



The “ideal” 401(k) plan design – Concepts to increase retirement readiness for participants and decrease fiduciary liability

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Executive summary

While there is no single "ideal" 401(k) plan design that is right for every plan sponsor, this paper explores two overarching plan design themes that can be incorporated into every 401(k) plan in some way that make a particular plan sponsor's 401(k) plan "ideal" for it and its employees. Those plan design themes are: (i) retirement readiness for employees/plan participants; and (ii) protection for the plan sponsor and plan fiduciaries from claims associated with the plan's investments. This paper will focus on plan design elements that, if properly utilized, should increase participants' financial preparedness for retirement and decrease the potential for liability on the part of the plan sponsor and plan fiduciaries with respect to the plan's investments.

Today's typical retirement plan design

We have transitioned as a society from a world of defined benefit plans to one of defined contribution plans. The defined contribution plan design of choice for most employers is the ubiquitous 401(k) plan, defined for purposes of this paper as a profit-sharing plan with the following components: (i) a cash or deferred arrangement ("CODA") allowing for pre-tax and/or Roth salary deferrals by participants; (ii) some form of matching contributions by the employer sponsoring the plan; and (iii) some level of discretionary or profit-sharing contributions by the employer sponsoring the plan. The main problem with the 401(k) plan design is that the 401(k) plan was never intended to be a primary retirement program or the only employer-sponsored retirement program; it was intended to be a supplement to the traditional employer-sponsored defined benefit or defined contribution (money purchase and/or profit-sharing) plan. For better or worse, the 401(k) plan has evolved into today's sole employer-sponsored retirement program for a majority of employers.

The typical defined contribution plan investment design has also evolved from a trustee-directed, pooled investment platform with balance-forward accounting into a participant-directed, daily valuation investment platform with individual accounting. This fundamental shift in responsibility for investment of the plan's assets from the trustee to participants was facilitated in large part by the issuance of DOL regulations in 1992 implementing ERISA section 404(c). That section of ERISA affords protection to plan fiduciaries for the investment decisions of participants, provided that the requirements of the regulations are met, both in form and in operation. Other contributing factors to the shift from trustee control over the investment of plan assets to participant control over the investment of plan assets allocated to their respective accounts include: (i) demand by some participants for control over the investments in their accounts; (ii) the internet and associated computerization of modern society which leads to greater availability of information regarding the accounts; and (iii) the desire by some individual trustees to relieve themselves of the responsibility for investing the plan's assets and transferring that responsibility to the participants.

Snapshot of 401(k) Plan Activity as of December 31, 2018

The Employee Benefit Research Institute ("EBRI"), on March 4, 2021, published its annual report on 401(k) plan asset allocation, account balances, and loan activity for the year 2018. Following are some highlights from that report that provide background information on the observations noted in this paper concerning retirement readiness on the part of 401(k) plan participants.

1. Size of 401(k) Plan Account Balances

At year-end 2018, the average account balance was \$73,672 and the median account balance was \$16,010, but balances varied widely. For example, about three-quarters of the participants in the 2016 EBRI/ICI 401(k) database had account balances that were lower than \$73,672, the size of the average account balance. In fact, 41.8 percent of participants had account balances of less than \$10,000, while 18.5 percent of participants had account balances greater than \$100,000. The variation in account balances partly reflects the effects of participant age, tenure, salary, contribution behavior, rollovers from other plans, asset allocation, withdrawals, loan activity, and employer contribution rates.

2. Participants' Asset Allocation

Younger participants tended to favor equity funds and balanced funds, while older participants were more likely to invest in fixed-income securities such as bond funds, GICs and other stable-value funds, or money funds. For example, among participants in their twenties, the average allocation to equity and balanced funds was 80 percent of assets, compared with about 64 percent of assets among participants in their sixties. Younger participants had consistently higher allocations to target-date funds. A target-date, or lifecycle, fund pursues a long-term investment strategy, using a mix of asset classes that follow a predetermined reallocation, typically rebalancing to shift its focus from growth to income as the fund approaches and passes its target date. At year-end 2018, 26.6 percent of 401(k) assets in the database were invested in target-date funds, up from 25.3 percent in 2017. Among participants in their twenties, 50.5 percent of their 401(k) assets were invested in target-date funds at year-end 2018; among participants in their sixties, 22.9 percent of their 401(k) assets were invested in target-date funds.

The data shows that investment options that a plan offers can significantly affect how participants allocate their 401(k) assets. In the case of plans that offer neither company stock nor GICs or other stable-value funds, 28 percent of participants in the 2018 EBRI/ICI 401(k) database were in these plans, which generally offer equity funds, bond funds, money funds, and balanced funds as investment options. Another 46 percent of participants were in plans that offer GICs and other stable-value funds as an investment option, in addition to the base options. Alternatively, 12 percent of participants were in plans that offer company stock but no stable-value products, while the remaining 15 percent of participants were in plans that offered both company stock and stable-value products in addition to the base options. Target-date funds were available in 68 percent of the 401(k) plans in the year-end 2016 database. These plans offered target-date funds to 79 percent of the participants in the database. Among participants who were offered target-date funds, 72 percent held them at year-end 2018. Target-date fund assets represented 34 percent of the assets of plans offering such funds in their investment lineups.

3. Participants' Loan Activity

In the 2018 EBRI/ICI 401(k) database, 53 percent of participants were in plans offering loans. However, relatively few participants made use of this borrowing privilege—which has been the case for the 23 years that the database has tracked 401(k) plan participants. At year-end 2018, 19 percent of those eligible for loans had 401(k) plan loans outstanding. As in previous years, loan activity varies with age, tenure, account balance, and salary. Of those participants in plans offering loans, the highest percentages of participants with outstanding loan balances were among participants in their thirties, forties, or fifties. In addition, participants with five or fewer years of tenure or with more than 30 years of tenure were less likely to use the loan provision than other participants. Ten percent of participants with account balances of less than \$10,000 had loans outstanding.

Among participants with outstanding 401(k) loans at the end of 2018, the average unpaid balance was \$8,162, compared with \$7,935 in the year-end 2017 database. The median loan balance outstanding was \$4,486 at year-end 2018, compared with \$4,293 in the year-end 2017 database. The ratio of the loan outstanding to the remaining account balance increased slightly, from 9 percent at year-end 2017 to 10 percent at year-end 2018. In addition, as in previous years, variation around this average tends to correspond with age (the older the participant, the lower the average), tenure (the higher the tenure of the participant, the lower the average), account balance (the higher the account balance, the lower the average), and salary (the higher the participant's salary, the lower the average).

Observations on Today's Typical Retirement Plan Design in Terms of Facilitating Participants' Retirement Readiness

1. Participants fail to take affirmative action to enroll in the plan, with the result that they oftentimes pass up an opportunity to save the amount necessary to secure a comfortable retirement income.

Description of the issue

A March 1, 2021 announcement from the Bureau of Labor Statistics reported the following data for access to employer-sponsored retirement plans by private sector employees as of March 2020:

- 67% had access to employer-sponsored retirement plans
- 3% had access only to defined benefit plans
- 12% had access to both defined benefit and defined contribution plans
- 52% had access to only defined contribution plans

The Pension Protection Act of 2006 ("PPA") took note of the boon to participation in defined contribution plans that automatic enrollment could have and removed disincentives to automatically enrolling employees in defined contribution plans by: (i) establishing safe harbor rules in terms of nondiscrimination; (ii) pre-empting state payroll laws that stated an employee had to make an affirmative election to have his or her salary reduced as a means of contributing to a tax-qualified retirement plan covered by ERISA; and (iii) adding rules to protect plan sponsors and plan fiduciaries from fiduciary liability for the plan's investment performance through the institution of the qualified default investment alternative ("QDIA").

The Internal Revenue Code ("Code") was modified by the PPA to allow for two distinct types of automatic contribution arrangements that serve different purposes. The Eligible Automatic Contribution Arrangement ("EACA") described in Code section 414(w) allows the employer to specify its own unique automatic contribution arrangement with the ability of an employee to withdraw contributions made pursuant to the automatic contribution arrangement. The EACA does not satisfy any nondiscrimination safe harbor, so testing under the actual deferral percentage ("ADP") test and the actual contribution percentage ("ACP") test must still be done. The Qualified Automatic Contribution Arrangement ("QACA") described in Code section 401(k)(13) has prescribed levels of automatic contributions that satisfy the nondiscrimination safe harbor for purposes of the ADP and ACP tests. The intricacies of the EACA and QACA are beyond the scope of this paper.

"Ideal" 401(k) plan retirement readiness design principle #1

The plan sponsor should consider automatic enrollment of eligible employees as participants. Incorporating this principle into the design of a plan sponsor's 401(k) plan will help lessen the gap between the number of employees who are eligible to participate in their employers' defined contribution plans and the number that actually become participants.

2. Many participants fail to elect to contribute a sufficient amount in order to: (i) trigger the maximum matching contribution from their employer; and (ii) accumulate a sufficient amount to provide for their post-retirement income needs.

Description of the issue

The 401(k) plan design puts the onus of saving for retirement on the employees, not on the employer, as is the case in traditional defined benefit plans or other types of defined contribution plans, such as money purchase pension plans. The 401(k) plan design is composed of three distinct components: (i) employee salary deferrals (i.e., savings); (ii) employer matching contributions that are made only if and to the extent of employee savings; and (iii) employer discretionary or profit-sharing contributions.

In order to determine what is "adequate" for their level of savings, participants, first of all, need to determine the amount of post-retirement income they will require to live the retirement lifestyle that they envision. Then, they need to consider the sources of their post-retirement income, which are traditionally composed of three distinct sources, to include: (i) private savings and investments; (ii) employer-sponsored retirement programs (e.g., the 401(k) plan); and (iii) government benefits, such as social security retirement, military or civil service pensions and the like. The last step that participants have to complete with respect to the post-retirement income analysis of their private savings and investment accounts and their 401(k) plan account balances is to ascertain the amount of lifetime income that those accounts balances could possibly provide. Many participants will need the help of a financial professional to assist them in this process.

How can plan design affect a participant's ability to accumulate more of an account balance at retirement? Let's look at the structure of the typical employer matching contribution. A typical employer matching contribution formula might be 50% of the employee's deferrals up to the first 6% of compensation and nothing thereafter. By restructuring the matching formula, the employer could encourage its employees to save more. For example, instead of matching 50% on the first 6% of compensation deferred, the employer could stretch the match to 25% on the first 12% of compensation deferred. This will have the effect of causing participants to defer more of their own compensation in order to attain the maximum possible company match at no additional out-of-pocket cost to the employer. However, any matching formula needs to be considered in light of the requirements for the QACA, if the employer wants to take advantage of the nondiscrimination safe harbor. As part of the restructured matching contribution formula, the employer could specify an automatic escalation in the rate of employee deferrals unless and until the earlier of the time that the employee elects to discontinue the escalation or the rate of employee deferral is 10% of his or her compensation.

"Ideal" 401(k) plan retirement readiness design principle #2

The plan sponsor may wish to consider automatic escalation of contributions by employees and force them to take affirmative action to opt out of any increase versus a plan design that requires employees to make an affirmative election to increase their contributions.

3. To the extent there is leakage in the system in terms of participant account balances being loaned out or distributed in the form of hardship and other distributions (e.g., after a fixed number of years or attainment of a certain age) prior to retirement, participants' ability to fully utilize the 401(k) plan as a wealth-generator will have been compromised.

Description of the issue

The EBRI report for the 2018 year noted that, for those participants who borrowed from their 401(k) plan account balances, the average loan balance was 10% of their account balance, not to exceed \$50,000, which is the statutory maximum on plan loans to participants. The plan must provide that the participant who takes a loan and secures it with his or her account balance must repay the principal amount over a five-year period (unless the loan is secured by a mortgage on the participant's primary residence) with a reasonable rate of interest. The problem for most participants is that they stop their salary deferral contributions when they take out a loan which means that not only are the participants not committing new funds on a regular basis, they also miss out on any employer matching contributions that would be triggered by the participants' salary deferral contributions. Finally, some participants simply default on the loan repayment when their employment ends with the result that some portion of the loan is never repaid.

In the case of 401(k) plans that allow participants to take hardship withdrawals for such reasons as emergency medical expenses, to prevent their home from being foreclosed and similar financial hardships, the amount of the hardship distribution is permanently removed from the affected participant's account balance (i.e., unlike a loan, it cannot be repaid) and the participant is taxed on the amount withdrawn with the additional 10% early withdrawal tax applied if the participant is under age 59 ½.

"Ideal" 401(k) plan retirement readiness design principle #3

The plan sponsor could consider limiting participants' ability to extract funds from their account balances prior to retirement by restricting the availability of loans (i.e., no more than one outstanding plan loan at any given time) and requiring automatic payroll deduction as a means of repaying the loan. The plan sponsor does not have to allow for hardship distributions from its 401(k) plan. In making a plan design decision not to allow for hardship distributions, the plan sponsor will have to assess the impact that not allowing participants to obtain funds prior to retirement by means of a hardship withdrawal will have on participation in the plan and make a determination if restricting participants' access to their accumulated account balances until retirement will offset any negative impact on plan participation from not including the hardship withdrawal feature.

4. Today's typical retirement plan design is structured so participants (who often know very little about investing) make the investment choices with respect to their 401(k) plan account that will affect their future account balance available for retirement. The evidence shows that participants (on average) do not fare as well as professionals when it comes to making investment decisions.

Description of the issue

Because the 401(k) plan is a defined contribution plan, the investment risk is entirely on the participants in the plan. Participants who attempt to invest the assets allocated to their accounts without professional help do not fare as well as those participants who have professional help in investing the assets allocated to their respective accounts.

A report from Aon Hewitt entitled *Help in Defined Contribution Plans: 2006 through 2012* reaches the following conclusions regarding the use of target date funds ("TDFs"), managed accounts, and online advice (collectively referred to in the report as *Help*) in employer-sponsored defined contribution plans:

- Across all age ranges and a wide range of market conditions, participants using *Help* ("Help Participants") earned higher median annual returns than those not using *Help* ("Non-Help Participants").
- The annual performance gap between Help Participants' and Non-Help Participants' median returns was 3.32%, net of fees over the period 2006-2012.
- Example - if two participants (one using Help and the other not using Help) both invest \$10,000 at age 45, assuming both participants receive the median returns identified in the Aon Hewitt report, the Help Participant could have 79% more wealth at age 65 (\$58,700) than the Non-Help Participant (\$32,800).
- TDF usage led the Help category, with 16.9% of all participants investing at least 95% of their assets in a TDF. TDF Help Participants accounted for only 3.7% of plan assets in the study, as most had small balances. The growth in TDF usage is largely because of the fact that TDFs are the default investment option in 12 of the 14 plans that comprised the Aon Hewitt study.
- Managed accounts were the second most prevalent form of Help, with 12.1% of all participants using managed accounts.
- Online investment advice Help usage was 5.4% across all plans.

"Ideal" 401(k) plan retirement readiness design principle #4

As noted in the referenced report from Aon Hewitt, each plan sponsor could consider adding all three forms of *Help* to its plan design: (i) TDFs; (ii) managed accounts; and (iii) online advice.

5. Participants do not sufficiently plan for a guaranteed stream of retirement income; instead, they tend to focus on accumulating a lump sum amount of assets.

Description of the issue

The design of the traditional 401(k) plan emphasizes the accumulation of as large a sum of money (i.e., a lump sum amount) as of the affected participant's normal retirement age as possible. The traditional 401(k) plan has a lump sum distribution as its only method of distributing accumulated assets to the affected participant at retirement or other severance from employment. Thus, it becomes incumbent upon the participant and his or her advisors to find a way to turn that lump sum amount into a stream of retirement income that cannot be outlived.

The Setting Every Community up for Retirement Enhancement ("SECURE") Act was signed into law by President Trump on December 20, 2019. The Act provisions are included as Division O in a larger piece of legislation; i.e., P.L. 116-94 – Further Consolidated Appropriations Act, 2020. The SECURE Act makes substantial changes to the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code ("IRC") provisions relating to retirement plans and individuals' ability to save for retirement.

SECURE Act participant disclosure requirements

Under ERISA 105(a)(1)(A), the plan administrator [ERISA 3(16)] of a defined contribution plan must provide benefit statements to participants annually, or if a participant has the right to direct the investment of assets in the account, quarterly. Prior to the amendments made by the SECURE Act, a benefit statement for a defined contribution plan was not required to include a lifetime income disclosure. The SECURE Act makes changes to ERISA 105(a)(2) by adding subparagraph (D) thereto to provide that the DOL: (i) issue a model lifetime income disclosure; (ii) prescribe assumptions that individual account plan administrators may use to convert total accrued benefits into lifetime income stream equivalents for purpose of the disclosure; and (iii) issue interim final rules not later than one year after December 20, 2019 (the date of enactment). Pension benefit statements must include disclosures regarding lifetime income effective for pension benefit statements furnished more than 12 months after the latest of the three actions described above.

Section 203 of the SECURE Act amended section 105 of ERISA to require plan administrators to include two illustrations of a participant's account balance converted to a lifetime income equivalent – one as a single life annuity ("SLA") and another as a qualified joint and survivor annuity ("QJSA") – at least annually. The SECURE Act also directed the DOL to, within one year of the Act's enactment, prescribe the actuarial and other assumptions necessary for plan administrators to convert an account balance into an SLA and QJSA and to issue model disclosures and an interim final rule. In response to that statutory mandate, the DOL issued an interim final rule ("IFR") that contains the following assumptions that plan administrators must use to

calculate the monthly payment illustrations of participants' account balances as SLAs and QJSAs: (i) assumed commencement date; (ii) assumed age; (iii) a single life annuity benefit illustration; and (iv) a joint and survivor annuity illustration. The IFR specifies an interest rate and mortality assumptions that must be used by the plan administrator [ERISA sec. 3(16)] in making the calculations. There are also special rules for in-plan annuities and deferred income annuities. Finally, the IFR provides model language that can be used.

The IFR provides that no plan fiduciary, plan sponsor, or other person will be liable under ERISA for providing a lifetime income illustration that satisfies the requirements of the IFR. This relief from liability addresses the concern of plan fiduciaries that participants might sue them if actual monthly payments in retirement fall short of illustrations provided prior to retirement. To qualify for this relief, the plan administrator must derive the lifetime income equivalents (i.e., the SLA and QJSA) using the assumptions set forth in the IFR and must use the IFR's model language, or language substantially similar to the model language, in participants' benefit statements.

The effective date of the IFR is September 18, 2021, which is one year from the date the IFR was published in the Federal Register (regardless of when the final rule is published), and shall be applicable to pension benefit statements furnished after such date. Thus, for example, in the case of a calendar year DC plan described in paragraph 2.1.2 that provides only an annual benefit statement, the inclusion of the lifetime income illustrations would be on the statement for December 31, 2021. However, in the case of a calendar year DC plan described in paragraph 2.1.1 that provides quarterly statements, the lifetime income illustrations would not be required to appear until the quarterly statement for the period ending June 30, 2022 because the requirement to include a lifetime income disclosure is required to be included in only one pension benefit statement during any one 12-month period.

SECURE Act fiduciary safe harbor for selection of a lifetime income provider (SECURE Act 204).

As plan participants are increasingly concerned about outliving their sources of retirement income, and as plan fiduciaries are wary of incurring liability for making such investments available to participants, Congress saw the need and filled it with this provision of the SECURE Act, which added ERISA 404(e) and provides measures that a plan fiduciary has the option to take to ensure that the prudence requirement of an ERISA fiduciary is satisfied in selecting an insurer to provide a guaranteed retirement income contract to the plan. Those measures include selecting an insurer that meets certain financial capability requirements. It is also important to note that the plan fiduciary in charge of selecting an insurer is under no obligation to select the lowest cost provider. A fiduciary which satisfies the requirements of ERISA 404(e) shall not be liable following the distribution of any benefit, or the investment by or on behalf of a participant or beneficiary pursuant to the selected guaranteed retirement income contract, for any losses that may result to the participant or beneficiary due to an insurer's inability to satisfy its financial obligations under the terms of such contract. ERISA 404(e) takes effect on December 20, 2019 (date of enactment of the SECURE Act).

"Ideal" 401(k) plan retirement readiness design principle #5

This design principle encompasses the following array of plan design solutions to accomplish the objective of providing participants with a means of providing for a source of lifetime income.

Illustrate Account Balances as Income Streams. To help participants prepare for and live in retirement in a financially secure manner, the plan sponsor and plan administrator will need to be prepared to implement the lifetime income disclosure requirements of the SECURE Act.

Annuity and Installment Distribution Options. The plan sponsor could consider building annuity and installment distribution options into its 401(k) plan in order to afford participants the means to convert a lump sum balance into a stream of retirement income that cannot be outlived. There are two specific types of annuity products offered by insurance companies that a plan sponsor can utilize to accomplish the mission of providing participants with a source of lifetime income: (i) an immediate annuity; and (ii) a deferred income annuity. In exchange for a lump sum payment, the insurance company that issues an immediate annuity provides the annuitant with a lifetime income that cannot be outlived. There are features that may be added to the immediate annuity contract, to include a term certain feature which provides a death benefit in the event the annuitant dies before having received a specified number of payments. A deferred income annuity is one that, in exchange for a lump sum payment, the insurance company will defer the income stream to a later age (no later than age 85).

Immediate Annuity Combined with a Deferred Income Annuity. By using an immediate annuity for a certain number of years in combination with a deferred income annuity, a participant may be able to maximize the value of his or her retirement account for future income benefits. The IRS has issued guidance concerning a form of the deferred income annuity called a qualifying

longevity annuity contract ("QLAC") that allows participants to purchase a deferred income annuity up to \$135,000 (2021 inflation-adjusted amount) and remove that amount from the amount that is used to compute the required minimum distribution.

Target Date Fund with Built-In Deferred Income Annuity. The IRS, in Notice 2014-66, has created an opportunity to include deferred income annuities as a component of TDFs. The IRS describes the way such an arrangement would work, as follows. The same investment manager manages all the TDFs under the Plan, and makes asset allocation decisions using a consistent investment strategy under which the asset mix is designed to change over time, becoming more conservative through a gradual reduction in the allocation to equity investments and a gradual increase in the allocation to fixed-income exposure as the participants in each TDF grow older. Each TDF is available only to participants who will attain normal retirement age within a limited number of years around the target date for the fund. For example, investment in the 2020 TDF is restricted to participants who will attain normal retirement age in 2019, 2020 or 2021.

Each TDF is intended to be a qualified default investment alternative (QDIA) within the meaning of section 2550.404c-5(e) of the Department of Labor regulations, which describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be a QDIA. Each TDF available to participants age 55 or older holds unallocated deferred annuity contracts as a portion of its fixed-income exposure. The deferred annuity contracts are purchased from an insurance company that is independent from the investment manager. None of the TDFs provides a GLWB (guaranteed lifetime withdrawal benefit) or GMWB (guaranteed minimum withdrawal benefit) feature.

As the age of the group of participants in such a TDF increases, a larger portion of the assets in the TDF will be used to purchase deferred annuities each year. The TDFs available to participants younger than age 55 do not include deferred annuity contracts. However, the series of TDFs is designed so that, as the asset allocation changes over time, each TDF will include deferred annuity contracts beginning when the participants in that TDF attain age 55. Each TDF is dissolved at its target date. When a TDF is dissolved, a participant who has an interest in that TDF will receive an annuity certificate representing the participant's interest in the annuity contract held in the TDF. The certificate provides for immediate or deferred commencement of annuity payments in accordance with the terms of the annuity contract and the plan. The remaining portion of a participant's interest in that TDF is reinvested in other investment options within the Plan.

Observations on today's typical retirement plan design in terms of potential liability of plan sponsors and fiduciaries with respect to participants' investment decisions

1. Many plan sponsors and fiduciaries assume that simply making investment selection choices available to participants relieves them of liability for investment decisions made by the participants. They fail to understand the intricacies of the ERISA section 404(c) regulations.

Description of the issue

A plan sponsor and/or fiduciary that incorporates direction of investments by participants as part of its plan design does not want to be responsible for the investment selections made by the participants. To the extent that authority for making investment decisions with respect to the assets allocated to their accounts has been ceded to the participants, the responsibility for making those investment decisions should also accrue to the participants and not the plan sponsor or fiduciary.

The DOL promulgated regulations implementing ERISA section 404(c) in 1992. Since the regulations were first promulgated, they have been amended over the years to add more requirements and to incorporate the requirements of the Pension Protection Act of 2006. The purpose of the regulations is to allow plan fiduciaries to transfer liability for investment decisions made by the participants with respect to the assets in their respective accounts from the fiduciaries to the affected participants. In order to be able to transfer that liability, the fiduciaries must satisfy the requirements of the regulations which can be complicated to understand and execute. The three fundamental elements of the ERISA section 404(c) regulations are: (i) at least three broadly diversified investment choices; (ii) the ability of the participant to change investments at least once each quarter; and (iii) certain notification requirements from the fiduciary to the participant.

The problem is that the regulations have become incredibly complex over the years, such that when the regulations are parsed, the three fundamental elements evolve into a checklist that contains 41 separate items that must be met in order to achieve the objective of transferring liability for investment decisions made by the participants from the plan fiduciaries to the participants who actually make the investment decisions with respect to their own accounts. Many plan sponsors and fiduciaries are not

aware of the intricate requirements of these regulations and, as a result, do not effectively transfer the liability for investment decisions made by participants from themselves to the affected participants.

"Ideal" 401(k) plan sponsor and fiduciary investment protection design principle #1

To insulate plan sponsors and fiduciaries from liability associated with participant investment direction, a plan sponsor could eliminate participant investment direction from the 401(k) plan design and have all investment decisions made by a registered investment adviser acting in the capacity of an ERISA section 3(38) investment manager. However, it is almost unheard of to suggest that participants not be allowed to select their own investments, as the entire 401(k) plan industry has evolved into a gigantic mutual fund platform that focuses on educating participants into becoming their own investment experts. As noted above in the discussion of *Retirement Readiness Design Principle #4*, participants do not fare as well as investment professionals when it comes to achieving investment returns with respect to their 401(k) plan account balances. That fact, coupled with the fact that many plan sponsors and fiduciaries are unaware of the intricacies of the ERISA section 404(c) regulations and, therefore, have not (in many cases) successfully transferred the liability for the investment decisions being made by participants from themselves to the affected participants, leaves many plan sponsors and fiduciaries exposed from a fiduciary liability standpoint.

To address the issue, the plan sponsor could, alternatively: (i) preclude participants from directing the investment of assets allocated to their respective accounts (not very realistic given current 401(k) plan models); (ii) mandate the use of TDFs, managed accounts, and/or advice from an investment advice fiduciary [ERISA section 3(21)(A)(ii)]; or (iii) continue to work with the plan's service providers to offer the participant robust investment education and interactive retirement planning tools that can assist participants to make better investment decisions. If, under the prevailing facts and circumstances, the plan sponsor and fiduciary decide that participants will be given the ability to direct their own investments, the services of an ERISA attorney should be employed to make sure that the requirements of the ERISA section 404(c) regulations are being followed, so as to effectively transfer the liability for the investment decisions made by the participants from the plan sponsor and fiduciaries to the affected participants.

2. The plan administrator [ERISA section 3(16)] has many fiduciary responsibilities associated with the operation of the participant investment direction program, including the gathering and dissemination of information regarding the investment options available to participants and the associated fees and expenses, rates of return, etc. associated with each designated investment alternative available to participants.

Description of the issue

The DOL has issued new regulations [29 CFR 2550.404a-5], commonly referred to as the "404a-5 regulations," that expand on the fiduciary standards set forth in ERISA section 404(a)(1)(A) and (B) and that apply to the investment of plan assets. The regulations state a requirement that, when the documents and instruments governing an individual account plan provide for an allocation of investment responsibilities to participants or beneficiaries, the plan administrator [ERISA section 3(16)] must take steps to ensure that the participants and beneficiaries are made aware, on a regular and periodic basis, of their rights and responsibilities with respect to the assets in their individual accounts. This responsibility on the part of plan administrators encompasses providing sufficient information regarding the plan and its investment options, including fees and expenses, to allow the participants and beneficiaries to make informed investment decisions.

The problem, in terms of plan design, is that many plan sponsors also serve in the capacity of plan administrator [ERISA section 3(16)] and are unaware of their responsibilities concerning the dissemination of information to participants who direct the investment of assets allocated to their respective accounts, as set forth in the 404a-5 regulations. Failure to comply with the letter of the regulations subjects the plan administrator to potential liability for the commission of a prohibited transaction under ERISA and a claim that basic fiduciary duties have been violated.

"Ideal" 401(k) plan sponsor and fiduciary investment protection design principle #2

In the typical 401(k) plan design, the employer who sponsors the plan also serves in the fiduciary role of plan administrator but is not properly equipped to do so. In the design of the "Ideal" 401(k) Plan, the employer hires a professional firm to serve as the plan administrator and, in so doing, removes from the employer the separate role and responsibility of serving as the plan administrator. The professional firm serving as the plan administrator will take unto itself all the fiduciary responsibility for properly administering the participant notifications required under the ERISA section 404a-5 regulations.

3. Individuals who serve as discretionary trustees (i.e., full responsibility and authority over the plan's investments) may be taking on more risk with respect to the plan's investments than is necessary.

Description of the issue

Only two categories of persons may serve as trustee of the plan's trust and its assets: (i) individuals (persons), usually the owner of the plan sponsor or one or more key employees of the plan sponsor; and (ii) a corporate entity with trust company powers under applicable state law. The position of trustee is also broken down into two categories when describing the trustee's control over the investment of the plan's assets: (i) discretionary (full responsibility and authority); and (ii) directed (limited responsibility and authority).

The most problematic, from a position of potential liability for investment decisions, for a trustee is to be an individual who is a discretionary trustee. Many plan sponsors, when they are making decisions with respect to the structuring of the plan fail to appreciate the responsibility and potential liability for investment of the plan's assets that individuals who serve as discretionary trustees are undertaking.

"Ideal" 401(k) plan sponsor and fiduciary investment protection design principle #3

There are three progressive steps that a plan sponsor can incorporate into its plan design that will offer increasing degrees of protection from potential liability associated with the investment of the plan's assets.

Assuming that the plan sponsor decides that it wants to appoint one or more individuals to serve as a discretionary trustee, the discretionary trustee (once appointed) could seek out the services of a professional fiduciary investment adviser [ERISA section 3(21)(A)(ii)] who agrees to serve as a co-fiduciary with respect to the investment of the plan's assets. This does not relieve the discretionary trustee of liability associated with the investment of the plan's assets, but it does provide some degree of protection in the form of co-fiduciary liability on the part of the fiduciary investment adviser. The contract between the discretionary trustee and the fiduciary investment adviser may also contain provisions under which the fiduciary investment adviser agrees to indemnify and hold harmless the discretionary trustee in connection with advice rendered by the fiduciary investment adviser.

If the plan sponsor decides that it still wants to appoint one or more individuals to serve as trustee, but is seeking a greater degree of protection for the trustee from liability associated with the investment of plan assets, the plan sponsor may appoint the individual(s) as a directed trustee. In this type of trustee arrangement, the trustee does not make investment decisions with respect to the plan's assets. The trustee receives investment direction either from another fiduciary investment manager [ERISA section 3(38)] or from the participants under an arrangement that properly takes into account the ERISA section 404(c) regulations (discussed above).

The final option for the plan sponsor in terms of appointing a trustee and the associated duties of investing the plan's assets is to appoint a corporate trustee (i.e., an entity that possesses trust company powers under applicable state law). The corporate trustee (and not one or more individuals employed by the plan sponsor) would bear all the responsibility and liability for the investment decisions with respect to the plan's assets. The corporate trustee could also serve as a directed trustee, as described in the preceding paragraph.

Conclusion — The "ideal" 401(k) plan design

The formula for determining the amount of money that may be accumulated by any participant in a defined contribution plan as a source of retirement income is: [Employee Contributions + Employer Contributions + Forfeitures added to the Account - Forfeitures deducted from the Account] + [Investment Gains - Investment Losses] - Expenses Allocated to the Employee's Account = Dollar Amount Available to be Spent on Providing Retirement Income. In summarizing the "Ideal" 401(k) plan design, we focus on three phases of the plan participant's retirement plan lifecycle: (i) enrollment and contributions; (ii) investment performance and expense management, together with the fiduciary risk factors associated therewith; and (iii) the post-retirement distribution phase. In so doing, we incorporate the principles discussed above into the three phases of the plan participant's retirement plan lifecycle.

Enrollment and Contributions. In the first phase, our objective is to encourage participation in the plan by all eligible employees and to make sure that each eligible employee is contributing a sufficient amount to trigger the maximum matching contribution from his or her employer and, that coupled with a well-designed investment strategy will lead to the maximum possible accumulation of assets with which to provide post-retirement income. The "Ideal" 401(k) plan design achieves this objective by utilizing auto-enrollment of the employee in the plan and auto-escalation of employee contributions to ensure that: (i) all eligible employees are enrolled in the plan; and (ii) eligible employees make a financially meaningful contribution toward their retirement savings that triggers a significant matching contribution on the part of their employer. To prevent "leakage" (defined as use of plan assets by participants prior to retirement for purposes other than retirement income), the "Ideal" 401(k) plan design restricts the ability of participants to access their account balances through loans and hardship withdrawals.

Investment Performance. The second phase of a plan participant's retirement plan lifecycle focuses on the growth of the contributions (both employee and employer) that have been allocated to his or her account. The main factors impacting the growth of the accumulated contributions are investment performance and the drag of plan and investment expenses. Research has shown that professionally-invested accounts perform better than accounts in which participants choose their own investments without professional help. However, participant-directed investment plans are the norm in the 401(k) plan world. Therefore, the "Ideal" 401(k) plan design for a plan design in which participants direct the investment of assets allocated to their accounts is one that seeks to maximize investment performance by defaulting a participant's contributions into an age and risk appropriate target date fund or other acceptable qualified default investment alternative ("QDIA") that is professionally managed. For those plan participants who have the desire and the expertise to make their own investment choices, the "Ideal" 401(k) plan design affords them the opportunity to do so through the use of a mutual fund window (i.e., a plan feature that makes available mutual fund selections not offered in the plan's standard fund lineup) or a self-directed brokerage account (i.e., a plan feature that allows participants to purchase individual stocks and bonds and other ERISA-approved investments outside of the plan's standard fund lineup). To assist those participants who want help in selecting their investments, the "Ideal" 401(k) plan makes available robust investment education services from experienced financial professionals and/or actual investment advice from SEC-registered investment advisers who are fiduciaries under ERISA section 3(21)(A)(ii).

Expense Management. According to a publication of the Employee Benefits Security Administration entitled *A Look at 401(k) Plan Fees*, expenses play a significant part in how much of an account balance an employee will accumulate at retirement:

Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of \$25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to \$227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only \$163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

The "Ideal" 401(k) Plan design addresses the issue of expense management by selecting only those funds for inclusion in the array of investment alternatives offered to participants that have passed rigorous screening requirements and provide the best overall performance in relation to the fees being charged. The fiduciaries of the "Ideal" 401(k) Plan also scrutinize the expenses and fees of service providers to the plan, such as attorneys, accountants, investment professionals, and third-party administrators or record keepers, to make sure that their charges are in line with what is reasonable and customary for the types of services being provided to a plan similar in characteristics to the plan in question.

Fiduciary Risk Mitigation. To mitigate the fiduciary risk associated with status as a plan administrator, the plan sponsor could appoint a professional firm that would agree to carry out the duties of plan administrator and assume the fiduciary liability associated therewith. To mitigate the risk that comes from being a trustee, the "Ideal" 401(k) Plan design could incorporate the following types of trustee structures, each with an increasing level of protection in terms of fiduciary risk mitigation: (i) one or more individuals serving in a discretionary trustee capacity, with the assistance of a co-fiduciary investment adviser [ERISA section 3(21)(A)(ii)]; (ii) one or more individuals serving in a directed trustee capacity, with the investment management being handled by a fiduciary investment manager [ERISA section 3(38)]; or (iii) an institutional trustee possessing trust company powers under applicable state law.

Post-Retirement Income Planning. An employee/participant spends his/her working years accumulating assets and then enters into a new phase upon retirement, when the accumulated assets in the employer's 401(k) plan together with other personal assets and government benefits, such as social security retirement and/or military retirement benefits, must be effectively managed to provide a lifetime of income for the affected participant. Of course, the problem that all of us face when planning for a lifetime of retirement income is that none of us knows how long he or she will live, nor do we know with any degree of certainty what kinds and amounts of expenses we will face in our retirement years. Many studies have concluded that a retiree's greatest fear is outliving his or her income. So, how can the "Ideal" 401(k) Plan design help prepare participants in the plan for a life in retirement that is free from the worry of outliving one's income?

Post-Retirement Income Distribution Phase. There are several design features that the "Ideal" 401(k) plan can incorporate to facilitate the goal of providing the retired participant with a source of income that cannot be outlived. First of all, the distribution options available in the plan could be amended to include both annuity and installment payment options from the plan itself. As part of the annuity distribution options, the plan design could provide for both immediate and deferred income annuities. By structuring his or her retirement income distribution partly in the form of an immediate annuity coupled with a deferred income annuity that qualifies under the IRS rules as a qualifying longevity annuity contract ("QLAC"), the retired participant can accomplish his or her goal of establishing a source of retirement income that cannot be outlived.

For the plan sponsor that does want to complicate its plan design with installment and annuity distribution options, it could facilitate a rollover to an IRA of the retired participant's choosing that would provide the immediate and deferred income annuity combination for distribution of the participant's retirement benefit.

Finally, the plan sponsor and trustee can seek out unique target date funds (TDFs) of the type described in IRS Notice 2014-66 that incorporate a deferred income annuity into the TDF, thereby facilitating a participant's retirement income distribution planning without having to make any changes in investments upon reaching the target retirement date of the particular TDF.



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