* mandate employer participation. In other words, no mandate, no auto-enrollment. The DOL was concerned that an employer might try to manipulate automatic enrollment absent a mandate; however, I believe this was a legal and strategic mistake. Historically in the 401(k) realm, the auto-enrollment feature has proven effective and free from employer shenanigans. And by linking automatic enrollment with a required employer mandate, the DOL 2016 safe harbor alienated interested red states legislatures for whom "mandate" is a four-letter word.

THE EMPIRE STRIKES

As the DOL was considering the added safe harbor and states were developing their programs, right-leaning think tank pundits were busy targeting the DOL's safe harbor for both state auto IRAs and state programs generally. Indeed, Congress may employ the Congressional Review Act to repeal the 2016 safe harbors. (The lead time for publishing *Benefits Law Journal* is too long to report the outcome in this issue.) With or without the 2016 ERISA safe harbor, the states are committed to proceeding with their programs, and the battle in Washington will continue. Let's examine the somewhat specious arguments being used to undermine these state retirement savings initiatives:

- **Auto-IRAs are unfunded pension plans in disguise.** The number one criticism being offered is also the most absurd: Auto-IRAs will be used by state government to promise participants (read voters) a generous lifetime pension that won't be adequately funded, ultimately leaving employees and taxpayers holding the bag. In fact, by their very design, an IRA cannot be either underfunded or overfunded. That's because an IRA is an individual savings account, from which the benefits paid out are limited to the accumulated value of the employee's contributions plus any interest. Even if a program wished to provide workers with a "pension," it would be through a lifetime annuity issued by a regulated insurance company; payments would be guaranteed by the insurer not the state or its taxpayers.

- **Auto-IRAs will be used to prop up underfunded state pension plans.** A close second in absurdity is the accusation that states will force private-sector employees to invest in a "pension bond" that is funneled into state employee pension systems. Need I address the dire political and legal consequences of any such nefarious plot? Or point out that, instead of creating a new program to highjack the hard-earned savings of their poorest workers to pay government retirees, states could have targeted the billions already held in 529 college savings plans? Rather, I'll just point out that every state initiative now being developed proposes a conservative mix of index funds or indexed-based lifecycle funds, managed by regulated private-sector money managers that have a clear fiduciary duty to participants.

- **Workers need ERISA protections.** Although ERISA does a good job of safeguarding retirement savings, college 529 programs already help millions of people to save for higher education without ERISA protections. And, an auto-IRA would enjoy more safeguards than a 529. First, under the federal tax code, any IRA must be managed for the "exclusive benefit" of the participant. Second, IRAs must be held by a federally regulated trustee or custodian. Third, state wage theft or similar laws expressly guard against employers mishandling or pilfering salary withholdings. Finally, state auto-IRA enabling laws plus previously existing trust rules impose fiduciary duties to protect participants on state-appointed oversight boards.

- **Auto-IRAs might not work.** Correct. These are new programs that have not yet been tested in the marketplace. But so too were 401(k), 529s, and IRAs—all innovative savings strategies that financial institutions willingly tested in the marketplace and that all proved phenomenally successful. Auto-IRAs could turn out to be less popular or unexpectedly expensive despite all the studies, hearings, and analyses that suggest otherwise. But failing to even try to address the demonstrated and serious employee savings gap strikes me as a much bigger risk than doing nothing.

- **Auto-IRAs are not as good as 401(k)s.** Also correct. 401(k)s have higher contribution limits, allow for employer contributions, and provide for a well-developed administrative infrastructure. Indeed, some states and cities are considering an open turnkey 401(k) program targeted for smaller private-sector employers. But IRAs offer the alternative advantages of simplicity, less regulation, and lower costs, and can be mandated if states choose to do so. States should be free to determine which retirement programs are best for their citizens, without congressional interference.

- **State-sponsored auto-IRAs have an unfair advantage over the private sector.** Mutual funds, banks, and insurance companies have done little to develop or market a retirement savings product geared to small employers. Be honest: The private sector is not particularly interested in this small and mostly unprofitable niche market. In fact, auto-IRAs are good for the private sector because states will be hiring recordkeepers and investment managers to run their programs. Also, auto-IRAs also will not tempt employers to dump their own 401(k) plans in favor of a state program. IRAs are the "starter" retirement savings vehicle, and more advanced employers will not want to give up the employee recruitment and incentive value of a 401(k) to trade down to an IRA.

States are trying to fill an unmet need. Unless and until the federal government comes up with a uniform nationwide solution, states should have the freedom and flexibility to develop programs such as auto-IRAs to help workers sock away their own money toward retirement.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

David E. Morse
Editor-in-Chief
K & L Gates LLP
New York, NY