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Department of Labor Rule Paves the Way for State-Run Retirement Plans

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On August 24, the United States Department of Labor (DOL) announced a final rule governing the exemption of state-run retirement plans from the Employee Retirement Income Security Act (ERISA). Over 30 states have either implemented or are considering such plans. One major hurdle to their broader adoption has been uncertainty over whether they would be governed by ERISA, resulting in unwanted preemption of relevant state laws. The rule adopts a safe harbor exemption reminiscent of, but critically distinguishable from, the one created in 1975 for IRAs. To qualify for exemption, the plan must, among other things, prohibit employer contributions, and require the state to implement and administer the plan and "assume[] responsibility for the security of payroll deductions and employee savings." Perhaps most important, employee participation must be "voluntary," as opposed to the more stringent "completely voluntary" standard used in the traditional IRA safe harbor. Under the "completely voluntary" standard, IRAs were exempted from ERISA only if employees had to opt in. Because a central attribute of state-run plans is automatic enrollment — which would fail the "completely voluntary" standard — the DOL established a mere "voluntary" standard. Automatic enrollment plans meet this requirement so long as employees are free to opt out. The DOL will next consider extending this rule to plans administered by cities and counties. Although the DOL is enthusiastic, not everyone is so sanguine. In addition to public cost, critics note potential conflicts of interest by investment managers. And, in the plan currently under consideration in California, an investment board would be allowed to earmark certain investment returns to curb losses in a bear market. Aside from the difficulty of defining the contours of such a program, some wonder whether short term investors might never benefit from such a reserve and might actually lose investment returns otherwise earned. These concerns are compounded by the fact that participants are likely to be unsophisticated and apathetic investors. Though IRAs have long been widely available, only those who are not otherwise invested in a retirement plan of their own will be automatically enrolled. It is unlikely that such individuals will fully investigate and understand how state-run plans compare to traditional IRAs.

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