employee benefits update

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TARGET DATE FUNDS AND FIDUCIARY DUTY

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Examine your TDFs' glide paths to ensure suitability

Retirement plan fiduciaries generally are absolved from liability with respect to plan participants' selection of investments in plans that offer multiple investment choices with various levels of risk. This includes target date funds (TDFs). Fiduciaries' duties with respect to TDFs were fine-tuned under the Pension Protection Act. However, fiduciaries must still act prudently in selecting TDFs.

ABCs of TDFs

A key element in a TDF's design is its glide path. This is the scheduled asset allocation evolution from a more aggressive posture to a more conservative one as the target date nears. Plan fiduciaries should make sure they understand the TDF's glide path, including when the fund will reach its most conservative asset allocation and whether that occurs on or after the target date.

Some TDFs maintain a significant equity allocation at the target date, while others don't. Generally, the former are for employees who don't expect to withdraw their entire 401(k) plan savings immediately on retirement. Ideally, few, if any, employees would do so other than to roll the fund into a similarly invested IRA.

Plan fiduciaries should make sure they understand the TDF's glide path, including when the fund will reach its most conservative asset allocation.

TDFs with minimal equity exposure at retirement are suitable for those employees who want or need to cash out. Fiduciaries must be confident that participants understand the glide path when deciding to invest.

In addition, fiduciaries should review TDFs on a regular basis (as they would any other investment) to determine whether to continue offering them to employees. Consider whether any circumstances have changed with regard to the plan and its participants since selecting the TDF array. Also, if the plan's objectives for offering a TDF change, it may be prudent to replace the fund.

Russell research

How can you assess the appropriateness of a TDF's glide path? An important way is to understand what the TDF manager says about its methodology for determining its glide path. Russell Investments recently issued a report detailing its analysis of that very topic, which resulted in a fine-tuning in its own glide path models.

Russell's research summarized five "key findings":

1. Participants' contribution and earnings patterns. Educated guesses about how much money participants ultimately will have in their accounts at retirement influence glide path decisions. Lifetime

401(k) plan "DIY" participants aren't doing much — at their own risk

The theory and hope of defined contribution plans with multiple investment options is that participants will make wise use of their ability to pick funds and periodically review and make changes to their asset allocations to stay on track with their goals. Unfortunately, in many cases this isn't happening. That's the conclusion of recent research by Fidelity Investments, a leading provider of workplace savings plans.

Of the approximately 13 million 401(k) plan participants in the plans Fidelity serves, 63% are invested in such funds. Fidelity calls them "do it yourself" (DIY) participants. They stand in contrast to "do it for me" participants, who are invested in managed accounts or target date funds (TDFs), thereby delegating much of the asset allocation decisions to professionals. Fidelity has found that many DIY participants are "unengaged" with their retirement portfolios, based on the fact that they haven't made any portfolio changes within the last two years.

Fidelity's data reveals variations in participant behavior by age. For example, 56% of millennial generation participants delegate the investment management decisions to the pros, while 24% actively manage their investments themselves. Only 20% are unengaged participants.

The story is different for baby boomers: Only 27% delegate their decisions. 33% actively manage their own investments, but a full 40% are unengaged participants. Given the boomers' proximity to retirement — if not already in retirement — this should raise red flags.

So what should you do? Consider making TDFs and managed account funds available, so participants who don't want the responsibility of picking and choosing among a variety of funds won't have to do it. If you already offer TDFs and managed account funds, make sure their existence and purpose are well understood by the participants who haven't selected them.

contributions will be "significantly" higher than originally assumed, based on a projection of greater employer contributions to employees' accounts and higher employee final salaries.

2. Participant spending patterns in retirement offset retirement income. While a retiree's spending evolves over time, the analysts found it generally decreases each year until about age 80. Russell dropped the proportion of retirement income derived from Social Security to 30% from 36% to reflect an individual benefit instead of a couple's benefit.

3. Unexpected retirement costs. Analysis of retirees' health care costs led Russell to increase its projection of "target income replacement" — what participants need to shoot for as a percentage of their final preretirement income — to 79% (49% from sources other than Social Security).

4. Low interest rates and bond yields. Russell found that the prolonged period of low interest rates and bond yields has forced savers to bear extra risk to realistically attain a real positive rate of return.

5. Modest allocation changes. Some modest changes to allocations to growth assets within the TDF's glide path may improve participant outcomes.

Time to analyze your TDF

Different TDF providers may look at the same or other data and draw different conclusions. Fiduciaries should review the TDF glide paths offered by their plan and determine whether it reflects today's market and retirement expense realities. And be sure your investment policy statement clearly states whether the TDFs are your plan's default option and how they were chosen. This will go a long way toward properly discharging your fiduciary duties.

Upcoming compliance deadlines:

10/1 Deadline for setting up a SIMPLE for 2014
10/15 Extended deadline for filing 2013 Form 5500
10/15 Extended deadline for filing 2013 individual tax returns
11/1* 2014 SIMPLE notice due to current participants
12/1 2014 safe harbor plan notice for calendar year plan due to participants

** Even though this date falls on a Saturday this year, the notice must be delivered 60 days prior to the start of the plan year.*

ESOPs facing tougher scrutiny by regulators and courts

Employee Stock Ownership Plan (ESOP) fiduciaries are facing closer scrutiny by the Department of Labor (DOL), while federal courts, including the U.S. Supreme Court, are weighing in on ESOP cases. As a result, ESOP sponsors should take a fresh look at how their ESOPs are structured and overseen by fiduciaries.

The DOL estimates put the number of existing ESOPs at around 6,800, covering approximately 13.4 million workers — a 7.5% gain since 2006. The Employee Benefit Research Institute estimates that, for about one-third of those ESOP-sponsoring companies, the ESOP is the only retirement plan.

DOL and ESOP regulations

The DOL is hoping to finalize regulations to strengthen the standards and accountability for firms that perform the annual company valuations for ESOP plan purposes. The regulations were originally proposed in 2010 and the DOL hopes to finalize them next year. Among other things, the DOL proposed making those firms performing ESOP evaluations de facto fiduciaries of the ESOPs whose stock they value.

The proposal was criticized by several industry groups, including the American Institute of Certified Public Accountants (AICPA). The AICPA and other critics feared many appraisers would exit the field due to the lack of, or high cost of, fiduciary liability insurance for practitioners in their field. Some voiced the opinion that the DOL proposal was an overly harsh response to a small number of ESOP appraisals.

DOL and ESOP settlements

In testimony before Congress earlier this year, Labor Secretary Thomas Perez compared some ESOP stock appraisals to real estate valuations performed during

the real estate bubble that "masterfully came in at what you needed." The DOL has at least a dozen cases pending in which it has accused privately held ESOP sponsors of using inflated company stock valuations to enable company owners to sell their shares to the ESOP at above fair market value. The DOL has filed 28 such cases since October 2009.

In June 2014, the DOL reached a $5.25 million settlement with Illinois-based GreatBanc Trust Co. illustrating the DOL's position in these cases. GreatBanc was the trustee of an ESOP sponsored by Sierra Aluminum Co. The DOL charged GreatBanc with allowing the ESOP to buy company shares from top company executives for above-market prices. According to the DOL, GreatBanc failed to "adequately inquire into an appraisal that presented unrealistic projections of [the company's] future earnings and profitability … and adjustments to financial statements that went into the appraisal."

ESOP fiduciaries are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they don't have to diversify the ESOP fund's assets.

In addition to paying the penalty to the ESOP, GreatBanc agreed to put in place new procedural safeguards. These included new requirements for selecting and overseeing a valuation advisor, analyzing the fiduciary process, and documenting the valuation analysis.

In a similar case settled in January, the DOL extracted $10 million (to be paid to the ESOP) from the former owners of People Care Holdings, Inc. According to the DOL, People Care overvalued the company when it was sold to the ESOP with optimistic revenue projections, even after People Care lost a key contract.

Compounding their legal problems, the former owners attempted in the stock purchase agreement

to indemnify themselves and hold the ESOP responsible for costs incurred by the owners in conjunction with any future investigation or litigation. The DOL asserted that that provision invalidated the agreement.

Supreme Court and ESOP litigation

In June 2014, the U.S. Supreme Court unanimously ruled in *Fifth Third Bancorp et al v. Dudenhoeffer* that ESOP fiduciaries can no longer be presumed to have exercised their fiduciary duties in certain ESOP cases. Specifically, the Court shot down a well-established legal standard called the "Moench presumption," accepted by federal appeals courts.

Under the now-void "Moench presumption," plaintiffs had to make allegations implicating the company's viability as an ongoing concern or show a precipitous decline in the employer's stock. This presumption of prudence essentially gave ESOP fiduciaries offering company stock as an investment option in their defined contribution plans the benefit of the doubt.

However, the Supreme Court held that ESOP fiduciaries aren't entitled to any special presumption of prudence. Instead, they're subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they don't have to diversify the ESOP fund's assets.

ESOPs in the future

With ESOPs growing in numbers, staying on top of current DOL regulations and court litigation is in your best interest, whether you already have an ESOP or are considering one. Contact your benefits specialist to learn more.

Are your 401(k) plan administrative fees allocated equally?

Generally, some 401(k) plan participants shouldn't bear a higher proportion of a qualified retirement plan's administrative costs than other participants because of their investment choices. Yet that's the reality for many participants — and the numbers can be significant.

What's the problem?

Many plans defray or offset some of the administrative or recordkeeping costs through expense reimbursement from the plan's investment options. These expense reimbursements are often referred to as "revenue sharing."

Revenue sharing is built within a mutual fund's expense ratio. Thus, depending on the chosen fund, participants may be selecting funds with more revenue sharing built into the fund's cost than other available options. As a result, a significant portion of plan costs may be paid for by workers who select high-cost funds because of the wide range of payments provided by different asset managers and share classes.

This means that, if two participants have the same account balances but are invested in different funds, one could be paying much more in plan administration fees.

Plan sponsors should examine whether this is occurring within their own plans. Allowing what's essentially a discriminatory practice to occur could be construed as a fiduciary breach. And it's unfair to those participants who are paying a disproportionate share of plan administrative expenses.

What to do about it

According to research by national consulting firm Aon Hewitt, plan sponsors are focusing on their 401(k) fees. However, only 21% have recently restructured their plan's administrative fees so they're assessed more equitably.

Aon Hewitt identifies these 21% as "best in class" employers. These employers are designing their plan's fee models so that employees pay the same amount in asset-based fees regardless of how they allocate their portfolio.

What can you do to equitably allocate fees? A "fee equalization" strategy can include the following steps:

Analyze fees. Review how your plan distributes administrative fees among your participant population. If disparities exist, be sure you have a clear rationale to justify such distinctions.

Cover the cost of administrative services. If possible, choose a set of funds for your plan that doesn't reimburse vendors for administrative services. Instead, have the plan itself cover administrative services and deduct them from participants' accounts in a consistent fashion.

Choose institutional share fund classes. These fund classes generally reduce asset-based fees overall and provide for fee transparency. Most institutional funds have no revenue sharing and pay no 12b-1 fees.

Aon Hewitt's research reveals that 10% of employers charge an administration fee as a percentage of participants' account balances, and 25% add administration fees uniformly to each fund's expense ratio.

If you still want to charge all participants the same administrative fee regardless of the level of assets in their accounts or the nature of the investments, use an investment lineup that applies a discrete fee to participant accounts on an ongoing basis, typically monthly or quarterly. The percentage of employers that now use this approach is 26% of Aon Hewitt's survey base, up from only 11% in 2009.

Don't wait to act

401(k) plan fees and their connection to a plan sponsor's fiduciary duties is one of the most litigated areas in retirement planning. To avoid problems, maintain internal processes to monitor whether your plan's costs are reasonable for the offered services. An annual review of your plan's allocation of administration fees should be standard.

DOL sets 2015 regulatory agenda

Each year, the Department of Labor (DOL) sets an agenda for the year ahead. 2015 looks to be a busy year.

On the list

The DOL will unveil the following regulatory initiatives in January:

Fiduciary investment advice. This long-delayed proposal would amend the DOL's rules to expand the scope of advisory activities deemed to be "investment advice" subject to fiduciary accountability.

Annuity selection safe harbor. The proposal will amend the rule listing what plan fiduciaries should consider when giving defined contribution plan participants an option of taking their distributions as an annuity.

Lifetime income disclosure and benefit statements. The DOL plans to implement the 2006 Pension Protection Act's (PPA's) quarterly benefit statement requirements. The regulation might also require plan sponsors to express the value of a participant's benefit in the form of an income stream at retirement.

Voluntary fiduciary correction program (VFCP). Proposed changes to the VFCP (allowing fiduciaries to correct certain prohibited transactions) seek to expand the transactions eligible for correction and streamline other correction procedures. The proposal will come in the form of an entire restatement of the current program rules.

And about TDFs . . .

In addition, before the end of 2014, the DOL intends to reopen for comment a proposed regulation on disclosure requirements for target date funds (TDFs) and other qualified default investment alternatives (QDIAs). The DOL originally made the proposal in 2010, and the new proposal adds "greater specificity" to the 2007 regulations, issued just one year after the PPA's enactment creating QDIAs. For example, the proposed regulations clarify that non-TDF QDIAs (such as managed accounts) are subject to the same disclosure rules as TDFs.

The regulations also would require that, if the TDF's name includes a date, the fund's description must define whom the fund is intended for and the date's relevance. It must then address any assumptions about a participant's contribution and withdrawal intentions in relationship to that date.

To learn more about the DOL's agenda, contact your benefits specialist.