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RISKS TO DC PLANS: INVESTMENT MENU DESIGN & EMPLOYEE COMMUNICATIONS

Plan sponsors must design their investment menus as fiduciaries acting in the best interests of their plan participants. This well-known, long-standing obligation has come under heightened scrutiny of late as litigation aimed at excessive fees has increased nearly five-fold this year1. Plan sponsors would be well served to carefully review their plan offering (as well as many other aspects of their plan) for compliance with this important fiduciary liability.

At a minimum, this means that the investment options that are offered should cover a wide range of asset classes and investment styles so that participants' individual portfolios can be tailored to their personal goals and risk tolerances. It also means that the sponsor should ensure that participants are provided with timely reports of fund managers' performance and style consistency, as well as any other information participants might need to manage their portfolios effectively.

Employers who sponsor tax-favored retirement savings programs for their employees are more than just dispensers of fringe benefits. They are fiduciaries who have a legal obligation to ensure that the plan is properly equipped to meet the tangible retirement goals of the participants. One important expression of this fiduciary responsibility is the obligation to provide a suitable selection of investment choices in the plan's menu of investment options.

ERISA AT THE ROOT

The Employees Retirement Income Security Act of 1974, as amended, (ERISA) created the legal foundation for these requirements. ERISA compels employers to clearly define the funding, investment, and custody practices to be used in the plan, and it established the "prudent person" standard for evaluating the appropriateness of the relevant policies, procedures, and services. In other words, the plan must do what a knowledgeable professional in the field might do or be expected to do under the same circumstances.

In the context of defined-contribution investment management, a plan sponsor has two basic choices. One alternative is to make all investment decisions and assume the risks inherent in asset management. The other is to provide a suitable menu of investment options and allow participants to make their own asset management choices. If this second option is done according to the detailed provisions of ERISA's Section 404(c), it means that the participant will assume the risks of his or her investment decisions.

A plan investment menu that complies with the terms of Section 404(c) must provide a range of investment portfolios that might be appropriate to the ages, retirement goals, and risk tolerances of all employees. At an absolute minimum, that means a plan must include at

least three diversified core investment options, each of which has different risk and return characteristics. The investment choices in this menu must be sufficiently liquid to permit participants to change their investment selections at least once each quarter. And the plan must provide the participant with sufficient information about the performance and composition of the investment options so that the participant has the opportunity to make appropriate choices.

MAKING IT RIGHT, FROM THE START

A typical investment menu may offer a significant number of customized investment vehicles as well as access to a wide array of mutual funds. But despite the appearance of diversity, there is a significant risk that the menu will not fully meet the strictures of Section 404(c). To do so, the customized investment options should be professionally designed to meet specific planning goals, and these options must be clearly identified as to their asset class and investment style composition. The mutual funds that are offered should likewise cover the full range of asset classes needed to create targeted portfolios for diverse retirement horizons and risk tolerances. The industry-standard asset classes include large- mid-, and small-cap domestic stocks; global developed-market stocks; global emerging market stocks; long-, medium-, and short-term bonds; and money market funds. Many stock portfolios are also managed according to styles such as growth, value, and sector. Since diversified portfolios for any planning goal require assets of several different classes and styles, an appropriate investment menu should be built to provide the needed diversity across all of these categories. Haphazard fund selection focusing on popular or widely known funds introduces the risk that important investment categories might be overlooked and thus unavailable to plan participants.

Other considerations imposed by Section 404(c) in menu setup include manager selection and due diligence. An ideal menu will include managers who have the potential to outperform their peers after all fund management costs and investment expenses are accounted for. And an ideal menu selection process will include relevant documentation of all investigations and analyses.

AN ONGOING RESPONSIBILITY TO MANAGE THE INVESTMENT MENU

Under ERISA's Section 404(c), the plan sponsor is responsible for ensuring that the actual behavior of fund managers included in the plan's investment options is carefully monitored for consistency and performance. The sponsor should also ensure that any relevant developments are reported to participants in a timely manner. For example, fund managers sometimes change their asset class or style targets as the market climate changes. The plan sponsor should be certain that these instances of drift are identified and reported to participants so that the participants can decide whether to adjust their own portfolio balance if need be. Also, if a fund manager's performance deviates significantly from benchmarks, the sponsor is responsible for ensuring that the divergence is properly explained to participants.

WEEDING THE MENU

There may come a time when it is necessary to remove a fund from an investment menu. The manager may have drifted too far from original style targets, the management team may have been broken up or the fund performance may have begun to lag peers chronically. When a fund is removed from the plan roster, its place should be taken by a fund with similar risk, reward, and style characteristics so as to sustain the diversification blueprint created by the plan's initial design. Whenever a fund is removed, participants should be told that an investment option is being eliminated or replaced by a comparable fund and why this action was taken. This should be done as soon as possible. Participants can then be offered the option of either transferring their assets automatically to the replacement fund or reallocating their portfolios.

CODIFYING THE LOGIC BEHIND AN INVESTMENT MENU

Many experts recommend that the steps used to evaluate each investment manager, the rules used to select each investment option, and the procedures for monitoring and amending the investment menu be set forth in a formal investment policy. This policy could also spell out the intended risk and return profiles of each investment option and define the benchmarks to be used for evaluation. And it can spell out the guidelines for manager termination.

1From: 401Kspecialist Nov 30, 2020

The laws defining a sponsor's obligations under ERISA are changing constantly, and this summary cannot replace professional plan design, implementation, and legal advice. So before taking any action, please consult with an appropriate professional who has expertise in ERISA law. But a plan that broadly adheres to these principals can serve the needs of participants and sponsors alike for a stable, predictable retirement savings program.

KEY PLAN DOCUMENTS TO SHARE WITH PARTICIPANTS

Getting the word out about your retirement plan is an ongoing activity. In addition to the enrollment materials you provide newly eligible employees, you probably communicate with participants routinely, answering their questions and encouraging them to take full advantage of the plan.

REQUIRED DOCUMENTS

In addition to these efforts, plans are required to make certain plan documents available to all plan participants and beneficiaries receiving benefits. Required documents include the following:

- Summary plan description (SPD). This easy-to-understand description of the plan's provisions must be distributed to employees within 90 days of becoming plan participants. The SPD must contain specified information about the plan, such as requirements for participation and a description and explanation of the plan's provisions for determining years of service for purposes of eligibility and vesting. When your plan is materially amended or modified, you must revise the SPD within a specified period (210 days after the end of the plan year that occurs five years after the last date there was a change). Where no such amendments have been made, you must furnish an updated SPD within 10 years and 210 days after the required date for the original.
- Summary of material modifications (SMM). If your plan is amended and the amendment affects information that is required to be in the SPD, participants must receive an SMM. The SMM must be distributed within 210 days after the close of the plan year in which the modification occurred. If the SPD lists the modifications, it can be issued in place of the SMM provided an updated SPD is prepared and distributed within the same 210-day period.
- Summary annual report (SAR). Department of Labor (DOL) regulations outline what must be included in this summary. The SAR generally must be distributed by the later of (1) nine months after the end of the plan year or (2) two months after the due date of the plan's Form 5500 (including any extensions from the IRS).

DOCUMENTS REQUESTED BY PARTICIPANTS

Upon receiving a request from a participant or beneficiary, the plan administrator must provide the most recently updated SPD, the most recent annual report, and any other documents under which the plan is established or operated (e.g., the bargaining agreement, trust agreement, or contract). The DOL has further clarified that these documents should also include any material that details formulas, procedures, methodologies, and schedules used to determine a benefit.

EXPENSES OF PROVIDING INFORMATION

The plan administrator may not charge participants for required documents, but participants can be charged for additional copies of required documents they have already received. As for requested documents, participants may be charged a reasonable fee of up to 25¢ per page. The DOL considers a fee reasonable if it is equal to the actual per-page cost of the least expensive way of reproducing the documents. Reasonable expenses do not include handling and postage fees.

PENALTY FOR NOT BEING TIMELY

Administrators must provide copies of materials required to be disclosed under the pension law within 30 days of receiving a participant's request. A penalty of up to $110 per day may be imposed for failing to furnish documents within this time frame.

This penalty applies to each individual participant request, so each violation is a distinct event. If multiple participants request a document and don't receive it within 30 days, the daily $110 penalty applies to each separate request. However, the penalty is not enforced if the cause for the delay is reasonably beyond the control of the plan administrator.

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