Insider

Volume 20 | Number 3 | March 2010

DB Plans Still Face Sizable Funding Obligations Despite Market Run-Up In 2009

Towers Watson has projected aggregate regulatory funded status and minimum required contributions for single-employer defined benefit (DB) plans in a continuing series of studies.[1] To again facilitate discussions in the pension community — particularly about the necessity and the nature of legislative funding relief — we update the projections to reflect new financial and economic conditions and outlooks. Absent a legislative reprieve, we estimate that the funding obligations of DB plans will remain substantial, despite the excellent run in the capital markets in late 2009.

Our model incorporates the current-law provisions of the Pension Protection Act of 2006 (PPA), the Worker, Retiree and Employer Recovery Act of 2008 (WRERA), and March and October 2009 IRS guidance and regulations. The PPA establishes the general seven-year schedule for funding shortfall amortization, and the WRERA essentially allows smoothing of asset values. The March guidance gives sponsors more flexibility in asset and liability valuation methods, particularly in allowing them to choose the most favorable interest rate for valuing their 2009 liability.

Under the PPA, plan sponsors can choose between two interest rate bases for measuring pension liabilities for minimum funding purposes: a one-month average of high-quality corporate bond yields (the “yield curve” approach) and a 24-month average of those yields (the “segment rates” approach). Generally, sponsors must obtain IRS approval before changing interest rate methods. However, in the October 2009 final section 430 regulations, the IRS grants automatic approval for switching to a different interest rate method for plan year 2010. Under these regulations, the IRS also grants automatic approval for a plan using segment rates for 2010 to switch to the yield curve for 2011 or any later plan year (although switching back to segment rates requires IRS approval). The October regulations also allow plan sponsors to change their asset method for 2010 (subsequent changes require IRS approval).

This analysis updates the funding projections for capital market conditions as of Dec. 31, 2009, newer forward-looking assumptions of dynamic asset returns over 2010 to 2013, and the segment rates and composite corporate bond rate (CCBR, as a proxy in the model for the yield curve) recently published by the IRS. **Figure A-1** in the Appendix lists our baseline financial and economic assumptions.

The new results appear in **Figure 1** on page 2. The average funding status is projected to be 87.3% for plan year 2010, 78.1% for 2011, 86.3% for 2012 and 88.3% for 2013. These percentages represent roughly 3.2 and 0.2 percentage-point improvements for the immediate plan years 2010 and 2011, respectively, compared with our October 2009 projections. The improvement is attributable to the market’s continued rally in late 2009 after the good run before October. Based on our assumptions in Figure A-1, plans elect smoothed asset values for

In This Issue

1 DB Plans Still Face Sizable Funding Obligations Despite Market Run-Up in 2009

4 DOL and IRS Ask for Information About Lifetime Income Options for Retirement Plan Participants and Beneficiaries

5 Investments Emerging From Recession: Optimism, Concerns and the Way Forward

News in Brief

4 DOL Issues Guidance on Form 5500 Compliance for 403(b) Plans

8 Court Finds Retiree Health Plan Amendment Violates Anti-Cutback Rule

DOL Proposes Investment Advice Regulations for 401(k)-Type Plans

[1] The studies are published in the January, April, June, October and November 2009 issues of *Watson Wyatt Insider,* Towers Watson.

2009, 2010 and future years, the October yield curve for plan year 2009, segment rates for 2010 and 2011, and the full yield curve again for 2012. Absent the automatically approved 2012 election, the aggregate funded status would be lower by a couple of percentage points.[2]

The minimum required contributions remain substantial — $77.3 billion for 2010, $143.3 billion for 2011, $119.6 billion for 2012 and $122.3 billion for 2013. These results confirm that DB plan sponsors still face considerable funding challenges in the years ahead.

Figure 1. Measured funded status and minimum required contributions under current law

Plan year	Funded status (%)	Contributions ($b)	Extra contributions ($b)
2007	**95.9**	**53.1**	
2008	**96.3**	**38.1**	**0.5**
2009	**93.8**	**32.4**	**0.9**
2010	**87.3**	**77.3**	**1.5**
2011	**78.1**	**143.3**	**12.0**
2012	**86.3**	**119.6**	**1.1**
2013	**88.3**	**122.3**	**0.4**

Notes: Contributions are the minimum required by law. Extra contributions are those assumed to be made by certain plans to avoid benefit restrictions at the 80% funded status level.
Source: Towers Watson.

We now test how funding obligations would change in more optimistic economic and financial conditions (see **Figure 2**, page 3). In Scenario A, strong equity returns in 2010 increase funded statuses by roughly 1.9, 3.5 and 4.9 percentage points for 2011 to 2013, respectively. The use of a smoothed asset value causes the funded status improvement to be phased in rather than being fully reflected in the year of strong returns.

If higher interest rates prevail, as in Scenario B, the funded status improves relative to the baseline case by 7.6, 4.9 and 3.4 percentage points for these years, respectively. This is because the switch from segment rates to full yield curve now occurs in 2011, one year earlier than in the baseline case, thus reducing liabilities significantly.[3]

Scenario C is characterized by both strong equity returns and higher interest rates — the most favorable economic conditions for plan sponsors — which boost aggregate funded status by 8 to nearly 10 percentage points for 2011 to 2013. The minimum required contributions in these years is $45 billion to $50 billion less than under the baseline economic conditions, but still considerably larger than the historical average. It is difficult to quantify the likelihood of these conditions' occurring.

Appendix: The funding model and assumptions

The model simulates plans of various initial funded statuses, asset allocations, valuation methods and active statuses. Weights are applied to these plans to reflect their empirical distributions, as calculated from Form 5500 data files and

[2] The elections of asset and liability valuation methods for plan year 2009 assumed in our model approximate actual elections by about 100 large DB plans that were recently surveyed by Towers Watson.

[3] The full yield curve approach implies greater volatility of calculated liabilities and thus might not necessarily represent the desired long-term choice. Many plan sponsors, however, may feel compelled to use this option by the credit crunch and the lack of cash.

Insider

***Insider* is a monthly newsletter developed and produced by the company's Research and Innovation Center.**

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Figure 2. Measured funded status and minimum required contributions under current law, assuming strong equity returns and/or higher interest rates for 2010

	Scenario A. Strong equity returns of 20%		Scenario B. Higher interest rates		Scenario C. Both	
Plan year	Funded status (%)	Contributions ($b)	Funded status (%)	Contributions ($b)	Funded status (%)	Contributions ($b)
2007	95.9	53.1	95.9	53.1	95.9	53.1
2008	96.3	38.1	96.3	38.1	96.3	38.1
2009	93.8	32.4	93.8	32.4	93.8	32.4
2010	87.3	77.3	87.3	77.3	87.3	77.3
2011	80.0	136.3	85.7	102.0	87.8	94.7
2012	89.8	105.3	91.2	90.4	95.0	74.9
2013	93.2	102.1	91.7	100.3	96.8	77.7

Notes: Assumptions in Scenario A are identical to those in Figure A-1 except for a 20% equity return for 2010. In Scenario B, CCBR is assumed to be 100 basis points higher at the end of 2010 than the baseline assumption of 6.08%, and then to remain at 7.08% through 2013. Segment rates are calculated as 24-month moving averages. Bond return in 2010 is assumed to be zero given the rise in interest rates. Scenario C assumes all the above financial conditions.
Source: Towers Watson.

Towers Watson surveys. These plans elect valuation methods and amortize funding shortfalls as required by the PPA, the WRERA, and IRS guidance and regulations.

Depending on the plan sponsor's election, pension assets are measured at fair market value or smoothed value. The latter is computed as the average value of three year-end market values in the model, includes expected future investment earnings (at no more than a specified interest rate, the third segment rate), and is constrained by the legal requirement that such smoothed value fall between 90% and 110% of market value.

Pension liabilities are valued using either the spot bond yield curve (in actuality, a one-month average, approximated by the CCBR in the model) or the smoothed segment rates (in the model, the second segment rate). These rates are published by the IRS. The model assumes an average duration of 14 years for active plans and nine years for frozen plans.

Certain economic and financial assumptions are also made, as in Figure A-1:

- Asset returns for 2009 are based on the Standard & Poor 500 Total Return and Dow Jones Corporate Bond Total Return indexes as of Dec. 31, 2009.
- The year-by-year average equity and bond returns for 2010 to 2013 are based on Watson Wyatt Investment Consulting forward-looking projections (the January 2010 assumptions in the Global Asset Model developed by Watson Wyatt in 2009 and updated since then based on the legacy Watson Wyatt process), which assume a gradual path to market equilibrium over five years. Monthly returns are log-linearly interpolated.
- At year-end 2011 CCBR is set equal to the end-of-2007 level and then remains constant in 2012 to 2013.
- Future segment rates in 2010 to 2013 are calculated as 24-month moving averages.

Absent a legislative reprieve, the funding obligations of DB plans will remain substantial.

Figure A-1. Economic and financial assumptions at end of calendar year (%)

	2007	2008	2009	2010	2011	2012	2013
Equity return	5.49	–37.00	26.45	9.18	8.92	8.56	8.63
Bond return	5.24	1.80	17.88	2.66	2.55	2.58	5.28
CCBR	6.28	7.90	5.88	6.08	6.28	6.28	6.28
2nd segment rate	5.90	6.38	6.67	6.19	6.09	6.23	6.28
3rd segment rate	6.41	6.68	6.77	6.19	6.09	6.23	6.28

Note: The most favorable CCBR (as a proxy for spot yield curve) for the 2009 plan year was 7.90% in October 2008, while December 2008 had the highest segment rates.
Source: Towers Watson.

DOL and IRS Ask for Information About Lifetime Income Options for Retirement Plan Participants and Beneficiaries

The agencies are considering whether to facilitate arrangements that provide a reliable stream of retirement income.

To improve the retirement security of American workers, the Department of Labor (DOL) and Internal Revenue Service (IRS) are considering whether to promote the use of lifetime income distribution arrangements in employer retirement plans and individual retirement accounts (IRAs). To help them determine whether such steps are called for and, if so, the best way to proceed, the agencies have issued a request for information (RFI) from plan sponsors and other interested parties. Comments are due by May 3, 2010.

Retirement income trends

In defined contribution (DC) plans, participants bear the investment risk — the employer does not guarantee a specific account balance or income stream in retirement. Moreover, while defined benefit (DB) plans generally must make annuities available at retirement, 401(k) and other DC plans most often do not provide annuities. Furthermore, many traditional DB plans have converted to lump sum-based hybrid designs, such as cash balance, and many others have simply added lump sum options. Consequently, the continuing trend away from traditional DB plans to DC plans and hybrid plans — and from annuities toward lump sum distributions — has made employees increasingly responsible for their own financial security after retirement, as well as that of their spouses and dependents.

The request for information

In light of such retirement income trends, the agencies are considering whether to take steps, regulatory or otherwise, to facilitate the availability and use of arrangements that provide a reliable stream of retirement income. They are reviewing existing regulations and other guidance and are considering various changes to these rules. The RFI asks questions about lifetime income options in terms of current plan practices and employee behavior. The RFI also solicits feedback on whether lifetime income payments could be fostered through new kinds of participant education and disclosure, product changes or rule changes.

Towers Watson (TW) plans to respond to the RFI. A future *Insider* article will discuss the TW response.

News in Brief

DOL Issues Guidance on Form 5500 Compliance for 403(b) Plans

The DOL has issued Field Assistance Bulletin (FAB) 2010-01 regarding the revised Form 5500 filing requirements for 403(b) plans. Before 2009, 403(b) plans subject to Title I of ERISA generally had only limited Form 5500 reporting obligations. In particular, they were not required to attach an independent qualified public accountant's opinion or any schedules to the Form 5500.

Beginning with the 2009 plan year, however, 403(b) plans are subject to the same reporting obligations as other ERISA plans. So "large" ERISA-covered 403(b) plans (generally plans with 100 or more participants) must file audited financial statements with their Form 5500.

The DOL had previously issued FAB 2009-02 to provide transitional relief from the annual reporting and related auditing requirements for plans with respect to certain tax-sheltered annuity contracts and custodial accounts entered into before Jan. 1, 2009. FAB 2010-01 responds to questions about the transition relief provided by FAB 2009-02, as well as to questions about the exclusion from ERISA coverage for 403(b) plans that are not "established and maintained" by the employer. The DOL has a new web page dedicated to 403(b) plan reporting and coverage available at www.dol.gov/ebsa/403b.html.

Investments Emerging From Recession: Optimism, Concerns and the Way Forward

Investment experts foresee modest economic recovery and are optimistic about investment returns in the near term. But their 10-year outlook is less hopeful. The experts project an upward trend in inflation and continued weakness in the labor market, according to the second annual Towers Watson Global Survey of Investment and Economic Expectations.

The survey was launched in December 2009 and received about 100 responses from investment managers.[1] The managers' business focuses are around the globe; the vast majority have more than 10 years of industry experience; and they collectively manage assets of about $13.3 trillion. Their views therefore should be fairly representative of the global investment community.

Capital market expectations

The survey respondents generally predict normal market returns in 2010 — a follow-on to the excellent returns in 2009. The median view of managers for global equity returns in 2010 is 10%. The U.S., Euro, Australian and Japanese markets are expected to tie with a 9% return. The U.K. market may slightly underdeliver at 8.5%, while other Asian equity markets are expected to significantly outperform the rest at 14.5%. Volatilities of equity returns are expected to settle to historical average levels (see **Figure 1**).

These statistics depict a more optimistic one-year-ahead outlook compared with the 2009 Towers Watson survey, which predicted median equity returns of only 6.7% globally and 8.8% in the United States for 2009 (significantly lower than the actual market returns).

These statistics depict a more optimistic one-year-ahead outlook compared with the 2009 Towers Watson survey.

Figure 1. Survey respondents' median predictions (%) for capital markets

	Global	United States	United Kingdom	Euro Zone	Australia	Japan	Asia (excl. Japan)
Average in 2010							
Equity return	10.0	9.0	8.5	9.0	9.0	9.0	14.5
Equity volatility (standard deviation)	15.0	15.7	17.5	16.0	15.0	15.0	22.0
Corporate AA spread over gov. bond (10-year maturity)	1.5	1.4	1.1	1.1	0.8	0.7	0.9
Short-term (3-month) government yield	1.3	0.5	1.0	1.3	4.4	0.4	3.0
Long-term (10-year) government yield	4.0	3.8	4.0	3.5	5.5	1.6	5.0
Real yield on 10-year inflation-indexed gov. bonds	2.0	2.0	2.0	1.8	3.0	1.9	2.5
Annualized average over the next 10 years							
Equity return	8.0	8.0	6.3	7.0	8.0	5.0	10.0
Equity volatility (standard deviation)	15.0	15.0	16.0	16.2	16.5	16.8	20.0
Corporate AA spread over gov. bond (10-year maturity)	1.2	1.1	1.3	1.0	2.8	1.0	1.2
Short-term (3-month) government yield	3.5	3.0	4.3	4.0	4.6	1.8	4.5
Long-term (10-year) government yield	5.3	5.0	5.5	5.0	5.5	3.0	6.0
Real yield on 10-year inflation-indexed gov. bonds	2.5	2.5	2.6	2.5	3.0	2.0	3.0

Source: Towers Watson 2010 Global Survey of Investment and Economic Expectations.

[1] For more information, visit http://www.towerswatson.com/research/1150.

Figure 2. Survey respondents' median predictions (%) for macroeconomic indicators

	United States	United Kingdom	Euro Zone	Australia	Japan	Asia (excl. Japan)
Average in 2010						
Real GDP growth rate	**2.5**	**1.7**	**1.5**	**3.0**	**1.2**	**7.0**
Unemployment rate	**10.0**	**8.0**	**10.0**	**6.0**	**5.5**	**5.0**
CPI inflation rate	**2.0**	**2.0**	**1.3**	**2.8**	**0.0**	**3.8**
Central bank interest rate	**0.5**	**1.0**	**1.3**	**4.5**	**0.1**	**3.0**
Annualized average over the next 10 years						
Real GDP growth rate	**2.5**	**2.1**	**2.0**	**3.0**	**1.0**	**6.1**
Unemployment rate	**7.0**	**6.8**	**8.0**	**5.0**	**5.0**	**4.5**
CPI inflation rate	**3.0**	**2.4**	**2.0**	**2.5**	**1.0**	**3.5**
Central bank interest rate	**3.1**	**3.0**	**2.8**	**4.5**	**1.0**	**4.0**

Source: Towers Watson 2010 Global Survey of Investment and Economic Expectations.

Figure 3. Actual levels (%) of economic indicators around the survey time in late 2009

	United States	United Kingdom	Euro Zone	Australia	Japan	China
Real GDP growth	**–2.6**	**–5.1**	**–4.0**	**0.6**	**–5.1**	**7.7**
Unemployment rate	**10.0**	**7.9**	**10.0**	**5.7**	**5.2**	**4.2**
CPI inflation rate	**1.8**	**1.9**	**0.5**	**1.3**	**–1.9**	**0.6**
Central bank interest rate	**0.25**	**0.50**	**1.00**	**3.75**	**0.10**	**5.31**

Source: Towers Watson data collections.

Investment managers, however, do not expect credit terms to return to precrisis confidence levels for either corporate or governmental borrowers. These credit worries manifest in capital market projections. Take the United States, for instance. In 2010, these investment managers expect corporate AA spreads over government bonds to remain high at 140 basis points. They also think the short-term three-month government yield will increase from 0.5% in 2010 to 3% over the next 10 years. This latter projection is largely explained by managers' expectations for inflation — which average 3% a year for the next 10 years. The real cost of borrowing is expected to increase modestly — by 50 basis points — over the next 10 years, using the real yield on 10-year inflation-indexed government bonds as a barometer.

Macroeconomic forecasts

Economic recoveries are under way for most economies, according to the survey, and investment managers are essentially positive about the near-term prospects. The recoveries, however, are expected to be somewhat delayed and to underperform the historical yardstick of steep post-recession rebounds. For instance, the respondents expect that real gross domestic product (GDP) in the United States will expand by 2.5% in 2010 (median prediction), and this mild pace will be the new norm during the next 10 years.[2] **Figure 2** reports macroeconomic expectations, and, as a reference, **Figure 3** reports the actual levels around the survey time.

Many respondents anticipate unemployment rates in the United States, United Kingdom and Euro zone to peak in 2010 and remain fairly high for the next 10 years. This continued weakness in the labor market and the modest economic growth will be intertwined in these regions. The vast majority (more than 88%) of respondents envision a bumpy economy (W shape), stagnation (L shape) or a delayed recovery (U shape) for these economies over the next five years.[3] In contrast, a rapid boom (V shape) is considered the most likely scenario for Australia and Asia (excluding Japan), by about

[2] In the nine economic expansions between 1949 and 2003, the historical average real GDP gain over the six quarters after recessions was 7.7%, according to Michael Mussa, "World Recession and Recovery: A V or an L?" Peterson Institute for International Economics, paper presented at the 15th semiannual meeting on Global Economic Prospects, April 7, 2009.

[3] A W-shaped recession is characterized by a sharp downturn followed by a modest, temporary recovery, followed by another, milder downturn and then, slowly, full recovery. In a U-shaped recession, the economy takes much longer to recover from a steep downturn. An L-shaped recession is followed by years of stagnant growth. A V-shaped recession is a quick and steep downturn followed by a rapid, strong recovery.

48% and 67% of the respondents, respectively. This differentiation of development probably contributes to the managers' predictions of decreasing economic competitiveness and investment attractiveness in the Western economies over the next five years.

Inflation risk looms large around the world, and asset bubbles are forming in some regions, in the respondents' view. Inflation expectations clearly trend upward and central bank interest rates will jump to rein in inflation, according to survey statistics. For instance, in the United States, the 10-year average consumer price index (CPI) inflation rate is expected to rise to 3% and the Federal Reserve benchmark interest rate to reach 3.1% (the current target is only 0.25%).

Respondents believe house prices in most markets hit bottom in 2009. Their opinions, however, are more divided about the United States, where about 25% of respondents expect weakness in the housing market to linger until the third quarter of 2010.

Responding investment managers give relatively high marks to the government responses — monetary, regulatory and fiscal policies — for stabilizing markets in the recent economic downturn. Many respondents believe these policies have been balanced and conducive to economic growth across the regions except for Japan (only 8% of respondents). More than two respondents of every 10, however, think the policies are too stimulative and inflationary for the U.S., U.K. and Asian economies, while about 40% of respondents view the policies as too limited and ineffective for economic recovery in Japan.

Changing investment landscape

Capital market players can expect varied developments over the next five years, according to the survey. The roles of insurance funds, pension funds and sovereign funds will most likely grow, while commercial and investment banks may cede a modest amount of influence. Four in 10 respondents think hedge funds will strengthen their market influence over the next five years — a significant reversal from the 2009 survey, when more than 80% of respondents expected a shrinking trend for hedge funds' influence. To a lesser degree, respondents' attitudes about the role of investment banks have also shifted from strongly pessimistic to neutral or even positive. Central banks will continue gaining in influence, according to the survey. These dynamics reflect the financial upheaval and consequent worldwide surge of government interventions and regulations. The latter is listed by the respondents as one of the most significant investment issues ahead, just after inflation.

Institutional clients are generally expected to hew to a modestly more conservative investment strategy in 2010. At the same time, the percentage of respondents who expect investment strategies to become "substantially more aggressive" increases from the 2009 survey, which hints at changes in risk attitudes among the investment managers. They posit that "added value through active management" is the most important attribute for investment success for institutional investors, while "adequate risk control" was the top attribute last year.

Financial reforms and a new reality

The respondents estimate the odds as better than even for comprehensive financial reforms — including regulator consolidation, consumer protection, derivatives regulation and disclosure of products — within the next five years. They expect these reforms to improve financial stability and strengthen governance but doubt they will promote healthy innovation or increase the supply of credit. These well-intended measures thus come with some costs.

Looking forward, the respondents envision a "new reality" that includes the following:

- Periodic financial instability and crises
- Increased regulations and costs but net positive results
- More attention to corporate governance
- Difficult economic and political conditions with lower than trend growth in many economies
- Large segments of the population suffering inadequate retirement incomes from defined contribution plans

The last point, lack of retirement income security, has been repeatedly raised in a series of surveys. To address this concern, flaws in defined contribution plans could be fixed and better risk-sharing features could be implanted.

To a limited degree, respondents also anticipate that new focuses in the investment industry and accepted investment thinking will emerge, that faith in investment professionals and the risk appetite of investors will decline, that the demand for alpha-seeking and skill-based investment products will recover, that ESG (environmental, social and governance) issues will assume greater importance, and that investment decision making will better reflect long-term goals.

Among the most needed innovations in institutional investments, respondents place great emphasis on transparent evaluations of investment products and effective risk management, in particular asset-liability matching and liability-driven investment strategies.

The percentage of respondents who expect investment strategies to become "substantially more aggressive" hints at changes in risk attitudes.

News in Brief

Court Finds Retiree Health Plan Amendment Violates Anti-Cutback Rule

In *Battoni v. IBEW Local Union No. 102 Employee Pension Plan,* the 3rd U.S. Circuit Court of Appeals held that an amendment to a collectively bargained welfare plan illegally reduced plan participants' pension benefits. Under the amendment, participants who elected to receive their pension benefits in a lump sum became ineligible for retiree health benefits. The court found that the plan amendment violated the anti-cutback rule — even though the rule does not apply to health and welfare plans. According to the court, the violation occurred because the amendment "constructively amended" the pension plan by conditioning receipt of the lump-sum benefit on surrendering health care benefits provided by the welfare plan.

DOL Proposes Investment Advice Regulations for 401(k)-Type Plans

The Department of Labor (DOL) has proposed regulations that provide guidance regarding the statutory prohibited transaction exemption for investment advice added by the Pension Protection Act of 2006 (PPA). The exemption generally allows employers to provide investment advice to participants in 401(k) and other participant-directed individual account plans via either a computer model certified as unbiased or a fiduciary advisor compensated on a level-fee basis.

Earlier DOL final regulations addressing investment advice and a related class exemption were scheduled to take effect on March 23, 2009. However, the Obama administration delayed the effective date to review the guidance, which was withdrawn in November 2009.

The revised rule is limited to the implementation of the PPA statutory exemption, and the proposed regulations are nearly identical to the January 2009 final rule (although some clarifying language was added). However, the related class exemption was not re-proposed.

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TW-NA-2010-15829

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