FINANCIAL SERVICES INSTITUTE | VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

POSITION PAPER

States and Cities Will Best Enhance Private-Sector Retirement Security by Promoting Existing Retirement Solutions for Small Businesses

A number of states and cities are considering legislation that would create state and city-run retirement plans for private-sector employees. Many of these plans would mandate employers not otherwise providing retirement benefits to join such plans. The goal of these proposals – to increase both participation by private-sector employees in retirement plans and the amounts being set aside by those employees for retirement – is an important one that is shared by the Financial Services Institute (FSI)[1] and its members.

FSI believes that reliable retirement savings products and plans already exist. As a result, states and cities could achieve their goal more by adopting a "marketplace" style plans similar to those adopted by New Jersey[2] and Washington State[3] and by actively promoting retirement literacy programs. We provide more detailed analysis and recommendations below.

<u>Background on FSI's Members</u>

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[4] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[5]

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

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[1] The Financial Services Institute (FSI) is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has successfully promoted a more responsible regulatory environment for more than 40,000 independent financial advisors, and more than 100 independent financial services firms who represent upwards of 160,000 affiliated financial advisors. We effect change through involvement in FINRA governance as well as constructive engagement in the regulatory and legislative processes, working to create a healthier regulatory environment for our members so they can provide affordable, objective advice to hard-working Main Street Americans. For more information, please visit www.financialservices.org.

[2] New Jersey A.B. 4275 was signed into law by Governor Chris Christie (R) 1/1/2016.

[3] Washington S.B. 5826 was signed into law by Governor Jay Inslee (D) 5/18/2015.

[4] Cerulli Associates, Advisor Headcount 2016, on file with author.

[5] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[6]

Overview of Current Proposals

The majority of state-run retirement plan proposals impose a mandate on employers. There are several variations of this model, but the essential feature is that a private-sector employer who employs a minimum number of employees, typically five, must participate in the state-run retirement plan if it does not otherwise sponsor a retirement plan for its employees. Most proposals also provide for auto-enrollment with an automatic deferral rate, generally 3% (rising under some proposals), unless the employee opts out of the program. These proposals are often referred to as "Secure Choice" plans by their sponsors.

Under some of the Secure Choice proposals, a nominal individual account would be set up for each participant, but unlike a true Individual Retirement Account (IRA) the participant's benefit would not be based on the actual investment performance of an account held for the participant's benefit. Instead, deferrals would be pooled and invested at the direction of an investment board. Some programs contemplate a specified interest credit, although it is unclear whether there is any true guaranteed rate of return. Although intended to be treated as a series of IRAs, this model does not meet the tax qualification requirements for IRAs but instead resembles a complex qualified pension plan known as a hybrid cash balance pension plan.[7] Other programs contemplate a model that looks more like a true IRA, where an account would be maintained for each participant with the benefit based on an employee's account balance plus any actual investment gain or loss.[8]

Several proposals containing employer mandates have failed to pass their respective legislatures while other proposals have been altered to authorize a feasibility study.[9] At the time of this writing, only five states have implemented mandatory state-run retirement plans.[10]

Finally, some proposals establish a virtual marketplace where qualified financial services firms will offer low-cost retirement saving plans to businesses including sole proprietors and self-employed individuals (Marketplace Plans).[11] Marketplace participation is voluntary; employers may choose whether to offer Marketplace Plans to employees; and employees may choose

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[6] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

[7] *See*, *e.g.*, California S.B. 1234.

[8] Illinois S.B. 2758.

[9] *See*, *e.g.*, Arizona HB 2063; Colorado HB 14-1377; Indiana S. 66; Louisiana S.B. 283; Maine H 1054/LD 1473. California S.B. 1234; Connecticut S.B. 249; Nebraska LR 344; Maryland S.B. 921; Minnesota HF 2536; Vermont S. 193; Wisconsin HB 838/S.B. 611; WV HB 4375/S.B. 488.

[10] As of this writing, five states have enacted mandatory state-run retirement plans for private sector employees. Those states are: California, Connecticut, Illinois, Maryland, and Oregon. Massachusetts enacted a mandatory state-run retirement plan for non-profit workers. Other states have established task forces to study the creation of a state-run program but have not specifically designated that the program studied be a mandatory plan. These states include Hawaii, Minnesota, Nebraska, New Hampshire, New Mexico, Utah, Vermont and Virginia (which specifically charged the task force to consider whether the program should include a mandated plan).

[11] *See*, *e.g.*, New Jersey A.B. 4285, which was enacted in 2016; Washington S.B. 5826, which was enacted in 2015.

whether to participate. The plans offered through the state's Marketplace Plan could be Employee Retirement Income Security Act (ERISA)-covered plans that employees could later roll over into an IRA or other retirement plan account. Under this proposal, a designated third party could assume responsibility for administrative and asset management functions.

City-Run Retirement Plans

In the same spirit as state-run retirement plans, some cities have considered launching their own retirement plans for nongovernment workers. New York City and Philadelphia all have considered doing so under a former federal safe harbor discussed more in detail below. Despite looming obstacles, Seattle Mayor Tim Burgess (D) signed legislation that establishes a Seattle Retirement Savings Plan. The program is the nation's first city-facilitated retirement savings plan administered by an outside private party for the benefit of private sector workers. The future of the Seattle Retirement Savings Plan is unclear because it may run afoul of Federal Law.

Federal Action on State & City-Run Retirement Plans

There has been significant debate across the country as to whether a state or city-run plan for private sector workers is a pension plan covered by the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor (DOL) finalized rules in August 2016 for states and in December 2016 for cities and other large political subdivisions that granted a safe harbor for them to establish payroll deduction individual retirement accounts for private-sector workers who do not have access to workplace retirement savings programs. Specifically, the safe harbor allowed for states and cities under which select payroll deduction plans were offered to be excluded from the definition of an "employee benefit plan" as defined under and governed by ERISA. The ERISA exemption strips Americans of federal consumer protections and imposes a new burden on employers by creating a patchwork of laws across the country. The safe harbor offered states and cities a "green light" to establish these types of plans. However, in 2017 both safe harbor rules were repealed by Congress with the approval of President Trump.

FSI was instrumental in the effort to repeal DOL safe harbor rules allowing states, cities and other large political subdivisions to set up private-sector retirement savings programs because we believe the private sector, with the helpful support of state and city legislators, is better positioned to address the retirement crisis. Without the benefit of the safe harbor, a court will likely determine that these plans are subject to or preempted by ERISA. Recently, a lawsuit was filed against the State of Oregon challenging the State's requirement that all employers register with the state and certify whether they maintain qualified retirement plans for their employees so as to be exempt from participation in the mandatory state IRA program[12]. Similar lawsuits can be expected as state-law implementation dates draw nearer. ERISA coverage and preemption would ultimately only be determined through litigation, leaving a great deal of uncertainty as to the viability of state and city-run retirement programs.

ERISA Coverage and Preemption

Subject to certain exceptions, ERISA governs any pension benefit plan established or maintained by an employer or employee organization for its employees.[13] It accomplishes this through a

[12] The ERISA Industry Committee v. Read, Case No.3:17-cv-01605 (D. Or. Filed October 12, 2017).

[13] Although many of the proposals are described as a state-sponsored retirement plan, the plans would not qualify as governmental plans for purposes of the ERISA exception because the plan would cover employees of a private employer, and not employees of the government. ERISA section 3(32). *See also* DOL Adv. Opin. 2012-01 A, concluding

broad preemption clause that provides that ERISA "shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan."[14] The United States Supreme Court has explained that the purpose of this broad preemption clause is to "establish a uniform administrative scheme, which provides a set of standard procedures to guide processing of claims and disbursement of benefits."[15] ERISA's legislative history reflects that preemption was intended to eliminate the threat of a multiplicity of conflicting state laws, and to achieve broad preemptive effect in the areas of record-keeping, reporting and disclosure.[16]

Further, many of the proposed plans directly contradict the two main objectives of ERISA:

- Uniformity. ERISA is designed to encourage employer sponsorship of employee benefit plans by protecting employers from being subjected to varying state law standards and instead creating a uniform body of federal law to govern such plans. Subjecting employers to multiple state retirement plan programs is exactly what ERISA's preemption clause was designed to prevent.

- Protection of plan participants. An arguably even more important principle of ERISA is to protect the promised benefit to plan participants and their beneficiaries. This is accomplished by (i) subjecting those who administer plans and manage plan investments to a high fiduciary standard of care; (ii) setting forth a number of specific "prohibited transactions" between plans, fiduciaries and other "parties-in-interest" to a plan; and (iii) imposing a number of reporting and disclosure requirements. States that are conditioning their programs on ERISA "relief" seek to avoid these core ERISA requirements designed to protect employees. Some proposals have gone so far as to impose ERISA-type fiduciary duties on the state while at the same time attempting to avoid liability by directing that those responsibilities be assigned to outside parties.[17]

The structure of mandatory city and state-run retirement plans suggest that if the programs are indeed ERISA plans, these state laws are likely to be preempted by federal law, ERISA. The courts and the DOL must consider whether the plans comply with a regulatory safe harbor for payroll-deduction IRAs. It is unlikely that these plans will qualify.

Excessive Costs and Administrative Issues

State studies and testimony by state agencies uniformly cite the high costs of a state-run plan as a serious problem. The costs of administration and investment management, together with the potential liabilities associated with those activities, have been a serious impediment to the passage of many proposals.[18] Further, neither state proposals nor the DOL's proposal has discussed implementation costs for participants in state-run retirement plans.

The following examples of administrative complexities and costs have been cited in state feasibility studies:

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that the State of Connecticut Group Health Plan would no longer qualify as a governmental plan if it permitted employees of certain nonprofit corporations to participate.

[14] ERISA Section 514(a)

[15] *Egelhoff v. Egelhoff*, 532 U.S. 141, 148 (2001).

[16] *See, e.g., Liberty Mutual Insurance Co. v. Donegan*, 746 F.3d 497, 503 (2d Cir. 2014).

[17] Ohio S.B. 199.

[18] In 2014, the Connecticut legislature, for example, considered passage of a bill establishing a state-run mandated plan but ultimately rejected it, instead passing a bill that only authorized a feasibility study of such a plan.

- Underestimates of Cost: The California Department of Finance opposed S.B. 1234, concluding that much of the bill is fiscally unworkable. Under the bill, annual administrative costs are capped at 1%, but this amount would be taken up by required insurance premiums to the federal Pension Benefit Guaranty Corporation alone, and the California general fund lacks the resources to absorb additional costs. The Department also expressed concern about "multi-billion dollar" liability if investment returns fail to achieve the guaranteed level under the bill. The Illinois law caps expenses at 0.75%, yet the program contemplates the need for purchasing guaranteed insurance contracts. The Joint Interim Task Force on Oregon Retirement Savings reached similar conclusions.

- Start-Up Costs: All of the studies recognize that although the plans are intended to be self-sustaining, there will be considerable start-up costs that will have to be absorbed by the state. These costs can include plan documentation, systems design, communication to employers and costs of obtaining regulatory relief from federal government agencies. In addition, there will be an initial period of time, variously estimated as between two and seven years, before the plans accumulate enough assets to be self-sustaining with regard to ongoing expenses. The state will bear the administrative costs during that time period as well.[19]

- On-Going Costs: Many studies, including California's, concluded that the state would need to expend additional resources, including the creation of new administrative departments and additional staffing. Staffing would have to include personnel skilled in retirement plan administration and investment management who would command a high salary.[20] Ongoing costs will be greater in states that are proposing mandatory participation, as the cost of enforcement activities would also need to be considered.

- Administrative Inefficiencies: Studies have also questioned the assumption that pooling small employers into a single plan leads to administrative efficiencies. Diversity in individual employer recordkeeping systems and payroll processes will require much work at the centralized state agency operating the plan.[21]

- Current Economic Environment: Many studies express concern that these additional costs are not prudent in the current economic environment.[22] Similarly, many question this use of resources by states that are dealing with severe underfunding of existing public pension plans.[23]

- Potential liabilities to the state. There has been significant debate across the country as to whether a state-run plan for private sector workers is a pension plan covered by ERISA. Many states that have adopted state-run retirement plans will have to ensure that their program is structured to meet the DOL safe harbor before opening it for enrollment, which

[19] *E.g.*, Tennessee SJR 1075 Feasibility Study Report; Maryland Voluntary Employee Accounts Program Study; Washington Voluntary Accounts Report to the Legislature.
[20] *See* Testimony of Maine Department of Labor in Opposition to LD 1473.
[21] Maryland Voluntary Employee Accounts Program Study, citing a report prepared by AARP.
[22] Testimony of Maine Department of Labor in Opposition to LD 1473; Tennessee SJR 1075 Feasibility Study Report.
[23] *See* ACLI Public Policy Issue Brief on State-run Retirement Proposals.

could result in significant changes to the different programs as envisioned. Of course, even with a safe harbor, legal challenges are possible.

- State Common Law Liability. Even if efforts to obtain an ERISA exemption were successful, that would not remove the state's fiduciary responsibilities and potential liability. ERISA is a codification of the common law of trusts, thus a state would still be subject to similar duties and exposures under that body of law as it would be under ERISA. Many of the proposals have even incorporated ERISA's fiduciary duties and some ERISA-prohibited transactions into the proposals.

- Litigation Costs. States must anticipate a legal challenge to its plan's attempt to avoid ERISA. For example, a lawsuit could be brought by employers unhappy with being forced to participate in a mandated program, or by participants with regard to proposals that attempt to avoid ERISA and make the state immune from fiduciary responsibility. The cost of litigation, as well as wasted resources in developing the program should it be determined to be preempted by ERISA, are real economic risks that need to be carefully considered.

Employer Resistance
Small businesses have expressed concern about the current proposals, especially those that mandate participation.[24] Studies show that employers and employees have questioned the need for state-run plans when federal law already provides for low-maintenance plans for small employers (e.g., payroll-deduction IRAs, SEPs and SIMPLEs.)[25]

Leakage from Existing Plans
In addition to limiting the growth of stronger workplace retirement savings options such as 401(k)s, a state or city-run retirement plan could also encourage employers with strong existing plans to drop them in favor of the state alternative. This would be counterproductive, particularly since the state or city alternative likely will be subject to lower contribution levels and have no matching of employee contributions. The loss of an employer match is particularly concerning as a match is provided by roughly 9 out of 10 employers[26] who offer a workplace retirement plan, and the most common match is a dollar-for-dollar match[27] that can effectively double a worker's savings rate.

FSI's Proposed Solution to Enhance Retirement Security
As the experience with state retirement systems demonstrates, the maintenance of any substantial state or city-run retirement plan is challenging. If the complexities of an ERISA-regulated environment and multiple, unrelated employers with vastly different human resources and payroll systems are added, undertaking that challenge becomes imprudent, even if many of the operational functions could be outsourced to established retirement plan providers. Given the ongoing convergence of and thin profit margins for these providers, it is improbable that a state

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[24] *See, e.g.*, National Federation of Independent Businesses comment letter to Connecticut Retirement Security Board.
[25] California Department of Finance Bill Analysis of S.B. 1234; Tennessee SJR 1075 Feasibility Study Report.
[26] *See* WorldatWork and American Benefits Institute, "Trends in 401 (k) Plans and Retirement Rewards," March 201 3 at p. 11.
[27] *See* Society for Human Resource Management, "Dollar for Dollar is Now Most Common 401(k) Match," October 30, 2015.

or city-run plan could achieve cost efficiencies (absent subsidization by the state treasury) that are sufficiently meaningful to materially incentivize employer and employee participation.[28]

There are, however, other important and unique ways that states or cities might advance retirement security for their citizens employed in the private-sector, without the complications and risks of operating a state-run retirement plan. Ideally, any such approach would avoid ERISA entanglements for the state, minimize cost and liability exposure to the state and encourage both employers and employees to overcome their existing predispositions against retirement savings. FSI's members would be pleased to work with a state or city on any of these initiatives.

Marketplace Plans

Marketplace Plans provide a method for employers to assist employees to save for retirement without the necessity for the employer to sponsor an ERISA-covered plan. Through such a marketplace, employers can take advantage of existing ERISA and non-ERISA private-sector retirement savings offerings. Key features of a Marketplace Plan would include: (a) Employer involvement is limited to permitting IRA providers to publicize program and to collect contributions and remit to providers and; (b) Participation by employers and employees must be voluntary.[29]

These ERISA-exempt payroll deduction IRAs address many of the concerns small employers have about maintaining retirement plans, but the limitations on employer involvement often create practical difficulties. FSI suggests that employer hardship can be mitigated by facilitating ERISA-exempt payroll deduction IRAs in a variety of ways. At a minimum, the state or city could provide educational and awareness programs to employers of the existence and advantages of ERISA-exempt payroll deduction IRAs. The state or city could also set up an online clearinghouse in which IRA providers authorized to conduct business in the state could offer their programs, providing a one-stop shopping concept for employees. State and city involvement could be limited to maintaining a website and selecting the providers who could participate on it. Employers could direct employees to the website, and only take needed steps to facilitate the payroll deduction. This alone would mitigate many of the practical difficulties small employers face in qualifying for the ERISA exemption.

As federal law and retirement offerings evolve to extend the retirement system to small employers, a state with a well-designed exchange could be at the forefront of the enhanced retirement security those developments make available.[30] Washington will be the first state to offer a Marketplace Plan for private-sector workers. The Washington Small Business Retirement Marketplace will be available in January 2017. Through the marketplace platform, private sector workers will be able to choose among several established retirement plan providers, which will be screened by Washington State Department of Commerce. We expect the Small Business Retirement Marketplace to be very successful.

Publicity and Education Campaigns

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[28] See Tennessee SJR 1075 Feasibility Study Report; Maryland Voluntary Employee Accounts Program Study, both of which question the assumption of greater efficiency.

[29] A number of the proposals for state-run retirement plans appear structured on this model, although those proposals often raise ERISA questions to which there are no answers and overlook that states are not authorized providers of IRAs.

[30] For example, a number of 401(k) reform proposals are currently before Congress, and both statutory and regulatory changes are currently being considered for "multiple employer plans" that could expand their usage. Also, some retirement plan providers and intermediaries, including FSI members, are now taking responsibility for many of the ERISA fiduciary functions that small employers would otherwise bear.

While the Choose to Save®[31] campaign, the Financial Services Roundtable Save 10[32] program and other private-sector efforts devote significant resources to retirement literacy, states and cities can support retirement security simply by raising awareness and providing educational materials.[33] Suggested basic methods include:

- Raise awareness of existing retirement saving opportunities for individuals and small employers through public service announcements in the form of media ads and on government websites.
- Provide retirement educational materials at various points of contact with the state, e.g., new business start-up packages, tax return packages and government offices such as the Department of Motor Vehicles.
- As part of a long-term solution, incorporate retirement planning education as part of K-12 curriculum.

States and cities could go a step further and facilitate employer sponsorship by providing employer assistance with participant educational and enrollment materials. Certain materials could be provided that would lower start-up costs to the employer without significant liability risk to the state.

Financial Incentives
States and cities may be able to provide financial incentives for retirement savings at far less cost and exposure than that associated with operating a state-run plan. For states and cities that do not already do so, a tax credit similar to the federal savers credit could be provided to lower income employees who contribute to IRAs or employer-sponsored plans, whether through employer payroll deduction or otherwise. A one-time tax credit could also be given to small employers that do not have a plan in place when they first set up a payroll deduction IRA or employer-sponsored plan. The tax credit would be designed to offset some or all of the start-up costs for the program. In cases where reluctance to participate in the retirement system on the part of either employers or employees is sourced in economic considerations, these sorts of incentives may be a direct and more state budget-friendly way to advance retirement security. At least one state has included tax credits as part of its proposal.[34]

Conclusion
While there is no question that the goals of the current mandatory state and city-run retirement proposals are commendable, they fail to consider and vastly underestimate the potential costs and liabilities. Appropriate retirement plan solutions already exist, and studies and experts concur that the best way of achieving increased retirement savings is leveraging those existing solutions through education and incentive Marketplace Plans.

As a result, FSI supports the creation of state and city-run retirement plans that include financial advisors by setting up an online clearing house. The online clearing house would be designed to allow authorized IRA providers who conduct business in the state to offer their programs, providing a one-stop shopping concept for employer and employees. State and city involvement

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[31] Choose to Save ® campaign *available at*, http://www.choosetosave.org/
[32]Save 10 Program *available at*, http://www.fsroundtable.org/category/save10/
[33] Registered mark of the Employee Benefit Research Institute and its American Savings Education Council (ASEC) program.
[34] Illinois S.B. 2758

could be limited to maintaining a website and selecting the providers who could participate. Employers could simply direct employees to the website, and only take needed steps to facilitate the payroll deduction. This alone would mitigate many of the practical difficulties small employers face in qualifying for the ERISA exemption.

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