# CIEBA[sm]

**Committee on Investment of Employee Benefit Assets**

# Defined Contribution Plans

*Answers to the questions most frequently asked about the investment, administration and regulation of Defined Contribution Plans*

**December, 2001**

Association for Financial Professionals

*Defined Contribution Plans are a critical retirement savings building block for many American workers and their families. The current and future success of these plans is served by understanding how they affect the obligations and risks of both employers and employees.*

*The Committee on Investment of Employee Benefit Assets (CIEBA) of the Association for Financial Professionals has published this overview in an effort to increase the knowledge base of employees, providers and regulators on these retirement vehicles as they are implemented in the U.S. private sector.*

*CIEBA is a nationally recognized voice for those corporate financial officers who administer and manage, as fiduciaries, the investment of funds for employee and welfare benefit plans regulated under the Employee Retirement Income Security Act (ERISA). As of Fall, 2001, CIEBA's 120 members collectively managed $1 trillion in assets for 15 million participants including both union and non-union employees and retirees and their beneficiaries.*

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# DEFINED CONTRIBUTION PLANS

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## THE BASICS OF DEFINED CONTRIBUTION PLANS

### *Q: What is a defined contribution plan?*

**A:** A defined contribution plan is a retirement savings vehicle that provides benefits "defined" by the contributions to the plan and the investment earnings on those contributions. These contributions and subsequent earnings are credited to an individual account for each participant. The amount owed to participants at retirement is based solely on their account balances at the time of withdrawal. In these plans participants often bear responsibility for managing the investments of their account. They may need to choose among a few or many investment options that are offered by the employer (plan sponsor). The investment earnings that a participant accumulates are directly related to that participant's investment choices.

### *Q: What is a defined benefit plan?*

**A:** In a defined benefit plan, the benefit payment for each participant is calculated ("defined") by a formula specified in the plan. The formula is most often based on factors such as level of pay and length of service. The projected future benefit payments for all participants are then aggregated and discounted to obtain the present value of the plan's **liability**, also sometimes referred to as the plan's **obligation**. That liability or obligation is funded by employer contributions (and sometimes employee contributions) and their cumulative earnings. The value of the assets is measured independently of the liability and is based on fair market value. A defined benefit plan can thus be overfunded or underfunded, depending on whether the value of the plan's assets is greater than or less than the amount of the liability. In contrast, in a defined contribution plan the asset and the liability are by definition always equal in value.

### *Q: What is the primary difference between a defined contribution plan and a defined benefit plan?*

**A:** The primary difference between defined benefit and defined contribution plans lies in who bears the risk of a shortfall in investment results. This risk accrues to the **employer** in the case of defined benefit plans. It is borne by the **employee** in the case of defined contribution plans, although commensurately, the employee also receives all the benefits of better than expected investment performance.

In other words, a typical defined benefit plan promises a benefit upon retirement linked to pay and years of service. If contributions and investment earnings on the contributions do not provide enough funds to meet that promise at retirement, then the employer must make additional contributions to meet the shortfall. If investment earnings exceed expectations, then the employee still receives only the promised benefit. In defined contribution plans, on the other hand, higher than expected investment returns

are passed on directly to the employee, who, however, must also accept the risk of a lower asset value if returns are disappointing.

Other important differences include the fact that in the early years of an employee's career account values in defined contribution plans generally grow faster than in defined benefit plans (but generally grow more slowly in later years). Additionally, defined contribution plan assets are generally more portable.

## *Q: What are some examples of defined contribution plans?*

**A:** The most prominent type of defined contribution plan is the **401(k)**. The 401(k) feature of a savings plan permits deferral of taxes on employee contributions. The term "401(k)" refers to Section 401(k) of the Internal Revenue Code (IRC) of 1986, as amended. **Profit-sharing plans** may also have a 401(k) feature, as long as the profit-sharing contribution does not exceed a stated maximum percentage of pay. **Employee Stock Ownership Plans** (ESOPs), which are also defined contribution plans, are designed to invest primarily in employer securities.

## *Q: What are some key reasons that defined contribution plans exist?*

**A:** Defined contribution plans foster long-term savings behavior among employees. In some firms, a defined contribution plan is offered alongside a defined benefit plan as a complementary benefit. In fact, employers often use defined contribution plans as a workforce recruitment and retention method. The defined contribution plans can in some cases provide a vehicle for large-scale employee ownership of company stock (e.g., ESOPs) by offering employees the opportunity to invest in the common stock of the employer as one of several investment choices. Finally, most defined contribution plans create a link between the assets of the employee and the success of the employer through the latter's matching of all or part of each employee's contributions. In some cases, the link is made particularly strong by setting the level of employer contributions as a function of company profitability, such as in plans with profit-sharing provisions.

## *Q: What are some of the major attractions of defined contribution plans for employees?*

**A:** Key attractions include:

- In most defined contribution plans, the account value grows faster in the early years of employment than the benefit in a traditional defined benefit plan.
- Defined contribution plans have a portability or lump-sum feature, which allows employees to take this benefit with them if they leave their current employer.

- Deferral of taxes on employee contributions and/or earnings, along with deductibility of employer contributions, provides a financial incentive for both the participant and the employer.
- The value of the average defined contribution plan tends to be more easily understood by employees and is more visible to them than is the value of a traditional defined benefit plan.

## *Q: What risks are borne by participants in defined contribution and defined benefit plans?*

**A:** As discussed above, in **defined contribution** plans that are participant-directed – where the participant is responsible for deciding how individual account assets are invested among a plan's available investment options – investment risk is transferred to the participant. This, combined with the need to implement a realistic, adequate savings plan, are key concerns for participants.

In a defined contribution plan mortality risk is also transferred to the participant. Mortality risk is the risk that the participant may live longer than average, and thus outlive their retirement assets. In participant-directed plans, the employee has more control over the building of retirement assets, through the selection of investments and the ability to direct a portion of his or her pay to the plan. However, participants have few avenues of recourse should their accumulated assets turn out to be insufficient for their retirement needs.

Thus, insufficiency of retirement assets can be ascribed to several factors:

- adverse market results,
- an inadequate rate of savings by the employee,
- poor investment fund selection or asset allocation by the employee, and/or
- a greater need for retirement assets than originally anticipated due to changing personal circumstances, or simply to a longer lifetime.

In a **defined benefit** plan, on the other hand, the employer is generally responsible for bearing both investment risk and mortality risk, although the situation differs somewhat with defined benefit "cash balance" plans (see below under "Hybrid Plans"). An additional level of security is provided for employees by the Pension Benefit Guaranty Corporation (PBGC), a U.S. government agency that insures the pension plans of private U.S. corporations; nevertheless, in the event the company does not fulfill its obligations, some residual risk of insufficiency is also borne by the participants who are owed larger pensions, to the extent that the PBGC may not cover 100% of the promised benefit. For most employees, however, this risk is generally considered to be small.

As well, a portion of the defined benefit owed to a higher-paid employee may exceed the maximum allowable limit that can be paid out of an ERISA-qualified plan (see below under "Regulation of Defined Contribution Plans" for a discussion of the Employee Retirement Income Security Act, or ERISA), and thus for that higher-paid employee, the excess benefit does bear long-term corporate credit risk.

***Q: How does the risk to the employer differ with a defined contribution plan vs. a defined benefit plan?***

**A:** The employer's reported expense for a defined contribution plan is closely aligned with employer contributions. This is an attractive feature for employers, since in most cases, the amount of employer contributions is far less volatile than potential employer contributions to defined benefit plans, which are affected by current interest rates, actuarial assumptions and investment performance. The affect of these factors on defined benefit plan assets can contribute to volatility in the employer's operating income.

On the other hand, the potential opportunity to reduce employer contributions is generally available only in defined benefit plans. If the value of the assets in a defined benefit plan is greater than the promised payments to participants, the required employer contributions may decrease over time. This opportunity to decrease the level of contributions does not generally exist in a defined contribution plan, as contributions are set by a specified plan formula such as a "company match" and are not related to the value of the assets.

Finally, as stated above, the transfer of investment risk and mortality risk to participants also serves to reduce the employer's risk.

***Q: How does participant control of investment decisions impact the employer?***

**A:** Most, but not all, defined contribution plans are participant-directed. The successful use of a participant-directed defined contribution plan usually requires employers to inform and educate plan participants. The majority of employees need substantial education in order to effectively manage investment and mortality risk. It is important that the employer equip participants to make long-term investment decisions in market environments that can be characterized by unsettling fluctuations. However, in designing a financial education program for defined contribution plan participants employers must give careful consideration in order to avoid liabilities associated with offering investment advice.

***Q: What is the major plan design consideration resulting from the regulation of defined contribution plans?***

**A:** In order to remain qualified for favorable tax treatment of contributions and earnings, a defined contribution plan must clear a demanding array of nondiscrimination test rules. These tests are designed to ensure the plan does not discriminate in favor of highly paid individuals. The ability to pass these tests generally improves as the participation rate of non-highly compensated employees increases. Nondiscrimination tests are discussed further under the section entitled "Regulation of Defined Contribution Plans".

Thus designing a plan that will be attractive to the majority of the workforce is perhaps the most important factor arising from the regulations. There may be a large difference, however, between designing such a plan and actually persuading less-highly compensated employees, who are sometimes pressed to pay for ordinary living expenses, to participate. Effective education programs that explain the value gained from tax deferral and employer-matching programs are often critical to the plan's success.

### *Q: Beyond financial considerations, what is the burden of defined contribution plans on the employer?*

**A:** The breadth and complexity of compliance testing requirements are discussed under "Regulation of Defined Contribution Plans" below. Attractive investment options and effective participant communication are crucial to encouraging employees to participate. Thus communication, education and investment oversight responsibilities constitute meaningful fiduciary burdens. Investment oversight can become increasingly onerous as investment options are added in the effort to attract and sustain employee interest. Employers are also faced with additional administrative issues involving maintaining records for participant accounts, identifying cost components and reviewing trustee accounting records.

### *Q: How many participants are there in defined contribution plans in the U.S.?*

**A:** There were an estimated 53 million participants in private sector defined contribution plans in 1999. In defined contributions plans sponsored by 117 CIEBA members, the number of participants was approximately 6.1 million in 2000.

### *Q: What is the size of assets held in defined contribution plans?*

**A:** Assets held in private sector plans in 1999 totaled $2,126 billion. In defined contribution plans sponsored by CIEBA members, assets totaled $509 billion in 2000.

The growth in private defined contribution plans has been significant in recent years, as summarized in the following table:

| TOTAL PRIVATE SECTOR | 1994 | 1999 | 2000 |
|---|---|---|---|
| **Assets:** | $1.1 trillion | $2.3 trillion | $2.3 trillion |
| **Number of Participants:** | 40 million | 53 million | NA |
| **% of US Workforce Covered:** | 42.5% | 48.8% | NA |

| CIEBA MEMBERS | 1994 | 1999 | 2000 |
|---|---|---|---|
| **Assets:** | $234 billion | $515 billion | $509 billion |
| **Number of Plans:** | 468 | 354 | 463 |
| **Number of Participants:** | 4.7 million | 5.3 million | 6.1 million |

**Sources: EBRI, Bernstein Research, CIEBA Surveys**

## *Q: What are "hybrid" plans?*

**A:** Legally, every plan is either a defined benefit plan or a defined contribution plan, regardless of what its various characteristics may look like to the participant. However, hybrid plans have been developed that offer various blends of defined benefit and defined contribution characteristics. The increasingly popular cash balance plan, for example, often has a portability feature and reports participant "balances" that look just like defined contribution accounts. However, cash balance plans are actually defined **benefit** plans. Similarly, pension equity plans, (also known as retirement bonus plans) report account balances to participants and look like defined contribution plans but are also in reality defined benefit plans.

In both cash balance and pension equity plans, the "accounts" reported to participants are their actual balances, but these balances are not in any way impacted by actual investment results. The value of the "accounts" in each case is determined by an established formula rather than by a variable investment return. This qualifies the plans as defined benefit structures, but lessens the employer's exposure to investment risk, as well as to mortality risk.

Other examples of hybrid plans include various "floor" plans, which are actually two coordinated plans, one of which is a defined benefit plan and the other a defined contribution type. The defined benefit plan normally sets a floor retirement payment. Investments in the defined contribution plan will determine the retirement payment if its value exceeds the value of the floor payment. If the value of the defined contribution account drops below the floor, the defined benefit plan funds the gap and the participant receives the floor payment.

## *Q: What is the difference between a cash balance plan and a pension equity plan?*

**A:** The basic difference between the two types of plans is that the cash balance plan is a **career average** plan and the pension equity design is a **final pay** plan. In a cash balance plan benefits increase by a rate applied to eligible compensation for each year of employment, without consideration of future inflation. In a pension equity plan a rate is applied to average final compensation, which generally incorporates the effect of inflation over the service period. The equity plan rate is a cumulative rate based on age and/or years of service.

***Q: Why would an employer with an existing defined benefit plan choose a hybrid plan instead of a defined contribution plan if a change is contemplated?***

**A:** When an employer decides to change from a traditional defined benefit plan to a plan with defined contribution characteristics, converting to a hybrid plan may be the preferred alternative. A hybrid plan may be the more attractive choice if the existing defined benefit plan is substantially overfunded. Redesigning the existing plan as a hybrid allows the surplus assets in the plan to continue to prefund employer contributions, thus controlling costs more effectively than a plan termination would allow. The employer may also prefer to retain control of investment decisions in the plan.

The employer may use a hybrid plan design to improve the workforce recruitment and retention power of the existing plan by giving it some user-friendly defined contribution-like characteristics, such as "account" balance reporting and portability. Portability may have additional usefulness to the employer, since it helps to control the size of the plan liability by paying it out more rapidly.

***Q: What is an ESOP?***

**A:** An Employee Stock Ownership Plan (ESOP) is a defined contribution plan that is required by law to invest primarily in the securities of the sponsoring employer. An ESOP is a trust to which an employer makes tax-deductible contributions. These contributions can either be in cash (which is then used by the ESOP to buy employer stock) or directly in the form of company shares. These contributions are allocated to individual employee accounts within the trust based upon a specified formula. A key motivation for setting up one of these plans is to broaden the ownership of a company's capital to align employer and employee interests.

***Q: What is an ERISA Section 404(c) plan?***

**A:** An ERISA 404(c) plan is one "which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account". The plan sponsor remains a fiduciary for the purpose of manager selection for any investment option offered, but is not considered a fiduciary in the case of a participant's selection of one investment option over another. 401(k) plans generally meet requirements of Section 404(c), however, the 404(c) definition is wider, encompassing certain non-401(k) plans as well.

# SAVING FOR RETIREMENT WITH DEFINED CONTRIBUTION PLANS

## *Q: What are before and after-tax savings?*

**A:** As mentioned, the most frequently sponsored defined contribution plan is the 401(k) plan. Participants can defer federal income taxes and, in most cases, state and municipal income taxes on their qualified pre-tax contributions to these plans. Participants can also defer taxes on earnings on those contributions until they withdraw money from the plan. The employer plays an important role in promoting financially secure retirements for participants by communicating the value of tax deferral on both qualified contributions and earnings.

Many plans also allow after-tax savings. Although after-tax contributions do not reduce the participant's taxable income, earnings on those contributions are generally not taxed until the participant withdraws them.

Plans generally provide flexibility when it comes to allocating between the two. In some cases, a plan offering both before and after-tax contributions will automatically convert the employee's before-tax contributions to after-tax when the before-tax contribution limits (see below under "Regulation of Defined Contribution Plans") are breached. Others require explicit instructions from the participant.

## *Q: How do defined contribution plans grow over time to provide benefits to participants upon retirement?*

**A:** Generally, as employee and employer contributions in 401(k) and similar defined contribution plans are invested, earnings compound on a tax-deferred basis until assets are withdrawn. These plans are designed to grow in value over the career of the participant, although provisions are available to allow some access to the assets as well as early withdrawal under certain circumstances. The amount that will be available to the employee upon retirement is determined by:

1) The total contributions to the plan,
2) The number of years that an employee participated in the plan, and
3) The amount earned on those contributions.

Earnings on investments are reinvested and additional contributions can be made on a regular schedule. Therefore, the value of a defined contribution account can grow substantially over time. Below are some examples of the value at retirement of different contribution levels over different time periods, assuming an 8% annual return, on average, over the time period:

| | Annual Contribution | Number of Years | Value at Retirement |
|---|---|---|---|
| **Participant 1** | $2,000 | 20 | $ 92,000 |
| **Participant 2** | $2,000 | 30 | $227,000 |
| **Participant 3** | $5,000 | 20 | $229,000 |
| **Participant 4** | $5,000 | 30 | $566,000 |

By contribution through payroll deduction, participants typically invest a fixed amount with each paycheck. Investing a fixed amount on a set timetable has the effect of dollar-cost averaging investments in the market, a method that may help to enhance investment results over the long-term. Dollar-cost averaging means that an investor can buy more shares of an asset when market prices are low, and conversely buys fewer shares of the same asset when market prices are high, given the same dollar amount available each period for investment.

## *Q: How are employee contribution limits set?*

**A:** The Internal Revenue Service (IRS) limits the amount a participant can contribute before taxes to 401(k) plans to a maximum dollar amount subject to special non-discrimination tests. The amount an employee can contribute after tax is also subject to certain limitations. A more complete discussion is contained below in the section entitled "Regulation of Defined Contribution Plans".

Until recently, a tax-qualified retirement plan could not include an IRA. However, under the tax legislation passed in 2001 such plans (e.g., 401(k) plans) are permitted to accept voluntary employee contributions to a separate account that (1) is established under the tax-qualified arrangement, and (2) meets the requirements for a traditional IRA. These accounts would be deemed IRAs and the IRA rules would apply, effective for plan years beginning after 2002. Furthermore, after 2005 employers may allow employees to make "Roth" contributions to 401(k) plans. An employee would contribute after-tax dollars, but, as with Roth IRAs, both contributions and earnings generally would not be subject to tax upon distribution from the plan.

## *Q: What are the withdrawal provisions in a 401(k) plan?*

**A:** A participant or beneficiary can withdraw assets upon the participant's retirement, death, disability or separation of service. Subject to a plan's design, participants can take their money in the form of a lump sum distribution, including rolling the money into another qualified retirement plan or an Individual Retirement Account (IRA). Plans may allow participants to leave some, or all, of their money in their employer's plan. Some plans also offer lifetime annuities or the ability to make periodic withdrawals from the account. If they have retired from the employer, participants must begin to withdraw their assets by April 1 following the calendar year during which they attain age 70 ½.

Should an employee need assets before retirement, the regulations allow plans to incorporate two methods for participants to access their balances:

- **Loan provisions** – Loans permit individuals to borrow from their accounts, but they must repay the loan with interest at market rates in order to maintain the tax-deferred status of their accounts.
- **Hardship withdrawals** – Financial hardships in accordance with the Internal Revenue Code (IRC) include payment of college tuition for participants or their dependents, purchase of a primary residence, prevention of a foreclosure or eviction from a primary residence and coverage of unreimbursed medical expenses. Any such withdrawals are, however, taxable.

Some plans allow "in-service" withdrawals, whereby an annual withdrawal of after-tax monies and vested company contributions can be made without penalty.

Plan assets are generally portable, meaning that individuals who leave an employer may be permitted to transfer their plan assets to a new employer's qualified plan, or to roll their assets into an IRA. Thus, plan participants who do not work for the same employer for their entire careers are still able to save and invest for retirement without proliferating plans and investment vehicles.

### *Q: How do loan and withdrawal provisions impact the risk to the participants?*

**A:** As discussed, the loan, hardship and (in some cases) in-service withdrawal provisions of defined contribution plans give the participant flexibility to adapt to changing circumstances. Certainly most participants would view the availability of loans and withdrawals as reducing their short-term risk. What they may not fully appreciate, however, is that these provisions may very well increase their long-term risk rather than reduce it. Despite loan provisions requiring systematic repayment (without which many participants might simply withdraw funds) overuse of the loan feature naturally reduces the compounded growth of assets in a participant's account. Also, as the loan repayment is made with after-tax dollars, this can effectively result in double taxation when taxes are paid on future withdrawals (in other words, the loan is repaid with monies that have been taxed once, usually as income, and these monies then are subject to tax once again when later withdrawn from the plan during retirement). Moreover, failure to comply with loan terms can result in penalties for the participant.

As an aside, long-term risk for the participant may be reduced by the portability of defined contribution assets, since many defined contribution plans accept rollovers from other qualified plans, thereby reducing forfeitures. A lower incidence of forfeitures improves the likelihood of sufficient assets being accumulated for retirement by participants with relatively low balances.

***Q: What types of investment options are typically offered in a defined contribution savings plan?***

**A:** Defined contribution plans can offer a variety of investment options. The structures used for investment options can be comprised of an assortment of mutual funds, commingled trust accounts, and/or separately managed accounts. A **mutual fund** pools the money of many individuals to invest in specific types of assets. **Trust accounts**, such as bank pooled funds, which are exempted from SEC registration by the Investment Advisors Act of 1940, and Group Trusts, are similar to mutual funds but are restricted to IRS qualified benefit plans. **Separate accounts** can contain only assets of the sponsor's plan and are not available to other, outside investors.

Any of these structures can be used to provide an array of investment options. Examples of options that appear in many plans include:

- **Money market funds** – Invest in short-term securities and earn an interest rate equivalent to currently prevailing rates. It is unlikely that the value of these funds will fluctuate significantly, but the interest earned is usually low relative to more risky investments.
- **Stable value funds** – Invest in fixed annuity or guaranteed investment contracts issued by insurance companies, banks, or other financial institutions. The issuing company pays a rate of interest that it guarantees over some period. While the rate of interest is guaranteed, the credit risk of the contract depends on the creditworthiness of the issuing insurance company or other financial institution and sometimes on any bonds or other assets held in a separate account for the specific purpose of backing the contract.
- **Bond funds** – Invest in debt securities issued by corporations or governments. Some bond funds invest in specific types of bonds, for example, just government securities or corporate securities of specific quality. These funds may also target an average maturity or duration for the portfolio. Bond fund prices fluctuate with changes in interest rates. However, these changes in value are typically not as volatile as those of equity funds.
- **U.S. Equity funds** – Invest primarily in domestic stocks. The investment goals and guidelines of such funds can vary widely, as they are often structured to invest in a specific segment of the market. For example, an equity fund may invest primarily in large capitalization stocks, small capitalization stocks, growth stocks or value stocks. Actively managed funds seek to earn higher returns than the market index that most closely defines the investment management style of the fund. Indexed equity funds seek to replicate the performance of a particular market index.
- **Balanced funds** – Invest in a combination of equities and bonds. Some plans offer several balanced funds (often referred to as lifestyle, time-horizon or asset allocation funds) that offer different levels of expected risk and return.
- **International funds** – Invest in securities issued by companies and governments outside of the United States. International funds may invest primarily in equities, primarily in bonds, or in a combination (international balanced) of stocks and bonds. Global funds invest all over the world including the United States.

International and global funds may also invest in specific segments of the market and may be actively managed or indexed to a market index.

- **Company stock** – Many employers include a company stock fund as an investment option. Company stock funds offer employees tax-favored participation in the earnings and growth of their company.

## *Q: What are the costs to participants of defined contribution plans?*

**A:** The fees associated with defined contribution plans fall into two main categories – investment management fees and administration fees. **Investment management fees**, typically the largest cost component of a fund, are usually charged as a percentage of assets under management. In the case of non-mutual fund investment vehicles the percentage charged sometimes declines as the asset base increases. However, investment management fees charged by mutual funds are usually a set rate regardless of the amount of invested assets.

Investment fees vary by investment type. For example, money market funds, which offer low risk and return, generally have lower fees than stock funds. Actively managed funds have higher fees than index funds.

The cost of trading securities (broker commission and trade execution) is reflected in the reported value of the fund. Investment returns are reported net of all trading costs and, in the case of mutual funds, net of all investment management fees.

**Administration fees** (internal and external) include the cost of recordkeeping, trustee and custodial services, and of communications to participants. Some mutual funds also charge sales commissions, although this charge is usually waived for defined contribution plans. Mutual funds may also charge 12b-1 distribution fees and redemption fees. Although these fees are sometimes shown on the participant's statement, some or all administration charges may also be deducted directly from reported returns.

## *Q: What are 12b-1 fees?*

**A:** The 1980 U.S. Securities and Exchange Commission Rule 12b-1 (under the Investment Company Act of 1940) permits mutual funds to charge certain distribution-related expenses directly against fund assets. These charges may include fund administration charges, communications charges or promotional charges. Some mutual funds reimburse pension plans for 12b-1 fees, and sometimes for a portion of the funds' administrative charges.

## *Q: What are redemption fees?*

**A:** Redemption fees, sometimes referred to as short-term trading fees, are charged to a participant's account if the shares of the mutual fund are held less than a specified period of time. The fee is assessed to discourage short-term trading in a fund, which can have a

negative effect on the mutual fund's performance. The fee, deposited in the fund, helps offset trading costs that would otherwise be borne by the remaining fund participants.

### *Q: On average, how have plan participants allocated their defined contribution plan investments?*

**A:** Participants in CIEBA member plans made the following investment selections in recent years:

| **Category** | **% of Assets Invested in CIEBA Member Plans** | |
|---|---|---|
| | **1994** | **2000** |
| **U.S. Equity** | 13.8% | 31.0% |
| **International Equity** | 1.1 | 2.2 |
| **Other Equity** | 1.5 | 1.6 |
| **Employer Stock** | 35.2 | 35.5 |
| **Balanced Funds** | 6.0 | 6.7 |
| **Bonds** | 3.3 | 3.6 |
| **GIC/Stable Value** | 27.8 | 14.0 |
| **Other Fixed Income** | 6.6 | 3.0 |
| **Other** | 4.7 | 2.4 |
| **Total** | 100.0 | 100.0 |

**Source: CIEBA Surveys, 1994 and 2000**

### *Q: How should participants allocate their assets?*

**A:** Participants should base their allocation decisions on their individual savings situation, risk, and potential investment returns. Determining savings requirements and risk tolerance means that participants have to develop expectations regarding:

- Market returns and the rate of inflation
- Their personal tolerance for market variability
- The time they will participate in the plan
- Financial needs that might require loans/withdrawals (e.g., college expenses)
- The amount they will contribute, and the amount their employer will contribute on their behalf
- Their spending plans after retirement
- The number of years they will be retired

Investment education is important to help employees estimate their savings and risk requirements.

# MANAGING AND ADMINISTERING DEFINED CONTRIBUTION PLANS

## *Q: What is the employer's role in managing a defined contribution plan?*

**A:** The employer is responsible for establishing the basic structure and for providing overall management of the defined contribution plan. Investment management responsibility includes establishing investment policies and guidelines, and selecting and conducting due diligence on the investment management firms or mutual funds. Some companies also manage portfolios in-house, and some companies may offer mutual fund windows or brokerage windows to participants to provide more selection opportunities; certain investment management responsibilities extend to these structures as well.

The employer is also responsible for choosing and monitoring the recordkeeper (which may be an internal function), and the custodian/trustee. Finally, many employers provide investment education and communication to participants, either directly or through an outside organization, although in the latter case the employer retains fiduciary responsibilities.

## *Q: What are the different ways in which employers set up their investment programs?*

**A:** Employers use a variety of structures for investing and administering defined contribution plans. The most widely used are separately managed accounts and mutual funds. The following are examples of some typical fund designs:

- **Individual mutual funds or a family of mutual funds.** Employers choose an array of individual funds for investing plan assets. This can be accomplished in two ways – by selecting specific funds from a variety of mutual fund providers, or by selecting a variety of funds from a specific mutual fund company. Employers choosing the first approach usually appoint a separate recordkeeper, or maintain internal recordkeeping. Employers choosing one mutual fund company typically use the "bundled" approach, whereby the mutual fund company also provides recordkeeping services.
- **Other pooled vehicles, such as bank commingled funds and group trusts.** Employers retain one or more pooled funds, managed by banks or investment advisory firms, to manage fund assets. The pooled fund appoints a custodian/trustee to settle all trades in the fund, maintain accounting records for all assets, price the securities and post income gains or losses.
- **Separately managed accounts with professional investment management of funds.** Employers retain investment advisory firms to manage fund assets, or hire in-house investment experts. Investment options may consist of a single separate account or multiple separate and/or commingled accounts. Participant account recordkeeping may also be internal or external. The employer appoints an

independent custodian/trustee, as described below, to account for all investments and settle all transactions.

- **Mutual fund windows and brokerage windows.** Some employers offer participants a mutual fund window, which allows individuals to choose from numerous mutual funds in the marketplace. This option may offer a limited number, or a multitude, of funds. Brokerage windows allow participants to manage their own assets by selecting and trading individual securities as well as mutual funds.

## *Q: What are bundled and unbundled services?*

**A:** Bundled services include a combination of all or some of the following:

Traditional
- Investment management
- Recordkeeping
- Trustee services

Supplemental
- Investment communication
- Retirement planning
- Education

An unbundled service structure means that the employer selects and monitors each service provider separately. In this approach, the employer negotiates fees for each service separately. Bundled service providers charge a single fee for all services, which may provide greater efficiency, but attribution of those fees to the individual services may be difficult.

## *Q: What is the role of the recordkeeper?*

**A:** The recordkeeper is responsible for maintaining individual participant records for defined contribution plan assets. The recordkeeper posts contributions, investment earnings, withdrawals and benefit payments to the individual's account. The recordkeeper allocates participant activity, such as changes in fund choices or asset allocation, to the individual fund options. The recordkeeper also administers employee loans.

In addition, the recordkeeper may provide a toll-free voice response phone system or website to allow participants to access account balances, fund performance, and benefit information. These systems may also allow participants to transfer account balances from one fund to another, redirect future contributions, or change the level of contributions.

The recordkeeper may also offer a variety of other plan-related services including discrimination and compliance testing and filing required government reports.

## *Q: What is the role of the trustee / custodian?*

**A:** The trustee maintains custody of the plan assets. It is the trustee's responsibility to maintain accounting records for all assets, including individual securities, to settle all trades, post gains and losses, collect and post dividend and interest income, adjust for stock splits, and price each security. Any holdings of commingled or pooled funds are recorded by the custodian/trustee as shares or units of that fund. The trustee interfaces directly with the recordkeeper, who posts the investment earnings to participants' accounts.

The trustee may provide additional services, including securities lending, performance measurement, government reporting and proxy voting.

## *Q: How often are investment options priced?*

**A:** The number of defined contribution plans offering daily pricing has been increasing over the last several years. Most funds that are not priced daily are valued on a monthly basis, although there are some funds on weekly or quarterly pricing bases as well.

In 2000, 94% of CIEBA members surveyed reported that the funds in their defined contribution plans are valued daily. About 4% of members offer monthly valuations.

# REGULATION OF DEFINED CONTRIBUTION PLANS

***Q: What are the primary aspects of defined contribution plan regulation under ERISA?***

**A:** The Employee Retirement Income Security Act of 1974 (ERISA) is the principal legislation governing private pension funds. The Department of Labor (DOL) and the IRS enforce ERISA jointly. ERISA consists of four "Titles" as summarized below:

- Title I – Employee rights, including provisions related to reporting and disclosure, participation, vesting, funding, and fiduciary liabilities and responsibilities
- Title II – Requirements as to conditions of qualification for tax deferral under the IRC, and tax provisions (as administered by the IRS), including those related to the deduction of contributions and taxation of benefits
- Title III – Provisions related to administration and enforcement
- Title IV – Provisions related only to defined benefit retirement plans

***Q: Does other legislation and regulation affect defined contribution plans?***

**A:** There is an increasing amount of legislation affecting defined contribution plans, such as the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997 and more recently, the Economic Growth and Tax Relief Reconciliation Act of 2001. In addition, there are numerous Treasury and DOL regulations, as well as revenue rulings and procedures. The SEC may also require the filing of Form 11-K for plans containing employer securities.

***Q: What is a fiduciary?***

**A:** A fiduciary is a person or a member of a Board given possession of property (in this case, plan assets) "in trust", i.e., with the legal obligation to administer it solely for the purpose specified.

***Q: What are the basic fiduciary standards for defined contribution and other retirement plans?***

**A:** The cornerstone of ERISA's fiduciary standards is found in Section 404, which explicitly sets forth ERISA's requirements for prudence in asset management. Specifically, Section 404(a)(1) directs a fiduciary to "discharge his duties with respect to

the plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of administering the plan."

ERISA further requires that a fiduciary act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims."

The "prudent man" standard has been interpreted and applied as a "prudent "expert" standard. It is more stringent than standards contained in most other corporate and securities laws, which generally require only that there be an absence of various forms of negligence.

## *Q: What is a prohibited transaction?*

**A:** A prohibited transaction is an economic transaction directly, or indirectly, involving plan assets and parties related to the plan. Such a "party-in-interest" includes fiduciaries, legal counsel, or employees of the plan, persons providing services to the plan, an employer whose employees are covered by the plan, a relative of any of the preceding, or various other people and entities with ties to the employer or plan (ERISA Section 3(14)).

Prohibited transactions include the sale, exchange, or lease of property, a loan or other extension of credit, the furnishing of goods, services, or facilities, and the transfer or use of plan assets involving a party-in-interest. Prohibited transactions also include the acquisition of employer securities or employer real estate in excess of the limits set by law.

## *Q: Are there exemptions to prohibited transactions?*

**A:** ERISA provides three kinds of exemptions from prohibited transactions rules. ***Statutory*** exemptions cover certain routine transactions, such as payment of benefits to a participant who is also a fiduciary. ***Class*** exemptions have been granted for certain transactions that are not specifically defined in ERISA, but are considered acceptable by the DOL. ***Individual*** exemptions are granted on a case-by-case basis. These exemptions require that the individual or party-in-interest demonstrate that the transaction is in the best interest of the plan participants.

## *Q: What sanctions are imposed by ERISA on fiduciaries that do not meet their responsibilities?*

**A:** Civil liabilities and/or criminal charges can be imposed on a fiduciary that breaches any of the responsibilities, duties, or obligations imposed under Title I of ERISA. The fiduciary is liable for any loss to the plan resulting from each breach. A fiduciary is also liable to the plan for any profits that the fiduciary or other party-in-interest made through

the use of plan assets. Tax sanctions, in the form of special excise taxes, can be imposed on those who participate in prohibited transactions. A fiduciary must be aware that if a plan is "disqualified" all earnings of the plan would immediately be subject to taxation.

## *Q: How do funding and vesting provisions affect plan administration?*

**A:** To be qualified under ERISA, a retirement plan must be funded. This means that contributions by both employer and employees must be placed in a separate fund held by a third party. The third party is generally a bank trustee or insurance company.

Vesting represents the nonforfeitable amount in participants' account balances. Participants are always 100% vested in their own contributions and earnings on those contributions. Under the 2001 tax bill, a plan is not a qualified plan unless a participant's employer contributions, and their earnings, vest at least as fast as under either a three-year cliff vesting or a six-year graded vesting schedule, effective for contributions for plan years beginning after 2001. The three-year cliff vesting schedule means that the entire amount attributed to employer contributions is forfeited if the participant leaves the employer prior to his or her third service anniversary, but nothing is forfeited if the participant is credited with three or more years of service. The graded vesting schedule requires 20% vesting after two years of service, increasing 20% per year thereafter. It should be noted that vesting rules for top-heavy (i.e., plans in which at least 60% of the contributions/benefits are held for "key employees") and multi-employer plans are different.

## *Q: What is the basic nondiscrimination rule?*

**A:** A retirement plan is qualified under ERISA only if it does not discriminate in favor of Highly Compensated Employees (HCEs). The plan must comply in both form and operation to this rule. To satisfy this basic nondiscrimination rule, there are three requirements:

1) The contributions or benefits of the plan must be nondiscriminatory in amount,
2) The benefits, rights, and features provided under the plan must be available in a nondiscriminatory manner, and
3) The effect of plan amendments and terminations must be nondiscriminatory.

## *Q: What is the definition of Highly Compensated Employees (HCEs)?*

**A:** An HCE is an employee who was a 5% owner of the sponsoring company at any time during the current or preceding year or who had compensation during the prior year in excess of $80,000. The compensation limit is adjusted for inflation in $5,000 increments. Alternatively, the sponsor can elect to include those employees exceeding

the compensation limit only if they are in the "top paid group", generally defined as the top 20% of employees ranked on the basis of compensation.

### *Q: How does the definition of HCEs relate to defined contribution plans?*

**A:** The definition of HCEs is relevant to a plan's general nondiscrimination requirements, the actual deferral percentage (401(k) plans), the actual contributions percentage test, and minimum coverage requirements, as well as other more specific situations.

### *Q: Are there additional nondiscrimination tests for 401(k) plans?*

**A:** A 401(k) plan that provides for matching and/or after-tax contributions must also satisfy an Actual Contribution Percentage (ACP) test. In the ACP test, the average of the actual contributions ratio (sum of employee and employer matching contributions divided by employee compensation) of the HCEs may not be more than a specified percentage of the average of the actual contribution ratio of the non-highly compensated employees (NHCEs). The plan must also satisfy the Actual Deferral Percentage (ADP) test. In the ADP test the average employee contribution ratio (sum of employee contributions divided by employee compensation) of HCEs may not be more than a specified percentage of the ADP of the NHCEs. The "Multiple Use" test, which potentially limited combined 401(k), after-tax and employer matching contributions on behalf of HCEs, was repealed for years starting in 2002 under the tax legislation passed in 2001.

### *Q: What are the minimum coverage requirements?*

**A:** In order to receive favorable tax treatment, a retirement plan must satisfy one of two coverage tests – either the ratio percentage test or the average benefit test. Under the ratio percentage test, the percentage of NHCEs who benefit under the plan must equal 70% of the percentage of HCEs who benefit under the plan. Under the average benefits test, the plan must cover a nondiscriminatory group of NHCEs and the benefits (expressed as a percentage of compensation) provided to NHCEs must be at least 70% as great as provided to HCEs.

### *Q: How are contributions regulated?*

**A:** Under the Economic Growth and Tax Relief Reconciliation Act of 2001 limits on elective deferrals by 401(k) plan participants, set a maximum of $10,500 in 2001, will gradually increase to $15,000 in 2006 with indexing in $500 increments thereafter. For 2001 total annual contributions to defined contribution plans are limited to the lesser of

$35,000 or 25% of the employee's compensation, but for subsequent years the total contribution limit is $40,000, and the 25% of employee compensation cap is eliminated. The annual compensation that may be taken into account in determining contributions or benefits under a qualified plan is limited in 2001 to $170,000, and is raised to $200,000 for subsequent years, with future indexing in $5,000 increments.

Finally, beginning in 2002 401(k) plan participants age 50 and over may make additional pre-tax "catch-up" contributions (over and above the otherwise applicable limit) running from $1,000 in 2002 to $5,000 in 2006, with indexing in $500 increments thereafter 2006. Catch-up contributions would not be taken into account in applying other contribution limits.

## *Q: What are the minimum distribution requirements?*

**A:** Minimum distribution requirements are the rules governing when distributions from a qualified plan must commence and which define the maximum time period over which benefits can be paid. Distributions generally must begin by April 1 of the year following the year in which the participant reaches age 70 1/2. Subsequent annual distributions must be made by December 31 of each year. The balance must be distributed over:

1) The life of the participant,
2) The lives of the participant and his designated beneficiary,
3) A period not extending beyond the participant's life expectancy, or
4) A period not extending beyond the joint life expectancy of the participant and his designated beneficiary.

After 1996, the rules were changed for non-5-percent owners (see above under the definition of HCEs). The required beginning date for non-5-percent owners is now the later of the year following the year in which the participant reaches age 70 1/2 or the year in which he retires. It should be noted that if a participant does not receive a distribution in the later of the calendar year in which he retires or reaches age 70 1/2, he would be required to receive two distributions the following year – by April 1 and again by December 31. Minimum distributions are not eligible for rollover.

## *Q: How are distributions taxed and when do they occur?*

**A:** Generally distributions are taxed as ordinary income. In some instances balances are not taxed as ordinary income when they are paid out, such as when assets are rolled over into another qualified plan or IRA. It should be noted that loans in good standing are generally not considered distributions.

In addition to being taxed, 401(k) distributions prior to age 59 1/2 are also assessed significant penalties. Other distribution limits are listed below. Although in-service distributions may be allowed, there are numerous restrictions depending on the type of defined contribution plan.

***Q: What are the additional limitations on distributions from 401(k) plans?***

**A:** In addition to the age 59 1/2 provision, a distribution to a participant can't be made earlier than:

1) The participant's retirement, death, disability, or separation of service,
2) The occurrence of participant hardship, subject to plan design,
3) The termination of the plan without the establishment of a successor plan.

Also, if the employer, or substantially all the assets of the employer, are acquired by a third party, then an employee who continues working for the acquirer may not take a distribution of plan assets at that time (the "same desk" rule).

***Q: What are some of the distribution requirements in an ESOP?***

**A:** Distributions under an ESOP must begin no later than one year after the end of the plan year in which the individual terminates employment by reason of death, disability or of the reaching of retirement age, unless the participant elects otherwise. If the participant otherwise terminates employment, distributions must begin the fifth plan year following the plan year after termination, again, unless the participant elects otherwise. Generally, distributions must be made in substantially equal installments over a period not longer than five years. If a participant's balance exceeds $500,000, the time period can be extended one year for each $100,000 in excess of $500,000. However, the distribution period cannot exceed 10 years.

***Q: What are the requirements of an ERISA Section 404(c) plan?***

**A:** The DOL issued final regulations (ERISA Reg. 2550.404c-1) which set forth the requirements for maintaining a 404(c) plan. An ERISA Section 404(c) plan must include at least three investment options that are materially different from one another in terms of risk and return characteristics. The plan must provide enough information to allow participants to make informed investment decisions, enable diversification of investments, and allow the participants to change investments at least quarterly; more frequent changes are mandated in cases where the market volatility to which the investment alternative may reasonably be expected to be subject to is relatively high. A participant will not be considered to have enough information unless provided with a description of the investment options, including their investment objectives and risk and return characteristics. A participant also needs to be informed that the plan is intended to constitute an ERISA Section 404(c) plan.

Participants must be provided, directly or upon request, the following information:

1) The annual operating expenses of each investment options and the aggregate amount of expenses expressed as a percentage of net assets,
2) Copies of any financial statements, prospectuses, and reports available to the plan,

3) A list of the assets in the portfolio in each investment option, and
4) Information on the value of shares as well as past and current investment performance net of expenses.

Finally, participants must also be informed that the plan fiduciaries are not liable for investment losses that are incurred as a result of investment instructions given by a participant, as long as the DOL requirements are satisfied.

### *Q: What investment education materials are allowed to be distributed by employers?*

**A:** According to the Pension and Welfare Benefits Administration Interpretive Bulletin 96-1, employers may distribute the following information to participants without such employers being considered investment advisors:

1) Plan information,
2) General financial and investment information,
3) Asset allocation models, and
4) Interactive investment materials.

Under the provisions of the 2001 tax act, after 2001 an employer may provide retirement planning services to participants on a non-taxable basis, as long as such services are available on substantially the same terms to a reasonable classification of employees.

### *Q: Are the requirements for maintaining a qualified defined contribution plan static?*

**A:** New legislation and regulations have had an increasing impact on defined contributions plans in recent years, reflecting the growing importance of these investment/savings vehicles to the U.S. private retirement system. Therefore, it is very important for a sponsoring employer to monitor changing requirements for qualified plans closely, and to make amendments to plan design, administration and operation as appropriate.