

INSTITUTIONALIZING DC PLANS: A STARTING POINT FOR ADDRESSING FIDUCIARY ISSUES

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Research and Surveys Committee

INTRODUCTION AND PURPOSE

The changing US legal/regulatory environment and recent trends in new investment products mean that defined contribution (DC) plans can now deliver better retirement outcomes for plan participants. Improved outcomes for plan participants should result in better fiduciary and risk management profiles for plan sponsors/plan fiduciaries.

If your plan hasn't yet embraced institutionalization, you may be wondering how to get started and what issues need to be considered from a fiduciary perspective. Or, if your plan has already taken some steps in this direction, you may be wondering what's next or what new features may now be appropriate.

This article provides a basic framework for plan sponsors and fiduciaries interested in exploring perspectives on institutionalizing their DC plans. For those who would like further details, page 10 of this paper lists additional DCIIA resources on select topics.

To gather insights on related fiduciary issues, the Defined Contribution Institutional Investment Association (DCIIA) hosted a Legal Roundtable in Washington, D.C., on May 7, 2012; participating were 10 Employee Retirement Income Security Act of 1974 (ERISA) attorneys and consulting specialists¹. The collective input and ideas from these experts helped shape topics for this article, and some of their specific comments are quoted on the following pages.

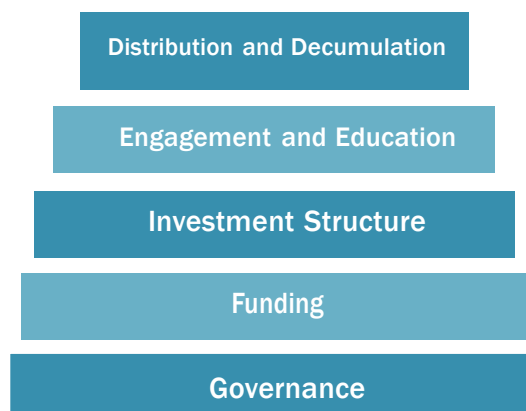
INSTITUTIONALIZATION...A DEFINITION

In October 2011, DCIIA published the paper, *Institutionalizing DC Plans: Reasons Why and Methods How*²; it offered the following definition of the term:

“‘Institutionalization’ is a broad mindset that applies beyond investment options. It’s how you get people into the plan; how you design it properly; how money moves out of the plan over time; what options are offered; how fees are structured; and what type of unbiased advice might be available for participants along the way.”

According to the paper, the overarching advantage for institutionalizing a DC plan is the likelihood of better retirement outcomes for participants, thanks to: greater use of automatic features that increase participant contributions; more efficient investment portfolios and effective asset allocation; a more significant role for professional investment management; more targeted investment management practices; and lower fees.

In addition, the paper proposed the following “hierarchy” of institutionalization levels for DC plans:



The following sections of this paper highlight some key fiduciary topics related to each level of the institutionalization hierarchy.

FOUNDATIONAL LEVEL: GOVERNANCE

“Plan sponsors have done a very good job over the last decade developing their plans. They need to consider institutionalization as an evolution to the next generation of plan—not an abandonment of what they already have”³.

| 🗨️ Fiduciary Perspectives: | 🔗 Issues / Actions: |
|---|---|
| <p>According to the US Department of Labor (DOL)⁴, DC plan fiduciaries have important responsibilities to exercise on behalf of participants and are subject to fiduciary standards of conduct, which include:</p> <ul style="list-style-type: none"> • Acting solely in the interest of plan participants and their beneficiaries, and with the exclusive purpose of providing benefits to them, • Carrying out their duties prudently, • Following the plan documents unless inconsistent with ERISA, • Diversifying plan investments, and • Paying only reasonable expenses from plan assets. <p>Given these responsibilities, all DC plan sponsors, regardless of the size of their plans’ assets, should—as part of their overall process of evaluating their plans—consider how their plans could benefit from institutionalization.</p> <p>In the end, plan sponsors may decide that some features of institutionalization are not right for their plans. They should, however, at least ask questions about institutionalization and formally document the reasons for their decisions.</p> | <p>DETERMINE YOUR PROCESS</p> <ul style="list-style-type: none"> • Consider working with an investment consultant, plan advisor, and/or legal advisor to explore what features of institutionalization may be right for your plan and its participants. <p>DOCUMENT YOUR DECISIONS</p> <ul style="list-style-type: none"> • Consistent with sound fiduciary practice, document the steps of your inquiry and any resulting changes to demonstrate that you engaged in a prudent process. <p>UPDATE YOUR PLAN AND GOVERNANCE DOCUMENTS</p> <ul style="list-style-type: none"> • Many plan design features associated with institutionalization may make it necessary to update or amend governing plan documents, investment policy statements, etc. Because fiduciaries have a duty to operate their plans in accordance with plan documents, you should carefully review these materials and make required updates before you implement any changes in order to adopt institutionalization (i.e., “Amend first, act later”). • Work closely with your plan’s record keeper to update operational systems, web sites, transaction processes, etc., to accommodate any new plan features. • Also, be sure to revise all required plan enrollment and investment communication materials for participants—including the summary plan description. |

FIRST LEVEL: FUNDING

“Institutionalization makes a lot of sense for a lot of plans. Part of the decision-making includes answering: Why are you sponsoring a plan in the first place? What are you trying to achieve to maximize its effectiveness? How are you structuring the plan to yield the results you want to get for people to participate and contribute at the right levels?”

🗨️ Fiduciary Perspectives:

The Pension Protection Act of 2006 (PPA) clarified and simplified administrative processes that plan sponsors can adopt to implement institutionalization via plan design features such as automatic enrollment and automatic escalation of participant contributions.

These “funding” aspects of institutionalization can significantly improve retirement outcomes for plan participants.

In addition, the PPA clarified that ERISA generally pre-empts state and local laws that might require active consent from employees for wage withholding, through payroll deductions, for automatic enrollment of their retirement savings in a DC plan.

🔗 Issues / Actions:

ADOPT “AUTOMATION”

- Consider implementing automatic enrollment and automatic escalation as first-level steps in embracing institutionalization for your plan and its participants.

DETERMINE A DEFERRAL RATE

- Consider working with an investment consultant, plan advisor and/or legal advisor to explore what automatic deferral rates may be right for your plan and its participants.
- Realize that choosing the appropriate automatic deferral rates for your plan can be based on different factors. These include the demographics of your eligible employees and those of your current plan participants, your plan’s purpose, and the availability of other employer-sponsored retirement sources such as a defined benefit (DB) plan. The amount and rate of any employer matching contributions and vesting are other factors that may also influence your decision.
- Be careful not to set your plan’s initial automatic enrollment deferral rate too low; this could compromise your plan participants’ ability to build sufficient retirement savings over time.
- Be aware that many industry experts advise an initial automatic enrollment deferral rate of 4 percent to 6 percent of a participant’s eligible pay, with escalations that encourage a “savings reach”. For example, escalations could automatically increase deferrals over time, up to a deferral rate of 10 percent, 12 percent or 15 percent.

SECOND LEVEL: INVESTMENT STRUCTURE

“As a plan fiduciary, it’s important to get an education about the investment options you are considering, to follow a process in implementing your investment selections, and to document this process accordingly.”

“In an ideal world, you would reach a certain level of assets under management and then transform your plan into an institutional structure to take advantage of the economy of scale. But institutionalization doesn’t have to be a huge, daunting shift. It could be much more gradual—not a sweeping change.”

Institutional Investment Offerings

🗨️ Fiduciary Perspectives:

Many plan fiduciaries are not familiar with the different types of institutional investment structures (and related fees) that are available. These include mutual funds, collective investment trusts (CITs), insurance products and separately managed accounts.

Mutual funds, for example, can have multiple retail and institutional share classes. So, while a particular mutual fund may offer an appropriate investment strategy and structure for a particular plan, an institutional share class may be more advantageous, from a fee perspective, than a retail share class.

CITs can also have different investor classes and fee structures. Some fiduciaries of mid-sized plans (generally plans with assets of \$10 million to \$249 million) mistakenly believe that CITs are available only to large- and mega-sized plans (generally ones with assets of \$250 million or more). This is not the case. Depending on the circumstances, CITs may be effective options for small-to mid-sized plans too.

Separately managed accounts may also be available for mid- to large-sized plans (generally ones with plan assets of \$100 million or more); these may offer the same investment strategy as mutual funds or CITs, but with lower overall fees and greater control of risk via investment guidelines that can be customized.

↔️ Key Comparisons:

MUTUAL FUNDS VS. CITs

Regardless of whether a plan offers investment options to participants as mutual funds or CITs, ERISA fiduciary rules govern the plan fiduciary's selection and monitoring of those investment options. The DOL's disclosure rules also apply to both mutual funds and CITs.

📌 Issues / Actions:

CONDUCT AN INVESTMENT STRUCTURE REVIEW

- Consider working with an investment consultant, plan advisor and/or legal advisor to develop an effective understanding of how institutional investment structures and products differ from one another in design and fees, and how they differ from what you might see from a retail perspective.
- Understand that fee and pricing structures vary, as do other features. Together with your consultant or advisor, compare and contrast the different fee structures and other terms.
- Make sure that the results of your review confirm which investment structures and pricing are appropriate for your plan. By documenting a good understanding of the advantages and challenges of different investment structures, you can show that you, as a fiduciary, engaged in a prudent process.

CONSIDER CHANGES TO YOUR INVESTMENT MENU

- Look at restructuring your investment offerings and streamlining the funds in your plan by:
 1. Using multi-strategy investment options to achieve defined benefit-like diversification without cluttering the fund line-up. For example, in lieu of offering large-cap, small-cap and mid-cap as separate investment options in value and/or growth styles, you may wish to combine them into one broader U.S. equities investment option.
 2. Simplifying options into two to three menu tiers (e.g., default option, core options and a possible brokerage window) in order to facilitate better participant decision making and to improve participant outcomes.

Institutional Investment Offerings

 **Fiduciary Perspectives:**

Rules govern the plan fiduciary's selection and subsequent monitoring of the plan's investment options. The DOL's disclosure rules also apply to both mutual funds and CITs.

Mutual funds are investments funds that are registered with the Securities and Exchange Commission (SEC). They have an independent board of directors and specific rules and requirements dictated by the SEC (including provisions for providing prompt liquidity and valuation, as well as a detailed prospectus), all of which are meant to protect the interests of investors.

CITs, on the other hand, are not registered with the SEC. Instead, they are established by banks or trust companies, and are regulated by federal or state banking agencies. As a result, the rules and requirements that apply to CITs are typically different from those that apply to registered mutual funds.

CITs can be beneficial from a cost perspective. Their administration can be more streamlined and simplified than mutual funds', and therefore less expensive. There is, however, usually less uniformity with CITs than with mutual funds, so specific terms and conditions need to be reviewed for appropriateness.

Mutual funds are required to process withdrawals promptly—generally within less than a week after a request. CITs have more flexibility in terms of withdrawals, liquidity, and required disclosures and communications; sometimes this may translate to less uniformity in withdrawal provisions in CITs than in mutual funds.

Mutual funds can prohibit certain types of alternative investments and illiquid investments beyond a certain specified percentage.

CONSIDER THE LEVEL OF ASSISTANCE YOU MAY NEED

If you are planning on working with an investment consultant or advisor, evaluate how you, as a plan sponsor, may benefit from having the consultant serve as a fiduciary to your plan for the advice provided.

 **Issues / Actions:**

(Sometimes this level of advice is referred to as a “3(21) advisor.”) You may also want to consider appointing a “3(38) investment manager” for fund selection which means the investment manager could exercise discretion over fund selection. Appointing advisors to serve in a 3(21) fiduciary or 3(38) investment manager capacity can, for some plan sponsors, improve diligence and add additional fiduciary protections. However, selecting fiduciary advisors is itself a fiduciary act. So, you will need to act prudently in selecting the advisor, document your selection process criteria and monitor the advisors you select.

UPDATE TRUST AGREEMENTS / INVESTMENT POLICIES FOR CITs

- From a governance perspective, offering a CIT as an institutional investment product may not require changes to your plan document. (Many stable value funds are CITs, so if your plan offers a stable value fund, you may already be familiar with this product.) For some plans, however, offering a CIT may require changes to the plan's trust agreement or investment policy.
- The plan's trust agreement should include a provision that authorizes an investment in a CIT. It is important for the trust agreement to stipulate that the CIT trust agreement is included as a part of the plan's trust document, as this is a technical IRS requirement for CITs that obtain their tax exempt status from the CIT's retirement plan investors. Do not assume that all plan trust agreements have this provision; not all do. Plan sponsors interested in offering a CIT should therefore examine and update as necessary their trust agreements.
- In addition, certain investment policy statements specifically authorize registered mutual fund investments, but may not address CIT investments. As such, you should clarify, and revise as necessary, your investment policies to allow for implementation of CITs; you should also review and consider the documents required to invest in a CIT.
- As stated previously, it is important that all plan documents are updated and/or amended prior to implementation of any changes, both for consistency and to confirm that none of the changes conflict with the plan documents.

Qualified Default Investment Alternative (QDIA) and Re-Enrollment

🗨️ Fiduciary Perspectives:

Under the PPA, plan sponsors can receive fiduciary protection by designating a QDIA (or default investment option) for participants' pay, which is automatically deferred to the plan. In other words, when a plan sponsor directs contributions into an eligible QDIA investment option on behalf of a plan participant who does not otherwise make an affirmative investment election, the plan fiduciary is generally relieved of fiduciary liability for participant investment selections, as long as certain procedures are satisfied.

GENERALLY, UNDER THE PPA, PLAN SPONSORS CAN CHOOSE ANY OF THE FOLLOWING AS A QDIA

- A fund such as a balanced fund with a mix of equity and fixed-income investments that is diversified to mitigate the risk of large losses; this option takes into account an overall group demographic profile vs. that of an individual participant.
- A fund such as a target-date fund with a mix of equity and fixed-income investments that is diversified to mitigate the risk of large losses; this takes into account a participant's age or estimated retirement date.
- A managed account, such as one in which a professional investment service allocates a participant's plan balance among a mix of the plan's existing investment options that is diversified to mitigate the risk of large losses; this takes into account the participant's age or estimated retirement date.
- A qualifying stable value or money market fund—but only for a period of 120 days after the participant is automatically enrolled.

📌 Issues / Actions:

ACT PRUDENTLY IN SELECTING A QDIA

- Consider working with an investment consultant, plan advisor and/or legal advisor to conduct a due diligence analysis and comparison of various investments that could be designated as a QDIA for your plan.
- Work with your advisor or consultant to confirm that applicable reporting, disclosure and other QDIA rules are satisfied.

DEFAULT AUTO ENROLLMENT INTO QDIA

- When implementing auto enrollment and auto escalation, default the investment of participants' pay automatically deferred into the plan's QDIA in order to achieve the fiduciary protections of the QDIA rules.

IMPLEMENT RE-ENROLLMENT

- Consider implementing re-enrollment by defaulting new contributions or even existing account balances for current plan participants into your selected QDIA; determine a default automatic deferral rate.
- You can think about default contribution rates for re-enrollment in the same way as you would those for automatic enrollment/escalation. However, because re-enrollment involves a much larger group of eligible employees (all plan participants vs. individual new hires or smaller groups of employees not participating in the plan), carefully evaluate the possible consequences related to setting the default rate too low, which could then bring down participant contribution rates.

Qualified Default Investment Alternative (QDIA) and Re-Enrollment

🗨️ Fiduciary Perspectives:

Re-enrollment is another feature of institutionalization that enjoys fiduciary protections. With re-enrollment, a plan sponsor can automatically direct balances and future contributions of existing participants who are participating in the plan into the plan's QDIA at a set deferral rate if the participant does not take action by a certain date—even if the participant previously provided an active investment election and/or deferral rate election. Establishing re-enrollment into a QDIA allows plan sponsors to effectively direct the balances and contributions of longer-term employees who may not have considered their deferral levels and/or investment allocations actively in many years.

🔗 Key Comparisons:

QDIA vs. ERISA 404(c)

- Even though participants do not make an active investment election into the QDIA with automatic enrollment, or as a result of a re-enrollment default, the traditional safe-harbor protection of ERISA 404(c) applies so long as the requirements of 404(c), including applicable QDIA requirements, are met. For example, the DOL takes the view that the plan fiduciary responsible for fund selection remains responsible for the prudence of selecting any plan investment option intended to comply with 404(c) or designated as a QDIA.
- Neither 404(c) nor QDIA relieves the plan fiduciary of fiduciary responsibility related to fund selection, so the investment selection and monitoring process should be well documented.

🔗 Issues / Actions:

RESEARCH STABLE VALUE / COMPANY STOCK FUND ISSUES

- If considering implementing re-enrollment, be aware of issues that may affect any stable value fund or employer stock funds:
 1. **STABLE VALUE FUNDS:** Because a broad re-enrollment of participants into a QDIA may cause an adverse re-distribution of stable value fund assets, you should check with any stable value fund managers before making re-enrollment implementation decisions.
 2. **COMPANY STOCK FUND:** Carefully consider the impact of re-enrollment on any employer stock fund—particularly in relation to the tax treatment of “net unrealized appreciation”. Unless existing company stock fund account balances are excluded from re-enrollment, redistribution of company stock fund balances into the QDIA may, for example, impact trading in the stock, or may impact the tax treatment of such amounts.

DOCUMENT YOUR DECISIONS

- Document all of your decisions and actions connected to the plan's QDIA selection and monitoring, re-enrollment implementation and related considerations.

THIRD LEVEL: ENGAGEMENT AND EDUCATION

“Institutionalization is not about one size fits all. It’s about a variety of plan design, investment, and engagement solutions that can build better retirement outcomes for plan participants.”

| 🗨️ Fiduciary Perspectives: | 🔗 Issues / Actions: |
|----------------------------|---------------------|
|----------------------------|---------------------|

DC industry research demonstrates that a majority of plan participants do not take an active role in their savings and investment strategies. However, in order to limit fiduciary risk and encourage engagement, prudent plan sponsors will seek to provide meaningful plan descriptions and investment education to constituents—even if the majority of participants do not appear to take action as a result of these communications.

As a fallback for participants who don’t or won’t take an active decision-making role in their plan accounts, plan sponsors can use auto features such as automatic enrollment, automatic escalation, automatic rebalancing and re-enrollment, as discussed earlier.

Plan sponsors should also consider re-focusing their participant-education efforts to offer personalized messaging at key inflection points in participants’ lives (i.e., marriage, birth of a child, nearing retirement, at retirement, etc.) as a way to improve outcomes. Highlight estimated annual retirement income versus wealth accumulation. Forthcoming DOL guidance and requirements on the methodology and assumptions for determining annual retirement income estimates should help support plan sponsors in this initiative.

At a minimum, plan fiduciaries need to ensure that their plans provide all legally required documentation to eligible individuals within prescribed time frames, including the 404a-5 participant fee disclosure, annual QDIA notification, summary plans description, summary of material modifications, etc.

ADOPT “AUTOMATION”

- Consider automatic enrollment/escalation, rebalancing, re-enrollment, etc., as a way to address certain behavioral finance traits (such as procrastination...loss aversion, etc.) in participants’ lack of decision-making and active elections.

PROVIDE TARGETED COMMUNICATIONS

- Work with your investment consultant, plan advisor and/or legal advisor, as well as your record keeper, to determine calculations and assumptions that will make it possible to include estimates of annual retirement income on a participant’s account information (on both the plan’s website and on quarterly account statements). Consider including an explanation of the assumptions that helped determine how the estimates were calculated.
- Provide participants with simple calculators that can help them easily model different withdrawal rates of a lump-sum balance.
- Provide personalized letters and e-mails to participants, highlighting how their account could grow if they actively increase deferrals.
- Consider creating targeted communications around key inflection points in participants’ lives.
- Create measurable campaigns that make it easy for participants to take action. Incorporate a tear-off, pre-filled reply card focused on increased deferrals in education mailings. Consider using e-mail "one-click" links messaging to support better participant choices.
- Integrate messages on the importance of periodically re-balancing portfolios as part of other employee-benefits communications campaigns. For example, for plan sponsors who offer online annual health and insurance enrollment, consider adding a simple “Yes/No” check box in disclosure materials for DC participants to rebalance back to a target portfolio every year.

 Fiduciary Perspectives:

 Issues / Actions:

- Periodically auto-enroll employees who have opted out of the plan and require them to actively elect to discontinue their participation. Include “savers like me” examples in plan communications and education; these can give participants an idea of how other investors use certain features of the plan based on age, career status, compensation, risk tolerance, eligibility for a DB plan, etc.

FOURTH LEVEL: DISTRIBUTION AND DECUMULATION

“Institutionalization is primarily about focusing on participant outcomes. If you do that, and you are well advised by consultants and legal practitioners, your fiduciary processes will fall into place.”

 Fiduciary Perspectives:

 Issues / Actions:

An advantageous feature of a DB plan is the delivery of guaranteed retirement income to participants.

Plan sponsors can help DC plan participants manage longevity and market risk to achieve similarly successful retirement outcomes by adopting retirement income solutions.

In addition, plan sponsors can help both current and separated participants by retaining assets in the plan after separation of service; sponsors can leverage this increased scale to achieve lower investment expenses that benefit all plan participants.

CONDUCT A REVIEW OF RETIREMENT INCOME SOLUTIONS

- Consider working with an investment consultant, plan advisor and/or legal advisor to develop an effective understanding of what institutional retirement income products and services may be available for your plan and how they differ in design and fees. A thorough review of the insurer and portability features are important.
- After your review, confirm which structures and pricing are appropriate for your plan, as well as how certain solutions would be integrated with existing fiduciary processes and governance documents.
- The selection of retirement income solutions is a complex topic. The DCIIA Retirement Income Committee is working on a retirement considerations paper that will cover this topic in greater detail.

DEVELOP YOUR PLAN’S RETIREMENT INCOME SOLUTIONS STRATEGY

- Consider developing an approach for your plan with “phase in” options over time for retirement income solutions for participants.

DOCUMENT YOUR DECISIONS

- Document your considerations, decisions, strategy and other related actions about how to implement retirement income solutions.

① For More Information: <http://www.dciia.org/info/publications>

- DCIIA “Institutionalizing DC Plans: Reasons Why and Methods How” (October 2011)
- DCIIA “The Impact of Auto-Enrollment and Automatic Contribution Escalation on Retirement Income Adequacy” (October 2010)
- DCIIA “Plug the Drain: 401(k) Leakage and the Impact on Retirement” (August 2011)
- DCIIA “Research Report on Raising the Bar: Pumping up Retirement Savings” (October 2010)
- DCIIA “Institutional Fund Structures” (March 2013)
- DCIIA “What’s on the Menu? A recipe for Better DC Plan Design” (March 2013)
- DCIIA “Complex Investments and Navigating the New Participant Disclosure Rules” (April 2013)

FOOTNOTES:

1. Please reference DCIIA roundtable participants below
2. Published by DCIIA in October 2011
3. Quotations included in this article are taken from remarks made at DCIIA’s Legal Roundtable in Washington D.C. on May 7, 2012
4. US Department of Labor Web Site, 2012 www.dol.gov/ebsa/publications/fiduciaryresponsibility.html

ATTORNEYS AND CONSULTANTS WHO PARTICIPATED IN THE DCIIA-SPONSORED LEGAL ROUNDTABLE ON INSTITUTIONALIZATION ON MAY 7, 2012 IN WASHINGTON, DC INCLUDED:

| | |
|---|---|
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ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a non-profit association dedicated to enhancing the retirement security of American workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants. For more information, contact www.dciia.org