

Retirement Income Team Newsletter

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Dear Reader:

This newsletter is published by the Drinker Biddle Retirement Income Team - a group of attorneys whose combined focus is on retirement income investments and products - but whose individual specialties include employee benefits, securities law, investment management, insurance, income taxation and government relations.

The purpose of the newsletter is to inform our clients and friends about issues of interest to the investment managers and insurance companies that create retirement income vehicles, people in their organizations who deal with the compliance issues, advisers and consultants who assist in the distribution of those products and services, and retirement plan sponsors who evaluate and select them.

With the aging of the baby boomers and the ongoing retirement of the first generation of 401(k) participants, the issue of retirement income is gaining in importance. The question is: how will the average retiree invest and withdraw his or her money in a way that it lasts for a lifetime (and the lifetime of the retiree's spouse), regardless of whether that is 10, 20, 30 or more years? That is a complex and difficult task.

Because of these issues, we believe there is a need to focus on the laws and compliance issues of importance to retirement income products and services. That is the work of our Retirement Income Team. Because of our combined expertise, we are able to address

those issues arising under insurance and securities laws, as well as those under ERISA that govern the use of those products and services in 401(k) and other defined contribution retirement plans. It is a unique combination that we believe offers value to our clients.

Before ending this introduction, I want to thank John Blouch for his leadership of our Team since its inception. John is an outstanding attorney and a good friend. But, at this stage of life, he has decided to become the object of our focus... that is, John has become a retiree. John, we will miss you.



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Julie A. Govreau Joins Drinker Biddle

We are proud to announce that Julie A. Govreau has joined Drinker Biddle & Reath LLP as counsel in the firm's Employee Benefits and Executive Compensation Practice Group. Julie focuses her practice on all aspects of employee benefits law, including ERISA litigation, deferred compensation plans, defined benefit plans, nonqualified deferred compensation plans, executive compensation arrangements, employee stock ownership plans, multiemployer plans (withdrawal liability), and welfare benefit plans. She also has experience practicing general labor and employment law. Julie is admitted to practice before the U.S. Department of Veterans Affairs and represents a number of veterans seeking VA benefits pro bono.

Update on Retirement Income Projections



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In our last newsletter, we wrote about the DOL's Advance Notice of Proposed Rule Making (ANPRM) concerning the projection of retirement income on ERISA participant benefit statements. Since that article was published, a number of plan sponsor and service provider organizations have filed their comments with the DOL, and the comment period has now expired. This article contains a general summary of the comments and our view of the next steps.

The DOL will now begin its review of the comments filed by the private sector. Many of the comments were thoughtful and detailed... which will give meaningful input to the regulatory process. Different comments filed by a number of knowledgeable and credible organizations supported almost all of the alternative approaches suggested by the DOL, meaning that the comments often conflicted with each other. Also, many of the organizations noted significant disagreement on key issues even within their own membership. As a result, the DOL should find some level of support (and some level of dissent) for virtually any avenue that it decides to pursue. Examples of the alternatives discussed include whether the projections should be made mandatory or merely voluntary with a fiduciary safe harbor to encourage their use, and even whether the project should be abandoned entirely in favor of online calculators for plan participants.

Realistically though, we suspect that the DOL will,

after reviewing the comments, draft a proposed regulation that mandates retirement income projections on participant benefit statements. While some employer organizations and service provider organizations argued against the mandate, organizations that represent employees, participants and retirees were nearly unanimous in arguing that mandated projections would provide value to plan participants.

Allowing for a reasonable period of time to review the comments and draft a proposed regulation, it is possible that a regulatory package could be sent to the Office of Management and Budget (OMB) in mid-first quarter 2014. It ordinarily takes the OMB three months for its review, which suggests that the proposed regulation would not be publicly available for comment until well into the second quarter. That would then be followed by a comment period and perhaps public hearings. Allowing time for that, together with the development of the final regulation and its review by the OMB, would add another seven to nine months to the process.

So, our "best guess" is that we could have a final regulation in the second quarter of 2015, but with a deferred effective date to allow time for system changes and other necessary implementation steps.

Once again, the DOL received comments from knowledgeable and credible organizations that would support almost any outcome. That said, based on our reading of the comments, we think that the following are "high possibility" outcomes:

- The projection of retirement income on benefit statements will be mandated.
- There will be a safe harbor... of sorts. Many of the commenters responded unfavorably to the safe harbors in the ANPRM, which consisted largely of fixed assumptions. These commenters suggested that fixed percentages are too rigid and would inhibit innovation and efforts to improve the quality of projections by adjusting assumptions over time to reflect "real life" shifts in the interest rate and capital markets. Instead, they recommended that the DOL provide retirement income projection guidelines similar to the investment education guidelines in Interpretive Bulletin 96-1. At a high level, this approach would ensure that plan sponsors could avoid having their projections deemed to be fiduciary "investment advice" (and avoid corresponding potential liability) so long as they are based on reasonable assumptions and do not steer plan participants toward specific investment prod-

ucts. We believe there is a significant possibility that the DOL will adopt this approach in developing the proposed regulation.

- Most of the commenters suggested that plan sponsors should be able to select from among a variety of methods for projecting the payment of retirement income. For example, some of the commenters favor the withdrawal method, rather than the annuity method. Others prefer the annuity method, but with the calculations based on commonly accepted actuarial assumptions, rather than the specific annuity contracts offered by each particular plan. We believe that there is a significant possibility that the DOL will adopt the latter alternative.

Those are our thoughts. At best, it is a guessing game. So, we encourage readers to view this as our attempt to “handicap” the odds rather than make specific predictions.

Fred Reish is chair of the Financial Services ERISA practice at Drinker, Biddle & Reath. Fred has been recognized as one of the “Legends” of the retirement industry by both PLANADVISER magazine and PLANSPONSOR magazine. He was selected as one of the top ten most influential individuals in the 401(k) industry for 2012 by RLABiz. Fred has also received the IRS Commissioner’s Award and the District Director’s Award; the Eidson Founder’s Award by the American Society of Professionals & Actuaries (ASPPA); the Institutional Investor and the PLANSPONSOR magazine Lifetime Achievement Award; and the ASPPA/Morningstar 401(k) Leadership Award. Fred was recently selected by American Lawyer Media and Martindale-Hubbell as a 2013 Top Rated Lawyer in Labor & Employment.

Bruce Ashton is in the firm’s Financial Services ERISA and Retirement Income Teams. Bruce’s practice focuses on all aspects of employee benefits issues, especially representing plan service providers (including RLAs, independent record-keepers, third party administrators, broker-dealers and insurance companies) in fulfilling their obligations under ERISA and in assisting service providers and plan sponsors in addressing the retirement income needs of participants. He is a well-known speaker and author on employee benefits topics.

Joshua Waldbeser has been in the Employee Benefits and Executive Compensation Practice Group at Drinker Biddle & Reath’s Chicago office since 2008. Prior to this he worked for the U.S. Department of Labor, Employee Benefits Security Administration. Joshua’s practice focuses on working with plan sponsors and service providers with respect to Title I of ERISA and the IRS qualification requirements for retirement plans.

The Role of Managed Payout Funds in Retirement



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Managed payout funds are mutual funds designed to provide a steady stream of retirement income while still allowing retirees access to their money during their lifetime. Managed payout funds are of relatively recent vintage (2008). The launch of these products coincided with the economic downturn, which adversely affected their popularity and growth for a time. As the economy has rallied, however, managed payout funds are gaining more assets. Managed payout funds make periodic distributions at a specified annual or monthly rate, but because they are mutual funds and not insurance products, they cannot offer a guarantee that payments will continue for a specified period or the life of the retiree.

Managed Payout Funds vs. Annuity-Like Products

Managed payout funds are often compared to annuity products or annuity-like products such as guaranteed minimum withdrawal benefits (GMWBs). There are key differences, however. In particular, annuity participants generally relinquish their retirement account (and access to its value during life) in return for guaranteed payments. A GMWB is an insurance product, owned by the investor, that provides guaranteed income for a retiree’s life as long as the retiree does not withdraw more than a specified percentage from the fund each year; if the retiree opts for larger withdrawals, the lifetime income guarantee is forfeited. Managed payout funds allow investors to withdraw more than the payout (or their entire investment) at any time, but this liquidity benefit is offset

by the loss of the anticipated payout. While managed payout funds seek to provide steady income to investors, such payouts will generally rise and fall depending on market conditions. It is possible for a managed payout fund to suffer substantial investment losses and simultaneously experience additional asset reductions as a result of distributions to shareholders. Thus, managed payout funds are a useful investment tool when combined with more certain sources of retirement income. For example, it may be prudent for a retiree to buy an annuity or GMWB to cover fixed costs and invest in a managed payout fund for discretionary spending that can be scaled back if the fund underperforms.

Types of Managed Payout Funds

Managed payout funds generally fall into two categories: those that pay out indefinitely and those that pay out for a set term and then liquidate (i.e., reverse target date funds). A principal difference between these types of funds is that the income for the indefinite payout funds will tend to vary more than the reverse target date type funds.

Indefinite Payout Funds. Indefinite payout funds function as you would expect. They are designed to pay out monthly income for an indefinite period of time. Schwab Funds and Vanguard Funds typify this type of funds.

Schwab offers three types of monthly payout funds: moderate payout, enhanced payout and maximum payout. Each fund type has the same investment objective: to seek to provide current income and, as a secondary investment objective, capital appreciation. Each fund is also a fund of funds, meaning that its principal investment strategy is to invest in other Schwab funds, which are a mixture of equity, fixed income and money market funds. The main difference among the three funds is the target asset allocation used to achieve the investment objective suggested by the name of each fund. The funds' principal risks are linked to those of the underlying funds and the adviser's ability to manage the fund to produce the monthly payout goal. The Schwab maximum payout fund aims to provide monthly income in the ranges of 1-5% in a low interest environment and 5-8% in a high interest rate environment. The other two funds aim for progressively lower percentages.

Vanguard also offers three different managed payout funds. Their investment objectives are to make

monthly distributions of cash while seeking to provide inflation protection and capital appreciation. Vanguard's managed payout funds operate similarly to that of the three Schwab funds in that they have different asset allocation strategies geared to their distribution goals. They, too, are funds of funds, and their principal risks are similar to that of the Schwab managed payout funds. The monthly distribution goals range from 3-7% depending on the fund.

Reverse Target Date Funds. Fidelity's and PIMCO's fund offerings are examples of reverse target date funds. Essentially, these funds aim to pay out all of their principal and earnings by a date certain, thus the monthly income paid to investors is a combination of both principal and earnings. Fidelity has at least 14 of these funds with target liquidation dates ranging from 2016 to 2042. The allocations become more conservative over time. The Fidelity funds invest in all types of affiliated funds, in contrast to PIMCO's two managed income funds that liquidate in 2019 and 2029, respectively, and seek to invest at least 90% of their assets in "laddered" inflation-indexed Treasury bonds. PIMCO's investment objectives are to provide "consistent real (inflation-adjusted) distributions" through the maturity of the fund. The Fidelity managed payout funds' investment objectives seek total return through a combination of current income and capital growth, but their returns are not inflation adjusted like the PIMCO funds. Each of these reverse target date funds aims to make distributions that gradually increase over time to the date of maturity of the fund.

A main difference between the reverse target date funds and traditional target date funds is that the former seeks to provide monthly income for the investor *through* retirement, whereas traditional target date funds are designed to provide the investor with assets by the time of retirement.

Conclusions

Managed payout funds are relatively new and are only starting to gain traction in the market as investors and their advisers become more knowledgeable about how to use them. Generally, they are not necessarily intended to be an investor's sole source of income because their monthly income is not guaranteed. They are probably most useful for investors who have other sources of steady income, whether they be annuities, GMWBs, pensions or other sources.

Diana McCarthy has substantial experience in representing a broad spectrum of investment management clients including: registered open- and closed-end investment companies; private investment entities; exchange-traded funds; and broker-dealers. She has counseled multiple class funds, funds serving as underlying investment vehicles for variable insurance products and multimanager funds. In addition, she regularly counsels investment advisers on regulatory requirements, risk management and compliance issues, and has handled a number of reorganizations of investment products and acquisitions and mergers of investment companies and investment advisers.

David Williams has experience in representing and counseling a variety of clients in the investment management industry. He has prepared registration and proxy statements and handled various securities filings for both open-end and closed-end funds. He has counseled multi-series and multi-class funds and their boards, money market funds, exchange-traded funds, multi-manager funds and investment advisers. David's practice also focuses on representing and advising sponsors of unregistered investment funds organized both in the United States and offshore.

Variable Annuity Contracts May Require Continuing Attention – What Broker-Dealers Need to Know



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The Variable annuity contract (“Contract”) sales practices were again included in the Financial Industry Regulatory Authority’s (“FINRA”) 2013 Regulatory and Examination Priorities Letter as among the “key investor protection and market integrity issues” that it

will focus on in the coming year. This article discusses two potential risk areas that broker-dealers should consider in connection with the Contracts that their registered representatives (“Advisors”) sell, and steps that they can consider to mitigate these potential risks.

Contracts often contain provisions permitting the annuity provider to implement future changes or require action by the policyholder (the “Client”) as a condition to receiving the guaranteed payment. Broker-dealers whose Advisors recommend Contracts to Clients that include these provisions should consider whether those Contracts should be monitored on an on-going basis to ensure continued suitability, and to determine whether future Client communications would be prudent.

Broker-dealers whose Advisors recommend Contracts have an obligation under FINRA rules to ensure that recommended products are “suitable” in light of the Client’s financial needs, investment objectives, and other relevant information. As a general matter, to carry out this obligation, the broker-dealer and/or Advisor will evaluate the Contract’s terms, asset allocation and investment line-up and determine whether those characteristics align with the Client’s financial needs, objectives and circumstances. What if - after undertaking this analysis and recommending a Contract that is suitable for the Client - the Contract’s terms, asset allocation and/or investment line-up is significantly modified?

Recently, annuity providers have exercised their contractual right to make changes to existing Contract terms, including investment line-up changes, shifts in asset allocation and the imposition of investment restrictions. These changes have presented a challenge for Advisors because a Contract as modified in this way may no longer be suitable for the Client. In addition, Contracts may contain provisions that require the Client to take action in order to avoid lapse of the guaranteed payment. If a Client fails to take such required steps, and as a result loses the guaranteed benefit, the Client may try to claim that the Advisor had an obligation to remind them of the required action. These provisions create risk that broker-dealers may want to consider mitigating.

How can broker-dealers address these challenges? One of the most effective ways to address these issues, at least as a first step, is Advisor training. Broker-dealers can review their Advisor training materials to ensure that the issues discussed above are addressed in an appropriate manner. Secondly, broker-dealers may want to consider a specific suitability review process for Contracts, to

ensure that these issues are considered by the Advisor at the time the Advisor is making a recommendation of a specific Contract to a specific Client. Finally, broker-dealers may want to consider whether specific compliance/supervisory procedures that monitor changes to Contracts purchased by Clients are feasible.

Broker-dealers also should consider whether proactive steps for existing Contracts are warranted as a risk mitigation tool. These steps could include identifying those Contracts held by Clients that contain these provisions and determining whether monitoring of these Contracts is warranted and feasible. Where an existing Contract requires policyholder action to avoid lapse of the guarantee, broker-dealers should consider whether a communication to Clients about the lapse and the steps the Client needs to take to avoid the lapse is feasible. We can assist broker-dealers in developing specific compliance and supervisory procedures to help address these issues.

Mark Costley, working out of the Washington, DC Investment Management Practice Group, focuses his practice on the representation of financial services companies on matters relating to the development and offering of investment products and services. Mark has over 25 years of experience in the financial services industry. He represents a wide variety of broker-dealers and investment advisers in all aspects of their businesses. He also regularly advises mutual funds and exchange-traded funds. Mark advises clients on the distribution of securities, regulatory investigations and enforcement proceedings.

Joan Neri is in the firm's Financial Services ERISA Team. With more than 25 years of experience, Joan counsels clients on all aspects of ERISA compliance including fiduciary responsibility and plan operational issues. A part of Joan's practice includes representing registered investment advisors in fulfilling their obligations under ERISA. Joan is a frequent speaker throughout the country on legislative and regulatory developments impacting ERISA fiduciaries.

Surviving DOL Investigations of Plans - Part II

Look for invitations soon in your inbox for Part II of "Surviving DOL Investigations of Plans." The October 1, 2013 webinar on this topic created more questions than we had time to answer, so we will be presenting a second part on December 18, 2013 at 9 am pacific/noon eastern... just to answer those questions. Registration will be open soon, and posted to the Drinker Biddle website under <http://www.drinkerbiddle.com/resources?Section=Events>.

Selecting an Annuity Provider: Part III



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In earlier newsletters, we discussed two of the key issues for selecting an insurance company to provide guaranteed income for retirees under 401(k) and other defined contribution plans. We explained that the process is not inherently different from - or more difficult than - other fiduciary decisions (for example, selecting investment products or providers). We pointed out that the DOL safe harbor regulation is helpful, but does not give specific guidance on what information should be reviewed. We described some of the information a plan committee or other fiduciary should consider, noting that a plan committee does not need to predict the future, but instead just needs to make an informed, prudent decision.

In this article, our focus is again on the fiduciary process of selecting an insurance company.

But first, why should a plan consider offering a lifetime income guarantee? By "lifetime income guarantee," we mean an annuity (or other product provided by an insurance company) that guarantees a stream of payments for the life of a retired participant, and possibly his or her spouse. The reason to offer a guarantee is to eliminate, or at least reduce, the risk that a retiree will outlive the money in his or her plan account or rollover IRA. Elements of this risk include the possibility of living longer than expected, market downturns at the "wrong" time, the impact of withdrawing retirement funds too quickly and the erosion of critical decision-making capacity as the retiree ages. A guarantee of payment for life addresses those risks.

How should a committee select an insurance company? ERISA requires fiduciaries to engage in a prudent

process, which entails gathering and assessing relevant information and making a rational decision based on that information. But what if the committee just selects a well-regarded insurance company that has a long history of providing annuity benefits to thousands of annuitants? In one case, then Appeals Court Judge Antonin Scalia (now Supreme Court Justice Scalia) said that “[e]ven if a trustee failed to conduct an investigation before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway.”¹ In other words, if other fiduciaries would have chosen that insurance company after engaging in a prudent process, the committee making the same choice - but without conducting an investigation - would not be exposed to liability.

We are not advocating that fiduciaries avoid engaging in a prudent process. However, it may help a committee feel comfortable with its decision if it knows that many others have chosen that insurance company to provide guaranteed retirement income.

With that in mind, what information should a committee consider? Among other factors, some key issues for evaluating insurance companies include the following:

¹ *Roth v. Sanyer-Cleator*, 16 F.3d 915, 919 (8th Cir. 1994); *Herman v. Mercantile Bank, N.A.* 143 F.3d 419, 420 (8th Cir. 1998). See also, *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 300 (5th Cir. 2000): “ERISA’s obligations are nonetheless satisfied if the provider selected would have been chosen had the fiduciary conducted a proper investigation.” Note, however, that while the “hypothetical prudent fiduciary” standard may protect a fiduciary that engaged in an imprudent search from being liable for *damages*, it may not prevent an injunction against the fiduciary from acting on behalf of the plan in the future. See, *Brock v. Robbins*, 830 F.2d 640, 646-647 (7th Cir. 1987).

- Whether the company is regulated by all, or almost all, of the states. The degree of scrutiny by state regulators varies from state to state, but many state agencies conduct thorough, detailed and rigorous investigations; fiduciaries can take comfort in their findings of soundness.
- The company’s commitment to the annuity or guaranteed income business assessed by the number of guaranteed income contracts and total assets in guarantees.
- The quality and consistency of the company’s ratings across all of the major rating agencies.
- The consistency of the ratings over an extended period (generally, at least one economic cycle). The long-term financial stability of an insurance company - expressed by uniformly high ratings over extended periods of time - is particularly important for selecting a provider that will pay benefits many years in the future.

For further information regarding the issues discussed in this article, see the White Paper we published in May 2012 (co-authored with Joe Faucher) titled “Lifetime Income in Defined Contribution Plans: A Fiduciary Approach” at www.drinkerbiddle.com/resources/publications/2012/Lifetime-Income-in-Defined-Contribution-Plans?Section=Publications.

Retirement Income Team Around the Firm

On October 15, 2013, **Joan Neri** spoke at a panel discussion in Philadelphia, sponsored jointly by Drinker Biddle and The CEO Trust, called "Is Your Business Ready for Health Reform."

Fred Reish was quoted in the October 9, 2013 *benefitspro* article, "Fiduciary rules could spawn thousands of RIAs."

On October 14, 2013, **Fred Reish, Bruce Ashton** and **Josh Waldbeser** spoke at the Drinker Biddle Fiduciary Forum in Chicago.

Fred Reish gave a keynote address and spoke at the October 7-9, 2013 CFDD conference in San Antonio, Texas, as well as speaking on "Do Participants Benefit from Revenue Sharing." **Bruce Ashton** spoke at the conference on "What Advisors are Experiencing and Doing about 408(b)(2) Disclosures," and he presented a "Mock Plan Sponsor Committee Meeting."

On October 7, 2013, **Fred Reish's** LinkedIn email was sent to his contacts on "Selection and Monitoring of Target Date Funds." Fred's prior LinkedIn transmissions may be found as "Insights" on Fred's blog, at www.fredreish.com.

Summer Conley was a speaker at the IA Fall Compliance Best Practices Summit on October 4, 2013.

Fred Reish, Bruce Ashton, Brad Campbell, Josh Waldbeser and **Heather Abrigo** hosted a webinar on October 1, 2013 on "Surviving DOL Investigations of Plans," at which over 900 people registered.

Fred Reish and **Joan Neri** co-authored a white paper for Pioneer Investments and fi360 October 1, 2013 on "Custom Target Date Funds."

Joan Neri spoke at the ESOP Workshop sponsored by ING Retirement Services and Focus Pension in New York on September 26, 2013.

On September 26, 2013, **Fred Reish** spoke on "Guaranteed Lifetime Income Strategies in DC Plans" during the Lincoln Financial webcast.

Fred Reish presented at two webinars on September 19, 2013. The first, for TIAA-CREF, was a "Checklist for Selecting Insurers." The second, for Natixis, was on "Evaluating Adviser Compensation."

Summer Conley spoke during a Live Streaming event sponsored by the CFO Alliance on "The Impact of Changing Regulations – Health Care Reform and More."

Fred Reish spoke at the September 18, 2013 Lincoln East Coast Consultant Forum on "Guaranteed Lifetime Income Strategies in Defined Contribution Plans."

On September 12, 2013, **Fred Reish** and **Brad Campbell** held their fifth Inside the Beltway audiocast, which covered a number of DOL-focused topics. All five of the Inside the Beltway presentations may be accessed here: <http://www.drinkerbiddle.com/beltway>.

Joan Neri spoke on "The Impact of Changing Regulations – Health Care Reform and More" in Philadelphia at The CFO Alliance Institute on September 10, 2013.

Summer Conley participated in an audiocast with three other Drinker Biddle lawyers, **Cheryl Orr, Kate Gold,** and **Heather Abrigo,** on "DOMA and Prop 8" on September 9, 2013.

Fred Reish's LinkedIn contacts received an email on "Responsible Plan Fiduciaries and Disclosure Issues" on September 4, 2013.

On August 16, 2013, **Fred Reish** sent his thought on the "The 'Yale' Letters on Fund Expenses" to his LinkedIn connections.

Back by popular demand and a large number of audience questions from the first webinar, **Fred Reish, Bruce Ashton, Brad Campbell, Summer Conley** and **Josh Waldbeser** presented Part II of "Surviving DOL Service Provider Investigations" on July 31, 2013.

Mark Costley was quoted July 24, 2013 in a *Fund Fire* article titled "SEC to Goldman: OK to Skip Manager ADVs."

On July 24, 2013, **Bruce Ashton** spoke on "Keeping Fiduciaries Out of Trouble," during the Ameritas RP Forum.

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Any discussion of tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under Federal tax laws.