Promoting and evaluating the success of your plan

Prepared by The Wagner Law Group

What's inside

All investments involve risk, including possible loss of principal.

Important Note: The Wagner Law Group has prepared this white paper on behalf of Legg Mason & Co., LLC. This paper includes suggested practices and metrics that plan sponsors, and the financial professionals who work with plan sponsors, may wish to consider in promoting and evaluating the success of their plans. It is important to note that the suggested practices and metrics are not the exclusive means of promoting and evaluating the success of a plan. Other combinations of practices and metrics also may be effective. Plan sponsors and other fiduciaries should consult with their own legal counsel concerning their responsibilities under ERISA in the administration and management of their respective plans.

Future legislative or regulatory developments may significantly impact these suggested practices and the related matters discussed in this paper. Please be sure to consult with your own legal counsel concerning the application of ERISA to the selection of plan investments and any related future developments.

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FiduciaryFirst
Where Process Drives Success

Introduction

401(k) plans and other similar tax-qualified retirement plans ("Plans") are important long-term savings vehicles that employers can establish for the exclusive benefit of their employees. Plan sponsors and other responsible fiduciaries should consider establishing voluntary goals to help evaluate and promote the success of their Plans. Focusing on the right goals can substantially improve a Plan's performance and help assure a Plan's success as an employer-sponsored benefit arrangement for employees. Plan fiduciaries who take the initiative to improve Plan performance can mitigate the legal risks associated with operating their Plans and also reduce their potential fiduciary liability. Successfully managed Plans can also help employers reap the economic rewards of a more motivated and productive workforce.

Legal standards for plans and plan fiduciaries

In recognition of the need to promote and to protect the retirement savings of Plan participants, federal law imposes strict requirements on Plans, which are interpreted and enforced by the Internal Revenue Service (the "IRS") and the U.S. Department of Labor (the "DOL"). In addition to imposing other requirements, these rules require Plan sponsors to ensure that their Plans meet certain participation requirements and that the investment alternatives offered to Plan participants meet certain fiduciary standards.

The IRS rules and the underlying tax laws governing Plans include numerous requirements that must be satisfied in order for a Plan to maintain its tax-qualified status. These rules include a nondiscrimination test that is designed to ensure that a sufficiently broad cross-section of the employer's workforce actually contributes to the Plan each year, and also to ensure that the Plan does not disproportionately benefit highly compensated employees.

To satisfy the annual nondiscrimination test, the average payroll contributions made by the employer's highly compensated employees ("HCEs") under the Plan must not be disproportionately greater than the average payroll contribution made by the non-highly compensated employees ("NHCs").[1] Thus, a Plan generally will satisfy the nondiscrimination testing requirement if a balanced mix of employees (HCEs and NHCs) contribute to the Plan and the average amounts contributed by the respective groups are comparable. A failure to satisfy this nondiscrimination test would result in a qualification failure under the IRS rules. Such failure may, in turn, result in heavy tax penalties for the employer, and it could even result in the disqualification of the Plan if the failure were to remain uncorrected.[2]

While the IRS rules regulate the benefits-related aspects of Plans, the DOL rules issued under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), govern how Plan sponsors and other responsible fiduciaries may offer investment alternatives to the Plan's participants. Plan fiduciaries have a duty to prudently select and monitor the investment alternatives offered to Plan participants.[3] Furthermore, the DOL rules are designed to ensure that the participants are "aware of their rights and responsibilities" with respect to the investment of their Plan accounts and to ensure that they have "sufficient information" regarding the Plan and the Plan's investment alternatives.[4] A failure to satisfy the DOL's requirements may result in the responsible Plan fiduciary becoming subject to personal liability for any related losses incurred by the Plan's participants, as well as additional civil penalties.[5]

1 Section 401(k)(3) of the Internal Revenue Code.

2 IRS Revenue Procedure 2013-12.

3 Section 2550.404a-5(f) of the DOL regulations.

4 Section 2550.404a-5(a) of the DOL regulations.

5 ERISA Sections 409 and 502.

Legal benefits for promoting plan success

Given the severity of the penalties for the failure to comply with the IRS' or DOL's rules, Plan sponsors have a legal incentive to manage their Plans in compliance with their requirements. Specifically, Plan sponsors should be monitoring participation levels within their Plans and they should seek to improve the contribution rates of their Plan participants as necessary. They should also be managing their respective Plan's menu of investment alternatives prudently, and they should make sure that the Plan's participants have sufficient information with respect to the Plan and the investment of their individual Plan accounts in accordance with the DOL rules.

The good news is that many Plan sponsors view these legal incentives to be wholly aligned with their economic incentive to manage their Plans as successful retirement vehicles for their employees. Typically, a Plan sponsor's overall vision for a successful Plan includes its benefitting as many employees as practicable and helping each participant to save appropriately for his or her retirement years. Accordingly, many Plan sponsors are interested in promoting participation and improving the contribution rates of their Plan participants. They are also interested in ensuring that the Plan offers an appropriate selection of investment alternatives and that the Plan's participants are equipped with the necessary knowledge to properly manage the investment of their individual accounts.

Furthermore, by promoting the success of the Plan, the Plan sponsor is able to reduce and mitigate its risk of potential Plan-related legal liability. Employees who are satisfied with the level of retirement savings in their Plan may be less likely to file legal claims against the Plan sponsor and the Plan's other fiduciaries. Furthermore, participants who are financially literate and able to appreciate the risk-return trade off found across all investments may be less inclined to file legal claims relating to any short-term volatility exhibited by one or more of the Plan's investment alternatives. Thus, when a Plan sponsor promotes the success of its Plan in this manner, it may be able to significantly reduce the likelihood of any Plan-related litigation and mitigate the risk of potential Plan-related liability.

Economic benefits for promoting plan success

Additionally, when Plan sponsors are able to manage their Plans successfully, they may also able to reap the rewards of increased worker productivity and the other economic gains that are typically associated with a successful Plan. Employees who are able to save meaningful amounts through their employer-sponsored retirement vehicles may display increased worker loyalty, reducing employee turnover and employee absenteeism. Furthermore, employees who are financially literate and who exercise greater financial discipline may be able to apply their knowledge and skills to the workplace, improving productivity.

Conversely, employees who have serious concerns with regard to their financial security in the near future may be less productive, and their personal concerns may distract them from workplace priorities. If older workers continue employment with their firm solely because they cannot afford to retire, they may feel that the Plan sponsor has failed them in some way. As the number of workers who cannot afford to retire rises at a firm, feelings of resentment may become widespread, hurting employee morale and workplace productivity. In addition, if an employer chooses to offer early retirement to its workforce members, employees with inadequate retirement savings may be substantially less likely to accept the employer's offer.

As discussed above, the benefits of Plan sponsors who promote the success of their Plans may be manifold. By promoting participation in the Plan and offering an appropriate selection of investment alternatives in a prudent manner to participants, Plan sponsors can avoid the legal penalties under the IRS and DOL rules, as well as mitigate their potential liability. They may also enjoy the economic gains often associated with successful Plans, such as significant increases in worker productivity, improved employee morale and other related economic benefits.

Using plan-related metrics to evaluate level of plan's success

To promote the success of their Plans, Plan sponsors should consider examining various Plan-related metrics to help them evaluate the performance of their respective Plans. In fact, as a suggested "best" practice, they should consider using the metrics described below to establish specific goals for the Plan and to measure the Plan's progress in improving its performance and attaining these specific goals.

Participation Rate. One metric that is customarily recorded by the providers of Plan recordkeeping services is the number and proportion of eligible employees who actually contribute to the Plan (the "Participation Rate"). Many providers are able to compute the Participation Rate for the entire workforce or for subcategories of employees. For example, a provider may be able to identify the Participation Rate for employees in a certain age bracket (e.g., age 21–age 30) or for employees who are in a certain income range (e.g., $50,000–$75,000).

Contribution Rate. Another metric that is routinely measured by Plan recordkeepers is the average rate of payroll contributions made by the Plan's eligible employees (the "Contribution Rate"). As is the case with Participation Rates, recordkeepers are also often able to determine the Contribution Rate for the entire Plan population or for segments of such population. For example, a provider may be able to identify the Contribution Rate for employees in a certain age bracket or income range.

Portfolio Risk. Some recordkeepers are able to review a participant's investment allocation across the Plan's designated investment alternatives and evaluate the level of portfolio risk ("Portfolio Risk") for such a participant based on the historical volatility or other risk-related metrics of the underlying portfolio investments. By way of illustration, a recordkeeper may be able to identify the Portfolio Risk for a participant's account by calculating a historical risk-related metric for the participant's portfolio (e.g., the portfolio has a standard deviation of 64% over a 10-year trailing period) or by categorizing the participant's account as a risk-based portfolio type (e.g., conservative, moderate, aggressive) based on the historical risk-related criteria designated by such a recordkeeper. Portfolio Risk information may be computed for the entire Plan population or for segments of such population. For example, the recordkeeper may be able to ascertain the percentage of participants in a certain age bracket who have invested their accounts with an "aggressive" level of Portfolio Risk.

Investment Education. Given the difficulty of directly measuring the level of financial literacy or investment education ("Investment Education") of participants, Plan sponsors should consider examining metrics that are indirectly associated with Investment Education, such as the frequency of participation in a Plan's investment education program or the length of time that a participant has remained on a website page to view the educational information posted there. For example, the Plan sponsor may wish to track the number of people attending its annual investment education meetings, as well as the number of new attendees and the number of regular attendees.

Retirement Readiness. Recordkeepers have developed various metrics for measuring the level of financial wellness for participants or their readiness for retirement ("Retirement Readiness"). One simple metric used to measure a participant's Retirement Readiness is based on the participant account balance, where the current balance is converted to a multiple of the participant's annual income from the employer (e.g., account balance is 16 times participant's current income level). Other recordkeepers have developed more sophisticated ways of assessing a participant's Retirement Readiness. For example, another way to measure Retirement Readiness would be to forecast a participant's "projected replacement rate" or the projected retirement income (stated as a percentage of projected pre-retirement income) that is expected to be generated from the participant's future account balance. For example, the projected replacement rate for a participant may be estimated to be 85% of his or her projected pre-retirement income, based on an assumed earnings rate for the participant account and an assumed rate of future contributions to such an account.

Establishing goals to measure a plan's success

Once a Plan sponsor has identified the key metrics that it intends to utilize to evaluate the Plan's level of success, the Plan sponsor may wish to obtain benchmarking information for comparative purposes, so that it can evaluate how the Plan is performing in comparison to other similarly situated Plans in particular areas. Armed with such benchmarking information, in addition to the Plan's current performance information, the Plan sponsor would be well-positioned to establish appropriate goals for the Plan's operation.

For example, a Plan's fiduciaries may determine that the Plan's goal with respect to participation is going to be a Participation Rate of 90% for the entire Plan population. After observing that the NHCs in the employer's workforce are contributing substantially less than the HCEs, the Plan's fiduciaries may also determine that the Plan's goal for the segment of employees earning less than $50,000 will be a Contribution Rate of 5% of compensation.

As a further example, if the Plan's fiduciaries observe that a disproportionately large segment of young employees (under age 25) have accounts with a "conservative" Portfolio Risk, such fiduciaries may determine that the goal with respect to such participants will be to have at least 90% of them attend the Plan's Investment Education meetings until their Portfolio Risk metrics are more consistent with the Plan's benchmarking results. And as a final example, the Plan's fiduciaries may determine that its Retirement Readiness goal for those participants who are age 60 or older is going to be an average projected replacement ratio that is forecasted to be at least 70% of their pre-retirement income.

Using goals to improve a Plan's performance

When the Plan's fiduciaries establish their goals for the Plan, they should bear in mind that these goals are voluntary objectives that are intended to help them define what it means for their Plans to be operating as successful retirement vehicles for their employees. Therefore, the goals should be viewed as aspirational in nature, and a failure to attain one or more goals over time should not necessarily be viewed negatively. Instead, the Plan's fiduciaries should consider using the goals as a tool to help them monitor the overall health of the Plan annually and to better manage the Plan's operations in the long run.

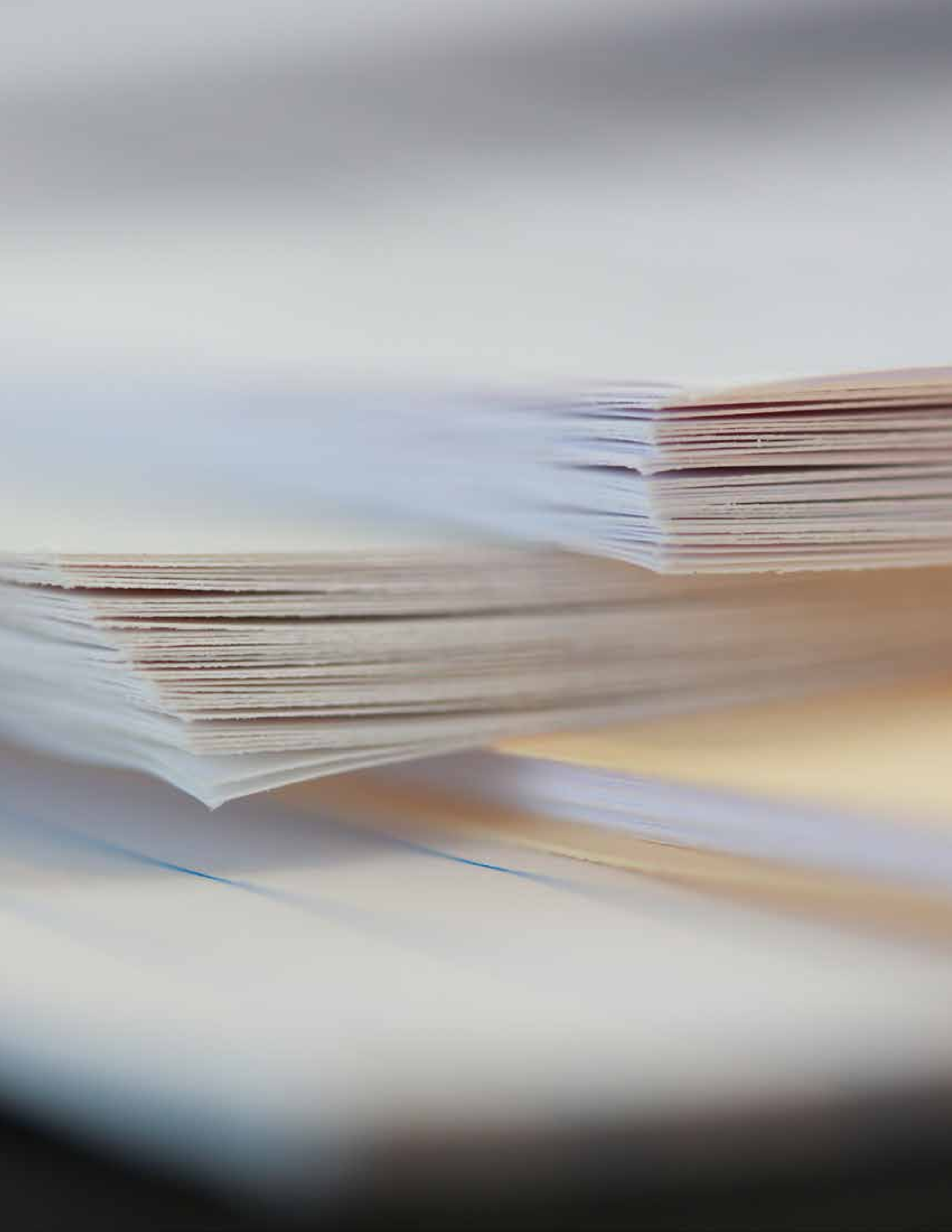
If the relevant Plan-related metrics are not improving or are deteriorating, it may be a symptom of a serious underlying problem. In these potentially adverse situations, the Plan's fiduciaries should consider identifying the root cause of any perceived problem and investigating the matter to determine the extent to which the Plan may be falling out of compliance with a requirement under the IRS' or DOL's rules. For example, if the Plan's overall Participation Rate were to decline suddenly, the fiduciaries should consider its potentially adverse impact on the Plan's nondiscrimination test results under the IRS rules.

How service providers can help plans succeed

To manage the Plan successfully as an effective retirement vehicle for employees, the Plan sponsor should explore working with qualified service providers with the appropriate capabilities and expertise. With respect to Plan recordkeeping services, as discussed above, it would be beneficial for the Plan's fiduciaries to work with a recordkeeper that is able to record and track the key metrics necessary to monitor the Plan's progress with respect to all of its goals (e.g., Participation Rate, Contribution Rate, Portfolio Risk, Investment Education, Retirement Readiness).

Regarding the Plan's third-party administration services, it would be advantageous for the Plan's fiduciaries to work with a third-party administrator ("TPA") with specific expertise in Plan design and implementing Plan design changes. A discussion of the various Plan design changes that might enhance the level of Plan participation is beyond the scope of this paper, but we would like to highlight the fact that there are various design features that may directly boost Participation Rates and Contribution Rates, thereby promoting the Retirement Readiness of participants. Auto-enrollment and auto-escalation features are just a couple of examples of techniques that TPAs may recommend to promote participation. Reducing the maximum number of Plan loans and minimizing in-service withdrawals are further examples of how Plan design may boost the Retirement Readiness of participants.

With respect to investment-related services, financial consultants and advisors ("Financial Advisors") can provide valuable assistance to a Plan's fiduciaries and help them establish a menu of investment alternatives that is participant-friendly and that also satisfies the fiduciary standards of ERISA. Plan fiduciaries should also explore working with Financial Advisors who can help them establish goals for the success of the Plan and help them achieve these established goals. In particular, they should consider working with Financial Advisors who can help improve the financial literacy of participants through regular educational meetings, equipping them with the necessary information for them to make investment decisions prudently. Given the experience that many Financial Advisors have with different recordkeepers, they can also help the Plan sponsor select a recordkeeper that is readily able to track the Plan's goal-related metrics. In support of the any Plan design changes implemented by TPAs, Financial Advisors can also help communicate these changes and encourage participation at enrollment meetings.



Conclusion

To promote the success of their Plans, a Plan's fiduciaries should consider examining various Plan-related metrics to help them evaluate the performance of their respective Plans, including the following:

1. Participation Rate
2. Contribution Rate
3. Portfolio Risk
4. Investment Education
5. Retirement Readiness

These key metrics may be used to establish appropriate goals, which may in turn serve as tools to help Plan fiduciaries monitor the overall health of their Plans and to better manage them. Professional service providers with the appropriate capabilities and expertise can help Plan sponsors manage their Plans more successfully. A qualified recordkeeper, TPA and Financial Advisor can play vital roles in helping the Plan's fiduciaries monitor the overall health of the Plan and assure its success as a long-term savings vehicle for employees.

The attached "Checklist for evaluating plan's level of success" provides a procedural overview of how a Plan's fiduciaries may use Plan-related metrics and goals to help them evaluate and assure the success of their Plan. The relevant goals are designed to help fiduciaries promote participation and to help them offer an investment menu that benefits participants appropriately. These steps may help Plan sponsors avoid the penalties under the IRS and DOL rules, reduce and mitigate their potential liability, and also enjoy the economic rewards associated with successful employer-sponsored retirement vehicles that benefit the employer's workforce.

EXHIBIT A:
Checklist for evaluating plan's level of success

	Yes	No
1. Key metrics Have the Plan's fiduciaries used the key metrics below to establish specific goals for the Plan?	☐	☐
Participation Rate is the number and proportion of eligible employees who actually contribute to the Plan.	☐	☐
Contribution Rate is the average rate of payroll contributions made by the Plan's eligible employees.	☐	☐
Portfolio Risk is the level of portfolio risk for a participant's Plan account based on the historical volatility or other risk-related metrics of the underlying portfolio investments.	☐	☐
Investment Education is the level of financial literacy or investment education of participants as measured indirectly by related metrics, such as the frequency of participation in a Plan's investment education program.	☐	☐
Retirement Readiness is a participant's financial wellness or readiness for retirement, which, for example, may be measured by a participant's projected replacement rate (projected retirement income stated as % of projected pre-retirement income).	☐	☐
2. Qualifications for recordkeeper With respect to the key metrics above, is the Plan's recordkeeper able to provide the relevant data for:		
The entire Plan population.	☐	☐
Different segments of the Plan population based on age brackets.	☐	☐
Different segments of the Plan population based on income ranges.	☐	☐
3. Establishing and monitoring goals		
With respect to the key metrics selected above for the Plan, has benchmarking information been obtained for comparative purposes?	☐	☐
Based on the Plan's current metrics and the relevant benchmarking information, have appropriate goals been established?	☐	☐
Have annual review dates been established for monitoring the Plan's progress in reaching its established goals?	☐	☐
4. Qualifications for TPA		
Does the Plan's TPA have the qualifications to make recommendations and implement Plan design changes that can help the Plan meet its established goals?	☐	☐
5. Qualifications for Financial Advisor		
Does the Plan's Financial Advisor have the qualifications to help the Plan's fiduciaries prudently manage a participant-friendly investment menu, improve the financial literacy of participants and help the Plan meet its established goals?	☐	☐

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